Are False Claims Act Settlements Fully Deductible?

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Damages paid by a business after a settlement or judgment are generally deductible if they are not a fine or penalty. False Claims Act payments are paid to the government and may appear to be penalty-like, but most businesses deduct them. With IRS scrutiny of these payments increasing, this article addresses what companies should consider.

Businesses settling civil matters with private parties or the government inevitably want to do so for as little as possible. That extends to taxes also. Paradoxically, however, many businesses do not even consider tax issues when settling cases. Many blithely assume that payments in business disputes are inevitably tax deductible no matter what.

One possible exception is punitive damages. Understandably, everyone in business regards them as anathema. Perhaps given their general fears over punitive damages, many assume punitive damages carry negative tax consequences also. There have been successive legislative proposals under presidents Clinton, Bush, and Obama to make punitive damages nondeductible,[1] but so far each bill has languished.

Paying Uncle Sam

Under current law, punitive damages in civil cases are fully deductible.[2] However, some fines and penalties paid to the government are not.[3] Even this is ambiguous. Some fines and penalties are nondeductible, but some are viewed as compensatory despite a fine or penalty label. Assessing which government settlements are regarded as a fine or penalty, and precisely what type of fine or penalty it may be, can be difficult.

Moreover, the rule that some fines and penalties paid to the government are nondeductible comes with a corollary. Sometimes the IRS views certain payments to the government in negotiated settlements as *akin* to a fine or penalty and thus nondeductible.[4] Although there are some seminal cases in this field, many businesses have never endured the difficulty of fine or penalty nondeductibility. But all that may change.

There has been a dramatic rise in the importance, volume, and sheer size of federal False Claims Act (FCA) cases and other government suits and investigations. Understandably, the IRS appears to be much more interested in these issues today. In 2007 the IRS issued an industry director directive (IDD) on the deductibility of government settlements.[5]

In 2008 the IRS issued a coordinated issue paper (CIP) on the deductibility of FCA settlements.[6] Both make useful reading. They suggest an increased focus on the reported (but not surprising) practice of companies involved in these settlements. Many companies simply deduct all of the settlement payments without trying to allocate between compensatory (deductible) and punitive (nondeductible) payments.

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[1]*See* Joint Committee on Taxation, ''Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal,'' JCS-1-99 (Feb. 22, 1999), at 256, *Doc 1999-7175, 1999 TNT 37-12*; JCT, ''Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal,'' JCX-20-00 (Mar. 6, 2000), at 404, *Doc 2000-6731, 2000 TNT 45-15*; Senate Finance Committee, ''Report on Jumpstart Our Business Strength (JOBS) Act,'' S. Rep. No. 108-192, 122 (2003), *Doc 2003-24258, 2003 TNT 217-31*; Senate Finance Committee, ''Report on Small Business and Work Opportunity Act of 2007,'' S. Rep. No. 110-1, at 35 (2007), *Doc 2007-1778, 2007 TNT 15-34*; Treasury Department, ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals'' (May 2009), *Doc 2009-10664*, or *2009 TNT 89-44*.

(Footnote continued in next column.)

[2]*See* LTR 7923006; *see also* Rev. Rul. 80-211, 1980-2 C.B. 57. For a general discussion of the deductibility of payments denominated punitive damages, see ''BP, Oil, and Deducting Punitive Damages,'' *Tax Notes*, Aug. 9, 2010, p. 663, *Doc 2010-15676*, or *2010 TNT 155-6*.

[3]Section 162(f).

[4]*See* TAM 200629030, *Doc 2006-15299, 2006 TNT 157-17*.

[5]*See* LMSB-04-0507-042, *Doc 2007-13682, 2007 TNT 111-7*.

[6]*See* LMSB-04-0908-045, *Doc 2008-19051, 2008 TNT 174-54*.

Tax Notes recently reported that Justice Department tracking documents are among the least significant pieces of evidence used to determine how much of a government settlement payment should be considered compensatory and how much should be considered punitive.[7] But that account seems to be disputed. A tracking statement is created by the DOJ and generally describes the distribution of the settlement award among the various government agencies.[8] Some say the tracking document is important, particularly if there are no more reliable pieces of evidence available.[9]

Divining Intent

Just how does one assess which fees paid to the government are meant to be compensatory and which are punitive? The IDD provides field direction from the IRS Large Business and International Division regarding the deductibility of settlements with a government agency. The CIP flatly says the taxpayer bears the burden of proving the payments are compensatory rather than punitive if a deduction for the payment is sought.

The common battleground is the line between deductibility as a business expense and nondeductible fine or penalty treatment under section 162(f). The CIP deals only with FCA settlements. The IDD covers FCA settlements with the DOJ and Environmental Protection Agency settlements for supplemental or beneficial environmental projects. Yet the preamble to the IDD states that its principles can apply to *any* settlement between a governmental entity and a defendant under any law in which a penalty can be assessed.

The Government Accountability Office has said that most taxpayers deduct the entirety of civil settlements, even though DOJ records reveal that almost every settled case includes substantial penalties.[10] Yet by its very nature, a settlement may be all about issues of perception. Plainly, a payer and payee settling a dispute usually do not agree on everything. The settlement may well include the degree of exposure the payer faces for potential fines and penalties.

The CIP addresses whether an FCA settlement payment is constrained by section 162(f). Not surprisingly, the IRS concludes that a portion of such a civil fraud settlement *may* be a penalty and thus nondeductible under section 162(f). This is mostly about intent, says the IRS, because the government may have a punitive or a compensatory intent.

If you think this is amorphous enough not to be of concern, think again. The IRS makes it plain that the taxpayer bears the burden of proving its entitlement to a full or even a partial deduction. Proving motive is tough, but taxpayers have a large incentive to show that a fine is imposed with a compensatory motive. How does one discern the motive of the government on any subject, let alone prove it?

Seminal *Talley*

Several cases are particularly important in exploring the purposes of a payment, but none more so than *Talley Industries Inc. v. Commissioner*.[11] In *Talley* a company and several executives were indicted for filing false claims with the federal government. This produced a claimed loss to the Navy of approximately $1.56 million. However, because of various potential liabilities, Talley and the DOJ settled for $2.5 million.

When Talley deducted the settlement, the IRS claimed it was a nondeductible fine or penalty. The Tax Court granted summary judgment for Talley, holding the settlement was not a fine or penalty, except for $1,885 explicitly characterized as restitution. The Tax Court found that the government had never suggested it was attempting to exact a civil penalty. At the time of Talley's indictment, the FCA violations gave rise to liability for (1) a civil penalty of $2,000; (2) an amount equal to two times the amount of damages the government sustains because of the act of that person; and (3) costs of the civil action. Noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the settlement was not intended to be penal or punitive, but rather to be compensatory.

The IRS appealed, and the Ninth Circuit reversed and remanded. The Ninth Circuit held there was a material issue of fact and that the matter was not ripe for summary judgment. Its remand instructions are telling:

[7]*See* Amy S. Elliott, ''Tracking Document Is of Little Significance in Government Settlement Taxation, IRS Official Says,'' *Tax Notes*, Oct. 4, 2010, p. 52, *Doc 2010-21008*, or *2010 TNT 186-7*.

[8]For an example, see *Fresenius Medical Care Holdings Inc. v. United States*, No. 108-cv-12118 (D. Mass. 2010), *Doc 2010-14218, 2010 TNT 123-11*.

[9]*Id.*

[10]GAO, ''Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments,'' GAO-05-747 (Sept. 15, 2005), *Doc 2005-21141, 2005 TNT 201-33*: ''The majority of companies responding to GAO's survey on how they treated civil settlement payments for federal income tax purposes deducted civil settlement payments when their settlement agreements did not label the payments as penalties. GAO received responses on 34 settlements totaling over $1 billion. For 20 settlements, companies reported deducting some portion or all of their settlement payments.''

[11]T.C. Memo. 1994-608, *Doc 94-10953, 94 TNT 244-9*, *rev'd and remanded*, 116 F.3d 382 (9th Cir. 1997), *Doc 97-18539, 97 TNT 121-31*.

> If the $940,000 [difference between the $2.5 million settlement and the $1.56 million loss] represents compensation to the government for its losses, the sum is deductible. If, however, the $940,000 represents a payment of double damages [under the FCA], it may not be deductible. If the $940,000 represents a payment of double damages, a further genuine issue of fact exists as to whether the parties intended payment to compensate the government for its losses (deductible) or to punish or deter Talley (nondeductible).[12]

The remand decision in *Talley* is extraordinarily detailed, referring to specific findings of fact about many developments during the settlement process.[13] Even though the settlement agreement was silent, the Tax Court concluded that the parties *intended* the settlement to include double damages under the FCA. The Tax Court then turned to whether the $940,000 double damage payment was intended to compensate the government for its losses or to deter or punish.

Talley argued that none of the $940,000 could be considered a penalty, while the government argued it was *all* a penalty. Concerning whether the amount was *intended* to reimburse the government for losses, Talley noted the government's actual losses exceeded $2.5 million. Because the $940,000 was merely a portion of this, it had to be a reimbursement.

Nevertheless, the Tax Court noted that the settlement was a compromise of many issues. Correspondence between the parties showed that Talley wanted the settlement agreement to expressly state that the amounts would be treated as restitution. The government rejected this proposal. That led the Tax Court to conclude that Talley failed to carry its burden of showing an intended remediation purpose.

Second Appeal

This time, Talley appealed. The Ninth Circuit reviewed the Tax Court's conclusions of law *de novo* and its factual findings for clear error. Finding no clear error, the Ninth Circuit again held that Talley had failed to establish the compensatory nature of the settlement.[14] Although other cases have come along, the primacy of *Talley* is striking.

[12]116 F.3d at 387.

[13]T.C. Memo. 1999-200, *Doc 1999-21339, 1999 TNT 118-94*.

[14]*See Talley Industries Inc. v. Commissioner*, 18 Fed. App. 661 (9th Cir. 2001), *Doc 2001-29836, 2001 TNT 232-6*, *aff'g* T.C. Memo. 1999-200.

The taxpayer was also denied a deduction in *Allied-Signal Inc. v. Commissioner*.[15] Allied-Signal made an $8 million payment into a nonprofit environmental fund and deducted it. The Tax Court found the entire payment nondeductible.

It so ruled because the $8 million payment was made with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least that amount. The Tax Court rejected the company's argument that the payment did not serve to punish or deter, concluding that it served a law enforcement rather than compensatory purpose.

What the IRS Reviews

The GAO has suggested that DOJ press releases as well as national and local newspapers are helpful in determining whether deductions are allowed for civil monetary assessments.[16] The Taxpayers Against Fraud website may also be a good source of information about the nature of FCA settlements.[17] There is a procedure for the IRS to contact the DOJ and for the examining IRS employee to liaise with the DOJ attorney who handled the case. Interviews and requests for records follow.

According to the CIP, the IRS will probably want to see *all* communications between the DOJ and the defendant and its representatives and employees (letters, memos, e-mails, and so on). The DOJ uses the term "multiples" for penalties. Initial letters often formalize the DOJ's position that "multiples" of damages will be included in any settlement. The critical documents also include all computations and settlement proposals made by either side and everything leading up to whatever settlement is ultimately reached.[18]

Predictably, any correspondence that addresses tax consequences is critical, although the IRS claims it is rare for this subject to be addressed. Interestingly, the IRS also requests discussions between the DOJ and the relator and relator's attorney in the FCA case.

The CIP notes that taxpayers frequently argue that the entirety of a settlement was to compensate the government for losses such as overbilling. If the settlement is less than the initially publicized

[15]T.C. Memo. 1992-204, *aff'd*, 54 F.3d 767 (3d Cir. 1995), *Doc 95-2752, 95 TNT 47-8*.

[16]*See* GAO-05-747, *supra* note 10, at Appendix I.

[17]*See* http://www.taf.org/.

[18]*See supra* note 6: "Critical documents that should always be requested include: all correspondence between DOJ and the defendant, and in particular those where multiples or penalties and the application of the FCA are mentioned, computations submitted to defendants, proposals made to defendants and counter-proposals made, and presentations made by DOJ or by the defendant."

amount of the government losses (which it generally is), taxpayers feel emboldened. Since the settlement is less than the losses the DOJ reported, they assert that all of the settlement must be "singles." That makes the payments compensatory and fully deductible, companies argue.

The CIP references the ostensible red herring phrase included in most DOJ settlement agreements written before June 2005: "The parties agree that this agreement is not punitive in purpose or effect." Understandably, taxpayers previously argued that this sentence means what it says. However, the CIP states: "This argument has no real merit as it is not factually based and it is not representative of the final settlement agreement."[19] According to the CIP, the DOJ included that phrase only because of double jeopardy under the Constitution and that it has no meaning for tax purposes.[20]

What You Can Do

The IRS is trying to get its ducks in a row. Taxpayers — who have the burden of proof — should too. Here are some suggestions:

- Keep correspondence, but be thoughtful and careful about what you say. For example, the fact that Talley requested (but failed to obtain) a statement in the settlement agreement that its payment was all restitution came back to bite it. Be careful what you document and how you do it.
- Consider a partial victory rather than an all-or-nothing one. If you cannot get language in a settlement agreement attesting to the compensatory and remedial intent of *all* the payments, consider sacrificing a portion of the payment. If the number for the penal and punitive portion is not too large, you may be better off with the relative certainty of the rest. (That probably would have worked for Talley.) Remember that if you insist on all or nothing, sometimes you get nothing.
- You may not have seen all the ammunition that will be used against you. You may have control over what correspondence you send, and you will know what you have received. However, there will be other items, such as internal DOJ communications, correspondence between the DOJ and the IRS, and other interagency and intra-agency materials. Try to gather what you can whenever you can.
- Consider creating some self-serving documents of your own. You may want to record impressions, observations, and facts contemporaneously with the settlement. Lawyers and company officials can all be appropriate signatories for those items. To give them added gravitas (and perhaps even admissibility), consider preparing and signing them under penalties of perjury, as declarations or affidavits.
- As to timing, consider all these items as you are settling the case. Documents prepared at tax return time — or even worse, at audit time — are never as persuasive.

Conclusion

Government settlements aren't simple and can involve bet-the-company stakes. Taxpayers make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of the payments. The IRS knows this.

But few taxpayers think about these issues thoroughly and creatively. Fewer still go to the trouble to document them contemporaneously. If you later find yourself in a dispute and you have thought through the issues in advance and documented what you can, you'll be glad you did.

[19] *See supra* note 5, at Attachment I.
[20] *Id.*