

Government Settlement Write-Offs May Be In Jeopardy

By Robert W. Wood

Business defendants concluding litigation want to pay the money, deduct it, and move on. That is often true in private party litigation too, but it can be especially true in suits and investigations brought by the government, where the stakes can be much higher. Among the many factors at play in such unhappy cases, there are usually tax considerations.

The government may push for explicit provisions about tax deductibility, saying that the defendant will not claim deductions. The defendant may push for the reverse. Often, explicit tax deductibility language will be a hard sell in this context. From a defendant's perspective, it is preferable to argue about it after the fact rather than face a permanent deduction denial.

As an old adage says, it is sometimes better to ask for forgiveness rather than permission. When it comes to tax deductions, sometimes hope springs eternal. But the government can and does push back.

For example, in *Fresenius Medical Care Holdings Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014), the company deducted a \$95 million settlement paid to the government for alleged fraud. The company deducted it, but the IRS said was clearly a nondeductible penalty. When the audit went to court, the IRS had a heads-we-win, tails-you-lose argument.

The IRS argued that a settlement agreement cannot call a settlement payment tax deductible, and that a defendant cannot deduct it unless it is so labeled! But the 1st U.S. Circuit Court of Appeals affirmed the district court's holding that the \$95 million was tax deductible. This wasn't expressly a nondeductible fine or penalty, the court rules.

In general, fines and penalties paid to the government are not deductible. Section 162(f) of the tax code prohibits deducting "any fine or similar penalty paid to a government for the violation of any law." You might think that this tax code section resolves the point.

Yet despite punitive sounding names, some fines and penalties are considered remedial and deductible. That allows some flexibility, provided that the actual settlement documents do not expressly say that something is a non-deductible fine. Companies often deduct 'compensatory penalties.'

Some defendants insist that their settlement agreement confirms that the payments are not penalties and are remedial. Conversely, some government entities insist on the reverse. Explicit provisions about taxes in settlement agreements are becoming more common. But barring express non-deductibility commitments, many penalties can be deducted, too.

For example, the Department of Justice expressly blocked Credit Suisse from deducting its \$2.6 billion settlement for helping Americans evade taxes. Same for the BNPP terror settlement, which states that BNPP will not claim a tax deduction. Sometimes the government and a defendant split the baby.

Of the \$13 billion JP Morgan settlement struck in late 2013, only \$2 billion was said to be nondeductible. The DOJ doesn't always disclose the terms of settlements either. But that could change.

This year, Sens. Elizabeth Warren (D-MA) and James Lankford (R-OK) reintroduced the Truth in Settlements Act, S.1145, 115th Cong. (2017). It would increase transparency for

settlements between federal agencies and corporations accused of wrongdoing. When federal agencies announce settlement agreements, they regularly tout the top-line dollar value made to resolve allegations of misconduct.

However, the public value of these settlements is diminished when corporations are allowed to receive massive tax write-offs and credits from these payments. Many times, these agreements are deemed confidential and details are hidden from the American public. This proposed legislation would require detailed and publicly accessible disclosures of these settlement agreements and the tax write-offs that accompany them.

In September 2015, the bill passed unanimously through the Senate. See Truth in Settlements Act of 2015, S.1109, 114th Cong. (2015). "Republicans and Democrats agree that the transparency of our government agencies is vital to ensuring public trust, a robust democracy, and fair settlement deals," said Michelle Surka, advocate with U.S. Public Interest Research Group. "When government agencies strike settlement deals on behalf of the American public, we deserve to know the details."

In recent years, some of the largest settlements between corporations and federal agencies included significant tax deductions for the corporation. British Petroleum, settling with the government for its role in the BP oil spill, earned a \$15.3 billion tax write off for the deal. Though the tax code does state that fines and other penalties are not tax deductible, a consistent lack of specificity in settlement agreements has allowed companies to claim deductions nevertheless.

"Government accountability requires transparency, and that's what this bipartisan bill provides," Warren said. "The Truth in Settlements Act will shut down backroom deal-making by shining a light on federal agency settlements with lawbreaking companies. More transparency means Congress, citizens and watchdog groups can better hold regulatory agencies accountable for enforcing laws so that everyone — even corporate CEOs — are equal under the law."

In the current climate, this bill probably does not have a high likelihood of passage. But that does not mean negotiating government settlements is easy. In a settlement agreement, including language that attests to the compensatory and remedial nature of the entire payment is ideal from a tax deductibility viewpoint.

Short of that, negotiating a lesser deductible portion in favor of some or most of the settlement remaining expressly deductible may be worth it. And then there is all the back-up documentation the settling company should keep. If you represent a defendant eyeing tax deductions, gather what you can, whenever you can.

Where appropriate, record impressions, observations, and facts contemporaneously as you are negotiating the settlement. Lawyers and company officials can be appropriate signatories for those documents. To add gravitas and perhaps admissibility in a later tax dispute, prepare and sign them under penalties of perjury. Some of them could be discounted as self-serving, but self-serving documents can be better than none.

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