Defendants Have New Incentives to Document Government Settlements

By Robert W. Wood


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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com.

Wood reviews the First Circuit's *Fresenius* decision as it concerns the tax deductibility of settlement payments made to the government. Although language expressly addressing taxes in settlement agreements remains appropriate, *Fresenius* suggests a broader approach to refining the proper tax treatment for a payment going beyond those provisions.

Are fines and penalties deductible? Many people aren't sure, and the tax code does not resolve the confusion. The code says that a deduction cannot be taken for any fine or similar penalty paid to a government for the violation of any law. For that purpose, a fine includes civil penalties and amounts paid to settle potential liability for any nondeductible fine or penalty.

That may sound straightforward, but the regulations take a step back, as does the case law. The regulations state that compensatory damages paid to a government do not constitute a fine or penalty.[1] Moreover, the case law makes clear that only some fines and penalties are meant to punish. Others are designed to be remedial.

Even something that is called a fine or penalty may not be. Funds that go into a remediation fund, for example, are more akin to compensatory damages or restitution and are deductable.[2] In short, like so much else in the tax law, one cannot go by name alone.

Those nuances are confusing for everyone — from tax advisers and business people, to lawyers and judges. That may help to explain *Fresenius Medical Care Holdings Inc. v. United States*, a First Circuit case[3] decided initially by a district court.[4] *Fresenius* concerns the deductibility of amounts paid to the government to resolve a federal False Claims Act (FCA) case.

Fresenius is an important case, and not only in the First Circuit. Defendants who run afoul of the government should be happy about the decision, but they should also get busy because the case suggests that they can improve the odds that their settlements will pass deductibility muster.

The FCA allows the government to recover treble damages from those who make false monetary claims against the United States.[5] Treble damages tend to be viewed as punitive in nature and therefore raise questions regarding deductibility for amounts beyond the compensatory damages.

Fresenius

Fresenius provides kidney dialysis. In 2000 Fresenius settled with the government and resolved claims for criminal and civil healthcare fraud. Its agreement included a criminal fine of $101 million and a civil settlement of $385 million.

Fresenius deducted its civil settlement payments in 2000 and 2001. The IRS disallowed 50 percent of those deductions, calling those portions nondeductible penalties under section 162(f). The IRS later allowed Fresenius an additional deduction of about $69 million, which the settlement agreement labeled as relator fees paid to the whistleblower. Those payments, all parties agreed, were inherently compensatory.

But Fresenius claimed that all of its civil settlement payments were compensatory and that there was no nondeductible penalty portion, and it sued for a refund.[6] The company asserted that the lump

[1] Reg. section 1.162-21(b).

[2] Reg. section 1.162-21(b)(2).

[3] No. 13-2144 (1st Cir. 2014).

[4] No. 1:08-cv-12118 (D. Mass. 2013).

[5] 31 U.S.C. section 3729.

[6] *Fresenius*, No. 1:08-cv-12118.

sum settlement amount was only double the government's claimed single damages, therefore not treble, not punitive, and compensatory.[7]

The settlement agreement stated that it didn't constitute a tax characterization for the amounts paid.[8] The government argued that Fresenius had to prove the parties agreed that the damages were compensatory when they signed the settlement agreement. Instead, the court asked the jury to decide whether Fresenius had:

> established by a fair preponderance of the evidence that some portion of the civil settlement payments . . . is not punitive for tax law purposes and consequently is deductible as an ordinary and necessary expense paid in carrying on a business.[9]

The jury returned a verdict in favor of Fresenius for $95 million. That amount was less than the $126 million the company had sought but more than the government would have allowed as a deduction.

IRS Guidance on Settlement Deductibility

The IRS has become more sensitive to settlements over the last 10 years, both on the income and the deduction sides of the equation. In 2007 the IRS issued an industry director directive (IDD) on the deductibility of government settlements.[10] In 2008 the IRS issued a coordinated issue paper (CIP) on the deductibility of FCA settlements.[11]

While the CIP deals only with FCA settlements, the IDD covers FCA settlements with the Justice Department as well as Environmental Protection Agency settlements for supplemental or beneficial environmental projects. Yet the IDD's preamble states that its principles can apply to any settlement between a governmental entity and defendant under any law by which a penalty can be assessed.

The CIP concludes that a portion of a civil fraud settlement may be a penalty and thus not deductible under section 162(f). According to the IRS, determining that portion hinges on whether the government's intent is punitive or compensatory. If the settlement agreement is not explicit, divining that intent is not easy.

One lesson from a leading authority in the field, *Talley Industries Inc. v. Commissioner*,[12] is that the party deemed to carry the burden of proof may lose the case. In *Talley*, a company and its executives were indicted for filing false claims with the government. The Navy claimed a loss of $1.56 million, but Talley and the Justice Department settled for $2.5 million.

When Talley deducted the settlement payment, the IRS claimed that it was a nondeductible fine or penalty. The Tax Court held that the settlement was deductible, except for the $1,885 explicitly characterized as restitution. The size of the damages was relevant as a benchmark of what could be punitive. Noting that $2.5 million was less than double $1.56 million, the court inferred that the settlement did not represent treble damages and was not therefore intended to be punitive. The IRS appealed, and the Ninth Circuit reversed and remanded, holding that Talley had failed to establish the compensatory nature of the settlement payment.[13]

Allied-Signal Inc. v. Commissioner[14] also denied the taxpayer a deduction. In that case, the Tax Court found Allied-Signal's $8 million payment into a nonprofit environmental fund nondeductible because Allied-Signal made the payment with the guarantee that the sentencing judge would reduce the company's criminal fine by at least that amount.

In *Fresenius*, the primary authorities discussed were *Bornstein*[15] and *Stevens*.[16] Those cases use a formulaic approach and treat the first third of FCA liability — the single damages — as direct compensation for the government's losses. Under *Bornstein*, the second third is compensatory, and *Stevens* treats the last third as punitive.

However, in *Cook County v. United States ex rel. Chandler*,[17] the Supreme Court strayed from that categorical approach. The Court emphasized that the FCA's "damages multiplier has compensatory traits along with the punitive."[18] As recognized in *Bornstein*, "some liability beyond the amount of the fraud is usually necessary to compensate the Government completely for the costs, delays, and inconveniences occasioned by fraudulent claims."[19]

Thus, the Court in *Cook County* refused to conclude that any portion of multiple damages under the FCA is necessarily remedial or punitive. Instead, the Court said that multiple damages can be either remedial or punitive and that the facts of the particular FCA litigation must be considered.

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[7] Mot. for Summ. J., Aug. 15, 2012, ECF. No. 128.

[8] *Fresenius*, No. 1:08-cv-12118, at 20.

[9] Transcript Day Six of Jury Trial, at 134, Aug. 15, 2012, ECF. No. 139.

[10] *See* LMSB-04-0507-042.

[11] *See* LMSB-04-0908-045.

[12] T.C. Memo. 1994-608, *rev'd and remanded*, 116 F.3d 382 (9th Cir. 1997).

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

[14] T.C. Memo. 1992-204, *aff'd*, 54 F.3d 767 (3d Cir. 1995).

[15] *United States v. Bornstein*, 423 U.S. 303 (1976).

[16] *Vermont Agency of Natural Resources v. United States ex rel. Stevens*, 529 U.S. 765 (2000).

[17] 538 U.S. 119 (2003).

[18] *Id.* at 130.

[19] *Id.*

Settling FCA Liabilities

Fresenius's settlement agreement said that it and its subsidiaries ''agree that nothing in this Agreement is punitive in purpose or effect.''[20] However, it is not clear that language had anything to do with taxes, and other provisions stated that they did not characterize the settlement payments as non-punitive for tax purposes.

The government argued that *Talley* meant that the parties had to agree that the purpose of a settlement payment is compensatory for it to be deductible. Nevertheless, the district court held that an agreement is not necessary for payments to be compensatory.

The FCA does not determine the purpose of settlement payments, thus a fact finder must decide it. Moreover, the Justice Department had refused to characterize Fresenius's settlement payments for tax purposes. Settlement payment language and negotiations are relevant, but so is other evidence regarding their purpose and application.

Other Evidence

What else is relevant? The district court considered negotiations and statements by various advisers and participants. None of the statements established that the settlement payments were not compensatory, but they didn't do the reverse either.

The statements didn't indicate that Fresenius's lawyers knew what expenses the government incurred to investigate the FCA violations, which would help evaluate the trebling question. Moreover, they didn't establish the extent to which the settlement paid the government for its losses or the extent to which the settlement exceeded those losses. There was no way to determine whether the settlement was double or triple the damages.

At trial, Fresenius emphasized the language in the agreements indicating that the payments were not punitive. It argued that the multiple damages were designed to compensate the government, primarily for prejudgment interest. Given all the mixed evidence, the court left the case to the jury. The jury found that $95 million of the disputed $126.8 million in settlement payments were compensatory and therefore deductible.

The jury struck a balance between the compensatory and punitive intent of the payments, but one that was in Fresenius's favor.

First Circuit

On appeal, the IRS contended that the absence of explicit tax language in the settlement agreement defeated Fresenius's deductions. The IRS relied on *Talley*.[21] There, in the absence of an explicit settlement agreement, deductibility depended on ''whether the parties intended the payment to compensate the government . . . or to punish'' the taxpayer.

In *Talley*, the taxpayer bore the burden of proving eligibility for deductions. That meant the taxpayer would suffer the consequences of any lack of evidence regarding the parties' intent. But the First Circuit in *Fresenius* said that view was too narrow.

The First Circuit said that *Talley* does not mean that intent can be proven only by showing a tax characterization agreement between the government and the taxpayer. Still, the IRS continued to argue that the district court should have entered judgment in its favor as a matter of law once it found that the parties had no tax characterization agreement. The First Circuit refused to adopt a rule that would require a tax characterization agreement for deductibility. That kind of rule would give the IRS the unfettered ability to defeat deductibility merely by refusing to agree — no matter how arbitrarily — to the tax characterization of a payment.

Instead, the First Circuit held that a court may consider factors beyond the presence or absence of a tax characterization agreement between the government and the defendant. Further, courts should look to substance and economic reality of the particular transaction, not just to form or language. Those broad tax doctrines apply not only to transactions, but also to settlement payments.

The First Circuit reiterated that the intent of a settlement payer, although not dispositive, is often the most persuasive evidence of the nature of settlement payments. If the government and a defendant settle an FCA claim and agree how the settlement will be treated for tax purposes, it is hard to envision any reason a court would not honor that agreement. If there is no agreed-on tax characterization, that is when a court's inquiry should shift to the economic realities.

The *Fresenius* court pointed out that the IRS's proposed ''no agreement, no deduction'' rule conflicted with another fundamental tenet of tax law: that a settlement payment should receive the same tax treatment as a judgment.

If an FCA case is tried rather than settled — thus, there is a judgment — there would be no tax characterization agreement. When the defendant pays the judgment, a portion beyond single damages may still have a compensatory purpose and therefore be deductible. The same result must apply to a settlement.

[20] *Id*. at 18.

[21] 116 F.3d 382 (9th Cir. 1997).

The First Circuit tried to reconcile *Talley* with its decision in *Fresenius*. In *Talley*, on remand following the Ninth Circuit's decision, the Tax Court considered the economic substance of the settlement, but it was hampered by the parties having not developed a factual record.[22] But Fresenius had developed one.

The First Circuit then considered the economic substance surrounding the settlement payment. Single damages are plainly compensatory and deductible.[23] But compensatory treatment can apply to more than single damages. That is, an enforcement action following a fraud brings additional costs and delays. It requires a recovery of more than single damages to make the government whole.

Additional costs may include, but are not limited to, the expenses of prosecuting the action and the time value of the delayed receipt of single damages, generally represented by interest. The First Circuit affirmed the district court's holding that $95 million was deductible.

Conclusion

After Boeing Co. settled a case in 2006, Senate Finance Committee member Chuck Grassley, R-Iowa, went on the warpath about why government settlements should not be deductible.[24] Grassley and others argued that all government settlements should expressly address taxes.[25] Yet they don't.

But there is more sensitivity in settlement agreements to tax issues today. For example, there were explicit tax provisions in several recent government settlements:

> 1. As part of its plea agreement regarding its aiding U.S. taxpayers evade taxes, Credit Suisse agreed to forgo any U.S. tax deduction for its $2.6 billion settlement payment.[26]
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> 2. BNP Paribas paid nearly $9 billion in penalties and pleaded guilty to illicitly transferring funds for Sudan, Iran, and Cuba despite economic sanctions. The settlement states that BNP agrees not to claim any deduction for U.S. federal, state, or local tax. The deal does not prohibit the bank from taking deductions overseas.[27]
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> 3. Bank of America reached a historic $17 billion legal settlement over soured mortgage securities.[28] It avoided any express agreement not to claim deductions, which should be worth $4 billion to the bank.

Business defendants concluding litigation want to pay the money, deduct it, and move on. Explicit provisions about deductibility avoid disputes. Still, from a defendant's perspective, it is preferable to argue about it after the fact rather than face a permanent deduction denial. Hope springs eternal, and that is especially so post-*Fresenius*.

The government's attitude in *Fresenius* should send a chill through the bones of tax advisers and in-house legal officers. The government maintained the striking Catch-22 that a defendant cannot call a settlement payment deductible and that a defendant cannot deduct it unless it is so labeled. But the First Circuit opinion offers a strategy.

Whether or not there will be an agreement, keeping supporting documents — especially those that show that the settlement is non-penal — is important. If there will be an agreement, including language that attests to the compensatory and remedial nature of the entire payment is ideal. Short of that, negotiating a lesser deductible portion in favor of some or most of the settlement remaining expressly deductible may be worth it.

You may have control over what correspondence you send, and you will know what you have received. Gather what you can whenever you can. Prepare documents on your own — record impressions, observations, and facts contemporaneously as you are negotiating the settlement. Lawyers and company officials can be appropriate signatories for those documents, but to add gravitas and perhaps admissibility, prepare and sign them under penalties of perjury. Some of them could be discounted as self-serving, but self-serving documents are better than none.

Fresenius should open a discussion about what settlement documents to keep, which ones to create, and how to negotiate settlement deductions. The contemporaneous documents I have suggested should be more likely to satisfy the IRS in audit or at appeals.

[22]T.C. Memo. 1999-200.

[23]Reg. section 1.162-21(c), Example 1.

[24]*See* Wood, "'It's Deductible': Sharp Pencils and Boeing's Imbroglio," *Tax Notes*, Sept. 18, 2006, p. 1053.

[25]*See* memorandum from Grassley to reporters and editors (Apr. 28, 2003), *available at* http://www.finance.senate.gov/newsroom/chairman/release/?id=3ee5fc48-5a6b-4ea9-9ee8-08402fd11a7e.

[26]*See* Department of Justice plea agreement with Credit Suisse AG (May 19, 2014), *available at* http://www.justice.gov/iso/opa/resources/6862014519191516948022.pdf.

[27]*See* Department of Justice plea agreement with BNP Paribas S.A. (June 27, 2014), *available at* http://www.justice.gov/opa/documents/paribas/plea-agreement.pdf.

[28]*See* Michael Rapoport, "BofA Could See $4 Billion in Tax Savings From $16.65 Billion Settlement," *The Wall Street Journal*, Aug. 21, 2014.