LJN LAW JOURNAL NEWSLETTERS

Business Crimes Bulletin ®

An ALM Publication

Volume 26, Number 3 • November 2018

Get It in Writing: Deducting False Claims Act Payments

By Joseph F. Savage, Jr. and Ashley M. Drake

In fiscal year 2017, the Department of Justice (DOJ) collected more than $3.7 billion dollars from False Claims Act (FCA) cases — part of the $86 billion it has collected from FCA cases since 1986. States and municipalities are aggressively pursuing FCA recoveries as well. For example, California has collected more than a billion dollars in settlements since the enactment of its FCA in 1987.

Whether or not such payments are deductible as business expenses under section 162(a) of the Internal Revenue Code is an important consideration when negotiating a settlement with the government since the corporate tax rate is still at 21%, even with the passage of the Tax Cuts and Jobs Act in December 2017. *See*, 26 U.S.C.A. §11(b); 26 U.S.C. §162(a).

Historically, DOJ has steadfastly declined to include in its settlement agreements language regarding the tax treatment of such payments, causing uncertainty. Most states likewise have refused to deal with deductibility in settlements. However, the new tax bill specifically addresses the issue and has altered the way parties negotiate and draft FCA settlement agreements.

Joseph P. Savage Jr., a member of this newsletter's Board of Editors, is a partner in Goodwin's Securities Litigation & White Collar Defense group. **Ashley M. Drake** is an associate with the firm.

Prior Law

Section 162(a) of the Internal Revenue Code allows a company to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. §162(a). Prior to Dec. 22, 2017, section 162(f) expressly excluded "any fine or similar penalty paid to a government for the violation of any law" from a company's deductible expenses. But federal regulations provided that "[c]ompensatory damages … paid to a government do not constitute a fine or penalty." *See*, 26 C.F.R. §1.162-21(b)(2). Deductibility thus depended on whether the settlement payment was deemed a penalty (and nondeductible) or compensatory (deductible). This distinction often became a matter of dispute with the IRS and courts split on their approach to the issue.

The U.S. Court of Appeals for the Ninth Circuit addressed the tax treatment of settlement payments in *Talley Industries Inc. v. C.I.R.*, 116 F.3d 382 (9th Cir. 1997), and held that since the taxpayer has the burden of establishing deductibility, "[i]f evidence to establish a deduction is lacking, the taxpayer, not the government, suffers the consequence." *Id.* at 387-88. On remand, citing the settlement agreement's silence on tax treatment, the tax court found that the taxpayer failed to establish the deductibility of the payment. *See*, 1999 WL 407454 (June 18, 1999). Later, the First Circuit Court of Appeals in *Fresenius Medical Care Holdings, Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014), went in a somewhat different direction, finding that "a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party." *Id.* at 72. Instead of focusing on the parties' "manifested intent," the court should look to the "economic realities of the transaction." *Id.* at 70.

New Law

Beginning with payments after Dec. 22, 2017, only such payments explicitly characterized as "restitution" (or separately, such payments as are made to come into compliance with law) in the settlement agreement will potentially be deductible and the government is now also required to characterize the tax treatment of the payment at the time of settlement in a separate filing to the IRS.

The amended section 162(f)(1) prohibits deductions "for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law." However, section 162(f)(2) provides that "amounts constituting restitution" are excluded from the general prohibition when:

> (i) the taxpayer establishes –
> (1) [the payment] 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]
> * * * *
> (ii) [the payment] is identified as restitution … in the court order or

settlement agreement…
§162(f)(2)(A)(i)-(ii).
In addition, the Internal Revenue Code now imposes reporting requirements at the time of settlement:

> (1) In general.--The appropriate official of any government or any entity described in secion 162(f0(5) which is involved in a suit or agreement described in paragraph (2) shall make a return in such form as determined by the Secretary setting forth--
> (A) the amount required to be paid as a result of the suit or agreement to which paragraph (1) of section 162(f) applies,
> (B) any amount required to be paid as a result of the suit or agreement which constitutes restitution…

26 U.S.C. §6050X(a)(1)(A)-(B).

Section 6050X(a)(1) requires the government to provide all parties to the settlement agreement with a written statement regarding the information contained in the required return. Unlike the statutory requirement that potentially deductible settlements must be explicitly denominated as "restitution," it is nowhere explicit that filing the form by the government is a condition precedent to any claim for deduction by the taxpayer, but attention to whether the government files the appropriate form would certainly be wise until that issue is clarified. *See*, §§6050X(a)(3), (b).

Under this new framework, getting the government to agree to characterize payments as "restitution" allows the taxpayer to argue for deductibility, but the new law is explicit that "[t]he identification under clause (ii) alone shall not be sufficient to make the establishment required under clause (i)." §162(f)(2)(A)(iii). The taxpayer still has an independent burden to show the payment is not a penalty, perhaps guided by the sort of analysis found in the *Fresenius* case.

Implications

Some things did not change under the new law — only restitution (not a penalty) is deductible and the burden is on the taxpayer. However, the requirement of an explicit characterization of what portion of a settlement is restitution will change the settlements. While the government long resisted characterizing the nature of settlement payments, with the new tax law companies and the government are now negotiating over what portion, if any, of the settlement constitutes restitution and including that in agreements. That characterization will set the upper limit of deductible restitution. Another change would appear to be the elimination of any argument that "disgorgement" payments are deductible, except to the extent they are also "restitution."

Since the government frequently starts FCA investigations with demands for single damages premised on supposed government losses that are wildly in excess of the ultimate settlement amount, close attention to (and documentation of) such positions can strengthen the company's position in later negotiations about the true restitution amount. Likewise, the scope of the "covered conduct" (the conduct that is subject to the release) used in the settlement agreement may be related to the amount the government can be persuaded to denominate as restitution. But persuading the government entity pursuing the FCA case is only the first step. Maintaining a clear non-privileged record of the government's various positions on the theory of liability, time frame and claims involved may also be important if the IRS later attempts to disregard the parties' description.

Recent state and federal settlements reflect a response to the new law. In February 2018, a North Carolina doctor executed an agreement with the DOJ to resolve allegations that he violated the FCA that included a statement that "$1 million of the Settlement Amount is restitution." Similarly, in May 2018, Pfizer agreed to settle allegations that it violated the FCA with a $23,850,000 payment. The settlement agreement states that "[o]f the Settlement Amount, $13,250,000 is restitution to the United States." William Beaumont Hospital's recent FCA settlement agreement with both the federal government and the state of Michigan employed similar language with the hospital agreeing to "pay to the state of Michigan $1,760,198.90 … of which $880,099.45 is restitution." While it has been reported that DOJ has a working group for this issue, it is not clear yet whether these barebones settlement agreement statements are a reflection of a uniform DOJ approach to the issue.

Even FCA cases that proceed to trial will be affected by the new tax law, as section 162(f) provides that "court ordered payments" that are identified in a court order as restitution may also be deductible. Thus, any amount that a corporate defendant is ordered to pay at the conclusion of a trial must also be categorized as restitution to be potentially deductible. Attention will have to be paid to framing appropriate jury verdict forms that give a court the necessary basis to order that a portion of the ultimate payment is "restitution."

Since the FCA push is not going away anytime soon the opportunity to get a 21% tax savings under settlement agreements will remain a focus. Advocacy on the restitution issue with the settling government agency and the IRS will be central, along with adherence to the new procedure under the tax code.

—❖—