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Deductibility of Payments to Settle False Claims Act Liability

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Taxpayers often settle claims made by a government that they have engaged in potentially criminal conduct. When such a claim, or, indeed, any claim made by a government under a statute imposing monetary sanctions with a clearly punitive component, is settled, the issue arises whether the full amount of the settlement payment can be deducted for income tax purposes, or whether deduction of all or part of the amount paid in settlement is precluded by the prohibition in Internal Revenue Code (IRC) section 162(f) against deducting "any fine or similar penalty paid to a government for the violation of any law."

Regulations under section 162(f) lay out the conceptual groundwork for resolving this question by distinguishing between two types of payments—payments made in settlement of the taxpayer's actual or potential liability for a fine or penalty, whether civil or criminal, which are not deductible, and payments of compensatory amounts such as actual damages in an antitrust case, which may be deducted.[1] Courts have generally determined whether payment of a civil liability is deductible by reference to the purpose or purposes indicated by the statute that is the source of the liability.[2]

In *Fresenius Medical Care Holdings, Inc. v. United States,*[3] a recent decision of the Court of Appeals for the First Circuit relating to the deductibility for income tax purposes of a portion of payments made in settlement of Medicare fraud claims under the False Claims Act (FCA),[4] the government argued in substance that a deduction should be denied because the settlement agreement failed to characterize the payments as non-punitive. The district court had rejected that potentially Draconian position and declined to overturn a jury verdict that permitted the deduction of more than half of the payments in question, and the Court of Appeals affirmed that decision.

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Facts in Fresenius

Subsidiaries of Fresenius Medical Care Holdings, Inc. (Fresenius) were alleged, in civil actions initiated by multiple whistleblowers (acting as *qui tam* relators), to have engaged in a conspiracy to defraud Medicare and other federal medical care programs by means of double billing, payment of kickbacks, unnecessary laboratory tests, and other actions. The federal government initiated criminal and civil investigations into the alleged wrongdoing in 1995.

In 2000 Fresenius and the United States entered into a global settlement agreement that included three criminal plea agreements (the Criminal Agreements) and four civil settlement agreements (the Civil Agreements). The Criminal Agreements required Fresenius to pay $101 million in fines. The Civil Agreements provided that Fresenius would be released from civil and administrative claims under the FCA and other laws, in consideration for a payment of $385 million, which included $66 million as awards to the relators in the *qui tam* lawsuits.

The Civil Agreements further provided that the Fresenius subsidiaries waived the assertion of defenses in any criminal or administrative action based in whole or in part on the position that, under the Double Jeopardy Clause of the Fifth Amendment of the Constitution, the settlement agreement barred a criminal or administrative remedy. In connection with that waiver, the Civil Agreements recited that nothing in them was "punitive in purpose or effect."

Fresenius claimed income tax deductions for the full amount paid under the Civil Agreements. The IRS issued a notice of proposed adjustment denying a deduction for approximately half of that amount, or $193 million, as payment of an obligation that was punitive in nature. Following an administrative appeal by Fresenius, the IRS agreed to increase the amount permitted to be deducted (as compensatory in nature) by the $66 million paid to the *qui tam* relators, but continued to insist upon the disallowance of the remaining $127 million paid in respect of the Civil Agreements. Fresenius paid the tax in dispute and filed suit in U.S. District Court in 2008 for a refund premised on the allowability of this amount as a deduction.

The core issue in the tax refund litigation was whether the payments the treatment of which was in dispute were compensatory in nature, and thus outside the scope of section 162(f) (and therefore deductible), or punitive.

Fresenius first sought summary judgment based on the argument that the statement in each of the Civil Agreements that "nothing in this Agreement is punitive in purpose or effect" meant that the entire payment was compensatory in nature. The district court denied the motion. Taking into account the placement of this statement in the context of a reference to the Double Jeopardy Clause, the district court reasoned that it was at the least ambiguous whether the statement meant that the payment was not punitive for any purpose, or only that the settling parties were conceding that the payments were non-punitive for the narrower purpose of potential Double Jeopardy Clause issues; and this ambiguity was resolved against Fresenius based on the surrounding circumstances.[5]

Following additional discovery regarding the purpose of the payments, the government moved for summary judgment, arguing that, "Fresenius could not meet its burden of showing that it was entitled to deduct the disputed sum as an ordinary and necessary business expense" because the parties to the settlement "did not agree that the entirety of the settlement constituted compensatory damages."

The government apparently argued that its position was supported by the FCA itself and prior case law relating to the tax treatment of payments under the FCA. The FCA at one time authorized the government to recover an amount equal to twice—rather than three times—its damages from fraudulent claims, and case law cited by the District Court decision describes such double damages as necessary to fully compensate the government for the costs and inconveniences of such claims. In 1986 the FCA was amended to provide for treble damages, a level that prior cases had characterized as clearly punitive in nature; and the Internal Revenue Code itself bars a deduction for two-thirds of payments that may be made under certain antitrust laws providing for treble damages.[6]

The government further pointed to the *Talley Industries* case,[7] in which the Court of Appeals for the Ninth Circuit held that section 162(f) could bar a deduction for a payment to the government by a Department of Defense contractor made in settlement of an FCA claim, to the extent the payment exceeded the government's internal estimate of the actual losses suffered by it. It found the settlement agreement that had been entered into by the parties to be ambiguous, concluded that the ambiguity should be resolved by reference to the intention of the parties as to the purpose that the payment (above the amount conceded to constitute actual damages) was intended to serve, and remanded the issue for further consideration by the Tax Court.

On remand, the Tax Court observed that "the parties [to the settlement of FCA claims] did not agree whether the portion of the settlement in excess of the Government's 'singles' damages would constitute compensation to the Government for its losses" or a penalty, and then concluded that "[i]t thus follows that petitioner has failed to establish entitlement to a deduction for the disputed portion of the settlement."[8]

In *Fresenius*, however, the District Court and (on appeal) the Court of Appeals for the First Circuit refused to conclude that the parties' failure to agree on whether or not the amount paid had a compensatory component established, as a matter of law, that no portion of the payment could be deducted under section 162(f). Rather, a payment in excess of actual damages could be motivated or justified by compensatory factors such as a need to compensate the government for lost interest (time value of money) and consequential damages.

The District Court therefore concluded that it was appropriate for the jury to decide whether some portion of the amount in dispute was compensatory; and the entry of judgment on the basis of the jury's finding that $95 million of the disputed settlement payments was compensatory was affirmed by the Court of Appeals.

In affirming the decision of the District Court, the Court of Appeals noted that the government's argument that the compensatory versus punitive allocation should be determined solely on the basis of the parties' intent would be anomalous and illogical. When the parties to a settlement have declined to agree (and, as in *Fresenius*, the government refused even to discuss) how the payment should be characterized for tax purposes, the payment should be characterized for tax purposes by reference to the economic realities of the settlement, and in the same manner (to the extent practicable) as would have applied if the dispute had been fully litigated and reduced to judgment.

Observations

The heart of the government's argument at trial and thereafter before the District Court and the Court of Appeals in *Fresenius* seems to have been an asserted general, but irrational, principle—that the taxpayer loses on an allocation issue unless the taxpayer and governmental parties to the settlement agreed to resolve the issue in the taxpayer's favor. This principle was derived from an overly literal reading of language in the final Tax Court memorandum decision in *Talley*. The Court of Appeals' rejection of that argument seems entirely sensible and appropriate.

More generally, *Fresenius* underscores that, even in the context of a settlement under the FCA, or under any other statute with a clearly punitive element, in which the governmental party has been adamantly opposed to providing any concession relating to tax treatment of the settlement payment, the taxpayer (the defendant in the action being settled) may later be able to obtain a deduction with respect to the major part of the amount ultimately paid, if only it can establish facts and circumstances showing that such part was compensatory even to the extent it exceeded actual damages (not necessarily an easy task).

1 Treasury Reg. §§ 1.162-21(b)(1), 1.162-21(c) Ex. 1.

2 *See, e.g., Bailey v. Commissioner*, 756 F.2d 44 (6th Cir. 1985).

3 114 AFTR 2d 2014-5688, Docket no. 13-2144 (1st Cir. 2014), affirming 111 AFTR 2d 2013-1938 (D. Ct. MA).

4 31 U.S.C. §§ 3729-3733.

5 *See also* the disposition of a similar taxpayer argument in *Talley Industries Inc. v. Commissioner*, 79 AFTR 2d 97-3096 (9th Cir. 1997), discussed below.

6 IRC § 162(g).

7 *Talley Industries Inc. v. Commissioner*, 116 F.3d 382 (9th Cir. 1997).

8 *Talley Industries Inc. v. Commissioner*, 77 TCM 2191 (1999), *aff'd*, 18 Fed. Appx. 661 (9th Cir. 2001). There was also evidence in the record that the parties had discussed but failed to agree on a characterization of the disputed portion of the settlement, and that the government had characterized that portion, at least in internal communications, as a penalty.