

2004

A Partnership with the Government?: How the Inclusion of Attorney Contingency Fees in a Plaintiff's Gross Income Negatively Impacts *Qui Tam* Litigation

Edward T. Ackerman

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/blr>

Recommended Citation

Edward T. Ackerman, *A Partnership with the Government?: How the Inclusion of Attorney Contingency Fees in a Plaintiff's Gross Income Negatively Impacts Qui Tam Litigation*, 70 Brook. L. Rev. (2004).

Available at: <https://brooklynworks.brooklaw.edu/blr/vol70/iss1/8>

This Note is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Law Review by an authorized editor of BrooklynWorks.

NOTES

A Partnership with the Government?

HOW THE INCLUSION OF ATTORNEY CONTINGENCY FEES IN A PLAINTIFF'S GROSS INCOME NEGATIVELY IMPACTS *QUI TAM* LITIGATION*

I. INTRODUCTION

Currently, the federal circuit courts are split as to whether the portion of a plaintiff's damages award paid as attorney contingency fees can be excluded from the plaintiff's gross income.¹ This restriction on the exclusion of attorney contingency fees is of particular importance because while attorney contingency fees are technically tax deductible as "miscellaneous itemized deductions,"² in practice, plaintiffs rarely can deduct them.³ Thus, in circuits where contingency

* © 2004 Edward T. Ackerman. All Rights Reserved.

¹ The Fifth, Sixth, and Eleventh Circuits have held that attorney contingency fees do not constitute gross income, while the Second, Fourth, Seventh, Ninth, and Federal Circuits have held that they do. *See Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Barlow-Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

² 26 U.S.C. § 67(b) (2000).

³ Since attorney's fees will generally constitute a sizable portion of a plaintiff's income, their deduction will trigger the alternative minimum tax (AMT),

fees are included in a successful plaintiff's gross income, the plaintiff will have to pay tax on both the portion of the damages he keeps and the portion paid to his attorney as fees. This results in the "double taxation" of attorney's fees: the monies are taxed once as income to the plaintiff, and then again as income to the attorney.

While this inclusion of contingency fees in the calculation of gross income and the resultant double taxation undoubtedly results in an irritated plaintiff, it also has much farther reaching implications. In the context of *qui tam*⁴ actions brought under the Civil False Claims Act (CFCA),⁵ this interpretation of the tax law has the effect of reducing the statutorily prescribed incentives for the prosecution of fraudulent acts perpetrated against the Government. This reduction in incentives results because the plaintiff, or "relator," as he is termed in the CFCA *qui tam* context, has to pay income tax on both his recovery and any additional attorney's fees that are awarded against the defendant, and then has to pay a non-deductible contingency fee to his attorney.⁶ Ultimately, the relator only gets to keep approximately four to seven percent of the Government's judgment, despite being awarded upwards of twenty percent.⁷ As *qui tam* actions are greatly beneficial to both the Government and the public, yet pose considerable professional and personal risks to the relator,⁸ this reduced award seems patently unfair and contrary to Congress's stated intent.

which in turn will prohibit the deduction of "miscellaneous itemized deductions." 26 U.S.C. § 56(b)(1)(A)(i) (2000); 26 U.S.C. § 67(a) (2000).

⁴ The term "*qui tam*" derives from the Latin phrase "*qui tam pro domino rege quam pro si ipso in hac parte sequitur*," which means "Who as well for the king as for himself sues in this matter." BLACK'S LAW DICTIONARY 1262 (7th ed. 1999). A *qui tam* action allows a private citizen to sue on behalf of the Government for damages incurred by the Government. See William E. Kovacic, *Pyrrhic Victories? Reexamining the Effectiveness of Antitrust Remedies in Restoring Competition and Detering Misconduct: Private Monitoring and Antitrust Enforcement: Paying Informants to Reveal Cartels*, 69 GEO. WASH. L. REV. 766 (2001).

⁵ 31 U.S.C. § 3729 (2000); 31 U.S.C. § 3730 (2000). The CFCA imposes liability on any person who knowingly presents or causes to be presented a false or fraudulent claim to the United States Government. Since its amendment in 1986, the CFCA has become a potentially powerful tool in combating frauds perpetrated against the Government. See Kovacic, *supra* note 4, at 766.

⁶ All or part of this fee may come from a court's award of attorney's fees against the defendant under 31 U.S.C. § 3730(d), depending on the terms of the contingency fee agreement.

⁷ See *infra* Part II.B. for tax analysis of a *qui tam* judgment.

⁸ See United States *ex rel.* Stillwell v. Hughes Helicopters Inc., 714 F. Supp. 1084, 1099 (C.D. Cal. 1989).

This Note argues that the current trend in the federal circuit courts to include attorney contingency fees in a successful plaintiff's gross income limits the full potential of the CFCA's *qui tam* provisions by substantially reducing the statutorily prescribed incentives for initiating these actions. Part II of this Note provides the background on this issue, including an analysis of how high damage awards will trigger the AMT and a discussion of the circuit split. Part III presents an overview of the CFCA and its *qui tam* provisions, including the reasons for their enactment. Part IV then examines how the inclusion of attorney's fees in the calculation of gross income reduces a relator's incentive to initiate *qui tam* actions. Finally, Part V considers possible solutions to this dilemma and suggests that a focused amendment to the Internal Revenue Code (Code), similar to the proposed Civil Rights Tax Relief Act,⁹ is the best solution to this problem.

II. BACKGROUND: THE INTERNAL REVENUE CODE AND COMMON LAW TAX PRINCIPLES

A. *The Calculation of Taxable Income*

The calculation of a person's taxable income can be distilled down to the basic equation of gross income minus deductions.¹⁰ Section 61 of the Code defines "gross income" as "all income from whatever source derived."¹¹ The Supreme Court has read the "sweeping terms" of section 61 to mean that the statute "should be broadly construed in accordance with an obvious purpose to tax income comprehensively."¹² Accordingly, the Supreme Court has concluded that Congress intended that all income be taxed except gains that are specifically exempted.¹³ As non-compensatory damages constitute income to a successful plaintiff within the meaning of the Code,¹⁴ attorney contingency fees must either be deducted or excluded from gross income in order for them not to be taxed.

⁹ Civil Rights Tax Relief Act of 2003, S. 557, 108th Cong. (2003).

¹⁰ 26 U.S.C. § 63(a) (2000).

¹¹ 26 U.S.C. § 61(a) (2000).

¹² *Comm'r v. Jacobson*, 336 U.S. 28, 49 (1949).

¹³ *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955) (citing *Jacobson*, 336 U.S. at 49; *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 87-91 (1934)).

¹⁴ *See id.* at 431 (holding that litigants must include the punitive damages portion of their awards in calculating their taxable income).

Deductions are calculated based on whether they are “above the line” deductions or “below the line” deductions.¹⁵ Above the line deductions, such as trade and business expenses, are one hundred percent tax deductible.¹⁶ This means that these expenses are subtracted dollar-for-dollar from a person’s gross income to determine their adjusted gross income.¹⁷ Below the line deductions, including “miscellaneous itemized deductions,” are not one hundred percent deductible; only a portion of below the line deductions may be used to offset one’s taxable income.¹⁸ Allowable below the line deductions, once calculated, are then deducted from adjusted gross income.¹⁹

Miscellaneous itemized deductions are allowed “only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.”²⁰ Therefore, if a taxpayer had \$100,000 of adjusted gross income, and \$5,000 of miscellaneous itemized deductions, only \$3,000 could be deducted from a taxpayer’s adjusted gross income as allowable miscellaneous itemized deductions.²¹ However, if the adjusted gross income exceeds \$142,700 (the statutory “applicable amount”), the amount of allowable itemized deductions is reduced by the lesser of “3 percent of the excess of adjusted gross income over the applicable amount, . . . or 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.”²² So, if a taxpayer had an adjusted gross income of \$200,000, and \$15,000 of miscellaneous itemized deductions, the deductions would be reduced by \$1,719, leaving \$9,281 in allowable miscellaneous itemized deductions.²³

¹⁵ DANIEL Q. POSIN, FEDERAL INCOME TAXATION 284 (1983).

¹⁶ *Id.*

¹⁷ See 26 U.S.C. § 62 (2000).

¹⁸ See 26 U.S.C. § 67(a) (2000).

¹⁹ See *id.*

²⁰ 26 U.S.C. § 67(a).

²¹ This is calculated by taking 2% of \$100,000 (\$2,000), and subtracting it from \$5,000.

²² 26 U.S.C. § 68 (2004).

²³ This is calculated by subtracting \$142,700 (the statutory applicable amount) from \$200,000 (the adjusted gross income), leaving \$57,300 in excess of the statutory applicable amount. Three percent of \$57,300 (\$1,719) is then subtracted from \$11,000 (allowable miscellaneous itemized deductions), leaving \$9,281. Because 80% of the miscellaneous itemized deductions (\$8,800) exceeds \$1,719, it is not taken into consideration in this example. See 26 U.S.C. § 68 (2004).

B. Limitations on the Deduction of Attorney Contingency Fees: The Alternative Minimum Tax

As attorney contingency fees are not considered to be trade or business expenses, they are included in the catchall category of miscellaneous itemized deductions and are theoretically deductible as such.²⁴ However, when plaintiffs win large awards that are dramatically higher than their normal yearly income, the deduction of a sizable attorney's fee will trigger the AMT and render the fees non-deductible.²⁵ The AMT is statutorily defined as "the tentative minimum tax for the taxable year, over the regular tax for the taxable year."²⁶ In substance, this formula means that a taxpayer must either pay the regular tax or the tentative minimum tax, whichever is greater.²⁷

The effect of the AMT is best illustrated by example. Suppose Mister Tax Payer wins a \$1 million award in a lawsuit and has no other income for the year. For purposes of this example, assume that this award consists wholly of punitive damages, as awards for compensatory damages can be excluded from gross income.²⁸ Payer's attorneys are then paid \$500,000 from the award for their contingency fee, leaving Payer with \$500,000. Suppose further that Payer also had no above the line expenses, making his adjusted gross income for the year \$1 million. If Payer were to deduct the \$500,000 in fees as a miscellaneous itemized deduction, his total taxable income would be \$545,719.²⁹ According to the current rates, the total regular tax liability on this amount would be \$192,633.24.³⁰ Thus, after his attorney's fees and his taxes have been paid, Payer would be left with \$307,366.76 of his \$1 million award.

²⁴ 26 U.S.C. § 67(b) (2000). See *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995).

²⁵ 26 U.S.C. § 56(b)(1)(A)(i) (2000). See *Alexander*, 72 F.3d at 946.

²⁶ 26 U.S.C.A. § 55(a) (2004).

²⁷ See J. MARIN BURKE & MICHAEL K. FRIEL, UNDERSTANDING FEDERAL INCOME TAXATION 670 (2001).

²⁸ 26 U.S.C. § 104(a)(2) (2000).

²⁹ This is calculated by subtracting \$142,700 (the statutory "applicable amount) from \$1,000,000 (the adjusted gross income), leaving \$857,300 in excess of the statutory applicable amount. Three percent of \$857,300 (\$25,719) is then subtracted from \$480,000 (allowable miscellaneous itemized deductions), leaving \$454,281 in total allowable deductions. See 26 U.S.C. § 68.

³⁰ The tax on \$545,719 is calculated as follows: \$75,528.50 + 39.6% of adjusted gross income in excess of \$250,000 (((\$545,719 - \$250,000) x .396 = \$117,104.72 + \$75,528.50 = \$192,633.24). See 26 U.S.C.A. § 1 (2004).

However, because the attorney's fees are extremely high in comparison to Payer's adjusted gross income, resulting in miscellaneous itemized deductions that would amount to nearly one-half of the adjusted gross income, the AMT would be triggered. Under section 56(b)(1)(A)(i) of the Code, miscellaneous itemized deductions are excluded from the calculation of alternative minimum taxable income (AMTI);³¹ thus, the entire \$1 million would be included as Payer's taxable income if the AMT is triggered. As Payer's tentative minimum tax liability on this amount would be \$276,500,³² \$83,866.76 more than his calculated regular tax, he would have to pay the alternative minimum tax amount.³³ After subtracting taxes and his attorney's fees, he would only be left with \$223,500, less than one fourth of his \$1 million award.³⁴

At this point, it is apparent that including attorney contingency fees in the gross income of a successful plaintiff will almost necessarily result in the plaintiff having to pay a substantial tax on them. Consequently, the only way to avoid this harsh result would be for the plaintiff to exclude the contingency fees from his gross income.³⁵

C. *Circuit Split: To Include or Not to Include?*

The federal circuit courts are presently split on the issue of whether attorney contingency fees can be excluded from a plaintiff's gross income. The majority of circuits, reasoning that attorney contingency fees constitute income to a successful plaintiff, hold that such fees must be included in a plaintiff's gross income.³⁶ On the other hand, a minority of circuits hold that the portion of a plaintiff's award paid to the attorney is not income realized by the plaintiff and, therefore, need not be

³¹ The AMTI is a taxpayer's taxable income if the AMT is triggered.

³² The tentative minimum tax on \$1,000,000 is calculated as follows: 26% of \$175,000 = \$45,500. \$45,000 + (28% of \$825,000) = \$276,500. See 26 U.S.C.A. § 55(b)(1)(A)(i) (2004).

³³ 26 U.S.C.A. § 55(a) (2004).

³⁴ As the share of the award allotted for attorney's fees increases, these results become even more dramatic. In cases where attorneys take a very high percentage of the award for their contingency fees, such as 60% or 70%, it may in fact be that the plaintiff is left in the red, owing the government more than he retained from the recovery. See *Kenseth v. Comm'r*, 114 T.C. 399, 425–26 (2000) (Beghe, J., dissenting).

³⁵ See *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995).

³⁶ See Greg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements*, 37 GA. L. REV. 57, 59 (2002).

describe the approaches that both sides have taken in analyzing this issue.

1. The Minority Approach: The “Exclusion” Circuits

In 1959, the Fifth Circuit was the first circuit court to pass on the inclusion/exclusion issue.³⁸ In the watershed case of *Cotnam v. Commissioner*,³⁹ the Court of Appeals for the Fifth Circuit held that the portion of a judgment paid to an attorney pursuant to a contingency fee agreement was not income to the plaintiff.⁴⁰ The court reasoned that because Alabama attorney lien law gave the attorney vested property rights in the contingency fee portion of the judgment, a plaintiff could never have received and retained that portion of the judgment and, therefore, the plaintiff did not realize it as income.⁴¹

Judges Rives and Brown, in an addition to the majority opinion, dismissed the notion that the anticipatory assignment of income doctrine was at odds with the court’s holding.⁴² The anticipatory assignment of income doctrine, as set forth in *Lucas v. Earl*,⁴³ states that one cannot assign a right to future income to avoid taxation.⁴⁴ In other words, a person is taxable on all income earned regardless of who actually receives that income. Judges Rives and Brown wrote that at the time of executing the contingency fee agreement, the value of plaintiff’s claim was “doubtful and uncertain,” and that the only way the plaintiff could derive economic benefit from the claim was to use part of it as a means of collecting the remainder.⁴⁵ Based on this assumption, Judges Rives and Brown concluded that the plaintiff assigned forty percent of her cause of action to her attorney, not forty percent of future income derived from the claim.⁴⁶ Because the court determined that the agreement amounted to an assignment of the cause of

³⁸ *See id.*

³⁹ 263 F.2d 119 (5th Cir. 1959). The relevant facts of *Cotnam* are as follows: Plaintiff, Ethel Cotnam, recieved a judgment of \$120,000 on a contract debt. Ms. Cotnam’s attorney’s fees amounted to \$50,365.83, leaving her with \$69,634.17. The tax court held that the entire \$120,000 was taxable income to her. *Id.* at 120–21.

⁴⁰ *Id.*

⁴¹ *Id.* at 125.

⁴² *Id.*

⁴³ 281 U.S. 111 (1930).

⁴⁴ Ronald H. Jensen, *Schneer v. Commissioner: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 628 (1993).

⁴⁵ *Id.*

⁴⁶ *Id.*

action, it found that the anticipatory assignment of income doctrine did not operate as a bar to this arrangement.⁴⁷

Since the landmark *Cotnam* ruling, both the Sixth and Eleventh Circuits have followed suit and allowed the exclusion of attorney contingency fees from a plaintiff's gross income.⁴⁸ The Eleventh Circuit ruled with the Fifth Circuit solely because it found *Cotnam* to be on point and controlling,⁴⁹ and did not do any further analysis of the issue.⁵⁰ The Sixth Circuit, on the other hand, expanded on the *Cotnam* analysis, further distinguishing the contingency fee agreement from the anticipatory assignment of income doctrine.⁵¹ First, the court noted that unlike the anticipatory assignment of income cases, where the assignment was between family members for a right to income already earned, contingency fee arrangements were arms-length transactions entered into when no right to payment had yet been earned.⁵² It then concluded that contingency fee arrangements operated "more like a division of property than an assignment of income."⁵³ Accordingly, the court held that the portion of the judgment that was paid directly to the plaintiff's attorneys under the contingency fee arrangement was not income to the plaintiff.⁵⁴

2. The Majority Approach: The "Inclusion" Circuits

Beginning in 1995, some circuit courts began to rule that attorney contingency fees could not be excluded from a plaintiff's gross income.⁵⁵ The prevailing analysis that runs through these opinions focuses on the anticipatory assignment of income doctrine and concerns regarding the assignment of

⁴⁷ *Cotnam*, 263 F.2d at 125 (citing *Lucas v. Earl*, 281 U.S. 111 (1930)).

⁴⁸ See *Estate of Clarks v. United States*, 202 F.3d 854, 855 (6th Cir. 2000); *Barlow-Davis v. Comm'r*, 210 F.3d 1346, 1347 (11th Cir. 2000).

⁴⁹ "In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (*en banc*), this Court [the Eleventh Circuit Court of Appeals] adopted as binding precedent all of the decisions of the former Fifth Circuit handed down prior to the close of business on September 30, 1981." *Barlow-Davis*, 210 F.3d at 1347 n.2.

⁵⁰ See *id.* at 1347 n. 4.

⁵¹ See *Estate of Clarks*, 202 F.3d at 851-57.

⁵² *Id.* at 553. The court also noted that unlike in the anticipatory assignment of income cases, where only the assignor was to be taxed, in the contingency fee context, the attorney would also pay income tax on the fees. *Id.*

⁵³ *Id.* at 857-58.

⁵⁴ *Id.* at 858.

⁵⁵ See *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

future income.⁵⁶ However, unlike the Fifth and Sixth Circuits, the majority of circuits hold that the anticipatory assignment of income doctrine *is* applicable to the contingent fee arrangement, and therefore bars the exclusion of attorney contingency fees.⁵⁷

The United States Court of Appeals for the Federal Circuit was the first circuit court to reject *Cotnam's* holding,⁵⁸ and ushered in a new line of reasoning that the other "inclusion" circuits would soon follow.⁵⁹ In *Baylin v. United States*,⁶⁰ the court flatly rejected the plaintiff's argument that because the value of a claim had not been established when the contingency agreement was executed, there was no earned income to assign.⁶¹ The court reasoned that the contingency arrangement was simply a mechanism by which the attorney set the value of the attorney's services by tying the fees to the award and then having the fee obligation discharged directly by the defendant.⁶² The court further noted that this arrangement was simply a "skillfully devised" fee arrangement created to allow the plaintiff to escape paying tax on a portion of its income,⁶³ and was therefore, in substance, exactly what the Supreme Court was trying to eliminate by announcing the anticipatory assignment of income doctrine.⁶⁴

To date, the most articulate argument against excluding attorney's fees comes from Judge Posner's majority decision in *Kenseth v. Commissioner*.⁶⁵ Like the court in *Baylin*, the *Kenseth* court mainly relied on the anticipatory assignment of

⁵⁶ See *Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 376; *Coady*, 213 F.3d at 1191; *Baylin*, 43 F.3d at 1454.

⁵⁷ See *Raymond v. United States*, 355 F.3d 107, 108 (2d Cir. 2004); *Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 377; *Coady*, 213 F.3d at 1191; *Baylin*, 43 F.3d at 1455.

⁵⁸ *Baylin*, 43 F.3d at 1455. While the Federal Circuit came to the opposite conclusion as the Fifth Circuit, the *Baylin* decision never acknowledged the Fifth Circuit's differing opinion on the issue. *Id.*

⁵⁹ See *Kenseth*, 259 F.3d at 881; *Young*, 240 F.3d at 369; *Coady*, 213 F.3d at 1187 (9th Cir. 2000); *Alexander*, 72 F.3d at 938; *Baylin*, 43 F.3d at 1451.

⁶⁰ 43 F.3d 1451. *Baylin* involved a dispute between a partnership and the State Roads Commission of the Maryland State Highway Administration, which condemned certain road-side lands owned by the partnership. The partnership disputed the State's valuation of its property and challenged it in court. The partnership's attorney's fees were to be paid pursuant to a contingency fee agreement. After winning the case, the partnership deducted the legal fees as a business expense incurred in the collection of income. *Id.* at 1452-53.

⁶¹ See *id.* at 1454.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ See *Baylin*, 43 F.3d at 1454.

⁶⁵ *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001).

income doctrine to bar the exclusion of contingency fees from gross income.⁶⁶ Finding that the Wisconsin lien laws created no proprietary interest in the plaintiff's claim,⁶⁷ and thus implicitly distinguishing the statutes from those at play in *Cotnam*,⁶⁸ Judge Posner stated that the effect of excluding attorney fees was the same as assigning the judgment income to the law firm.⁶⁹ He also noted that "had [the plaintiff] paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income."⁷⁰ Finally, Posner dealt a "death-blow" to the "exclusion" line of cases when he wrote that the *Cotnam* rationale "badly flunks the test of neutral principles" and that "it is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income."⁷¹

This circuit split regarding whether an attorney's contingency fees should be included or excluded in the calculation of the plaintiff's gross income is the source of numerous problems. First, this conflict is horizontally inequitable in that it is contrary to the principle that Federal tax laws should be applied uniformly, independent of geographic distinctions.⁷² Second, the majority view, which requires inclusion, has the effect of imposing significant taxes on successful plaintiffs.⁷³ Finally, in the context of the CFCA, which is largely enforced through *qui tam* litigation, this tax penalty has the effect of stifling the anti-fraud purpose of the CFCA.⁷⁴ The following two sections explore more fully how this trend towards inclusion in the circuits negatively impacts the efficacy of the CFCA.⁷⁵

⁶⁶ See *id.* at 884.

⁶⁷ In fact, the court held that Wisconsin law *prohibited* an attorney from obtaining an ownership interest in a client's claim. See *id.*

⁶⁸ See *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (stating that Alabama attorney lien laws created a proprietary interest in the plaintiff's claim).

⁶⁹ See *Kenseth*, 259 F.3d at 884.

⁷⁰ *Id.* at 883.

⁷¹ See Memorandum, Tax Implications of FCA Damages Award or Settlement (citing *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001)) (on file with author).

⁷² See *Dilts v. United States*, 845 F. Supp. 1505, 1510 (D. Wyo. 1994).

⁷³ See analysis *supra* Part II.A-B.

⁷⁴ See analysis *infra* Part IV.B.

⁷⁵ This Note does not seek to resolve the inclusion/exclusion debate or analyze which side's argument is more legally sound. Rather, it acknowledges the apparent trend in the circuits to require inclusion of attorney's fees in the plaintiff's gross income and discusses the negative impact of inclusion on the CFCA. The proposed solution is limited to the issues which arise in the CFCA context, and does not purport to address the larger inclusion/exclusion issue.

III. THE CIVIL FALSE CLAIMS ACT: PROSECUTING FRAUD ON BEHALF OF THE GOVERNMENT

To provide a context for considering how the inclusion of attorney's fees in conjunction with the AMT operates to reduce incentives for prospective relators to initiate *qui tam* actions, subsection A describes the general purpose and relevant provisions of the CFCA. Subsection B then addresses the risks *qui tam* plaintiffs face in initiating a CFCA action.

A. Overview of the Civil False Claims Act

In 1986 Congress amended the CFCA, and in doing so, commenced the "bold experiment" of allowing private participation in the decidedly governmental arena of law enforcement.⁷⁶ These amendments sought to strengthen the *qui tam* provisions of the original statute by enhancing incentives for private individuals to bring actions for fraud on behalf of the federal government.⁷⁷ In effect, the *qui tam* provisions permit a private plaintiff, termed a "relator," to "step into the Government's shoes" and file a civil action for violations of the CFCA.⁷⁸ While there is no limit on the subject matter of CFCA cases, the most common scenarios involve government contractor fraud, healthcare industry fraud, defense industry fraud, and grant fraud.⁷⁹

Since the addition of the 1986 amendments, *qui tam* suits have been an important enforcement mechanism of the

⁷⁶ Kovacic, *supra* note 4, at 766.

⁷⁷ *Id.* at 766 (citing William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799, 1801-07 (1996) (discussing adoption of 1986 Civil False Claims Act Amendments)). The CFCA was originally enacted in 1863 as a remedy to the pervasive contractor fraud that occurred during the Civil War. In 1943, the statute was revised to narrow the relator's ability to bring a suit and receive a monetary reward. The statute was so severely constricted by the 1943 amendments that it became ineffective as a deterrent to contractor fraud. It was not until the statute was again amended in 1986 that its efficacy as a fraud prevention tool was revitalized. The 1986 amendments reduced the burden of proof on relators, expanded the pool of those who could be *qui tam* relators, and increased the financial incentives to bring a *qui tam* action. AMERICAN BAR ASSOCIATION SECTION OF PUBLIC CONTRACT LAW PROCUREMENT FRAUD COMMITTEE, *QUI TAM LITIGATION UNDER THE FALSE CLAIMS ACT 1-12* (Howard W. Cox & Peter B. Hutt II eds., 2d ed. 1999).

⁷⁸ See AMERICAN BAR ASSOCIATION SECTION OF PUBLIC CONTRACT LAW PROCUREMENT FRAUD COMMITTEE, *supra* note 77, at 1.

⁷⁹ ROBIN PAGE WEST, *ADVISING THE QUI TAM WHISTLEBLOWER 4* (2001). Grant fraud is the misuse of government grant funds or procurement of funds via false statements on the grant application. AMERICAN BAR ASSOCIATION SECTION OF PUBLIC CONTRACT LAW PROCUREMENT FRAUD COMMITTEE, *supra* note 77, at 1.

CFCA.⁸⁰ With the addition of the enhanced *qui tam* provisions, relators are now able to work in partnership with the Department of Justice (DOJ) to fight against fraudulent use of public funds. Some of the largest *qui tam* recoveries include a \$375 million settlement paid by National Medical Care for submitting false claims for laboratory testing⁸¹ and a \$1.4 billion settlement paid by Columbia HCA for Medicare fraud.⁸²

1. Liability Provisions of the Civil False Claims Act

The CFCA imposes civil liability on any person who knowingly presents false claims for payment to the Government; knowingly makes a false record or statement to get a false or fraudulent claim paid by the Government; conspires to defraud the Government by getting a false claim paid; or knowingly makes a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government.⁸³ The penalties for such violations are court assessments of up to \$11,000 per false claim filed,⁸⁴ whether or not there are actual damages, plus three times the amount of damages which the Government sustains as a result of the fraudulent acts.⁸⁵

2. Enforcement Provisions

The CFCA provides that either the Attorney General or a “private person” can bring an action in the name of the Government for a violation of the CFCA.⁸⁶ Courts have broadly construed the language of this statute to grant standing to a wide variety of relators, including: individual citizens; employees of institutions that receive government funds; and

⁸⁰ Press Release, United States Department of Justice, Justice Department Recovers Over \$3 Billion in Whistleblowers False Claims Act Awards and Settlements (Feb. 24, 2000), at <http://www.usdoj.gov/opa/pr/2000/February/079civ.htm> (last visited Oct. 4, 2004).

⁸¹ *Id.*

⁸² National Press Club, *The Top 100 False Claims Act Settlements* (Dec. 30, 2003), available at <http://www.corporatecrimereporter.com/fraudrep.pdf> (last visited Aug. 20, 2004).

⁸³ See 31 U.S.C. § 3729(a) (2000).

⁸⁴ 64 Fed. Reg. 47,099 (Aug. 30, 1999) (to be codified at 28 C.F.R. pt. 71) increased the statutory penalty from \$10,000 to \$11,000 for violations occurring after September 29, 1999.

⁸⁵ 31 U.S.C. § 3729(a) (2000).

⁸⁶ See 31 U.S.C. § 3730 (2000).

private companies,⁸⁷ so long as the relator is the “original source” of the information if the fraud has been publicly disclosed.⁸⁸ Thus, virtually any party privy to information regarding violations of the CFCA can bring an action for damages on behalf of the Government under the Act’s *qui tam* provisions.

3. Award to the *Qui Tam* Relator

The CFCA further provides that *qui tam* relators receive a portion of the Government’s award if the suit is successful. If the DOJ proceeds with an action brought by a person under a subsection of the CFCA, the relator is entitled to receive at least fifteen percent but not more than twenty-five percent of the proceeds of that action.⁸⁹ If the DOJ does not intervene, the relator’s share increases to twenty-five to thirty percent to compensate for the additional risk and effort of prosecuting the action alone.⁹⁰

The CFCA identifies several factors that affect the percentage of the Government’s award apportioned the relator.⁹¹ On the one hand, the percentage depends on the extent to which the relator contributed to the prosecution of the action. This includes timely reporting of the fraud, disclosure of his participation in the fraud, and other relevant facts. If the relator did not fully cooperate in discovery or at trial, the Government can be expected to argue that the relator should receive only a fifteen percent share of the judgment, the CFCA’s statutory minimum.⁹² On the other hand, if the relator cooperated fully in the Government’s investigation and provided assistance during discovery by making full disclosure

⁸⁷ See Kovacic, *supra* note 4, at 768.

⁸⁸ 31 U.S.C. § 3730(e)(4)(A) (2000). See also Raegan A. McClain, *The Government, the Legislature, and the Judiciary – Working Towards Remediating the Problems with the Civil False Claims Act: Where Do We Go From Here?*, 10 ANNALS HEALTH L. 191, 201 (2001). “Original source” is defined by the CFCA as “an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this section which is based on the information.” 31 U.S.C. § 3730(e)(4)(B) (2000).

⁸⁹ 31 U.S.C. § 3730(d)(1) (2000). In certain circumstances, where the court finds that the relator plays only a minimal role in the CFCA suit, the statutory percentage is reduced to no more than 10% of the Government’s award. See *id.*

⁹⁰ 31 U.S.C. § 3730(d)(2) (2000). See also JONATHAN A. WILLENS, NAT’L INST. FOR TRIAL ADVOCACY, COMMENTARY: 31 U.S. § 3730, at LEXIS, 31 US NITA 3730.

⁹¹ 31 U.S.C. § 3730(d)(1).

⁹² WILLENS, *supra* note 90.

of evidence, the court is more likely to find the statutory maximum of twenty-five percent appropriate.⁹³

4. Attorney's Fees Provision

In addition to the relator's share of the Government's recovery, the CFCA also includes a fee-shifting provision which provides that *qui tam* relators are entitled to reasonable expenses, plus reasonable attorney's fees and costs, all of which are to be awarded against the defendant.⁹⁴ Attorney's fees awarded under the CFCA's fee-shifting provision differ markedly from the typical contingency fee arrangement. In the typical contingency fee arrangement, a plaintiff enters into an agreement with his attorneys whereby the attorneys receive a certain or graduated percentage of the plaintiff's ultimate recovery.⁹⁵ However, this is not the case with CFCA awarded attorney's fees. Under the CFCA, attorney's fees are to be awarded in addition to a relator's statutory percentage.⁹⁶ Furthermore, the attorney's fees that the court awards are completely independent of the underlying fee arrangements between a relator and his counsel.⁹⁷ Thus, if a *qui tam* relator were to enter into a forty percent contingency fee arrangement with his attorneys and then was later awarded reasonable attorney's fees by the court, the pre-existing contractual arrangement between the relator and his counsel would not be affected by the statutory award.⁹⁸ Accordingly, the attorney would receive his hourly rate as calculated by the court during the attorney's fee hearing and, if provided for by the contingency fee arrangement, the attorney would also receive forty percent of the relator's statutory percentage pursuant to the contingency fee arrangement.⁹⁹

⁹³ *Id.*

⁹⁴ 31 U.S.C. § 3730.

⁹⁵ STEPHEN C. YEAZELL, CIVIL PROCEDURE 344 (5th ed. 2000).

⁹⁶ 31 U.S.C. § 3730(d)(1).

⁹⁷ See *City of Burlington v. Dague*, 505 U.S. 557, 566 (1992); *Blanchard v. Bergeron*, 489 U.S. 87, 95-96 (1989).

⁹⁸ See *Blanchard*, 489 U.S. at 96.

⁹⁹ The issue of whether the relator has to pay a percentage of her award pursuant to the contingency fee agreement in addition to the court awarded fees is determined solely by the terms of the contingency fee arrangement. However, it is common practice for the contingency fee agreement to be paid regardless of whether additional attorney's fees are awarded by the court.

5. Purpose of the *Qui Tam* Provisions of the CFCA

Given the mechanics of the CFCA's *qui tam* provisions, there are many objectives served by the 1986 enactment of these private enforcement provisions. At the most general level, the addition of enhanced *qui tam* provisions to the CFCA in 1986 sought to remedy the perceived problem that the Government fails to investigate and prosecute fraud as vigorously as taxpayers would like.¹⁰⁰ The *qui tam* provisions invigorate the prosecution of CFCA violations in a number of ways. First, the *qui tam* provisions, by allowing private individuals to bring enforcement suits, reduce the costs associated with oversight, investigation, and prosecution of acts of fraud perpetrated against the Government.¹⁰¹ Private individuals who are already situated within businesses that contract with the Government can identify fraud at a lower cost than public employees because they are already familiar with the contractors' activities and can more readily assess relevant information.¹⁰²

Second, because it is often difficult or impossible for the Government to gain access to the information required to identify acts of fraud, the *qui tam* provisions grant persons with direct and immediate access to such information the ability to enforce the CFCA in situations in which the Government could not.¹⁰³ Simply put, the DOJ's investigative tools are inadequate to gather the information required to mount a successful CFCA prosecution.¹⁰⁴ This is because the DOJ civil attorneys, who primarily rely on FBI reports and information gathered by various Inspectors General, have no authority to compel document production prior to filing a suit.¹⁰⁵ Consequently, prior to the enactment of the *qui tam* provisions, the DOJ allowed many potential violations to go unprosecuted because of inadequate information.¹⁰⁶ As the Senate Report for the CFCA acknowledged, "[d]etecting fraud is usually very difficult without the cooperation of individuals

¹⁰⁰ William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799, 1806 (1996).

¹⁰¹ See *id.* at 1825 (citing 132 Cong. Rec. H9382-03 (daily ed. Oct. 7, 1986)).

¹⁰² See *id.* at 1821-24.

¹⁰³ See *id.* at 1822.

¹⁰⁴ See S. REP. NO. 99-345, at 6 (1986), reprinted in 1986 U.S.C.C.A.N. 5266,

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

who are either close observers or otherwise involved in the fraudulent activity.¹⁰⁷ For example, while the Government would have to initiate a full investigation and audit to discover any misdoings, a defense plant manager who was personally instructed to inflate the number of employees and hours for the books could easily identify the fraud.¹⁰⁸

Third, allowing public enforcement of the CFCA counteracts the institutional incentives that contracting government agencies may have for not exposing and prosecuting incidents of fraud.¹⁰⁹ For example, a government agency may be hesitant to expose a fraud that it is aware of for fear that the resulting scandal would endanger future funding of its programs.¹¹⁰ Moreover, government employees, under pressure from Congressmen or other government officials, might refrain from aggressively investigating certain contracts to protect specific programs.¹¹¹ Consequently, a significant number of frauds would presumably go unprosecuted were the DOJ to rely solely on contracting agencies to disclose fraud.¹¹² By empowering relators to sue on the Government's behalf, the *qui tam* provisions increase the flow of information about fraud to the DOJ, and reduce the possibility that reported frauds will go unprosecuted because of pressure on government employees.¹¹³

Thus, the *qui tam* provisions of the CFCA do not merely add an additional, private vehicle for the prosecution of frauds which violate the CFCA; in many cases, they supply the only vehicle. In these instances, the *qui tam* mechanism constitutes the final line of defense for the Government and for taxpayers. Without these provisions, a multitude of frauds, the losses from which would ultimately be borne by taxpayers, would continue undeterred.

¹⁰⁷ *Id.* at 4.

¹⁰⁸ See Kovacic, *supra* note 100, at 1822.

¹⁰⁹ *Id.* at 1823.

¹¹⁰ See WALTER ADAMS & JAMES W. BROCK, THE BIGNESS COMPLEX 327-47 (1986); MYRON PERETZ GLAZER & PENINA MIGDAL GLAZER, THE WHISTLEBLOWERS: EXPOSING CORRUPTION IN GOVERNMENT AND INDUSTRY 20-21 (1989); Patrick J. DeSouza, Note, *Regulating Fraud in Military Procurement: A Legal Process Model*, 95 YALE L.J. 390, 399 (1985).

¹¹¹ Kovacic, *supra* note 100, at 1823.

¹¹² *Id.*

¹¹³ *Id.* at 1823-24.

B. *Risks Facing Qui Tam Relators*

The 1986 amendments to the CFCA greatly enhanced the protections afforded to relators who brought *qui tam* actions. Specifically, the CFCA protects the relator from retaliation by his or her employer.¹¹⁴ The statute explicitly prohibits discharge, demotion, suspension, and harassment resulting from the relator's role in a CFCA suit.¹¹⁵ If there is any such discrimination, the statute entitles the relator "to all relief necessary to make the employee whole." This relief includes "reinstatement with the same seniority status such employee would have had but for the discrimination, 2 times the amount of back pay, interest on the back pay, and compensation for any special damages sustained as a result of the discrimination, including litigation costs and reasonable attorneys' fees."¹¹⁶

However, notwithstanding the CFCA's protection provisions, *qui tam* relators still face substantial professional risk by initiating a CFCA action.¹¹⁷ As the United States District Court for the Central District of California noted, "[p]ublic disclosure of the filing of the complaint, in spite of the rights provided by [the CFCA], will often result in termination of that relationship or in a compromised opportunity for future advancement."¹¹⁸ Furthermore, the disclosure to the Government may result in the suspension of a governmental procurement program, thus jeopardizing the relator's continued employment and creating difficulty for the relator in finding future employment in the same industry.¹¹⁹

In calculating the professional risks faced by relators, factors such as their standing in an industry must be considered. Given the complex nature of commercial transactions, the fraudulent activity revealed by a relator is likely to consist of highly technical violations.¹²⁰ Therefore, the insiders who have access to this information necessarily occupy senior positions in the corporate hierarchy and are deeply

¹¹⁴ See 31 U.S.C. § 3730(h) (2000).

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ WEST, *supra* note 79, at 17.

¹¹⁸ United States *ex rel.* Stillwell v. Hughes Helicopters Inc., 714 F. Supp. 1084, 1099 (C.D. Cal. 1989).

¹¹⁹ *Id.*

¹²⁰ Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 62 (2002).

ingrained in the corporate culture.¹²¹ Because these relators tend to be highly skilled and well-placed in their organization, these insiders incur greater risks than do lower-level employees whose skills and corporate position are more easily replaced.¹²²

Beyond the professional sphere, a *qui tam* relator also faces considerable personal hardship in filing a suit.¹²³ A *qui tam* relator website warns that “whistleblowing activity has proven to be very hard on a whistleblower’s personal life.”¹²⁴ The website suggests that persons contemplating disclosing fraud and initiating a CFCA action ask themselves, “Am I mentally ready to have my fellow workers and perhaps my friends turn against me because of my lawsuit?” and “Am I ready for personal attacks against my character and to have my past indiscretions made public?”¹²⁵ That a website intended to be a relator resource would pose such questions is a clear indicator of the adversity that faces *qui tam* relators.

In the end, the statutory safeguards against harassment and demotion put in place by the 1986 amendments to the CFCA, although important, are not sufficient to compensate relators for the residual risk they face. Only a generous share of the Government’s recovery will induce some relators to bring a *qui tam* action.¹²⁶ As discussed above, while the CFCA does provide protection against outright dismissal and overt harassment for bringing a *qui tam* suit, these anti-retaliation provisions cannot quash the “institutional hostility” that the filing of a *qui tam* suit is likely to provoke.¹²⁷ A prospective relator with a bright professional future must assume that filing a *qui tam* suit will preclude future advancement within the company, and perhaps, within the industry at large.¹²⁸ Consequently, a professionally well-placed relator will likely initiate a *qui tam* suit only if the expected gains from the suit are greater than the expected gains from his or her continued career.¹²⁹ With this in mind, the vital importance of the relator’s

¹²¹ *Id.*

¹²² *Id.*

¹²³ See WEST, *supra* note 79, at 17.

¹²⁴ How to Decide if Your Charges Can be Turned Into a Successful Qui Tam Case, at <http://www.quitam.com/wb2.html> (last visited July 27, 2004).

¹²⁵ *Id.*

¹²⁶ See Kovacic, *supra* note 100, at 1819–20.

¹²⁷ *Id.* at 1819.

¹²⁸ *Id.*

¹²⁹ *Id.*

statutory award becomes clear: without sufficient financial incentive, the *qui tam* enforcement provisions of the CFCA can not be effective. Were this not the case, the addition of the anti-retaliation measures alone would have been sufficient to encourage relators to bring suit, and presumably Congress would not have increased the relator's award when it amended the statute in 1986.

IV. INCLUSION OF ATTORNEY FEES IN THE *QUI TAM* CONTEXT

In light of the essential role that the *qui tam* provisions play in the enforcement of the CFCA and the risks facing *qui tam* relators, the amount of the relator's award is of critical importance. Generally, under fee-shifting statutes such as the provision included in the CFCA, any awarded attorney's fees are paid directly to the plaintiff for subsequent payment to the attorney.¹³⁰ This means that following a judgment in the plaintiff's favor, the plaintiff can himself be awarded attorney's fees, and then use those funds to pay his attorney pursuant to their agreement.¹³¹ Attorney's fees are separate and distinct from the plaintiff's judgment and are only awarded if the plaintiff makes a separate application for them.¹³² This rule flows from the Supreme Court holding that attorney's fees are awarded to parties, not counsel, by virtue of the fact that attorneys do not have standing to seek fees for themselves.¹³³ As fees awarded under fee-shifting provisions, such as the one included in the CFCA, are paid to plaintiffs and not to attorneys, in "inclusion" circuits these fees constitute taxable income to such plaintiff.¹³⁴ While there is extremely limited case law addressing the issue of taxation of statutory attorney's fees

¹³⁰ See *Gilbrook v. City of Westminster*, 177 F.3d 839, 873-75 (9th Cir. 1999); *Turner v. Sec'y of Air Force*, 944 F.2d 804, 808 (11th Cir. 1991); *Richardson v. Penfold*, 900 F.2d 116, 117 (7th Cir. 1990).

¹³¹ See *Gilbrook*, 177 F.3d at 874-75.

¹³² *Id.* at 873-75.

¹³³ See *Evans v. Jeff D.*, 475 U.S. 717, 730-32 (1986). See also *Willard v. City of Los Angeles*, 803 F.2d 526, 527 (9th Cir. 1986); *Freeman v. B & B Assocs.*, 790 F.2d 145, 149 (D.C. Cir. 1986). In the context of civil rights suits, the Supreme Court has stated, "while it is undoubtedly true that Congress expected fee shifting to attract competent counsel to represent citizens deprived of their civil rights, it neither bestowed fee awards upon attorneys nor rendered them nonwaivable." *Evans*, 475 U.S. at 731.

¹³⁴ See *United States ex rel. Doe v. Pennsylvania Blue Shield*, 54 F. Supp. 2d 410, 421 (M.D. Pa. 1999); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (holding that attorney's fees constitute income to the plaintiff even though they were paid by the court directly to the attorney).

in the context of CFCA *qui tam* actions, it appears that the rule that attorneys do not have standing to seek fees for themselves holds true in the *qui tam* context as well.¹³⁵

A. *The Relator's Award: Calculating the Bottom Line*

The economic realities that face a successful *qui tam* plaintiff are best demonstrated by example. Suppose a CFCA relator enters into a typical, forty percent contingency fee arrangement with her attorneys. Suppose further that the relator's claim results in a \$20 million award for the Government. Based on the level of the relator's cooperation and evidence, the court awards her twenty percent of the judgment, or \$4 million.¹³⁶ Upon subsequent application of the relator, the court awards the relator reasonable attorney's fees in the amount of \$4 million.¹³⁷ Thus, the defendant pays a total of \$24 million that is divided as follows: \$16 million for the United States Government; \$4 million for the relator; and \$4 million for the relator's attorneys. However, as it was the relator that made the application for the attorney's fees, in an "inclusion" circuit the relator would have to include the fees in her gross

¹³⁵ See *Pennsylvania Blue Shield*, 54 F. Supp. 2d at 421. Despite the Ninth Circuit's general rule that attorney's fees constitute income to the plaintiff and thus must be included in the calculation of their gross income, they have nonetheless allowed attorney's fees awarded in *qui tam* actions under the CFCA to be paid directly to the relator's attorney. *United States ex rel. Virani v. Jerry M. Lewis Truck Parts & Equip., Inc.*, 89 F.3d 574 (9th Cir. 1996). The court reasoned that if the fees were to be paid to the plaintiff, it would be a "compensatory payment which really belongs to the United States subject to allocation of a portion to the plaintiff." *Id.* at 578 (citing *United States ex rel. Gibeault v. Texas Instruments Corp.*, 25 F.3d 725 (9th Cir. 1994)). In other words, according to the Ninth Circuit, if the attorney's fees were awarded to the plaintiff, they would have to be included in the government's total judgment, of which the plaintiff only gets a portion. Consequently, as the relator is liable for 100% of the legal fees under the statute, he would be damaged because most of the fees would go to the government despite the relator's personal liability to his attorneys. See *id.*

No other "inclusion" circuit has yet to adopt this exception for CFCA attorney's fees. In fact, the United States District Court for the Middle District of Pennsylvania has explicitly rejected the Ninth Circuit's reasoning, holding that the plain language of section 3730(d)(1) requires that the defendant pay attorney's fees to the relator. *Pennsylvania Blue Shield*, 54 F. Supp. 2d at 421. Further emphasizing its point, the court stated, "[t]hat the court should concern itself with the final recipient of the funds is not a matter addressed by the statute." *Id.*

¹³⁶ This 20% share was used in this example because it is the median share allowed by the CFCA. See 31 U.S.C. § 3730(d)(1) (2000).

¹³⁷ The commonly accepted approach for calculating reasonable fees is the "lodestar" approach. *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air*, 478 U.S. 546, 563 (1986). The lodestar amount is calculated by multiplying the number of hours reasonably expended on the litigation by a reasonable hourly rate. *Id.*

income.¹³⁸ Thus, assuming the relator had no additional income for the year and no above the line deductions, the relator's adjusted gross income in this example would be \$8 million. As the AMT would be triggered in this situation, and no miscellaneous itemized deductions are permitted in calculating AMTI, the relator's total tax liability in this example would be \$2,236,500¹³⁹ more than fifty percent of her statutory share. Thus, after paying her taxes, the relator would be left with only \$1,764,500,¹⁴⁰ approximately one fourth of her statutory share or eight percent of the \$20 million award. Further aggravating the situation, the relator could then have to pay her attorney forty percent of her statutory share pursuant to the contingency fee agreement.¹⁴¹ This leaves the relator with a relatively miniscule \$164,000.¹⁴² Had the attorney's fees been excludable, the relator's tax liability would have been \$1,560,528.50,¹⁴³ leaving the relator \$2,439,471.50, thirty-eight percent more than if the fees had been included.¹⁴⁴ The relator's attorneys will, of course, have to pay tax on all of the monies they receive in fees as well.

B. *Reduced Incentives: The CFCA Relator's Significant Tax Burden*

While the enhancements made by the 1986 amendments have been exceedingly successful in increasing the number of *qui tam* recoveries,¹⁴⁵ the full potential of the 1986 amendments

¹³⁸ See *Pennsylvania Blue Shield*, 54 F. Supp. 2d at 421; *Baylin*, 43 F.3d at 1454.

¹³⁹ The tentative minimum tax on \$8,000,000 is calculated as follows: 26% of \$175,000 = \$45,500. \$45,500 + (28% of \$7,825,000) = \$2,236,500. See 26 U.S.C.A. § 55(b)(1)(A)(i) (2004).

¹⁴⁰ \$4,000,000 - \$2,236,500 = \$1,764,500.

¹⁴¹ The issue of whether the relator has to pay a percentage of her award pursuant to the contingency fee agreement in addition to the court awarded fees is determined solely by the terms of the contingency fee arrangement. However, it is common practice for the contingency fee agreement to be paid regardless of whether additional attorney's fees are awarded by the court.

¹⁴² 40% of \$4,000,000 = \$1,600,000. \$1,763,000 - \$1,600,000 = \$163,000.

¹⁴³ The tax on \$4,000,000 is calculated as follows: \$75,528.50 + 39.6% of adjusted gross income in excess of \$250,000 (((\$4,000,000 - \$250,000) x .396 = \$1,485,000 + \$75,528.50 = \$1,560,528.50). See 26 U.S.C.A. § 1 (2004).

¹⁴⁴ \$2,439,471.50 - \$1,763,000 = \$676,471.50 / \$1,763,000 = 38%.

¹⁴⁵ See Press Release, United States Dep't Justice, Justice Department Recovers Over \$1 Billion in Qui Tam Awards and Settlements (Oct. 18, 1995), at http://www.usdoj.gov/opa/pr/Pre_96/October95/542.txt.html (last visited Oct. 3, 2004); Press Release, United States Dep't Justice, Justice Department Recovers Over \$3 billion in Whistleblowers False Claims Act Awards and Settlements (Feb. 24, 2000), at <http://www.usdoj.gov/opa/pr/2000/February/079civ.htm> (last visited Oct. 3, 2004).

is being stifled by the current state of the tax law concerning attorney contingency fees. The inclusion of fees awarded under fee-shifting statutes in a relator's gross income continues to penalize relators for bringing a CFCA action.¹⁴⁶ This is contrary to Congress's intent in including a fee-shifting provision in the CFCA and lessens the overall effectiveness of the *qui tam* enforcement provisions.¹⁴⁷

It must first be noted that fee-shifting statutes are a departure from the long-standing American rule that each party in a case is responsible for paying their own legal fees, and are in no way the standard practice of the American judicial system.¹⁴⁸ The Supreme Court has recognized that the special purpose of fee-shifting statutes is to "enable private parties to obtain legal help in seeking redress for injuries resulting from the actual or threatened violation of specific federal laws."¹⁴⁹ In the context of *qui tam* suits, the fee-shifting provisions of the CFCA were enacted specifically to facilitate relator-initiated suits with a view towards the ultimate goal of redressing injuries sustained by the United States Government.¹⁵⁰ Without the fee-shifting provisions, Congress believed that this goal could not be met because private individuals did not have the financial wherewithal to initiate costly *qui tam* actions.¹⁵¹

However, because of the adverse tax consequences presently facing *qui tam* relators in inclusion circuits, the benefits of the fee-shifting provisions that were anticipated by Congress have been greatly reduced. Indeed, as demonstrated by the example in section IV.A, the relator in a CFCA action could theoretically be made to pay tax on two hundred percent¹⁵² or more of his statutorily prescribed share of the

¹⁴⁶ See analysis *infra* Part IV.B.

¹⁴⁷ S. REP. NO. 99-345, at 29 (1986), reprinted in 1986 U.S.C.C.A.N. 5266, 5294 (Unavailability of attorneys fees inhibits and precludes many private individuals, as well as their attorneys, from bringing civil fraud suits.).

¹⁴⁸ See *Buckhannon Bd. v. W. Va. Dep't of Health and Human Res.*, 532 U.S. 598, 598 (2001) (Under the 'American Rule,' parties are ordinarily required to bear their own attorney's fees, and courts follow a general practice of not awarding fees to a prevailing party absent explicit statutory authority.).

¹⁴⁹ *Pennsylvania v. Delaware Valley Citizen's Council for Clean Air*, 478 U.S. 546, 565 (1986).

¹⁵⁰ S. REP. NO. 99-345, at 23-24.

¹⁵¹ *Id.* at 28.

¹⁵² In the example from Part IV.A, the relator was awarded \$4 million as her statutory share and \$4 million in attorney's fees. As those fees are taxed to the relator, she owes taxes on \$8 million, or two-hundred percent of her statutory share.

Government's award.¹⁵³ This dramatic tax imposed on CFCA relators is the functional equivalent of the Internal Revenue Service reducing the CFCA's statutory fifteen to twenty-five percent share in circuits where attorney contingency fees must be included in a relator's gross income. For example, the after-tax proceeds of a relator in an exclusion circuit who received a \$4 million, twenty percent share, is \$1,764,500.¹⁵⁴ If a relator were to net the same amount in an inclusion circuit, it would mean that he was only awarded a fourteen percent share of the Government's total award, six percent less than the relator in an exclusion circuit.¹⁵⁵ Of course, it is impossible for a court to award a relator only fourteen percent, as the absolute minimum statutory share for a cooperative relator is fifteen percent.¹⁵⁶

In the face of explicit statutory language stating that a relator's fair share is based on the level of his participation in the CFCA action,¹⁵⁷ the substantial tax incurred by relators in inclusion circuits amounts to a reduction of financial incentives that is contrary to Congress's stated intent. The language of the CFCA is clear: the amount awarded to a *qui tam* relator is to be based on "the extent to which the person substantially contributed to the prosecution of the action."¹⁵⁸ Because relators in inclusion circuits are taxed significantly more than relators in exclusion circuits for bringing the same type of *qui tam* actions, their compensation for performing the same duties is reduced.¹⁵⁹ As this reduction is not based on the relator's involvement in, or dedication to, the prosecution of the CFCA violation, it is at odds with the language and purpose of the CFCA.

Likewise, the fact that subsection (d)(3) of the CFCA allows for a reduced relator's award only in limited circumstances also supports the contention that Congress had

¹⁵³ See analysis *supra* Part IV.A.

¹⁵⁴ See analysis *supra* Part IV.A. Of course, the relator may also have to pay out a portion of his or her recovery pursuant to the contingency fee agreement, further reducing the net profit. *Id.*

¹⁵⁵ 14% of \$20 million is \$2,800,000. The tax on \$2,800,000 is calculated as follows: \$75,528.50 + 39.6% of adjusted gross income in excess of \$250,000 ((\$2,800,000 - \$250,000) x .396 = \$1,009,800 + \$75,528.50 = \$1,085,328.50). See 26 U.S.C.A. § 68 (2004). The net proceeds (\$1,714,671.50) are calculated by subtracting the tax (\$1,085,328.50) from the gross award (\$2,800,000).

¹⁵⁶ See 31 U.S.C. § 3730(d)(1) (2000).

¹⁵⁷ See *id.*

¹⁵⁸ *Id.* See also analysis *supra* Part III.A.3.

¹⁵⁹ See analysis *supra* Part IV.A.

a definite and purposeful scheme in mind for the compensation of relators.¹⁶⁰ The statute only allows for a reduction of compensation “if the court finds that the action was brought by a person who planned and initiated the violation of section 3729 upon which the action was brought.”¹⁶¹

Further, while the tax consequences discussed above may seem sufficiently unfair to justify changing the inclusion tax policy, the fact that attorney’s fees in CFCA actions are awarded via fee-shifting statute means that a relator could suffer an even greater tax burden. As has happened in civil rights cases, where attorney’s fees are also awarded via fee-shifting statute,¹⁶² damages can be significantly lower than the awarded attorney’s fees.¹⁶³ If the damages are dramatically lower than the fees awarded, the taxes owed by the plaintiff on the attorney’s fees may in fact exceed the damages, leaving the plaintiff in the red despite his victory in court.¹⁶⁴ In effect, the plaintiff “can be penalized financially for bringing a meritorious case” under the statute.¹⁶⁵ For instance, if a civil rights plaintiff was awarded \$2,000,000 in damages and \$1,000,000 for attorney’s fees, but the damages were later reduced to \$250,000 on appeal, the taxes due on the attorney’s fees alone would exceed the damages awarded by over \$26,000.¹⁶⁶ The same risk exists in *qui tam* actions. Under the CFCA, an attorney’s legal fees could easily exceed the relator’s statutory share of the Government’s award if an extended litigation exposed only minimal fraud. In this situation, even

¹⁶⁰ See 31 U.S.C. § 3730(d)(3) (2000).

¹⁶¹ *Id.*

¹⁶² See, e.g., Civil Rights Attorney’s Fees Awards Act of 1976, 42 U.S.C. § 1988(b) (2000) (The court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney’s fee as part of the costs.); Civil Rights Act of 1964, 42 U.S.C. § 2000a-3(b) (2000) (The court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney’s fee as part of the costs.); Civil Rights Acts of 1964, 42 U.S.C. § 2000e-5(k) (2000) (The court, in its discretion, may allow the prevailing party, other than the Commission or the United States, a reasonable attorney’s fee [as part of the costs.]; Americans With Disabilities Act of 1990, 42 U.S.C. § 12205 (2000) (The court or agency, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney’s fee.).

¹⁶³ See, e.g., *Spina v. Forest Pres. Dist. of Cook County*, 207 F. Supp. 2d 764, 778–79 (N.D. Ill. 2002) (reducing plaintiffs’ \$3 million award to \$300,000, but leaving the \$949,761.26 awarded for fees and costs in *Spina v. Forest Pres. Dist. Of Cook County*, No. 98-c-1393, 2002 U.S. Dist. LEXIS 16005 (N.D. Ill. July 30, 2002)).

¹⁶⁴ See *id.*

¹⁶⁵ See 147 CONG. REC. S5273 (daily ed. May 21, 2001) (statement of Sen. Collins).

¹⁶⁶ The tentative minimum tax on \$1,000,000 is calculated as follows: 26% of \$175,000 = \$45,500. \$45,500 + (28% of \$825,000) = \$276,500. \$276,500 - \$250,000 = \$26,500. See 26 U.S.C.A § 55(b)(1)(A)(i) (2004).

though the relator would receive only a minimal recovery, the time expended by his attorneys would result in substantial fees which would ultimately be taxed to him.

In sum, adequate compensation for relators is necessary to induce them to initiate *qui tam* litigation because their net benefit must outweigh the harms their professional lives will sustain as a result of bringing the suit. Thus, if severe tax burdens reduce the financial incentives to bring a *qui tam* action, potential relators, presumably rational profit maximizers,¹⁶⁷ would forgo the risks of bringing a *qui tam* action in favor of not disclosing the information and continuing on their professional path. Hence, when tax burdens have the effect of reducing the incentives prescribed by Congress to encourage *qui tam* litigation, Congress's purpose of amending the CFCA to include more potent *qui tam* provisions is frustrated.

C. *A Partnership with the Government: Qui Tam Suits and their Public Benefit*

In addition to curbing the intended enforcement potential of the CFCA, the severe taxes and the resulting reduction in compensation to CFCA *qui tam* relators are even more untenable in view of the fact that the *qui tam* relator is performing a public good by initiating a *qui tam* action. The amended CFCA was envisioned to facilitate a "public-private partnership" that would battle against the "fraudulent use of public funds."¹⁶⁸ The relator, suing for damages incurred by the Government, would provide the evidence necessary to stop fraud that was draining the national treasury at a rate of up to \$100 billion annually.¹⁶⁹ Thus, by initiating a *qui tam* suit, the relator performs a service that benefits himself, in that the relator receives a portion of the damages, but more importantly, performs a service that also benefits the United States Government and the public at large.

Every time a *qui tam* action is successful, stolen taxpayer dollars are put back into the Government's coffers to be used for legitimate purposes. As of 2003, approximately \$12

¹⁶⁷ The theory that individuals are rational profit maximizers supposes that people exhibit a strong propensity to adjust their behavior in pursuit of benefits and to avoid costs. For further discussion of this proposition, see Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* (1953).

¹⁶⁸ Press Release, *supra* note 80.

¹⁶⁹ See S. REP. NO. 99-345, at 3.

billion dollars had been recovered through relator originated CFCA actions.¹⁷⁰ Without the efforts of *qui tam* relators, this money would have been lost, and many programs which are now funded by these recoveries would presumably have been paid for with additional tax dollars. It seems then that *qui tam* relators under the CFCA do what many politicians, DOJ investigators, and government accountants cannot: they save taxpayers money.¹⁷¹

However, while \$12 billion is a sizeable savings for taxpayers, the Government will ultimately derive the most financial benefit from the prophylactic effects of CFCA judgments. Prior to the enactment of the *qui tam* provisions of the CFCA, procurement fraud was so prevalent because of the lack of deterrence mechanisms in place.¹⁷² First, it was unlikely that acts of fraud would be detected, and second, if a fraud was uncovered, chances of a successful prosecution were slim.¹⁷³ In short, the pre-*qui tam* CFCA did not pose a sufficient threat to deter fraud. According to the Senate, prior to the amendment of the CFCA, the sad truth was that crime against the Government often did pay.¹⁷⁴

Much has changed since the enactment of the *qui tam* provisions of the CFCA. The relator-initiated *qui tam* suit now provides a potentially powerful mechanism to deter fraud against the Government.¹⁷⁵ For every CFCA judgment that was a part of the \$12 billion in total recoveries, untold numbers of other government contractors became aware of the substantial judgments and were put on notice that frauds were now more likely to be prosecuted. For example, if one hospital receives a \$50 million judgment against it for submitting inflated claims to the Government, numerous other hospitals that previously engaged in similar activity will be disinclined to continue that practice. Thus, *qui tam* recoveries are actually exponentially more valuable to the Government and to taxpayers than they may appear at face value. Consequently, by initiating a CFCA action, the *qui tam* relator is not simply suing to recover monies lost to a specific fraud, but is performing the even more

¹⁷⁰ *The 100 Top False Claims Act Settlements*, *supra* note 82, at 4.

¹⁷¹ *See* Press Release, *supra* note 80.

¹⁷² *See* S. REP. NO. 99-345, at 3.

¹⁷³ *See id.*

¹⁷⁴ *See id.*

¹⁷⁵ Kovacic, *supra* note 100, at 1800.

valuable service of deterring countless other acts of fraud that the Government could not otherwise prevent.

V. POSSIBLE SOLUTIONS

The negative consequences of including CFCA attorney's fees in the relator's gross income must be remedied in order to give effect to congressional intent and encourage universal application of the CFCA. This section will explore possible solutions to this dilemma and will conclude by arguing that the most appropriate solution is for Congress to amend the Code's treatment of attorney's fees in the *qui tam* context.

A. *Judicial Solution: Leave it to the Courts*

In 2004, after years of avoiding the issue,¹⁷⁶ the Supreme Court granted certiorari in two cases to resolve the long-standing circuit split regarding the inclusion/exclusion dispute.¹⁷⁷ However, the trend in circuit courts to require inclusion of attorney's contingency fees¹⁷⁸ does not bode well for a Supreme Court verdict in favor of exclusion, especially since the inclusion courts have used the Supreme Court's jurisprudence to justify their position.¹⁷⁹ Thus, even though the Court will resolve the circuit split so as to alleviate the problems stemming from the uneven enforcement of the CFCA,¹⁸⁰ it appears likely that this resolution will come at the expense of the CFCA's full anti-fraud potential.¹⁸¹

¹⁷⁶ *E.g.*, *Hukkanen-Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Sinyard v. Comm'r*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); *Benci-Woodward v. Comm'r*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

¹⁷⁷ *See Comm'r v. Banks*, 2004 U.S. LEXIS 2384 (Mar. 29, 2004); *Comm'r v. Banaitis*, 2004 U.S. LEXIS 2385 (Mar. 29, 2004).

¹⁷⁸ The Second, Fourth, Seventh, Ninth, and Federal Circuits have held that attorney contingent fees constitute gross income to the plaintiff. *See Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Coady*, 213 F.3d at 1187; *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

¹⁷⁹ *See Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 376; *Coady*, 213 F.3d at 1191; *Baylin*, 43 F.3d at 1454.

¹⁸⁰ An additional problem posed by the circuit split regarding the inclusion of attorney contingency fees is that the incentive to initiate CFCA *qui tam* actions varied between circuits. Because of this disparity, the CFCA may not be uniformly enforced throughout the country.

¹⁸¹ *See* discussion of impact of inclusion on enforcement of the CFCA *supra* Part IV.B.

However, even if the Court does decide the split in favor of the inclusion circuits, the troubles that face CFCA relators could still be remedied by the courts without legislative intervention. For example, the Ninth Circuit, recognizing the uniqueness of the CFCA *qui tam* situation, has held that CFCA attorney's fees are to be paid directly to the attorney.¹⁸² By this approach, courts could acknowledge that attorney's fees in the CFCA context are inherently different than contingency fees in non-quasi-governmental actions, and thereby eliminate the negative tax consequences imposed on relators by the AMT.

In *United States ex rel. Virani v. Jerry M. Lewis Truck Parts & Equipment*, the Court of Appeals for the Ninth Circuit carved out an exception to the general rule and held that attorney's fees should be paid directly to attorneys who represent relators in CFCA suits.¹⁸³ The court reasoned that the attorney's fees awarded under the statute could not be awarded to the relator because they would be the equivalent of a "compensatory payment which really belongs to the United States."¹⁸⁴ Further, because these compensatory fees would have to be paid to the Government, they could only be distributed to the plaintiff as part of his statutory percentage.¹⁸⁵ In other words, according to the Ninth Circuit, this distribution scheme would result in the plaintiff only getting a fifteen to twenty-five percent portion of the awarded attorney's fees. Since the relator is liable for one hundred percent of the legal fees under the statute, he would be damaged because most of the fees would go to the Government despite the relator's personal liability to his attorneys.¹⁸⁶

Despite the seemingly advantageous result, it is highly problematic to rely on the courts to craft a solution. First and foremost, because the *Virani* exception has not been recognized by the Supreme Court, it seems unlikely that the circuits would reach a consensus regarding an exception for *qui tam* relators. This would inevitably lead to uneven application of such an exception and ultimately would only add confusion to the

¹⁸² *United States ex rel. Virani v. Jerry M. Lewis Truck Parts & Equip.*, 89 F.3d 574, 575 (9th Cir. 1996). The precise tax consequences of this decision have not yet been determined by the courts, because the taxation of attorney's fees in the CFCA context has not been challenged in the Ninth Circuit since this decision.

¹⁸³ *See id.* at 579.

¹⁸⁴ *Id.* at 578 (citing *United States ex rel. Gibeault v. Texas Instruments Corp.*, 25 F.3d 725, 728 (9th Cir. 1994)).

¹⁸⁵ *Id.*

¹⁸⁶ *See* 31 U.S.C. § 3730(d) (2000).

existing morass. In fact, there are already conflicting opinions as to whether the CFCA requires fees to be paid directly to attorneys.¹⁸⁷ In *United States ex rel. Doe v. Pennsylvania Blue Shield*, the United States District Court for the Middle District of Pennsylvania flatly rejected the Ninth Circuit's reasoning in *Virani*, holding that the plain language of section 3730(d)(1) requires that the defendant pay attorney's fees to the relator.¹⁸⁸ While the Third Circuit Court of Appeals has not yet addressed the issue of whether CFCA attorney's fees must be paid directly to attorneys, the *Pennsylvania Blue Shield* court's decision makes clear that the Ninth Circuit's approach is not universally accepted.¹⁸⁹

B. Legislative Action

Rather than leaving it to the courts to stitch together a patchwork solution, the Legislature must act to rectify the inequities facing *qui tam* relators. One possible remedy available to Congress is amending the Code to provide for the total exclusion of all contingent and statutory attorney's fees from the plaintiff's gross income. In addition to resolving the tax problems faced by CFCA relators, this solution is advantageous because the broad nature of this amendment ensures horizontal equity among all classes of plaintiffs.¹⁹⁰ This type of broad legislation, because of its application to all similarly situated taxpayers, would also foster predictability and consistency of judgments.

Another possible legislative remedy is amending the Code to allow for complete above the line deductions of all attorney contingency fees. This solution has the same functional result as amending the Code to exclude contingency fees: it resolves the circuit split, eliminates the adverse tax consequences of bringing a CFCA suit, and results in horizontal equity among all plaintiffs.¹⁹¹ Moreover, support for such an amendment to the Code has already been expressed by various groups. The New York Bar Association's tax section has

¹⁸⁷ See *United States ex rel. Doe v. Pa. Blue Shield*, 54 F. Supp. 2d 410, 421 (M.D. Pa. 1999).

¹⁸⁸ *Id.* Further emphasizing that it was not the business of the court to decide this issue, the court stated, "[t]hat the court should concern itself with the final recipient of the funds is not a matter addressed by the statute." *Id.*

¹⁸⁹ See *id.*

¹⁹⁰ JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 5 (4th ed. 1983).

¹⁹¹ See *id.* at 626.

argued that the “[f]ailure to allow deduction of [contingency fees] undermines the tax policy goal of accurately measuring taxpayers’ real net incomes and taxing them at the appropriate statutory rate.”¹⁹²

The major shortcoming of across-the-board exclusion/deduction legislation is that it would result in a reduction in tax revenue. Since Congress amended the Code in 1996 to require that punitive damages and damages received on account of non-physical injuries be included in gross income,¹⁹³ the Government has received substantial tax revenue from these cases.¹⁹⁴ Given that the exclusion of all attorney contingency fees accruing in cases with punitive and non-physical injury damages would result in the removal of a substantial amount of tax-generating income from the purview of the 1996 amendments, the complete exclusion of attorney contingency fees would substantially impair the revenue generating ability of the 1996 amendments to the Code. Congressional budget rules, known as “pay as you go” rules, or PAYGO, make the revenue impact of the legislation a paramount concern, as lost revenue that results from legislation must be counter-balanced with legislation that makes up for the loss through tax increases or spending cuts.¹⁹⁵ Thus, Congress could probably not fix this problem by means of such sweeping legislation without cutting programs or reaching deeply into the pockets of other classes of taxpayers.

Because of the severe revenue consequences of amending the tax code to entirely exclude attorney contingency fees from a plaintiff’s gross income or allowing full above the line deduction of fees, a more tailored amendment, focusing solely on attorney’s fees in the CFCA context, might garner more congressional support. Legislation which is pointed solely at attorney’s fees accrued during CFCA actions will permit Congress to remedy the tax burden suffered by relators while minimizing lost revenue.

¹⁹² Robert H. Scarborough, *2001 TNT 36-18 NYSBA Tax Section Analyzes Civil Damages Legislation*, TAX NOTES TODAY, Feb. 22, 2001, at 31.

¹⁹³ 26 U.S.C. § 104(a) (2000).

¹⁹⁴ Marcia Coyle, *U.S. Tax on Damages Under Fire: Bill to Repeal '96 Levy Has Backing of Both Business, Plaintiff Bar*, 21 NAT. L. J. 50, Aug. 9, 1999, at A1 (stating that the estimated revenue resulting from the amendment through the year 2000 was \$230 million).

¹⁹⁵ See Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. REV 863, 866 (2002). In fact, the 1996 amendments were implemented because Congress needed to make up revenue lost in giving tax breaks to small businesses. Coyle, *supra* note 194 at A11.

In 2003, a bill sponsored by Senator Susan M. Collins was introduced which was directed at remedying a similar tax situation that occurs in the context of civil rights litigation.¹⁹⁶ The Civil Rights Tax Relief Act (CRTRA)¹⁹⁷ proposed to amend the Code to exclude damages awarded in certain discrimination suits from the plaintiff's gross income.¹⁹⁸ Naturally, as a result of this exclusion, attorney contingency fees paid from the award would also be excluded.¹⁹⁹

While this Note does not go so far as to suggest that the portion of the Government's judgment in a *qui tam* suit allotted to the relator should be excluded from his gross income, amending the Code to provide that a CFCA plaintiff can exclude or deduct his attorney's fees from his gross income is perhaps the best solution to this problem. Amending the Code, unlike a judge-found exception, would result in uniform application of federal tax law to all *qui tam* relators regardless of what circuit their action was litigated in. This certainty is clearly an advantage over judicial resolution, as potential relators in all circuits will be apprised of the tax consequences of their bringing a CFCA suit up-front without having to negotiate the murky waters of conflicting case law.

Moreover, because amending the Code will effectuate the uniform application of tax law to all CFCA relators, it would remove the possibility that relators in inclusion circuits, wary of the tax penalty associated with bringing a *qui tam* action, would be less inclined to initiate a CFCA suit. In effect, such an amendment to the tax code would result in relators from all circuits receiving equal statutory incentives to initiate *qui tam* actions, as Congress had originally intended.²⁰⁰ Thus, not only would federal tax law be uniformly applied, but also the provisions of the CFCA would be uniformly enforced.

Of course, amending the Code in this tailored fashion is also superior to a judge-found exception because its

¹⁹⁶ See Civil Rights Tax Relief Act, S. 557, 108th Cong. (2004), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s557.is.txt.pdf (last visited Aug. 25, 2004).

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at § 2.

¹⁹⁹ See 149 CONG. REC. S3316 (daily ed. Mar. 6, 2003) (statement of Sen. Collins). While the language of the CRTRA does not explicitly exclude attorney's fees from a plaintiff's gross income, it does provide for the exclusion of plaintiff's damages from gross income, which ultimately has the effect of excluding contingent attorney's fees because they would be paid from the excluded damages. See *id.*

²⁰⁰ See S. REP. NO. 99-345, at 2-3 (1986), reprinted in 1986 U.S.C.C.A.N. 5266, 5266-67.

implementation does not require an intrepid relator in an inclusion circuit to bear the risk of added attorney's fees resulting from the appeal from the tax court. It seems quite possible to this author that if implementation of an exception doctrine were left to the circuit courts, in many inclusion jurisdictions the courts would not even have the opportunity to create such a doctrine because relators, faced with the well established inclusion precedent, would acquiesce rather than challenge their tax situation and risk additional attorney's fees.

VI. CONCLUSION

In amending the CFCA to provide enhanced incentives for relators to bring *qui tam* actions, Congress sought to eliminate acts of fraud perpetrated against the United States Government. However, in certain circuits, the means employed by Congress to attain this important objective are being inhibited by an application of tax law which penalizes *qui tam* relators for bringing these socially important suits. Moreover, as only some of the federal circuits have required plaintiffs to pay these extra taxes, the circuit split has resulted in some jurisdictions having a less effective statutory tool for fighting fraudulent acts, a result which is not only contrary to Congressional intent, but also to the notion that federal law should be consistently and neutrally applied.

Thus, to effectuate the strong public-private partnership Congress envisioned in passing the amendments to the CFCA and to provide uniformly vigorous enforcement of the Act throughout the country, the split regarding the tax treatment of attorney's contingency fees, at least in the CFCA *qui tam* context, must be resolved in favor of eliminating the double-taxation of attorney's fees. The solution proposed by this Note, a focused amendment to the Code which provides for the exclusion or above the line deduction of attorney contingency fees from the calculation of the plaintiff's gross income solely in the CFCA *qui tam* context, would remedy the problems caused by the current inclusion/exclusion circuit split while curtailing tax revenue lost by the amendment.

VII. ADDENDUM

On the eve of publication of this Note, President George W. Bush signed a bill into law that provides the tailored tax

relief to relators that this Note has argued is appropriate.²⁰¹ The American Jobs Creation Act of 2004 (AJCA)²⁰² includes a modified version of the CRTRA that will eliminate the severe tax consequences that face both civil rights plaintiffs and *qui tam* relators.²⁰³ Unlike the CRTRA's remedy, the relief provided by the AJCA does not result from the exclusion of attorney's fees from gross income. Rather, the AJCA has remedied the problem by allowing attorney's fees and costs to be deducted in their entirety from a plaintiff's/relator's gross income. Specifically, section 703 of the AJCA, titled Civil Rights Tax Relief, amends section 62(a) of the Code to allow for above the line deduction of "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving . . . a claim of a violation of [the CFCA]."²⁰⁴ This means that attorney's fees accrued in connection with a CFCA suit are now entirely deductible from a relator's gross income,²⁰⁵ and because the legal expenses are no longer classified as miscellaneous itemized deductions, their deduction is not barred by the AMT.²⁰⁶ In effect, relator attorney's fees that are paid in connection with claims settled after the effective date of the AJCA²⁰⁷ will be used to offset the income a relator receives from the *qui tam* award. By way of example, if a relator in a successful *qui tam* suit is awarded a statutory share of \$2 million, attorney's fees of \$1 million, and a contingency fee of \$500,000,²⁰⁸ the relator will have \$3 million in gross income, but, because of the amendment, the full \$1.5 million in attorney's fees will be deductible. Thus, the relator's taxable income is only \$1.5 million, not \$3 million, as would have been the case prior to the enactment of the AJCA.

Interestingly, an examination of the Congressional Record reveals that the Senators, and even the members of the conference committee, hoped and believed that the AJCA would apply not only to future CFCA settlements, but also to

²⁰¹ American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2004).

²⁰² *Id.*

²⁰³ *Id.* at. § 703.

²⁰⁴ *Id.*

²⁰⁵ See 26 U.S.C. § 62(a) (2000).

²⁰⁶ See 26 U.S.C. § 56(b)(1)(A) (2000).

²⁰⁷ The effective date of the AJCA is October 23, 2004. See H.R. 4520 at § 703.

²⁰⁸ This \$500,000 would be paid to the attorney from the \$2 million award to the relator.

settlements reached prior to the enactment of the AJCA.²⁰⁹ Senator Grassley, the Chairman of the Senate Committee on Finance and supporter of section 703 stated: “[I]t is my strong belief that the courts and the IRS should apply the guidelines of Section 703 not only after the date of enactment but also to settlements put in place prior to that time.”²¹⁰ Unfortunately, because the plain language of the AJCA states that it only applies to attorney’s fees paid in connection with CFCA suits that were settled after October 23, 2004,²¹¹ many relators who already settled their claims this year will presumably have to fight to keep their CFCA awards in court.²¹² Moreover, it is unclear whether the legislative history of the AJCA will sway the courts deciding the tax treatment of attorney’s fees in previously settled CFCA suits to allow for the deduction of fees in light of the AJCA’s apparently contrary language. Thus, the question remains whether pre-enactment relators will benefit from the AJCA as the Senators had hoped.

Edward T. Ackerman[†]

²⁰⁹ See CONG. REC. S11036 (daily ed. Oct. 10, 2004) (statement of Sen. Baucus).

²¹⁰ *Id.* (statement of Sen. Grassley).

²¹¹ *Id.*

²¹² There have been numerous large *qui tam* settlements reached in 2004 that are beyond the purview of the AJCA, such as the \$430 million Parke-Davis settlement and the \$27 million Warrick Pharmaceuticals settlement. See BNA PLUS Health Care Fraud Settlements, at http://www.bna.com/bnaplus/docs/doc_fraud.htm (last visited Oct. 26, 2004).

[†] B.A., New York University; J.D. candidate, 2005, Brooklyn Law School. Associate Managing Editor of the *Brooklyn Law Review* 2004-05. The author would like to thank the staff of the *Brooklyn Law Review*, especially Editor-in-Chief, Josephine A. Vining, Managing Editor, Michael P. Simpson, and Executive Articles Editor, Erez Davy. In addition, the author would like to express special appreciation to his parents for their insight and unwavering support.