THE CASE AGAINST THE TAX DEDUCTIBILITY OF FCA RELATOR FEES

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The False Claims Act (FCA) imposes severe penalties on those who commit fraud against the federal government. The statute currently requires violators to pay treble damages plus a statutory penalty of five to ten thousand dollars per violation. The goal of the statute is to deter fraud by setting punitive damages at a high level. However, the tax law, as currently interpreted by the Internal Revenue Service (IRS), blunts the force of the statute by allowing a violator to deduct a portion of an FCA damages award as a business expense. Specifically, Treasury regulations allow for the deductibility of any portion of an FCA settlement or damages award that is paid to the whistleblower, known as the "relator," who brings suit under the FCA for the alleged fraud. This Note argues that, for reasons of efficiency and equity, the IRS should change its current position and disallow relator fee deductions.

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INTRODUCTION

In July 2004, the pharmaceutical company Schering-Plough admitted to overcharging Medicaid hundreds of millions of dollars for the blockbuster antihistamine drug Claritin, and settled civil fraud claims with the federal government.[1] Three company employees blew the whistle on the fraud in 1998, and the company was served with a civil action for violations of the False Claims Act (FCA).[2] Of the \$282.3 million settlement,[3] the government paid \$31.7 million to the whistleblowers, known as "relators," under the terms of the settlement agreement.[4]

What the settlement agreement and the organizations publicizing the success of the anti-fraud laws did not mention is that guidance published by the Internal Revenue Service (IRS) permits Schering-Plough to take a tax deduction for all \$31.7 million paid to the relators by claiming this amount is an "ordinary and necessary [business] expense[ ]."[5] Assuming that the pharmaceutical giant pays corporate tax at the highest marginal rate of thirty-five percent, this deduction would save the company over \$10 million. While the tax code and regulations do not clearly state that such fees are deductible, the IRS has issued guidance that allows violators to deduct these fees.[6] As long as the payments are expressly labeled as relator fees in the settlement

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[1] ANDY SCHNEIDER, TAXPAYERS AGAINST FRAUD EDUC. FUND, THE ROLE OF THE FALSE CLAIMS ACT IN REDUCING MEDICARE AND MEDICAID FRAUD BY DRUG MANUFACTURERS: AN UPDATE 11–12 (2004) (on file with the *New York University Law Review*) (describing the settlement and underlying fraud, which arose from Schering-Plough's violation of the "best price" rebate law).

[2] *Id.* (outlining the FCA claim).

[3] Settlement Agreement and Release at 14, Alcorn v. Schering-Plough Corp., No. 2:98-cv-05688-LS (E.D. Pa. July 30, 2004) [hereinafter Schering-Plough Settlement], *available at* http://www.elsevierbi.com/~/media/Images/Publications/Archive/The%20Pink%20Sheet/66/032/00660320020/040809_schering_settlement.pdf ("Schering agrees to pay to the United States and the Participating States, collectively, the sum of Two Hundred Eighty-Two Million, Three Hundred Forty-Three Thousand, and Twelve dollars.").

[4] *Id*. at 21–22 ("The United States agrees to pay the Relators Thirty-One Million, Six Hundred Sixty-Two Thousand, One Hundred Seventy-Three Dollars . . . as relators' share of the proceeds pursuant to 31 U.S.C. § 3730(d).").

[5] I.R.C. § 162(a) (2006).

[6] I.R.S. Gen. Leg. Adv. Mem. AM2007-0015 (July 12, 2007) [hereinafter GLAM], *available at* http://www.irs.gov/pub/irs-utl/am2007015.pdf.

agreement, the IRS does not consider these amounts to fall within the nondeductible category of "fine[s] or other similar penal[ties]."[7]

Because of this policy, violators can avoid bearing a significant portion of the burden of the penalty by strategically wording settlement agreements.[8] The result is that the penalty does not fully achieve its intended goal of deterring violations.[9] Though Congress has long been aware of this problem, efforts to pass legislation that would disallow such deductions outright have failed.[10]

This Note argues against allowing this deduction. Fees paid to a relator for uncovering fraud perpetrated against the federal government should constitute a nondeductible fine or penalty under Internal Revenue Code (I.R.C.) § 162(f), and should not be considered an "ordinary and necessary [business] expense[ ]" properly deductible under § 162(a). While the IRS has taken the position that such fees are deductible,[11] the textual reasoning in the IRS memos can be questioned.[12] In addition, there are strong policy arguments against this approach.

The Note begins, in Part I, with the history, background, and policy rationales for § 162(f), which denies an ordinary and necessary business expense deduction for certain fines or penalties.[13]

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[7] GLAM, *supra* note 6, at 1 (citing I.R.C. § 162(f)). If the agreement does not explicitly state the amount of the relator fee, then, absent specific evidence that a stipulated portion of the settlement is to be allocated to a relator, the violator may not deduct the amount eventually paid by the government as a relator fee. I.R.S. Tech. Adv. Mem. 200502041 (Jan. 14, 2005) [hereinafter TAM] (disallowing a relator fee deduction because the settlement agreement did not allocate any portion of the amount to a relator fee).

[8] This is true not only for FCA settlements, but for other civil settlements as well. *See* Robert W. Wood, *Cleaning Up: Tax Deductions for Restitution, Fines, and Penalties*, 122 TAX NOTES 489, 489 (2009) (noting that Exxon worded its $1.1 billion settlement after the Exxon Valdez oil spill to generate an after-tax cost to the corporation of only $524 million). For a discussion of how this cost is shifted to the American taxpayer, see *infra* notes 167–68 and accompanying text.

[9] *See infra* Part III.B (discussing the economics of deterrence).

[10] *See* Wood, *supra* note 8, at 489 (describing the failure of the Government Settlement Transparency Act of 2003, S. 936, 108th Cong. (2003), "which would have made nondeductible any payment to acknowledge actual or potential violations of law").

[11] GLAM, *supra* note 6.

[12] If the Internal Revenue Service (IRS) were to reverse its current position and deny the relator fee deduction, it could do so without revoking its previously issued guidance. *See infra* notes 100–01 and accompanying text (citing IRS procedures for issuing guidance). If a taxpayer wishes to challenge an IRS position, he has two options. He can pay the tax, and then litigate with the IRS for a refund in federal district court, the Court of Federal Claims, or the U.S. Tax Court. Alternatively, he can take the deduction, and, within ninety days of receiving a notice of deficiency from the IRS, petition for a hearing in the Tax Court. *See* RICHARD SCHMALBECK & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 32 (3d ed. 2011) (discussing taxpayers' litigation options).

[13] I.R.C. § 162(f) (2006) ("No deduction shall be allowed . . . for any fine or similar penalty paid to a government for violation of any law.").

Section 162(f) codified the Supreme Court's holding in *Tank Truck Rentals v. Commissioner*[14] that certain fines and penalties paid to the government are nondeductible.[15] Regulations promulgated by the IRS have limited this nondeductibility provision to punitive penalties only; a "compensatory" penalty is still properly deductible.[16]

The distinction between compensatory and punitive payments is at the heart of the deductibility inquiry for many penalties, and relator fees are no exception. To provide the background necessary to see this connection, the Note next summarizes the relevant provisions of the civil FCA,[17] the federal law that allows relators, as third-party plaintiffs, to bring *qui tam* suits against a person or company for defrauding the federal government.[18] Congress passed sweeping amendments to the FCA in 1986[19] to strengthen the statute and to crack down on rampant fraud.[20] In addition to increasing the statutory fines for violations,[21] the amendments also altered the nature of the FCA's penalties, leaving unclear whether the monies paid in settlement of FCA claims, including the relator fee, constitute compensatory or punitive damages.[22] Proper classification of relator fees became even more important after the amendments were passed because the legislation mandates that a significant portion of any resulting award or settlement, up to a possible thirty percent, goes to the relator.[23]

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[14] 356 U.S. 30 (1958).

[15] *See, e.g.*, S. Rep. No. 91-552, at 273–75 (1969) [hereinafter 1969 Senate Report] (citing the *Tank Truck Rentals* opinion and explaining that the new statute intended to codify the exact limits of the public policy exception).

[16] Treas. Reg. § 1.162-21 (2011).

[17] 31 U.S.C. §§ 3729–3733 (2006).

[18] *Qui tam* is taken from the Latin phrase "*qui tam pro domino rege quam pro se ipso in hac parte sequitur*," the one "who pursues this action on our Lord the King's behalf as well as his own." Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 768 n.1 (2000) (citing 3 William Blackstone, Commentaries *160).

[19] False Claims Amendments Act of 1986, Pub. L. No. 99-562, 100 Stat. 3153.

[20] S. Rep. No. 99-345, at 1–2 (1986) [hereinafter 1986 Senate Report] (explaining the statute's purpose as responding to the "growing pervasiveness of fraud" against the government).

[21] *See infra* notes 56–60 and accompanying text (describing the pre- and post-amendment provisions).

[22] *See* 1 John T. Boese, Civil False Claims and Qui Tam Actions § 3.02 (4th ed. Supp. 2012) ("Increasingly, courts are recognizing that in amending the FCA's damages and penalties provisions, Congress transformed the False Claims Act from a primarily remedial statute to one that has punitive features . . . .").

[23] *See* 100 Stat. at 3156–57 (stipulating that between fifteen and twenty-five percent of the award is to be given to the relator if the government intervenes in the suit and between twenty-five and thirty percent if the government does not intervene). *See also infra* notes 54–55 and accompanying text (discussing the relator fee provisions of the FCA).

Part II presents and then criticizes, from a textual standpoint, the IRS's current position as to the deductibility of FCA relator fees. The IRS, recognizing the magnitude of these fees and the proliferation of FCA settlements,[24] issued guidance to taxpayers allowing the deduction of relator fees by FCA violators.[25] However, the IRS's analysis is flawed and is based on a strained and selective reading of the FCA case law.

Part III criticizes the IRS's position from a policy perspective, and provides four reasons that FCA violators should not be able to deduct relator fees. First, disallowing the relator fee deduction would better combat fraud, which was Congress's goal in passing the 1986 amendments and, more recently, the 2009 amendments to the FCA. Second, from an economic standpoint, allowing deductions for relator fees distorts the incentives of those committing fraud by effectively lessening the punitive penalty, leading to a socially inefficient level of deterrence. Third, allowing defrauders to deduct the relator fee effectively translates into a subsidy provided by all American taxpayers to the FCA violator, raising equity concerns. Finally, the Note addresses the counterargument that grossing up settlement amounts or jury awards would be preferable to a policy of nondeductibility, and argues that, in fact, implementing a nondeductibility policy would be a better solution.

I
Statutory Background

Deductibility of relator fees implicates two distinct statutes: the FCA, which mandates the payment of such fees to relators in successful *qui tam* actions, and § 162 of the I.R.C., which governs whether the FCA violator can deduct these fees in calculating its taxable income. This section presents the relevant sections of these statutes and their legislative histories.

[24] Since the enactment of the amendments to the FCA, the number of *qui tam* suits has exploded, especially in the last ten years. *See* U.S. Dep't of Justice, Civil Div., Fraud Statistics Overview: October 1, 1987–September 30, 2011 (2011) [hereinafter DOJ Fraud Statistics], *available at* http://www.taf.org/DoJ-fraud-stats-FY2011.pdf (charting the volume of FCA cases and settlement amounts by year); *see also* Christina Orsini Broderick, Note, *Qui Tam Provisions and the Public Interest: An Empirical Analysis*, 107 Colum. L. Rev. 949, 955 (2007) ("The combination of . . . new incentives [under the 1986 amendments] directly led to the drastic increase in qui tam actions . . . . In 1987, only 32 qui tam suits were filed and they did not result in any recoveries. By 1997, the number of such suits filed reached 533, with $629.9 million recovered for the government."). Over 7000 *qui tam* suits have been filed since 1987, resulting in more than $3 billion in relator fees awarded since that time. DOJ Fraud Statistics, *supra*, at 2 (listing 7843 *qui tam* actions initiated since 1987 and total relator share awards of $3,418,672,503).

[25] GLAM, *supra* note 6.

A. Internal Revenue Code § 162(f)

As originally conceived, the tax code allowed deductions for all expenses incurred in the production of business income, regardless of the legality or nature of the expenses.[26] The original policy, today codified as I.R.C. § 162(a), provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[27]

However, in the first fifty years following the implementation of the income tax, judges carved out public policy exceptions, disallowing deductions for certain expenses that were paid as criminal fines or as civil penalties.[28] This line of cases culminated in the *Tank Truck Rentals*[29] case, in which the Supreme Court disallowed the deduction of fines paid by a trucking company for violating weight limits. The Supreme Court established the principle that a business expense incurred as a result of violating a law does not fall under § 162(a) because such an expense cannot be classified as necessary: "A finding of 'necessity' cannot be made . . . if allowance of the deduction would frustrate sharply defined national or state policies proscribing the particular types of conduct, evidenced by some governmental declaration thereof."[30]

In an attempt to codify and clearly delineate the category of business deductions that should be disallowed on public policy grounds, Congress passed legislation in 1969 creating I.R.C. § 162(f), which states: "No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law."[31] Although intended to codify the court-made public policy exceptions,[32] the legislation did little to clarify matters for the courts or the IRS, because the law provided no further detail on the

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[26] *See* F. Philip Manns, Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 13 VA. TAX REV. 271, 276–77 (1993) ("When enacting the modern income tax in 1913, Congress clearly chose neutral economic policies. . . . Congress rejected amendments that would have limited deductions to those incurred in a lawful trade or business.").

[27] I.R.C. § 162(a) (2006).

[28] *See* Manns, Jr., *supra* note 26, at 276–77 (describing the origination of the "public policy disallowance" in 1924).

[29] Tank Truck Rentals v. Comm'r, 356 U.S. 30 (1958).

[30] *Id.* at 33–34.

[31] I.R.C. § 162(f).

[32] *See* 1969 Senate Report, *supra* note 15, at 274 (noting that the legislation "represents a codification of the general court position").

definition of "fine or penalty."[33] The legislative history also provided little guidance.[34]

Two years later, the Treasury promulgated regulations defining "fine or penalty" to include civil penalties, stating that "a fine or similar penalty includes an amount . . . [p]aid as a civil penalty imposed by Federal, State or local law . . . ."[35] A number of taxpayers challenged the IRS's interpretation of § 162(f) in Tax Court, claiming that civil penalties could not reasonably be classified as "fine[s] or similar penalt[ies]."[36] In *South Pacific Transportation Co. v. Commissioner*, the Tax Court rejected this argument, holding that the inclusion of civil penalties reflected the underlying congressional intent in passing § 162(f).[37] The court distinguished between two types of civil penalties: punitive and remedial. Where the civil penalty serves a punitive purpose, it is nondeductible under § 162(f); where it serves merely a remedial function, a deduction is permitted.[38]

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[33] I.R.C. § 162(f).

[34] The 1969 legislative history in fact provides contradictory guidance. A 1969 Senate Report on the bill, after citing the holding in the *Tank Truck Rentals* case, states: "This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect." 1969 Senate Report, *supra* note 15, at 274. However, the "general court position" prior to 1969 was to *include* civil penalties within the public policy disallowance of deductions, creating an inconsistency between the first two sentences. The courts that dealt with this issue concluded that Congress intended for § 162(f) to apply to civil penalties, consistent with the pre-statute cases. *See infra* note 36 and accompanying text (citing S. Pac. Transp. Co. v. Comm'r, 75 T.C. 497, 649 (1980)).

[35] Treas. Reg. § 1.162-21(b)(1)(ii) (2011).

[36] I.R.C. § 162(f); *see, e.g.*, True v. United States, 894 F.2d 1197 (10th Cir. 1990) (finding a civil penalty imposed under the Federal Water Pollution Control Act nondeductible under § 162(f)); S. Pac. Transp. Co. v. Comm'r, 75 T.C. 497, 649–50 (1980) (finding civil penalties imposed under the Safety Appliance Act and Twenty-Eight Hour Act nondeductible under § 162(f)).

[37] *See S. Pac. Transp. Co.*, 75 T.C. at 652 ("Thus, Congress, by use of the word 'similar,' was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties."); *see also* S. REP. NO. 92-437, at 73 (1971) ("In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute."). Although this report was issued two years after Congress enacted § 162(f), the Senate Committee felt it necessary to clarify the initial congressional intent underlying the provision. *S. Pac. Transp. Co.*, 75 T.C. at 651 ("Two years later, [in 1971,] the Senate Finance Committee attempted to more clearly explain what was meant to be included within the definition of 'fines and similar penalties.'").

[38] *S. Pac. Transp. Co.*, 75 T.C. at 652 ("If a civil penalty is imposed . . . as punishment for the violation thereof, . . . it is 'similar' to a fine. However, if the civil penalty is imposed . . . as a remedial measure to compensate another party . . . [, it] is not 'similar' to a fine within the meaning of section 162(f).").

The court's conclusion that certain civil penalties could be classified as punitive begs the obvious question: How does one differentiate a punitive civil fine from a compensatory one? The IRS promulgated a regulation that explicitly excluded compensatory damage awards from § 162(f), stating that "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty."[39] However, no clear definition of compensatory damages appears in the regulation. The Tax Court, addressing the issue, held that "the origin of the liability giving rise to [the payment]," i.e., the underlying statute, rather than taxpayer motive, determines the classification of the penalty.[40] If the statute itself does not clearly indicate whether the payment is compensatory or punitive, courts look to the legislative history of the statute as well as judicial and administrative interpretations.[41] If no determination can be made from the legislative history and interpretations of the statute, courts and the IRS look to the language of the settlement agreement or the court order.[42] Finally, if the agreement or ruling is silent, other factors, such as how the payment is calculated and how the government uses the payment, are considered.[43]

B. The False Claims Act

The federal FCA is one of the most important statutes used by the government to combat fraud perpetrated by government contractors.[44] The statute covers a wide range of fraudulent activities, including billing the government for services not rendered or overbilling for services that are rendered,[45] conspiring to defraud the

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39 Treas. Reg. § 1.162-21(b)(2).

40 Middle Atlantic Distribs., Inc. v. Comm'r, 72 T.C. 1136, 1144–45 (1979) (citing Uhlenbrock v. Comm'r, 67 T.C. 818, 823 (1977)).

41 This hierarchy has not been articulated explicitly by the courts; it is based on one practitioner's classification of the varied court rulings on this issue. *See* Yoav Wiegenfeld, *Increasing the Cost of Settlements: Proposed Legislation Would Expand the Fine and Penalty Nondeductibility Rule*, 101 TAX NOTES 1341, 1343 (2003) (outlining this structure and citing Tucker v. Comm'r, 69 T.C. 675 (1978)).

42 *Id*. (citing Stephens v. Comm'r, 905 F.2d 667, 673 (2d Cir. 1990), where the court based its holding on the Tax Court judge's statement at sentencing that implied the fine was compensatory rather than punitive).

43 *Id*. (citing *Middle Atlantic Distribs.*, 72 T.C. at 1141); *but see* Manns, Jr., *supra* note 26, at 288 (presenting a slightly different version of the test based on older case law).

44 *See* Pamela H. Bucy, *Growing Pains: Using the False Claims Act To Combat Health Care Fraud*, 51 ALA. L. REV. 57, 57 (1999) ("The False Claims Act ('FCA') is one of the major tools in the government's arsenal to combat fraud against the federal government . . . .").

45 31 U.S.C. § 3729(a)(1)(A) (2006 & Supp. III 2007) (codifying liability for any person who "knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval").

government,[46] misappropriating government property,[47] and fraudulently withholding money owed to the government.[48]

1. *Relator Provisions*

A significant provision in the FCA is its grant of a cause of action to any individual, known as a relator, to bring a *qui tam* suit on behalf of the government.[49] The ability of any individual to file a *qui tam* action greatly enhances the effectiveness of the statute, since enforcement is bolstered by insiders with firsthand knowledge of the fraud.[50]

Once a relator files a claim, he must turn over all the evidence he has to the federal government, which has the right to intervene.[51] If the government intervenes, the government pays the legal expenses, although the relator remains a named plaintiff in the case.[52] If the government declines to enter the case, the relator can still pursue the action but must bear the costs himself.[53]

A relator who prevails in his suit is statutorily entitled to a portion of the damages award. In a case in which the government intervenes, the relator receives between fifteen percent and twenty-five percent of the amount recovered;[54] if the relator pursues the action

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46 *Id*. § 3729(a)(1)(C) (codifying liability for any person who "conspires to commit a violation of subparagraph (A), (B), (D), (E), (F), or (G)").

47 *Id*. § 3729(a)(1)(D), (F) (codifying liability for any person who "has possession, custody, or control of property or money used, or to be used, by the Government and knowingly delivers, or causes to be delivered, less than all of that money or property" or "knowingly buys, or receives as a pledge of an obligation or debt, public property from an officer or employee of the Government, or a member of the Armed Forces, who lawfully may not sell or pledge property").

48 *Id.* § 3729(a)(1)(D) (codifying liability for any person who "has possession, custody, or control of property or money used, or to be used, by the Government and knowingly delivers, or causes to be delivered, less than all of that money or property").

49 *See supra* note 18 and accompanying text (defining *qui tam*).

50 The *qui tam* plaintiff has Article III standing based on the theory that an assignee may assert the injury-in-fact of an assignor. *See* Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 772–73 (2000) (enumerating the standing requirements and concluding that *qui tam* plaintiffs satisfy them).

51 31 U.S.C. § 3730(b)(2) (2006) ("A copy of the complaint and written disclosure of substantially all material evidence and information the person possesses shall be served on the Government . . . . The Government may elect to intervene and proceed with the action within 60 days after [receipt].").

52 *Id*. § 3730(b)(4) ("[T]he Government shall (A) proceed with the action, in which case the action shall be conducted by the Government; or (B) notify the court that it declines to take over the action, in which case the person bringing the action shall have the right to conduct the action.").

53 *Id*.

54 *Id.* § 3730(d)(1).

himself, he is entitled to between twenty-five percent and thirty percent of the recovery.[55]

2. FCA Damages—Punitive or Compensatory?

When the FCA was first passed in 1863, it provided for double damages plus $2000 (as well as court costs) for each violation of the Act.[56] These penalty provisions were not updated for well over a century.[57] Beginning in 1984, the Reagan Administration, worried about massive growth in fraud, pushed for amendments to the FCA to strengthen the Act.[58] In response, Congress unanimously passed major amendments to the statute in 1986, including the implementation of harsher penalties.[59] Specifically, the amendments provided for damages of $5000 to $10,000 per violation, plus three times the amount of damages sustained by the government.[60]

The key issue, for purposes of this Note, is whether FCA damages are punitive or compensatory. The statute does not specifically classify the treble damages or the statutory penalty as punitive or compensatory in nature, but the clear implication of the language, "[three] times the amount of damages which the Government sustains,"[61] is that the treble damages consist of one measure of compensatory and double this amount of punitive damages. The statutory penalty, assessed on top of this amount, is wholly punitive. The classification of the damages provision as compensatory or punitive has ramifications in a

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55 *Id.* § 3730(d)(2). Prior to 1943, the statute entitled relators to fifty percent of the damage award. However, in that year, Congress amended the statute and, among other changes, reduced the size of the relator award. *See* Broderick, *supra* note 24, at 954 (discussing the 1943 amendments).

56 *See* Act of Mar. 2, 1863, ch. 67, 12 Stat. 696, 698 ("[The violator] shall forfeit and pay to the United States the sum of two thousand dollars, and, in addition, double the amount of damages which the United States may have sustained by reason of the doing or committing such act, together with the costs of suit . . . .").

57 *See* Brian C. Elmer & Andy Liu, "Because of": FCA Damages and Penalties 3 (2005), *available at* http://www.crowell.com/documents/Because-of_FCA-Damages-and-Penalties.pdf (noting that the FCA was initially passed in 1863 and "remained unchanged for more than 120 years").

58 *See* Interview by Tom Winter & Joseph Baldacchino, Jr., with President Ronald Reagan in Washington, D.C. (Dec. 6, 1984), *available at* http://www.presidency.ucsb.edu/ws/?pid=39485 (expressing his determination to expose defense contract fraud such as "$500 hammers and wrenches and so forth").

59 *See* Paul W. Morenberg, *Environmental Fraud by Government Contractors*, 22 B.C. Envtl. Aff. L. Rev. 623, 628–29 (1995) (discussing the passage and key provisions of the amendments).

60 31 U.S.C. § 3729(a)(1) (2006 & Supp. III 2007) ("[The violator] is liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000 . . . plus 3 times the amount of damages which the Government sustains because of the act of that person.").

61 *Id.*

number of different areas.[62] Most important for purposes of this Note, the classification of the damages as punitive or compensatory implicates tax law because of § 162(f) and its attendant regulations.[63]

Outside the tax realm, courts have interpreted FCA damages as compensatory or punitive, wavering between classifications depending on the particular case and context. Even before the 1986 amendments, the Supreme Court issued conflicting rulings on this point.[64] The early post-amendment jurisprudence from the 1990s generally cited language from the earlier cases to support the conclusion that the FCA damages were designed to provide "rough remedial justice"—that is, to serve a compensatory function.[65]

However, in 1999, the Supreme Court handed down *Vermont Agency of Natural Resources v. United States ex rel. Stevens*[66] and reversed this trend, concluding that FCA damages are punitive. The issue in *Stevens* was not the tax deductibility of damages, but rather whether states and state entities constitute "persons" subject to suit under the FCA.[67] Justice Scalia, writing for the majority, concluded that states were not persons subject to suit under the FCA, because "the current version of the FCA imposes damages that are essentially punitive in nature"[68] and there exists a strong presumption against the imposition of punitive damages against a government.[69] The Court noted that pre-amendment decisions had "suggested that damages

62 *See, e.g.*, Cook Cnty. v. United States *ex rel.* Chandler, 538 U.S. 119, 133 (2003) (discussing the immunity of state and local governments from the application of the provision); Cooper Indus., Inc. v. Leatherman Tool Grp., Inc., 532 U.S. 424 (2001) (discussing the type of appellate review given to FCA judgments); United States v. Mackby, 339 F.3d 1013, 1019 (9th Cir. 2003) (discussing whether the penalty constitutes an excessive fine under the Eighth Amendment); United States v. NEC Corp., 11 F.3d 136 (11th Cir. 1994) (discussing the survivability of a relator's *qui tam* claim after his death).

63 *See supra* note 39 and accompanying text (discussing the relevant tax regulation).

64 *Compare* United States *ex rel.* Marcus v. Hess, 317 U.S. 537, 551–52 (1943) ("We think the chief purpose of the [FCA] was to provide for restitution to the government of money taken from it by fraud, and that the device of double damages plus a specific sum was chosen to make sure that the government would be made completely whole.") *with* United States v. Halper, 490 U.S. 435, 449 (1989) (holding that for double jeopardy purposes, a civil FCA fine imposed after a criminal conviction can be considered "punishment" if the civil penalty "bears no rational relation to the goal of compensating the Government for its loss").

65 BOESE, *supra* note 22, at § 3.02[A].

66 529 U.S. 765 (2000).

67 *See id*. at 770 ("Petitioner [Vermont] . . . moved to dismiss, arguing that a State (or state agency) is not a 'person' subject to liability under the FCA . . . .").

68 *Id*. at 784.

69 *See id*. at 784–85 ("[T]he current version of the FCA imposes damages that are essentially punitive in nature, which would be inconsistent with state *qui tam* liability in light of the presumption against imposition of punitive damages on governmental entities.").

under an earlier version of the FCA were remedial rather than punitive," but distinguished them on the grounds that the earlier version imposed lighter damages, whereas "the current version, by contrast, generally imposes treble damages and a civil penalty of up to $10,000 per claim."[70] Focusing on the use of a multiplier to magnify the size of the damage award, the Court further stated that "'[t]he very idea of treble damages reveals an intent to punish past, and to deter future, unlawful conduct.'"[71]

Three years later, the Supreme Court dealt with the issue yet again. In *Cook County v. United States ex rel. Chandler*,[72] the Court addressed a similar issue to the one raised in *Stevens*. This time, instead of a state entity as defendant, the defendant was a municipality arguing that it could not be sued under the FCA.[73] The Court held against the county, concluding that the presumption against imposing punitive damages against governments was not applicable to municipalities sued under the FCA.[74]

Cook County, the defendant, began its argument with the established premise that, although a municipality, "'like a private corporation, was to be treated as a natural person subject to suit for a wide range of tortious activity, . . . this understanding did not extend to the award of punitive or exemplary damages.'"[75] The county then argued that, when Congress passed the 1986 amendments to the FCA and increased the damages from double to treble, it changed the nature of the penalty from compensatory to punitive, citing the Court's statement in *Stevens* classifying post-1986 FCA damages as "essentially punitive."[76] Finally, putting the pieces together, the county argued that, in altering the FCA damages scheme and creating a punitive remedy, Congress intended to exclude municipalities from the reach of the FCA.[77]

The Supreme Court disagreed, holding that municipalities are subject to suit under the FCA. In arriving at its holding, the Court

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70 *Id.* at 785.

71 *Id*. at 786 (quoting Tex. Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 639 (1981)).

72 538 U.S. 119 (2003).

73 *Id*. at 124 ("The County moved to dismiss the claims against it, arguing, among other things, that it was not a 'person' subject to liability under the FCA.").

74 *Id.* at 132 ("Working against the County's position, however, is a . . . presumption[ ]: the cardinal rule . . . that repeals by implication are not favored." (internal citations omitted)).

75 *Id.* at 129 (quoting Newport v. Fact Concerts, Inc., 453 U.S. 247, 259–60 (1981)).

76 *Id*. at 130 (citing *Stevens*, 529 U.S. at 784–85).

77 *Id*. at 130 ("The County . . . argue[s] that, even if municipalities were covered by the term 'person' from 1863 to 1986, Congress's adoption of a 'punitive' remedy entailed the elimination of municipal liability in 1986.").

wrote that this was a case of two conflicting presumptions: (1) the presumption against punitive damages imposed on municipalities, and (2) the presumption against implied repeal,[78] under which a court assumes that a later statute was not meant to override an earlier one unless the law explicitly so states.[79] The first would support the county's position; the second would support a finding of municipality liability. The Court held that the second presumption carried more weight than the first, since the legislative history of the 1986 amendments clearly indicated that, by increasing the level of damages to treble, Congress wanted to strengthen the FCA, not to weaken its applicability.[80] Before the amendments, it had been settled law that municipalities were subject to FCA liability. Now, Cook County claimed that in Congress's attempt to make the statute *stronger*, Congress had impliedly *repealed* the longstanding application of the FCA to municipalities.[81] The Court refused to accept that this was Congress's intention, and concluded in very strong terms: "It is simply not plausible that Congress intended to repeal municipal liability *sub silentio* by the very Act it passed to strengthen the Government's hand in fighting false claims."[82]

Although the Court, in weighing the conflicting presumptions, seems to have based its holding on the strength of the presumption against implied repeal, it gave another reason that the second presumption was dispositive. The first presumption against the applicability of punitive damages is particularly weak in the FCA context because "treble damages have a compensatory side, serving remedial purposes in addition to punitive objectives."[83] As an example of a remedial feature of the FCA damages scheme, the Court cited relator fees, which "may well serve not to punish, but to quicken the self-interest of some private plaintiff who can spot violations and start

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[78] *Id*. at 132 ("The presumption against punitive damages thus brings only limited vigor to the County's aid. Working against the County's position, however, is a different presumption, this one at full strength: the 'cardinal rule . . . that repeals by implication are not favored.'" (quoting Posadas v. Nat'l City Bank, 296 U.S. 497, 503 (1936))).

[79] Karen Petroski, Comment, *Retheorizing the Presumption Against Implied Repeals*, 92 CAL. L. REV. 487, 489 (2004) ("In its strongest form, the presumption amounts to a sort of clear-statement rule—allowing for repeal only by express provision—that negates the very notion of an implied repeal.").

[80] *Cook Cnty.*, 538 U.S. at 133–34.

[81] *Supra* note 77 and accompanying text.

[82] *Cook Cnty.*, 538 U.S. at 133–34.

[83] *Id.* at 130. The legislative history of the 1986 amendments confirms this point, indicating that the purpose of treble damages is both (a) to make the government "whole" for all of its losses and (b) to deter and punish fraudulent conduct. 1986 Senate Report, *supra* note 20, at 17; H.R. REP. NO. 99-660, at 16, 20 (1986).

litigating."[84] The Court considered this a weakness in the county's argument, finding that, because of the compensatory elements of FCA damages, "[t]he presumption against punitive damages thus brings only limited vigor to the County's aid."[85]

In an important footnote, the Court distinguished *Stevens*, noting that, with regard to states, there is no conflict of presumptions: Unlike municipalities, states are presumed to be *excluded* from the category of "persons" covered in the FCA.[86] As a result, the Court in *Stevens* held that FCA damages are "essentially punitive" in nature and that the statute does not apply to states.[87]

The *Stevens* and *Chandler* opinions demonstrate that the classification of FCA damages as punitive or compensatory differs depending on context—indicating that applying the Court's logic in *Chandler* to a tax question, while ignoring *Stevens*, may not be appropriate.[88] The very same damages which the Court found punitive in *Stevens* were held to be compensatory in *Chandler*, and the Court made clear in *Chandler* that it was not overruling *Stevens*.[89] Yet, when

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[84] *Cook Cnty.*, 538 U.S. at 131.

[85] *Id.* at 132.

[86] *Id*. at 133, note 10 (noting that, in *Stevens*, the background presumption was that states are not "persons" and that "in the present case the statement belies the County's argument that Congress meant to change the contrary presumption applicable to local governments and to remove municipal liability").

[87] Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 784 (2000).

[88] In addition to the distinctions presented in Part II.B, *infra*, the tax context differs in an important respect from others in which the Court has addressed FCA liability. In most cases (including *Stevens* and *Chandler*), the defendants (that is, the violators) argue that FCA damages are punitive in nature. *See* Boese, *supra* note 22, at § 3.02[B] ("[D]efendants commonly argue that the FCA's post-Amendment damages and penalties provisions are punitive . . . ."). This is because the law generally restricts the application of punitive damages in ways that it does not with respect to compensatory damages. For example, there are constitutional limits on punitive damages for due process purposes, which may spur defendants to motion for courts to set aside damage awards as excessive by arguing that the damages constitute a punitive fine. *See, e.g*., State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 428 (2003) (finding that the Due Process Clause of the Fourteenth Amendment was violated by an excessively high punitive damages award). Similarly, punitive fines are generally not imposed on municipalities and states, so state and local governments have challenged the application of the FCA to them on the grounds that the treble damages are punitive. *See, e.g.*, Cook Cnty. v. United States *ex rel.* Chandler, 538 U.S. 119 (2003) (municipality challenging the application of the FCA); Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765 (2000) (state challenging the application of the FCA). In contrast, taxpayers arguing for deductions would prefer that the damages be classified as compensatory, since this makes the case for deductibility easier.

[89] *Cook Cnty.*, 538 U.S. at 124–25 ("The [Seventh Circuit] Court of Appeals . . . distinguished *Stevens* . . . . We . . . now affirm the Court of Appeals."). The Seventh Circuit distinguished *Stevens* on the ground that, in contrast to municipalities, the term "person" in the FCA, absent a clear statement to the contrary, presumably excludes states. *See* United States *ex rel.* Chandler v. Cook Cnty., 277 F.3d 969, 980 (7th Cir. 2002) ("The central

the IRS issued its guidance memo on the classification of FCA damages for an altogether different purpose, the tax deductibility of relator fees, the IRS cited *Chandler* repeatedly as precedent despite the *Stevens* holding, which is equally if not more persuasive.[90] Part II presents the IRS's position, and then criticizes its memo's reliance on *Chandler* over *Stevens* in extrapolating from the government FCA liability context to tax.[91]

II
THE DEDUCTIBILITY OF FCA RELATOR FEES UNDER CURRENT LAW

This Part provides a detailed presentation of the current IRS position that permits the deduction of relator fees, followed by a critique of the IRS's reasoning and methodology in reaching its conclusion. Before presenting the IRS position, it begins with an example illustrating the importance of distinguishing between compensatory and punitive damages for tax deduction purposes. The example demonstrates that allowing a deduction for compensatory damages properly prevents the taxation of money that the violator earned but never retained.

Suppose a health care provider fraudulently bills Medicare for $100 million of medical services it never performed. Assuming that the provider does not commit tax fraud as well as Medicare fraud, it pays tax on the $100 million at ordinary income rates, incurring a tax bill of $35 million. When caught, the provider must pay compensatory damages of $100 million to the government.[92] In sum, then, the provider received $100 million and returned $100 million, for no net gain, but incurred a tax bill of $35 million. To redress this, the provider will get a tax deduction of $100 million. If denied this deduction, the provider would never recoup the $35 million that it paid in taxes on the $100 million of fraud money, even though this money was returned to the government in full.

This logic explains the deductibility of the portion of compensatory damages that constitutes the return of fraud payments to the

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holding of *Stevens* is that states are not within the FCA's definition of 'person' because of the 'longstanding interpretive presumption that "person" does not include the sovereign.' . . . [T]here is no such rule of construction applicable here." (quoting *Stevens*, 529 U.S. at 780)), *aff'd*, 538 U.S. 119 (2003).

90 *See infra* Part II.A (describing how the IRS relied on these cases in its memorandum regarding the deductibility of relator fees).

91 *See infra* Part II.B.1 (pointing out differences between the tax and municipal liability contexts).

92 31 U.S.C. § 3729(a)(1) (2006 & Supp. III 2007) (providing that, among other penalties, the violator is liable for the "amount of damages which the Government sustains").

government. However, this logic does not extend beyond these amounts to the government's legal fees, enforcement expenses, or relator fees. One should not assume that a given dollar of a penalty must be either compensatory or punitive; it can serve both functions. Any part of the damages award above and beyond pure restitution by definition serves a deterrent, and therefore punitive, function, even if it compensates the government for expenses as well.

The IRS, however, has taken the rigid position that relator fees are purely compensatory[93] despite the fact that the sheer size of these awards, taken from the portion of the settlement above the single damages amount, belies this. A portion of a treble damages award constituting anywhere from fifteen to thirty percent of the penalty[94] certainly has punitive and deterrent effects—effects which the statute clearly intended.[95] With this conceptual criticism in mind, consider the arguments of the IRS.

A. The IRS Position Permitting Deductibility

The IRS has determined that the portion of FCA damages allotted to relator fees constitutes "compensatory damages" under the Treasury regulations, and are therefore fully deductible.[96] While the IRS has not issued a binding ruling on this question, it set forth this opinion in a Generic Legal Advice Memorandum (GLAM),[97] an internal memo issued by the IRS Office of Chief Counsel for IRS staff attorneys.[98] The Office of Chief Counsel issues GLAMs in response to requests for advice from field offices of the IRS.[99] GLAMs are case-specific and nonbinding,[100] and the IRS can change its position at any

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93 *See, e.g.*, United States *ex rel.* Marcus v. Hess, 317 U.S. 537, 549 (1943) (stating that the pre-amendment double damages provision in the FCA was compensatory in nature); Talley Indus. Inc. v. Comm'r, 18 F. App'x 661 (9th Cir. 2001) (holding that the pre-amendment double damages served both compensatory and punitive functions and were subject to factual determination in each case); GLAM, *supra* note 6, at 9 (stating the IRS position that relator fees are compensatory and therefore deductible).

94 *See supra* notes 54–55 and accompanying text (citing the relator fee percentage provisions).

95 *See supra* note 83 and accompanying text (citing legislative history of the 1986 amendments that suggests a deterrence objective).

96 GLAM, *supra* note 6, at 9 (stating the IRS's position).

97 *Id*.

98 I.R.S. Internal Revenue Manual § 33.1.2 (2011), *available at* http://www.irs.gov/irm/part33/irm_33-001-002.html (detailing the rules and procedures for the issuance of a GLAM).

99 *Id*. § 33.1.2.2.3.5(2) ("Legal advice of this type may originate from a request for advice by the Service or a field office of Counsel . . . .").

100 *Id.* § 33.1.2.2.3.5(9) ("As with other forms of legal advice, this type of legal advice does not set out official rulings or positions of the Service and may not be referenced in other documents as precedent.").

time by issuing a new memo without revoking or withdrawing the previous one.[101] Despite this lack of precedential weight, a GLAM is instructive because it sets forth the current IRS position and is intended to ensure that similarly situated taxpayers are treated consistently.[102] As a result, the relator fee GLAM provides a strong basis for FCA violators to comfortably deduct these fees as § 162(a) ordinary and necessary business expenses.[103]

In the particular Medicare fraud case addressed in the GLAM, the settlement agreement apportioned a $200 million settlement as follows: $100 million to the Department of Health and Human Services (HHS) (the defrauded government agency), $20 million to the relator, and $80 million to the general Treasury.[104] The IRS field agents reviewing the case requested advice from the Office of the Chief Counsel concerning the deductibility of the relator fee portion of the settlement.[105] The request was accompanied by an analysis suggesting that only the $100 million paid to the HHS should be deductible as compensatory damages, and the remaining $100 million, including the $20 million in relator fees, should be nondeductible as a punitive fine under § 162(f).[106] The Office of the Chief Counsel

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[101] *Id.* ("A subsequent decision to adopt a different position on the same or a similar issue will, therefore, not require the withdrawal or revocation of the prior legal advice memorandum. Instead, a new memorandum setting out the current advice should be issued.").

[102] *Id.* ("[L]egal advice of this type may be issued upon a determination by an Associate Chief Counsel executive that it is appropriate to render such advice in this form to promote efficiency, to promote consistent treatment of similarly situated taxpayers, or to otherwise promote sound tax administration.").

[103] In addition to the GLAM, the IRS Large Business and International Division has more recently maintained this same position in a Coordinated Issue Paper. I.R.S. LARGE BUS. & INT'L DIV., LMSB-4-0908-045, FALSE CLAIMS ACT SETTLEMENTS WITH THE DEPARTMENT OF JUSTICE (DOJ) (2008), *available at* http://www.irs.gov/Businesses/Coordinated-Issue---All-Industries---False-Claims-Act-Settlements-With-Department-Of-Justice-(DOJ) (citing the GLAM for the position that "an amount paid by the taxpayer to compensate the government for its obligation to pay a relator from proceeds of a lump-sum settlement is deductible when the amount of the relator fee is specifically outlined in the settlement agreement"). Coordinated Issue Papers are released by the IRS Large Business and International Division after review by the Office of the Chief Counsel and indicate the Service's current thinking on "complex and significant industry wide issues." *Coordinated Issue Papers – LB&I*, IRS, http://www.irs.gov/Businesses/Coordinated-Issue-Papers---LB&I (last visited Sept. 6, 2012).

[104] *See* GLAM, *supra* note 6, at 2 (describing the allocation of the settlement).

[105] *See id.* ("The request for advice concerns only the relator fees portion of the settlement.").

[106] *See id.* ("[The IRS Large and Mid-Size Business Division'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).").

disagreed, and allowed a deduction for the relator fee portion of the settlement.[107]

The GLAM provides detailed reasoning for this conclusion, relying heavily on the *Chandler* case.[108] After restating § 162(f) and the attendant regulations,[109] the GLAM notes the difficulty presented when a penalty serves both a compensatory and punitive function.[110] The GLAM notes that the Supreme Court, in *Stevens*, had unequivocally classified treble damages as punitive; however, it immediately dismisses this holding as having been "refined" in *Chandler*.[111]

The IRS then cites *Chandler* for the proposition that treble damages under the FCA fall into this category.[112] Turning next to the issue of relator fees, the GLAM references the portion of the *Chandler* opinion that offers relator fees as an example of a compensatory portion of an FCA damages award.[113] Without citing to any Tax Court case dealing squarely with the question,[114] the IRS concludes that a relator fee "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."[115]

In the last paragraph of the GLAM, the IRS goes even further, taking the position that *Chandler* "prohibit[s] 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)."[116] In other words, in the IRS's view,

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107 *See id*. at 9 (concluding that relator fees may be properly deducted).

108 For a discussion of *Chandler*, see *supra* Part I.B.2.

109 GLAM, *supra* note 6, at 3–4.

110 *Id*. at 3 ("[D]iscerning 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 . . . difficult task.").

111 *Id*. at 5.

112 *Id*. at 4 ("[T]he multiple damages provision of the FCA serves both compensatory and punitive purposes.").

113 *Id*. at 7 (citing the Court's observation that "[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" (quoting Cook Cnty. v. United States *ex rel.* Chandler, 538 U.S. 119, 131 (2003)) (internal quotation marks omitted)).

114 The GLAM does cite three cases concerning relator fees, including one Tax Court case, but none deals with the issue of the tax deductibility of relator fees. *Id.* at 8 (citing Rocco v. Comm'r, 121 T.C. 160 (2003), discussing whether a relator fee is includible in the gross income of the relator, as well as United States *ex rel.* Semtner v. Med. Consultants, Inc., 170 F.R.D. 490 (W.D. Okla. 1997), and United States v. NEC Corp., 11 F.3d 136 (11th Cir. 1994), each dealing with whether a relator's claim for his statutory fee survives his death).

115 GLAM, *supra* note 6, at 9.

116 *Id*.

when the Court stated in *Chandler* that a municipality was subject to suit under the FCA and marshaled support by noting that relator fees under the FCA serve a compensatory function, it *foreclosed* the possibility of interpreting the relator fee provision as a penalty that cannot be deducted under § 162(f).

B. Questioning the IRS Position

Relator fees should be classified as punitive in the tax deduction context, as the Court held in *Stevens*, irrespective of the Court's holding in *Chandler*. Because the FCA does not clearly classify its treble damages provision as compensatory or punitive, the GLAM properly looks to judicial interpretations of the statute to answer the question.[117] However, the IRS errs in its analysis of the conflicting Supreme Court precedents. The IRS uses *Chandler* to support the argument in favor of deductibility of relator fees, and also takes the position that the reasoning in the case forecloses any arguments against deductibility. But this conclusion is incorrectly drawn from the *Chandler* case, because the Court in that case never overruled *Stevens*.[118] A closer examination of the GLAM reveals that it exhibits errors in both legal reasoning as well as methodology.

1. Chandler *Is Context-Specific and Should Not Control on a Tax Question*

The IRS makes the big—and unwarranted—assumption that the definition of "compensatory damages" for the purposes of determining municipality liability is identical to the definition of the term for the purposes of the § 162(f) regulations. However, the two should not be equated. When a penalty serves both a compensatory and punitive function, as the treble damages of the FCA do, the punitive side—the "sting" of the penalty—may be thwarted if a tax deduction is allowed. As a result, applying the tax policy underlying the congressional intent behind § 162(f), the treble damages provision should be viewed from a tax perspective as punitive.[119]

The issue in *Chandler* was a narrow one: whether the canon against implied repeal should be used to interpret the 1986 FCA

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[117] *See supra* notes 39–43 and accompanying text (describing Tax Court precedent on interpreting statutes for purposes of § 162(f)).

[118] *See supra* notes 86–89 and accompanying text (noting that *Chandler* did not overrule *Stevens*).

[119] *See supra* notes 40–43 and accompanying text (describing the methodology employed by the courts to determine whether a penalty is punitive or compensatory, and the importance of legislative history in this determination). *See also infra* Part III.B (elaborating on the economic argument in favor of treating relator fees as punitive in nature).

amendments with respect to municipal liability.[120] Before *Chandler*, municipalities could be held liable under the FCA.[121] To argue that the status quo had been altered, the county had the burden of proving that Congress, in passing the 1986 amendments, intended to change the law with respect to municipalities.[122] In response to this limited inquiry, the Court said that it would not presume that Congress wanted to remove municipalities from the ambit of the statute unless the amendments contained strong language indicating that this was the case.[123]

Chandler should not be relied upon to resolve the tax question about relator fees because different burdens of proof apply in the municipal liability and tax contexts. In *Chandler*, Cook County (the party arguing that damages were punitive) had an extremely high burden to overcome a presumption of liability. The Court reasoned that even *slight* indications that treble damages serve a compensatory purpose would defeat the county's weak claim. The Court rightly held that the federal government did not intend to bear a loss, just because the penalty it imposed was serving a deterrent purpose, in addition to making the government whole.[124] However, in the world of tax deductions, the opposite is true: The taxpayer bears the heavy burden to prove that damages are compensatory and that he is entitled to the deduction.[125] For purposes of § 162(f), applying this standard would require the taxpayer to demonstrate that the fine or penalty was *completely*, or at least *primarily*, compensatory in nature. But where a fine is "essentially punitive,"[126] as the Court in *Stevens* held regarding FCA damages, the government's deterrent purpose will be thwarted by allowing a deduction.

A comparison of the IRS memo with the text of *Chandler* reveals how much the holding of the case is distorted. The GLAM does not

[120] *See* Cook Cnty. v. United States *ex rel.* Chandler, 538 U.S. 119, 132–33 (2003) ("The County's argument . . . is that the treble damages amendment must be read to eliminate the FCA's coverage of municipal corporations entirely, after being the statutory law for over a century.").

[121] *Id.* at 133 (noting that the FCA had covered municipalities "for over a century").

[122] *Id.* at 132–33 (noting that the question was whether the amendments must be read to change the law with respect to municipalities from what it had been for more than a century).

[123] *Id.* at 133 (stating that because Congress could have excluded municipalities from the FCA, "it makes no sense to suggest that Congress did it under its breath").

[124] *See supra* note 83 and accompanying text (citing legislative history of the 1986 amendments that suggests a deterrence objective).

[125] *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) (stating that 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).

[126] Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 784 (2000).

mention anything about the canon against implied repeal,[127] which was critical to the holding of *Chandler*. Ignoring the Court's careful weighing of opposing canons of construction, the GLAM presents municipal liability and tax as analogues, improperly disregards *Stevens*, and reaches a faulty conclusion.

2. *Relator Fees Are Large Portions of FCA Awards and Differ from Other Expenses*

Additionally, the GLAM's comparison of relator fees to other expenses incurred by the government in bringing an FCA suit is flawed. Unlike other government expenses, the relator receives a fee only if the case is successful.[128] Thus, the relator simply shares in the punitive damages portion of the award. In this way, relator fees are analogous to the government earmarking a portion of punitive damages for public health care, education, or some other function. While it is certainly true that the high percentage given to the relator induces insiders within companies violating the FCA to come forward,[129] it is incorrect to classify the huge relator fees, which comprise between fifteen and twenty-five percent of the FCA award, as solely—or even primarily—compensatory in nature.

Consider the following extreme, but illustrative, example. Suppose the statute imposed not treble, but ten measures, of damages, and apportioned the entire amount of any punitive damages award to the relator. If, under this scheme, a violator defrauded the government out of $1 million and was assessed the full damage amount when caught, he would have to pay $10 million: $1 million of compensatory and $9 million of punitive damages. Of this amount, the entire $9 million would go to the relator. The prospect of such a huge windfall would encourage large numbers of whistleblowers to emerge. But such a huge damage award would also serve an enormous punitive function and would deter large numbers of potential violators. Under the IRS's view in the GLAM, however, the entire award would be deductible as "compensatory damages," since the government would not keep any portion of the award, instead passing it along to the relator.[130]

[127] *See* GLAM, *supra* note 6, at 6 (framing the question addressed by the GLAM).

[128] *See* 31 U.S.C. § 3730(d) (2006) (listing the statutory fees received by the relator if the government recovers under the relator's *qui tam* suit).

[129] *See* 1986 Senate Report, *supra* note 20, at 2–8 (legislative history of the 1986 amendments).

[130] Granted, such an extreme structure is unlikely to ever be implemented; however, relator fees already constitute up to thirty percent of the settlement award and the IRS does not recognize the significant deterrent effect of these large sums.

III
Policy Reasons for Disallowing the Deduction of Relator Fees

The IRS's current position has policy ramifications that extend beyond the tax bill of the FCA violator. This Part addresses a number of the negative policy effects of the relator fee deduction. Specifically, the allowance of the deduction (a) undermines Congress's intent, in passing the FCA amendments, to combat fraud, (b) provides a suboptimal set of ex ante incentives to potential violators, and (c) shifts part of the burden of the penalty onto all American taxpayers. Each of these issues is addressed in turn, followed by a section analyzing the counterargument that juries and settling parties could solve the problem by grossing up awards to account for the relator fee deduction.

A. Congress Has Declared Rampant Fraud To Be a Major Public Policy Concern

Allowing a deduction for relator fees undermines a key goal of the 1986 amendments to the FCA that created the treble damages provision: maximal deterrence of fraud.[131] More recently, in 2009, Congress passed further amendments to the FCA, and although not targeted at the damages provisions, the legislation was designed to make FCA claims easier for the government to bring and to win.[132] By passing tough legislation and intensifying its enforcement efforts,[133] the government has demonstrated a public policy commitment to curbing the rampant fraud perpetrated against the government in health care, defense, natural resources, and other areas.[134] The relator

131 *See* 1986 Senate Report, *supra* note 20, at 2 (noting the "growing pervasiveness of fraud" among government contractors and stating that the legislation "will decrease this wave of defrauding public funds"); H.R. Rep. No. 99-660, at 20 (1986) (explaining that the increased damages were recommended "in order that the False Claims Act penalties will have a strong deterrent effect; [and] will make the government whole for its losses").

132 *See* Brian A. Hill & Josephine Nelson Harriott, *FCA Amendments Broaden Government's Investigative Power*, ABA Health eSource (ABA Health L. Sec., Chi., Ill.), Aug. 2009, *available at* http://www.americanbar.org/newsletter/publications/aba_health_esource_home/Hill.html (detailing provisions of the Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617 (codified as amended in scattered sections of 18 and 31 U.S.C.), that make it easier for government to investigate and prosecute FCA violations).

133 *See, e.g.*, Press Release, U.S. Dep't of Justice, Health Care Fraud Prevention and Enforcement Efforts Result in Record-Breaking Recoveries Totaling Nearly $4.1 Billion (Feb. 14, 2012), *available at* http://www.justice.gov/opa/pr/2012/February/12-ag-213.html (describing the success of an enforcement action team created in 2009 to combat fraud).

134 For a list of the wide array of areas where fraud committed has been prosecuted under the FCA, see *False Claims Act Overview*, Taxpayers Against Fraud Educ. Fund, http://www.taf.org/resource/fca/false-claims-act-overview (last visited Sept. 6, 2012).

fee deduction, however, encourages fraud by reducing the sting of the treble damages provision of the FCA.[135]

Further, denying the deduction would promote Congress's intent in passing § 162(f). The purpose of § 162(f) is to prevent tax deductions from frustrating government public policy. Section 162(f) represented an effort by Congress to codify the holding of the Supreme Court in *Tank Truck Rentals*,[136] in which the Court stated that "the test of nondeductibility always is the severity and immediacy of the frustration [of public policy] resulting from allowance of the deduction."[137] Congress wanted to ensure that violators of statutes could not deduct the fines that they paid and thereby avoid bearing the full brunt of the penalty. In *Tank Trunk Rentals*, the Court stated this explicitly, denying a deduction wherever allowing one would "frustrate [government] policy in severe and direct fashion by reducing the 'sting' of the penalty [provision]."[138] Relator fees fall squarely into the category of deductions that the Court—and Congress—intended to abolish.

B. The Relator Fee Deduction Gives Violators Economically Inefficient Incentives

The relator fee deduction is economically inefficient. Congress, by setting a treble level of damages for violations of the FCA, intended these punitive damages to achieve a certain level of deterrence.[139] Knowing the high level of sanctions, potential violators of the FCA would rationally conclude that the expected cost of their considered actions outweighs the expected benefit. By allowing the deduction of relator fees, the IRS upsets the FCA damages scheme carefully implemented by Congress, and lessens the deterrent effect of the treble damages provision.[140]

Though a deduction for relator fees necessarily leads to a decrease in deterrence, this alone does not imply that the deduction is

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135 *See infra* Part III.B (discussing how the relator fee deduction leads to an economically inefficient result by lessening the deterrent effect of the treble damages provision).

136 *See supra* notes 14–15 and accompanying text (citing legislative history linking the Supreme Court's ruling and § 162(f)).

137 Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35 (1958).

138 *Id*. at 36.

139 *See* 1986 Senate Report, *supra* note 20, at 4 (noting that the FCA is a "powerful tool in deterring fraud" and that the "amendments . . . are aimed . . . to make the False Claims Act a more effective weapon against Government fraud").

140 Of course, if Congress expressly permitted the deduction of relator fees in the tax code, it would indicate that the legislature had considered the deterrent effect and had decided that its policy objectives could be achieved with a lower level of deterrence. However, as discussed in Part II.B, *supra*, the IRS's ruling on this issue likely does not reflect the intent of Congress.

economically inefficient or socially harmful.[141] It only indicates that the deduction may frustrate congressional intent with respect to the level of FCA damages. This is an important policy concern as well, but it differs from the question of whether the deduction is socially harmful or not. Congress may deliberately set the level of damages at an inefficient level. Additionally, even if Congress does have efficiency in mind, the level set may not be the correct one. Putting aside Congress's goals,[142] the social cost of the relator fee deduction, namely, higher levels of fraud perpetrated on the government, provides a separate reason for the IRS to reverse its position.[143]

The basic law and economics model of punitive damages focuses on an idea known as the multiplier principle.[144] The multiplier principle begins with the premise that not every violator of a given law will be caught; no system of enforcement is perfect. As a result, in order to give potential violators the appropriate incentive to abstain from criminal activity, the potential sanction that they face needs to be increased by an amount, known as the punitive multiplier, above the actual amount of the injury or damage that they cause.[145] This concept is rather intuitive, and can be presented with a simple example in the FCA context.

Imagine that a company is considering perpetrating a fraud on the government that will impose costs to the government of $1 million. If the government had perfect law enforcement, the company's fraud would be exposed with certainty, and compensatory damages of $1 million would be sufficient to compensate the government for its losses. No punitive damages would be necessary, and we would say that the punitive damages multiplier is zero. If, however, the probability of detection were lower, for instance, fifty percent, then imposing only compensatory damages on the perpetrator would lead

141 *But see* Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325 (2002) (arguing that we should infer from statutes what conduct the legislature deems socially beneficial). In his view, "if Congress enacts a tax credit for backflips, Congress has determined that backflips are socially desirable. If a taxpayer learns to do backflips and earns the credit, it is doing nothing wrong. On the contrary, in the view of Congress, the taxpayer adds to the overall social welfare." *Id.* at 385.

142 For a discussion of these goals, see *supra* Part III.A.

143 An economic model of deterrence was first proposed by Gary S. Becker in his groundbreaking paper, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

144 A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 889 (1998) (presenting the equation for the optimal punitive damages multiplier).

145 *Id*. at 873–74 (explaining that damages need to exceed compensatory damages when violators are caught so that, "on average, they will pay for the harm that they cause").

to underdeterrence. The potential criminal would reason as follows: If caught, I face a penalty of $1 million, and if I get away, I keep the $1 million. His expected payoff is (.5)($1,000,000 – $1,000,000) + (.5)($1,000,000) = $500,000. In this scenario, the criminal will have not only an economic incentive to carry out the crime, but in fact an incentive to spend significant sums of money to perpetrate the fraud and to cover it up.[146]

To properly deter the potential violator in light of its imperfect law enforcement capabilities, the government must increase the sanction for violators who get caught. In the above example, to remove the expected gain, the punitive damages should be exactly equal to the compensatory damages, a multiplier of one. The total damages would then be $1 million compensatory and $1 million punitive in the scenario where the violator is caught. Calculating the expected cost, then, the expected payoff to the criminal is (.5)($1,000,000 – $2,000,000) + (.5)($1,000,000) = $0. The potential violator no longer has an expected gain from the crime, and therefore would have a diminished incentive to try to commit it.[147]

However, reducing the expected gain to zero will deter only criminals who are risk-neutral or risk-averse.[148] Criminals who are risk-loving may very well decide that they want to take their chances, no differently from people who bet on stocks and other kinds of investments. To deter risk-loving criminals, the punitive sanction needs to correspond to a *higher* multiplier.[149] The efficient level of sanctions would make the criminal worse off if he committed the crime, rather than leaving him indifferent.[150]

Although a higher multiplier more effectively deters crime, setting punitive damages too high can be problematic. In addition to

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146 These costs, which serve no valuable social function and are purely wasteful, are known in law and economics literature as "transfer costs." *See* Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, CORNELL L. REV. (forthcoming 2013) (manuscript at 10), *available at* http://ssrn.com/abstract=1990430.

147 *See* Polinsky & Shavell, *supra* note 144, at 889 (stating a general formula for a standard tort case: "[T]he total damages imposed on an injurer should equal the harm multiplied by the reciprocal of the probability that the injurer will be found liable when he ought to be"); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 206 (7th ed. 2007) (discussing the level at which a sanction needs to be set to achieve deterrence goals).

148 Risk-averse individuals prefer to avoid an activity with an expected payoff of zero even though there is a possibility of a high payoff in the event that the individual is not caught, because of the chance of a negative payoff if the individual is caught.

149 *See, e.g.*, Becker, *supra* note 143, at 180 (pointing out that the higher expected punishments are set above expected gain, the greater the level of deterrence achieved).

150 This induces would-be criminals to make the economically rational choice and deters them from committing the crime. POSNER, *supra* note 147, at 220 ("[T]he criminal sanction ought to be calibrated to make the criminal worse off by committing the crime.").

potential constitutional issues,[151] a social cost accompanies the benefit of greater deterrence. If the sanction is set too high, legal and proper claims from the government, as well as legitimate contracting with the government, will be deterred. Companies will fear that their legitimate claims will be mistakenly classified as fraudulent, and will be overly hesitant when billing the government for items that are legitimate but perhaps lie close to the line.[152] Additionally, because all companies would face these higher potential costs of liability in the event that they were mistakenly found liable for fraud, all government contractors as a group would demand higher prices for contracting with the government, increasing the cost to the government of doing business generally. These costs of high sanctions, which lead to the deterrence of socially beneficial activity, are known in law and economics literature as "chilling effects."[153]

A determination of the efficient level of punitive damages, then, needs to account for the following factors: (1) the benefit of deterrence achieved, weighed against (2) the cost to the government of enforcement, (3) the cost the criminal incurs in avoiding detection, and (4) the chilling effects on socially beneficial activities.[154] Also, the probability of apprehension must be calculable for any given level of enforcement.

Although it is difficult to determine the exact level of sanction that maximizes social utility, an understanding of these elements of the model makes it possible to estimate whether a particular increase or decrease in sanctions will lead to a net benefit. One can estimate the benefit of deterrence by looking at the level of fraud that is currently taking place. The cost to the government is not a concern here, since a disallowance of the relator fee deduction is essentially costless to the government.[155] At the same time, the avoidance costs facing

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151 State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 416–18 (2003) (discussing due process concerns raised by excessively high punitive damages). *See also infra* note 181 (discussing potential constitutional issues with excessive punitive damages in the jury trial context).

152 Posner offers the following extreme example. If the government punished a speeding violation with death, people would drive much slower than the 55 mph speed limit to avoid coming close to a violation. Some people would choose not to drive at all to avoid the possibility that a cop might mistakenly pull them over and erroneously charge them with a violation. POSNER, *supra* note 147, at 221.

153 *See, e.g.*, Louis Kaplow, *An Economic Approach to Price Fixing*, 77 ANTITRUST L.J. 343, 366–70 (2011) (using the term "chilling effects" to describe the chilling of desirable behavior due to price fixing regulations).

154 *See* Raskolnikov, *supra* note 146, at 13–18 (applying this approach to deterrence of churning, a type of illegal trading by securities brokers).

155 For a discussion of the possible costs of a nondeductibility policy, see *infra* Part III.D.

potential violators and chilling effects are a real concern. However, if it can be demonstrated that the FCA's current liability scheme is far below the efficient level of deterrence, these secondary effects would be outweighed.

Applying the multiplier principle to the treble damages provision of the 1986 amendments to the FCA, the multiplier is two, which corresponds to a probability of detection of 33%.[156] This assumes that no part of the punitive damages portion of the liability amount is deductible.[157] A deductible relator fee of 25% of the total damage amount, which is relatively common, lowers the multiplier by 8.75%.[158] The result is a smaller penalty borne by the violator and a lower level of deterrence.

The fraud statistics compiled by the Department of Justice (DOJ) indicate that the actual enforcement rate is much lower than the efficient level, even before relator fee deductions are considered. In 2008 alone, the Government Accountability Office estimated that losses to the federal government from fraud were more than $72 billion.[159] In contrast, the total amount of money paid to the government to settle all FCA claims from 1987 to date is only $34 billion.[160] In other words, the government lost approximately two times more money through fraud in a *single year* than it collected via FCA settlements over a *twenty-year span*. One specialist in health care fraud estimates that within the Medicare program alone, as high as fourteen percent of all claims are fraudulent,[161] an amount exceeding $100 billion *per year*.[162]

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156 If x is the amount of money stolen and p is the probability of detection, the expected payoff under a treble damages statute is $x(1 - p) + p(x - 3x)$. Setting the expected payoff equal to 0, we have $x - px + px - 3px = 0$. This reduces to $1 - 3p = 0$, or $p = 1/3$.

157 The compensatory damages portion of the liability is deductible, as it does not fall under § 162(f). However, assuming that the violator paid tax originally on the money received from the government through the fraud, this amount cancels out.

158 $(0.25)(0.35) = 0.0875$. The total damages need to be decreased by the tax savings to determine the correct multiplier. Assuming compensatory damages of x, total damages would be $3x$. The tax savings from the relator fee deduction is $(3x)(0.35)(0.25) = 0.2625x$. The economic burden of the damage award to the violator would be $x(3 - 0.2625) = 2.7375x$. This corresponds to a probability of detection of .365.

159 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-628T, IMPROPER PAYMENTS: PROGRESS MADE BUT CHALLENGES REMAIN IN ESTIMATING AND REDUCING IMPROPER PAYMENTS 2 (2009).

160 DOJ FRAUD STATISTICS, *supra* note 24, at 2.

161 *Criminal Prosecution as a Deterrent to Health Care Fraud: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 66 (2009) (statement of Malcolm K. Sparrow, Professor, Harvard University) ("[E]stimates of fraud losses in the health industry range from 3% to 10% to 14%, depending on who you ask.").

162 *Id*. at 64 ("The units of measure for losses due to health care fraud and abuse in this country are *hundreds of billions* of dollars per year." (emphasis added)). Sparrow further testified that the Government Accountability Office numbers were a gross underestimate of the actual fraud amounts, because the government, by its own admission, failed to take

Clearly, both the government and society would benefit from the deterrence boost that would be provided by denying the relator fee deduction.

The law and economics model of the damages multiplier makes a number of assumptions that might lead one to question the above analysis. First, the model assumes that the probability of detection is constant for all potential criminals, and varies only with the level of enforcement and not based on evasion tactics by the criminal. In reality, this is not the case; the probability of detection may be higher or lower for different criminals depending on their skill at evading law enforcement officials. Additionally, the model assumes that both the enforcement officials and the potential criminals have accurate knowledge of the probability of detection. In many, if not most, instances, this information is unavailable or unknown. And even in situations where it is available, behavioral law and economics scholars, superimposing human psychology on the more traditional models, note that criminals tend to overestimate their ability to evade detection. This phenomenon, known as "optimism" in the literature, causes criminals to underestimate the real probability of detection.[163]

Although to be completely precise a model must incorporate both of these issues—the individual probability of detection and optimism—an exact model is unnecessary to draw the conclusions reached above. In the FCA context, a strong inference can be drawn even in the absence of empirical data on these two effects.[164] This is because evasion tactics lower the probability of detection and optimism lowers the perceived probability of detection, necessitating an *increase* in the multiplier to induce higher levels of deterrence. The relator fee deduction, however, *lowers* the damages multiplier, and consequently leads to higher levels of fraud. The basic model, as applied to the FCA, implies the presence of underdeterrence. These additional considerations imply a greater degree of underdeterrence. And the relator fee

into account some of the most egregious types of fraud, including kickbacks and false claims for services not provided. *Id*. at 68. It is impossible to calculate the exact level of enforcement for the numbers we have from the DOJ; it is possible, though unlikely, that all $72 billion the government lost in 2008 will eventually be recovered. But given the historical recoveries, it appears that only a small percentage of the money lost through fraud will actually be recovered. DOJ FRAUD STATISTICS, *supra* note 24, at 2.

163 Richard H. McAdams & Thomas S. Ulen, *Behavioral Criminal Law and Economics* 7–18 (Univ. of Chi. Law Sch. Inst. for Law & Econ., Working Paper No. 440, 2008), *available at* http://ssrn.com/abstract=1299963 (discussing the concept of optimism).

164 We would benefit from a full empirical analysis. However, even in the absence of this data, the information that we have about the FCA is sufficient to formulate a policy recommendation.

deduction leads the law even further astray from the socially optimal result.

It should be noted that the FCA's statutory penalty of $5000 to $10,000 per false claim also affects the probability calculation, and increases the multiplier. This effect can be significant, especially in the health care context, because large health care corporations routinely submit thousands of claims to the government.[165] However, despite the possibility that courts can impose damages significantly in excess of the treble damages ratio, they tend not to do so.[166] Given the staggering amount of fraud that continues unchecked, the data indicates a serious problem of underdeterrence in the current system.

Therefore, despite imperfect data, we can conclude that there is a strong likelihood of underdeterrence of fraud by government contractors in the current system. Because the relator fee deduction further lowers the multiplier and the level of deterrence, the IRS's current position makes a bad problem worse. As such, the IRS should reverse its position and deny the relator fee deduction, thereby increasing both the damage multiplier and deterrence of this costly crime.

C. The Relator Fee Deduction Shifts an Expense from Violators to Taxpayers

Not only is the relator fee deduction economically inefficient, it is also unfair. Tax deductions have an economic effect equivalent to direct government spending, and are sometimes referred to as tax expenditures.[167] The government, by collecting less tax revenue than it would in the absence of the deduction, essentially subsidizes the deductible activity in an amount equal to the taxpayer's marginal tax rate.[168] The major corporations involved in the huge FCA settlements

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165 *See* Bucy, *supra* note 44, at 58–59 (noting that plaintiff relator awards can be extremely large in health care FCA cases even if fraud per claim is small because of the statutory penalty).

166 Imposing damages significantly higher than the treble damages ratio runs into potential constitutional problems, namely, double jeopardy and excessive fines under the Eighth Amendment's ban against cruel and unusual punishment. *See, e.g.*, BRIAN C. ELMER & ANDY LIU, FCA DAMAGES AND PENALTIES: RECENT DEVELOPMENTS AND RECURRING THEMES (2005), *available at* http://www.crowell.com/documents/FCA-Damages-and-Penalties-Recent-Developments-and-Recurring-Themes.pdf (detailing ways in which courts have lowered FCA damage awards to avoid constitutional problems).

167 *See* Lily L. Batchelder, *Tax Expenditures: What Are They and How Are They Structured?*, *in* URBAN-BROOKINGS TAX POLICY CTR., TAX POLICY BRIEFING BOOK: A CITIZENS' GUIDE FOR THE 2008 ELECTION AND BEYOND at I-8-1 (2008), *available at* http://www.taxpolicycenter.org/upload/Background/I-8TaxExpenditures.final.pdf ("Tax expenditures are revenue losses attributable to tax provisions that often result from the use of the tax system to promote social goals without incurring direct expenditures.").

168 *See, e.g.*, Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?*, 47 ALA. L. REV. 825,

of the last decade are big-name companies.[169] When these corporations are allowed to deduct relator fees, the American taxpayer effectively bears the burden of paying thirty-five percent of the fee.

Thus, subsidizing the fee paid to a relator both lowers the cost of the crime to potential criminals and removes this burden from the criminal, placing it on the shoulders of all American taxpayers. From the perspective of equity, it is wholly inappropriate that relator fees should be paid for in significant part by the American public.[170]

This argument, incidentally, implicates the unsettled debate as to where the incidence of the corporate tax actually lies.[171] To the extent the FCA violator can pass its tax burden off onto its customers or workers, it does not bear the burden of the damages penalty itself, even though it pays the tax nominally. However, the fact that corporations spend millions of dollars on tax lawyers to devise tax avoidance schemes demonstrates that a certain portion of the incidence falls on the corporation's shareholders.[172] To the extent the incidence does fall on the corporation's owners, they should bear the full burden of the relator fee, rather than pass a chunk of it onto the American taxpayer.

D. Grossing Up Awards Would Not Effectively Address the Problem

One might think that the poor incentives provided by the relator fee deduction could be corrected by applying a solution originally

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825 (1996) ("Spending is spending, whether it be through a government appropriation or through a deduction granted in the tax code."). Charitable deductions under § 170 of the I.R.C. are an excellent example. Suppose a taxpayer is in the thirty-five percent marginal tax bracket and contributes $1000 to a § 501(c)(3) charity and is within the limits of § 170. Without the deduction, the taxpayer would owe $350 in tax on the $1000, netting him $650. As a result of the deduction, however, he can donate the $1000 to charity and pay no tax. Essentially, then, the $1000 donation costs the taxpayer only $650 and can be viewed as a government subsidy, with other taxpayers contributing $350 to the charity.

169 *Top 100 FCA Cases*, Taxpayers Against Fraud Educ. Fund, http://www.taf.org/general-resources/top-100-fca-cases (last visited Sept. 6, 2012) (listing, among other companies, Pfizer, Merck, GlaxoSmithKline, Eli Lilly, and Bristol-Myers Squibb).

170 For the application of this same argument to punitive damages in the tort context, see Pace, *supra* note 168, at 851–52.

171 *See, e.g.*, Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Research, Working Paper No. 11,686, 2005), *available at* http://www.nber.org/papers/w11686.pdf (concluding that shareholders bear a significant portion of the corporate income tax); John Whalley, *The Incidence of the Corporate Tax Revisited* (Dep't of Fin. Can. Technical Comm. on Bus. Taxation, Working Paper No. 97-7, 1997) (presenting multiple views on the issue of corporate tax incidence). The seminal paper in this field is Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215, 236 (1962), in which Harberger concludes that, under certain assumptions, capital, and not labor, "probably bears close to the full burden of the tax."

172 *See* Auerbach, *supra* note 171, at 40 (concluding that, "[f]or a variety of reasons, shareholders may bear a certain portion of the corporate tax burden").

proposed by Gregg Markel and Dan Polsky to a slightly different tax problem. The problem Markel and Polsky addressed was that juries charged with awarding punitive damages are unable to determine the appropriate level of damages. This is because of a procedural rule that prevents juries from being told what portions of the award will be tax deductible to the violator.[173] As a consequence of this rule, juries are unable to calculate the portion of the penalty that will be borne ultimately by the defendant, and cannot set damages at an optimal level.[174] Markel and Polsky argue that one solution is to inform juries of the tax implications of damage awards.[175] Juries can then gross up the size of the award so that the after-tax size of the penalty is set at the appropriate level. This is better, in their view, than a federal tax law solution implementing a nondeductibility policy for punitive damages, because the latter could be easily evaded by defendants through strategic use of settlements.[176] By allocating a larger portion of the settlement to compensatory damages than the jury would have if the case had gone to trial, defendants can sidestep the nondeductibility provision.[177]

In a standard punitive damages context, such as intentional torts, in which a plaintiff suffers harm and sues the injurer, Markel's and Polsky's position carries the most weight. When an alleged tortfeasor settles with a plaintiff, the settlements do not allocate the amount between compensatory and punitive damages.[178] Injurers would take this into consideration when negotiating settlements and would opt for them more often to take advantage of this ambiguity. The result would be a larger compensatory allocation, evasion of the nondeductibility policy, and underdeterrence.

However, this argument does not apply to FCA relator fees. Unlike the intentional torts context in which ambiguous settlements confer a deduction benefit on the violator, an FCA relator fee cannot be deducted, even under current IRS guidelines, unless the amount of

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173 Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 VA. L. REV. 1295, 1306 (2010) ("[A]s a matter of practice, it appears that punitive damages jurors are currently not tax aware.").

174 *Id*. at 1308 ("The problem . . . is that a jury cannot decide the amount of a proper punitive damages award without also knowing how much of the award the defendant will actually have to pay.").

175 *Id*. at 1299–1301 (advocating for an approach that would educate juries to be "tax aware").

176 *Id.* at 1330–31 ("In practice, it will be quite difficult for the IRS to enforce a rule of nondeductibility in cases that settle before a jury verdict is reached.").

177 *Id*. at 1330–36 (offering a hypothetical illustrating the mathematics behind this conclusion).

178 *Id*. at 1331 (indicating that it "might appear" that the entire settlement amount equal to the expected value of the jury award would be compensatory and therefore deductible).

the fee is specifically stated in the settlement agreement.[179] If the IRS changes its position and denies a deduction for relator fees, violators will not be able to use settlement language to their strategic advantage. Whether or not the relator fee is mentioned explicitly in the agreement (as is often done today to ensure that the relator fee can be deducted),[180] the violator will not be able to deduct the relator fee portion of the award.[181]

Additionally, because this is a tax problem, it makes little sense to suggest that the DOJ (or a jury), and not the IRS, should attempt to solve it. Especially since the practical considerations noted by Markel and Polsky do not apply to FCA settlements, the best approach would be for the IRS (or Congress) to clearly state a regulatory (or statutory) policy denying the relator fee deduction. The DOJ should handle enforcement, and the IRS should establish the appropriate tax policy. While the grossing up of settlement amounts and jury awards could serve as a stop-gap solution, the better long-term solution would be for the IRS to establish an efficient deduction policy.

Conclusion

To the average individual, it may sound unjust and inappropriate that big corporate violators of fraud statutes can deduct portions of punitive damages penalties no differently from everyday business expenses. To the tax scholar, though, the question is significantly more complicated. It involves an assessment of the goals of our tax system, the alternative solutions available to redress an incentive problem, and a complex web of statutory provisions, Treasury regulations, court cases, and IRS guidance memoranda.

This Note has examined the relator fee deduction from a doctrinal as well as a policy perspective. The doctrinal analysis, as shown above, is complicated, involving conflicting Supreme Court decisions on the FCA. At the root of the problem, the IRS—not the courts or

179 *See* TAM, *supra* note 7, at 15 (disallowing a relator fee deduction because the settlement agreement did not allocate any portion of the amount to a relator fee).

180 Because not all settlement agreements are publicly available (though most can be obtained through a FOIA request), we have no way of knowing if every settlement is structured the same way. However, the representative settlement discussed in the GLAM was structured this way. *See supra* note 104 and accompanying text (describing allocation of the settlement).

181 A separate problem with the Markel and Polsky solution is that, in the event of a jury trial, the grossing up of a damages award could run into a constitutional excessive fines problem. *See* State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 429 (2003) (holding that the Due Process Clause of the Fourteenth Amendment was violated by a punitive damages award with an excessively high damages multiplier). *But see* Polsky & Markel, *supra* note 173, at 1322 (arguing that the Court's reasoning in *State Farm* would not apply to the grossing up of jury awards).

Congress—was placed in the position to decide whether *Chandler* or *Stevens* should control. The IRS, in an uncharacteristic fashion,[182] provided a lengthy evaluation of the *Chandler* opinion, weighing in on complicated non-tax issues such as whether aspects of the case are holding or dictum.[183] Although the Tax Court has indicated that the IRS should look to judicial interpretations of statutes to determine the nature of a fine or penalty, in the face of conflicting rulings, as here, the IRS should avoid wading into unfamiliar territory and focus instead on its expertise, tax policy, which should dictate the result. If it had, the answer would have been clear: In the policy realm, the economics, equity, and congressional intent underlying the FCA all point to disallowance of the relator fee deduction.

The government has taken large strides in the last few years to strengthen the FCA and to put an end to the rampant fraud perpetrated by government contractors. Congress has enacted new FCA amendments to crack down on violators, and the DOJ has expended considerable resources on FCA enforcement. It is time for the IRS to do its part to ensure that FCA violators cannot pass along portions of the relator fees to the public fisc.

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182 Other GLAMs discussing deductibility questions focus much more heavily on the tax law and include very little analysis of non-tax opinions. *See, e.g.*, I.R.S. Gen. Leg. Adv. Mem. AM2010-007 (Dec. 13, 2010), *available at* http://www.irs.gov/pub/irs-utl/am2010007.pdf (presenting six pages of tax analysis on the deduction for energy efficient commercial buildings); I.R.S. Gen. Leg. Adv. Mem. AM2009-006 (June 6, 2009), *available at* http://www.irs.gov/pub/irs-utl/am2009006.pdf (discussing the deductibility of backdated stock options); I.R.S. Gen. Leg. Adv. Mem. AM2007-0010 (June 30, 2006), *available at* http://www.irs.gov/pub/irs-utl/am2007010.pdf (discussing the deductibility of administrative expenses of a bankruptcy estate).

183 GLAM, *supra* note 6, at 8 (referring to the discussion of relator fees in *Chandler* and concluding that, "[a]lthough it has been suggested that the above language from *Chandler* is *obiter dictum*, we disagree").