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CIVIL FALSE CLAIMS ACT: How “Tax Reform” Affects Settlements under the False Claims Act and Certain Other Statutes

While most of America has focused on more prominent features of the new tax law—such as changed corporate tax rates, increased standard deductions, and limitations on the deductibility of state and local taxes—very little attention has been paid to a less prominent provision that is sure to impact False Claims Act (“FCA”) and other settlements involving the government going forward. That provision amends the Internal Revenue Code (“IRC”) by, among other things, mandating that federal agencies specify, at the time of settlement of government claims, the portion of the settlement that may be deductible as a business expense.

Corporate defendants settling FCA and other cases that result in payments to the U.S. Treasury routinely factor in the tax impact of their settlements, but the Justice Department, citing a long-lost interagency agreement with the IRS, heretofore has declined to set forth or agree to any tax position at the time of settlement. This new provision will require both sides to add this item to the list of material settlement terms that will need to be negotiated. In addition, with the increased Justice Department focus on individual liability following the September 2015 Yates Memo, non-corporate defendants also will have to keep this provision in mind when negotiating FCA settlements. However, even with the additional federal agency reporting requirement, companies and individuals alike will have to ensure that the deductible “restitution” amount is included in the settlement agreement and, even with that, taxpayers remain exposed to later IRS challenges.

Prior Law

Since 1969, the IRC has prohibited taxpayers from deducting as a business expense “any fine or similar penalty paid to a government for the violation of any law.” 26 U.S.C. § 162(f). Shortly thereafter, the IRS issued a technical memorandum stating its “liberalized” position that single damages paid under the FCA would be deductible, while amounts attributable to the statute’s damages multiplier and penalties provisions would not be deductible. 1972 TM LEXIS 15 (July 25, 1972). However, the Supreme Court recognized in *Cook County v. United States ex rel. Chandler*, 538 U.S. 119 (2003), that the FCA’s damages multiplier (*i.e.,* treble damages) serves remedial as well as punitive purposes. This led to the general proposition—in tax cases concerning FCA payments—that the portion of the payment to the government that can be considered compensatory is deductible, while the portion of the payment that is punitive is not deductible.

Nonetheless, FCA settlement payments that lacked clarity or an adequate record as to the compensatory versus punitive allocation of the settlement amount presented some tax risk and uncertainty for the businesses making the payments. While a company may have expected to be able to deduct the full amount of a settlement based on its view that the entire payment was compensatory, the IRS—sometimes years later—would challenge the deduction and claim that a significant portion of the payment must have been attributable to punitive purposes either through a damages multiplier or statutory penalties. For those not familiar with FCA settlements, many not only did not distinguish between the punitive and compensatory aspects of any payment, they did not even identify the single damages amount. In 1999, the Tax Court emphasized the risk and uncertainty that companies faced through its holding that the absence of any characterization of the payment in the settlement agreement itself, and the fact that the taxpayer and the government disagreed over the tax treatment, meant that the taxpayer could not establish a right to the disputed deduction. *See Talley Indus., Inc. v. Comm'r*, No. 27826-92, 1999 Tax Ct. Memo LEXIS 237, at *23 (June 18, 1999), *aff'd,* 18 F. App'x 661 (9th Cir. 2001).

In 2004, an IRS Technical Advice Memorandum ("TAM") stated that, because the FCA's damages multiplier encompassed both remedial and punitive objectives, and Section 162(f) only precludes deductions for punitive payments, the deductibility determination may require an examination of the facts and circumstances surrounding the agreement to determine the parties' intent. The TAM also placed the burden on the taxpayer to prove the compensatory purpose of the portion of the settlement amount for which a deduction is sought. This IRS position disadvantaged businesses because of the Justice Department's refusal—at least in FCA settlements—to specify or allocate the compensatory versus punitive portion of the settlement payment. The absence of any expressed government intent, coupled with the taxpayer's burden of demonstrating intent, created unnecessary uncertainty and risk for the taxpayer, making it difficult to determine and account for—at the time of settlement—the true net cost of the settlement.

More recently, a federal court issued an important decision that turned the tide back toward the taxpayer. Recognizing the unfairness of the government's position of both refusing to characterize the payment for tax purposes in the settlement agreement, while at the same time using the lack of any tax treatment agreement as grounds for denying the deduction, the First Circuit rejected the Justice Department's arguments and the reasoning expressed by the Tax Court and affirmed by the Ninth Circuit in *Talley*:

> We cannot accept the government's rationale. A rule that requires a tax characterization agreement as a precondition to deductibility focuses too single-mindedly on the parties' manifested intent in determining the tax treatment of a particular payment. Such an exclusive focus would give the government a whip hand of unprecedented ferocity: it could always defeat deductibility by the simple expedient of refusing to agree—no matter how arbitrarily—to the tax characterization of a payment.

Fresenius Med. Care Holdings, Inc. v. United States, 763 F.3d 64, 70 (1st Cir. 2014). The seeming conflict between the First and Ninth Circuits on this topic remains unresolved. In the meantime, even following *Fresenius*, the Justice Department has continued to refuse to agree to any characterization of FCA settlement payments for tax purposes.

As a result, the debate and uncertainty continued. Prior to the recent tax law changes, it was generally accepted that compensatory payments—*i.e*., payments for actual damages—and non-punitive payments (including payment of relators' legal fees and the portion of the payment that is allocated to the relator's share) were deductible. *See* Treas. Reg. 1.162-21(b)(2); *Chandler,* 538 U.S. at 131 ("The most obvious indication that the treble damages ceiling has a remedial place under this statute is its *qui tam* feature with its possibility of diverting as much as 30 percent of the Government's recovery to a private relator"). However, there often was ample room for disagreement as to how much of the payment should be deemed compensatory and how much was properly deemed punitive. For example, if the Justice Department initially demanded $20 million to settle an FCA action (based on actual damages of $10 million and a double multiplier), but the case ultimately settled for $10 million, the taxpayer justifiably could have asserted that the entire settlement payment was compensatory (and deductible)—since it was equal to the government's claimed actual damages—while the Justice Department and IRS might have argued that, consistent with the Justice Department's initial demand for a double multiplier, only 50% or $5 million was deductible.

The New Tax Law

So what has changed? The new tax law adds important limitations and conditions on the deductibility of payments to the government. *See* H.R. 1, 115th Cong. § 13306(a) (2017) (enacted). As discussed below, (1) taxpayers will no longer be able to deduct settlement payments (or portions thereof) unless those payments are identified—in the settlement agreement—as restitution, and the taxpayer otherwise establishes that the payment constitutes restitution, (2) taxpayers will no longer be able to deduct payments to reimburse the government's investigation and litigation costs, and (3) federal agencies are now required to characterize and report the settlement payment—for tax purposes—at the time of settlement.

As amended by the new law, Section 162(f) begins with the general proposition that—absent specified exceptions—payments made to the government "in relation to the violation of any law or the investigation or inquiry by [the government] into the potential violation of any law" are not deductible. Although not mentioned expressly, the IRS is certain to contend that FCA settlement payments are "qualifying payments" to the government under this Section.

The key then, for FCA defendants, is the exceptions. Relevant here is Section 162(f)'s specification that the payment *will* be deductible if

1. the taxpayer demonstrates that the amount "constitutes restitution … for damage or harm which was or may be caused by the violation of any law or the potential violation of any law," *and*

2. the amount sought to be deducted "is identified as restitution … in the court order or settlement agreement" (although the provision specifies that this mere identification "alone" is not sufficient to carry the taxpayer's burden).

Section 162(f)(2)(A). Moreover, the amendment makes clear that this exception will not apply "to any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation." Section 162(f)(2)(B).

These new provisions are critical to understand, as they represent significant changes to existing law and apply to any payments made pursuant to settlements entered into after the effective date of the law (*i.e.,* on or after December 22, 2017). Thus, going forward, taxpayers may be precluded from taking deductions for settlement payments to the government (arising out of alleged violations of law) unless the settlement agreement itself specifies that the amount sought to be deducted is for restitution. And no amounts can be deducted for reimbursement of the government's investigation and litigation costs.

The next very important change that will affect FCA settlements is the addition of a new federal agency reporting requirement. *See* H.R. 1, 115th Cong. § 13306(b) (2017) (enacting new 26 U.S.C. § 6050X). On a going forward basis for all new settlements (including FCA settlements) resulting in a payment to the government, the affected government agency will be required to "make a return"—as directed—

specifying: (1) the amount paid to the government; (2) the portion of the amount that constitutes restitution to the government; and (3) any amount that was required to be paid as a result of the agreement for the purpose of coming into compliance with the law at issue in the investigation or suit. This return also must be prepared if the payments are made due to a court order (*i.e.,* following trial or judgment).

The new law specifies that the return must be completed by the "appropriate official of any government…which is involved in the suit or agreement." Section 6050X(a)(1). The provision does not clearly state whether the reporting may be completed by the Justice Department—which represents the federal agencies in FCA cases—or just the affected agencies themselves, or both. *See* Section 6050X(c) (defining "appropriate official" as the "officer or employee having control of the suit, investigation, or inquiry or the person appropriately designated for purposes of this section"). Either way, however, since the Justice Department has, by statute, control of all FCA litigation and negotiates FCA (and many other government) settlements, the Justice Department will need to be involved in both the establishment of the restitution amount and the new reporting.

Finally, the new law mandates that (1) the return must be "filed" at the time the agreement is entered into and (2) at the same time as it is filed, the government must provide each party to the agreement a "written statement" containing the same information that is included in the return. In the past, companies had been forced to use a Freedom of Information Act request to obtain this type of information, but that should no longer be necessary under the new bill. The provision may, however, open the Justice Department and relevant agencies to discovery in any later tax proceeding where the IRS has challenged the deductibility of the taxpayer's payment even in the face of clear settlement agreement language and the government's separate reporting to the IRS.

Key Takeaways

The new tax law changes the landscape for FCA settlements (and settlements of other potential violations of law).

With respect to FCA settlements, there are open questions about the application and workability of the statute in non-intervened *qui tam* cases. And, whereas FCA defendants previously could deduct amounts ultimately paid to relators, the revised law does not address that issue directly.

In most high value cases, the tax law changes will force all parties to negotiate over the amount of the settlement payment that will constitute "restitution." For settling companies or individuals factoring a deduction into their settlement position, they must insist on any settlement agreement including a characterization of the "restitution" aspect of the payment that is considered deductible as that is a precondition for later attempting to claim a deduction. Thus, the Justice Department will now have to abandon its stance of being "tax neutral" in the settlement (and such a stance would be contrived in light of the separate IRS reporting requirement that the government now must comply with at the same time as the settlement). How the Justice Department and defendants adapt to this new reality will become evident in the coming months.

Finally, FCA defendants and other settling parties, even in the face of agreed-upon tax treatment language in the settlement and the government's separate reporting to the IRS, will have to be prepared for an IRS challenge of the deductibility and the burden of establishing that the payments indeed are deductible "restitution." Defendants settling FCA cases should consult with tax counsel experienced in resolving FCA claims.

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Authors:*

Douglas W. Baruch

John T. Boese

Jennifer M. Wollenberg

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Contacts:

Washington, D.C.

Douglas W. Baruch	+1.202.639.7052	douglas.baruch@friedfrank.com
John T. Boese	+1.202.639.7220	john.boese@friedfrank.com
Jennifer M. Wollenberg	+1.202.639.7278	jennifer.wollenberg@friedfrank.com

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FRIED FRANK

New York
One New York Plaza
New York, NY 10004-1980
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
801 17th Street, NW
Washington, DC 20006
Tel: +1.202.639.7000
Fax: +1.202.639.7003

London
41 Lothbury
London, U.K. EC2R 7HF
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555