IRS Cracking Down on Government Settlements

Taxpayers who are charged with violating federal law routinely pay millions of dollars in settlement payments to the government. This article discusses the controversy surrounding the tax treatment of settlement payments, relevant case law on the subject, and the IRS directive to its employees on how to deal with settlement payments.

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EXECUTIVE SUMMARY

- **The IRS's Large and Mid-Sized Business Division has issued an Industry Director Directive to its employees on the deductibility of settlement payments made under a settlement with the Department of Justice for violations of the Fair Claims Act and the Environmental Protection Agency for supplemental or beneficial environmental projects.**
- **If a settlement payment is a fine or penalty paid to a government, it is not deductible; if it is compensation paid to the government for the damage done by the payor, it may be a deductible business expense.**
- **In cases where a settlement agreement is not clear about whether a payment is a nondeductible fine or penalty or a deductible compensatory payment, a court will look to the intent of the parties as expressed outside of the agreement to determine the purpose of the payment.**
- **A payment that is not made to a government (and thus not a fine or penalty under the express wording of Sec. 162(f)) may still be treated as such by a court if it is in substance a fine or penalty.**

The IRS issues a wide array of guidance. There are various types of regulations (final, proposed, and temporary), revenue rulings, private letter rulings, field service advice, notices, actions on decision, technical advice memoranda, audit guidelines, and so on.All of these pieces of guidance are not of equal weight, of course, and some are, technically speaking, not even treated as authority.

In a world of growing information accessibility, practitioners may become overwhelmed and may not carefully review every regulation release, piece of proposed legislation, and unofficial guidance. The sheer volume of material to read has a chilling effect on what many do read. Becoming a selective reader may be a modern survival skill, but with the increasing size and number of settlement payments made to the government, it would be wise to read all the information on the high-stakes topic of government settlement deductibility.

Industry Director Directive Release

On May 30, 2007, the IRS released an Industry Director Directive (IDD) on the tax deductibility of government settlements. The directive comes from the Service's Large and Mid-Sized Business Division (LMSB) and is labeled "Directive Number One," presumably indicating that there may be others.[1] It is formatted as a memorandum from "John Risacher, Industry Director, Retailers, Food, Pharmaceuticals and Healthcare" to "Industry Directors, Director, Field Specialists, Pre-filing and Technical Guidance, Director, International Compliance Strategy and Policy, and Director of Examination, SBSE."

The IDD provides field direction on the deductibility of settlements with a government agency. There is a dichotomy between a deductible business expense on the one hand and a nondeductible fine or penalty on the other (Sec. 162(f)). The memo's background notes that settlements are enforcement tools used by government agencies to resolve violations of law and to punish companies, short of going to court. According to the IRS, a settlement payment can include compensatory amounts, punitive payments, or a combination of the two.[2]

The specific types of settlements addressed include settlements with the Department of Justice (DoJ) under the False Claims Act (FCA) and with the Environmental Protection Agency (EPA) for supplemental or beneficial environmental projects.[3] But the IDD's preamble states that outside the context of DoJ and EPA settlements, its principles can apply to *any* settlement between a government entity and a defendant under any law in which a penalty can be assessed. The statement that this penalty *can* be assessed, not that it actually *will* be assessed or that it has been assessed, is significant.

Boeing Case

The IDD also reveals that the government settles cases without regard to the tax consequences of a payment. That hardly seems a revelation, given, for example, the furor that developed over a 2006 Boeing settlement and its tax benefits. In mid-2006, Boeing settled the largest "penalty" ever imposed on a military contractor for weapons program improprieties.[4] As final details of the $615 million settlement were hammered out, tax issues took center stage. In July 2006, Senators Chuck Grassley (R-IA), John McCain (R-AZ), and John Warner (R-VA) sent a letter to Attorney General Alberto Gonzales expressing outrage at the possibility that Boeing could deduct the $615 million. Allowing the Boeing settlement to be tax deductible, the senators said, would result in "leaving the American taxpayer to effectively subsidize its misconduct."[5]

The three senators made it clear that they were shocked that Boeing could legitimately whittle down the net after-tax “penalty” with a deduction that is effectively at taxpayers’ expense. McCain and Grassley had raised similar concerns in 2003 about a $1.4 billion settlement with several Wall Street firms involved in allegedly biased reports by their research departments. Some of that settlement was deductible. Indeed, $432.5 million of it went to finance independent research, and $80 million was to finance investor education programs.[6]

A GAO study released in 2005 found that four large federal agencies (including the DoJ) do not negotiate with companies over whether settlement payments are tax deductible. Instead, the GAO says the agencies believed that was the IRS’s job.[7]

On July 18, 2006, Senator Grassley questioned Gonzales:

> I am very troubled that . . . DoJ was completely blind as to the real amount of the penalty, that is, the after-tax amount.To have a situation where the federal government is negotiating a settlement without understanding what the real settlement amount will be, the after-tax amount, is embarrassing. . . I can assure you that the lawyers on the other side of the table. . . are very aware of the after-tax amount. . . It means millions of dollars to their client. . . It is actually worse that DoJ doesn’t even know what the tax treatment is of the Boeing settlement. It tells me that DoJ lawyers gave away 35 percent of the store without even knowing it.[8]

The DoJ formally responded to Grassley, saying that the Boeing settlement had been fully signed on June 30, 2006, before Grassley’s complaint was made. It also noted that as a matter of policy, its agreements are “tax neutral,” leaving the difficult issues of deductibility to the expertise of IRS tax lawyers. In fact, the DoJ’s letter to Grassley stated:

> It is the Department’s policy and practice in settling fraud investigations to remain tax neutral and defer those issues to consideration by the IRS after settlement. . . . The Department and the IRS have devised a system that routinely provides the IRS the information it needs to ensure that taxpayers are treating their settlement payments properly. Indeed, this information-sharing arrangement is consistent with the Government Accountability Office’s recommendation that the IRS “work with federal agencies that reach large civil settlements to develop a cost effective permanent mechanism to notify [the]IRS when such settlements have been completed and to provide [the] IRS with other settlement information that it deems useful in ensuring the proper tax treatment of settlement payments.”[9]

Responding to public attention, Boeing announced that it would not seek tax deductibility for the settlement, even though the bulk of the settlement was arguably deductible.

Settlements and Taxes

It is hard to read the Service's recent IDD without reflecting on the controversy over the Boeing settlement. Perhaps the IRS memorandum stating that the government does not pay attention to tax language is meant to be defiant. In any case, the IDD states that settlement language is typically neutral as to whether or not a portion of the settlement constitutes a penalty.

Interestingly, until some point in 2005, many DoJ settlement agreements apparently included the statement, "The parties agree that this agreement is not punitive in purpose or effect." This might lead taxpayers to think that the payment is entirely compensatory and therefore deductible. However, the IRS believes that this phrase relates only to double jeopardy under the Constitution and has no bearing on tax issues.[10]

In a cursory way, the memorandum describes the nature of DoJ and EPA settlements. The IDD notes that a portion of the civil penalty proposed for an environmental violation is typically reduced in exchange for the company's agreement to perform a supplemental environmental project (SEP).The memorandum notes that most defendants will either deduct the entire SEP amount as a Sec. 162 expense or capitalize it and claim depreciation deductions. Treating a portion as a nondeductible penalty is evidently rare.

Turning to the FCA, the stakes are even higher. Settlements and judgments between 1987 and 2006 totaled over $18 billion, with $9 billion of this amount between 2001 and 2006 alone. Here again, the concern is what portion of these payments the defendants are deducting. Over 75% of the settled cases involve health care companies, approximately 14% involve defense contractors, and the remaining 11% cover companies in a broad range of other industries.

Issue Spotting and Mandatory Audits

The memorandum states flatly that examination is mandatory for FCA settlements of $10 million or more and for SEP projects of $1 million or larger.That does not mean payments below these thresholds are exempt. Examiners are directed to use a risk-analysis process to determine whether settlements and projects below these thresholds merit examination.

The memorandum instructs that the government attorneys involved in these settlements should be key contacts, coordinating interviews and requests for records relevant to the particular settling taxpayer involved. Since the identity of these companies is typically no secret (the memorandum notes that soon after settlement is reached, most are covered by the media), the memorandum advises consideration of pre-filing agreements with the taxpayer.The pre-filing agreement project may substantially cut back on what the Service perceives as a trend in favor of immediate and 100% deductibility for these settlements.

Nondeductible Fines and Penalties

The memorandum reviews the language of Sec. 162(f) and its regulations. Sec. 162(f) states that "no deduction shall be allowed . . . for any fine or similar penalty paid to a government for the violation of any law."The regulations define fines and penalties as amounts:

- Paid pursuant to a conviction or a plea of guilty (or nolo contendere) for a crime (either felony or misdemeanor) in a criminal proceeding;
- Paid as a civil penalty imposed by federal, state, or local law; or
- Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).[11]

Significantly, legal fees are exempt from this strict regimen. Legal fees and related expenses paid or incurred in defending a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty are deductible.[12]

Whether a payment constitutes a nondeductible fine or penalty depends on the purpose the specific payment was meant to serve. Determining the purpose of a payment can be difficult in a negotiated settlement. But the IDD mentions several technical advice memoranda, including TAM 200502041,[13] in which the IRS allocated an FCA settlement between a portion treated as nondeductible under Sec. 162(f) and a portion deductible as compensatory damages.

In TAM 200629030,[14] the Service concluded that a portion of the costs incurred for the performance of an environmental project was comparable to a nondeductible fine or similar penalty under Sec. 162(f). Therefore, under Secs. 263A or 1012, this portion of the cost of performing the environmental project could not be included in the basis of the assets produced in the project.

Although the IDD cites these TAMs, perhaps as evidence that such allocation issues can be solved, the line between compensatory and noncompensatory fines can be difficult to discern. The taxpayer must establish the deductibility of any payment.

Motive of Payments—The *Talley* Case

Proving motive is not easy, yet it is relevant here. It may be difficult for the taxpayer to show that a fine is imposed with a compensatory motive. Indeed, how does one find out the government's motive on any subject? How high the stakes are, of course, depends on the size of the fine and the degree to which it is likely to be recurrent.

Several cases are particularly important in exploring a payment's purpose. The IDD mentions *Talley Industries, Inc.,*[15] which is worthy of note. A company and several executives were indicted for filing false claims for payment with the federal government. According to the Defense Contract Audit Agency (DCAA), the company's conduct resulted in a loss to the Navy of approximately $1.56 million. However, the settlement amount agreed upon between Talley and the DoJ was $2.5 million. Talley treated the amount of the settlement payment above the amount of the DCAA's loss estimate ($940,000) as additional compensation for the government's losses. When the company deducted the full amount of the settlement payment as an ordinary and necessary business expense, the IRS disallowed the $940,000 in excess of the DCAA's loss estimate as a nondeductible fine or penalty. It argued that the additional payment was a payment of double damages under the FCA.

The Tax Court granted summary judgment for Talley, holding that the settlement payment was not a fine or penalty, except for a very small amount ($1,885) that was explicitly for restitution in the criminal proceedings against Talley. The court found that the government had never suggested that it was attempting to exact a civil penalty. In addition, noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the $940,000 was not a payment of double damages. Therefore, the Tax Court held that the payment was not intended to be penal or punitive, but rather to be compensatory.

Unfortunately for the taxpayer, the Ninth Circuit reversed and remanded the case to the Tax Court, concluding that there was a material issue of fact and that the matter was not ripe for summary judgment. It is useful to review the instruction the Ninth Circuit gave to the court on remand:

> If the $940,000 represents compensation to the government for its losses, the sum is deductible. If, however, the $940,000 represents a payment of double damages [under the FCA], it may not be deductible. If the $940,000 represents a payment of double damages, a further genuine issue of fact exists as to whether the parties intended payment to compensate the government for its losses (deductible) or to punish or deterTalley and Stencel (nondeductible).[16]

The opinion of the Tax Court in the *Talley* case on remand is extraordinarily detailed, referring to the extremely specific findings of fact about many of the developments occurring during the settlement.[17]The Tax Court held that the settlement payment included double damages under the FCA because, even though the settlement agreement was silent on that point, that was what the parties intended.

The Tax Court then turned to whether the $940,000 double damage payment was intended to compensate the government for its losses or to deter or punish Talley.The settlement agreement also was silent on the issue. Talley argued that no portion of the $940,000 could be considered a penalty and the IRS argued that the entire amount was a penalty.Talley maintained that the government's actual losses exceeded $2.5 million, so the $940,000 was merely a portion of it and had to be regarded as a reimbursement. The IRS countered that, regardless of the government's actual losses, it intended that the disputed portion of the payment be a penalty imposed to deterTalley and other government contractors from submitting false claims.

The Tax Court was not persuaded by the wholesale nature of the payment; it noted that the settlement was a compromise on numerous issues and that the key to the characterization of the payment was the parties' intent. The court noted that there was correspondence about the settlement offers, and the taxpayer had actually tried to state in the settlement agreement that the amounts would be treated as restitution. Because the government rejected this proposal, the Tax Court concluded that the taxpayer failed to carry its burden of showing that a remediation purpose was intended.

Talley again appealed theTax Court's decision to the Ninth Circuit. There, in a brief opinion, the Ninth Circuit reviewed the Tax Court's conclusions of law and its factual findings for clear error. Finding no error in the Tax Court's ruling, the Ninth Circuit held that Talley failed to establish the compensatory nature of the disputed settlement.[18]

Fine in Substance—The *Allied-Signal* Case

As the IDD notes, taxpayers make every attempt to avoid penalty characterization and to emphasize the remedial effects (orintent) of the payments. A good example of this can be found in the *Allied-Signal* case.[19] In that case, a federal district court fined Allied-Signal $13 million for numerous criminal violations of federal environmental law related to the discharge by a subsidiary company of the pesticide Kepone into the environment in Hopewell, Virginia. In return for Allied-Signal's contribution of$8 million to a nonprofit environmental fund set up to alleviate the damage caused by the Kepone contamination and to improve the environment ofVirginia generally, the district court judge reduced the fine by that amount. Allied-Signal deducted the $8 million contribution to the fund as an ordinary and necessary business expense. The IRS disallowed the deduction, and Allied-Signal challenged the IRS's determination in theTax Court. The Tax Court determined that the entire payment to the fund was nondeductible because it was made with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least that amount. The Tax Court rejected the companyargument that the payment was not a fine or penalty because it did not serve to punish or deter, concluding that the payment served a law enforcement purpose, not a compensatory one.

It is not surprising that the government victory in *Allied-Signal* features prominently in the IDD. Allied-Signal's understanding that the proposed $13 million criminal fine would be reduced by the $8 million contribution led the Tax Court to hold that the $8 million payment was in substance a fine or similar penalty nondeductible under Sec. 162(f). In the current era of increased focus on substance over form, and given the anti-tax-shelter rhetoric that often now permeates tax cases, *Allied-Signal* was ahead of its time.

In fact, the IDD quotes some of *Allied-Signal*'s language. The court sounded prophetic in stating that "while the form of the payment does not necessarily fit within the letter of Section 162(f), in substance petitioner paid a criminal fine." Allowing the taxpayer a deduction, the *Allied-Signal* court went on to say, "would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[20]

Audit Techniques

The audit techniques discussion in the IDD text is short and nonspecific, noting that the facts and circumstances need to be developed and determined. But the IDD includes audit guidelines as attachments that provide more detailed information, with one set of guidelines for FCA settlements and another for EPA settlements.

FCA Settlements

The audit guidelines begin with the premise that almost every taxpayer deducts the entire amount of each FCA settlement.Yet the guidelines assert that a portion generally represents a penalty. To determine if a penalty has been imposed and, if so, how much, the guidelines say that two primary questions must be answered:

- Is a portion of the settlement payment a penalty and therefore not deductible?
- What is the penalty amount?

In answering these questions, the guidelines advise the examiner that the taxpayer must prove it is entitled to deduct *any* portion of the settlement amount.

Once the case is identified, there are procedures for the IRS to contact the DoJ and for the examining IRS employee to then meet with the DoJ attorney who handled the case. Interviews and requests for records follow. Although the guidelines say that no two cases are identical, the template for document requests suggests that all communications between the DoJ and the defendant, its representatives, and employees(letters, memos, e-mails, etc.) must be obtained.

Significantly, the guidelines state that initial letters often formalize the DoJ's position that "multiples" will be included in any settlement that is reached. The critical documents also include all computations and settlement proposals made by either side, as well as everything that leads up to whatever settlement is ultimately reached. As to the meaning of the term "multiple," the guidelines make it clear that the DoJ uses this term when it means "penalty."

Predictably, any correspondence that addresses tax consequences is critical. The guidelines note that "it is rare for this subject to be addressed, however, the request for this type of correspondence needs to be made." Interestingly, discussions between the DoJ and the whistleblower (and the whistleblower's attorney) in the FCA case are also likely to be requested. It is hard to see how the interaction with the whistleblower is relevant, but perhaps the Service is looking for a reference to "multiples" or other buzzwords.

Although audit guidelines need not contain taxpayer arguments, it is noteworthy that according to these guidelines, taxpayers frequently argue that a total settlement is to compensate the government for losses such as overbilling. If the settlement (as almost always occurs) is less than the initially publicized amount of the government's losses, taxpayers (predictably) argue that since the settlement is less than the reported losses, all of the settlement must be credited to those losses and thus compensatory and deductible.

In response, the audit guidelines state: "This argument has no real merit as it is not factually based and it is not representative of the final settlement agreement."[21] It is at this point that the guidelines refer to the phrase (now deleted) included in most DoJ settlement agreements written prior to June 2005: "The parties agree that this agreement is not punitive in purpose or effect." Taxpayers understandably argue that this sentence means what it says, but the IRS audit guidelines state that the DoJ included this phrase in reference only to double jeopardy under the Constitution and that it has no meaning for tax purposes.[22]

EPA Settlements

The audit guidelines for environmental violation enforcement settlements begin with a description of the EPA penalty framework. EPA settlements are far more likely to expressly address tax issues than are FCA cases. Indeed, there is often a consent decree lodged in federal court that expressly includes three major components: (1) a civil penalty amount that is separately stated and is typically expressly designated as nondeductible for income tax purposes; (2) injunctive relief that covers compliance projects; and (3) SEPs, voluntary projects incorporated into a consent decree in order to negotiate a significant reduction in proposed penalties.

According to the audit guidelines, only a portion of a SEP will typically be used to reduce the penalty amount. That means the actual amount paid for a SEP and a reduced penalty may add up to a figure greater than the original proposed civil penalty. The big question for the auditor in these cases, then, is to determine the penalty amount that is mitigated (or forgiven) as a result of the taxpayer agreeing to perform a SEP.

Sometimes, the audit guidelines assert, this amount can readily be ascertained in the body of the consent decree. In other cases, extensive factual development of the negotiations' history is needed. The audit guidelines suggest that the examiner should contact the environmental technical adviser once it is clear the taxpayer has agreed to perform a SEP. Complete copies of files, correspondence, and other relevant information are then to be solicited from the taxpayer, the EPA, the DoJ, etc. Any penalty exposure computations prepared by the EPA, the taxpayer, or the taxpayer's representative are to be solicited.

Using *Allied-Signal* as a guide, the memorandum concludes with the Service's summary position that:

- Taxpayers may not deduct the portion of costs incurred in performing a SEP that is "an amount analogous to a nondeductible fine or similar penalty" under Sec. 162(f).
- Taxpayers may not include in the basis of assets they produce the portion of the SEP cost that is "an amount analogous to a fine or similar penalty."
- For FCA cases, the question of whether the settlement includes a nondeductible penalty can be determined only through communication, coordination, and cooperation between the IRS and the DoJ.

Conclusion

These summary conclusions in the IDD are ultimately not very helpful. The big question for EPA cases is just what *is* an amount "analogous" to a fine or similar penalty. With slightly different wording, the same question applies to FCA cases. Despite Senator Grassley's exhortations, if the DoJ (and the EPA) do not attempt to address the pertinent tax questions, these issues are probably not going to be any easier to resolve.

The audit guidelines, and the intense focus on factual development, suggest that there will be a greater emphasis on the legal background and dynamic of the dispute than ever before. What seems clear is that the IDD's focus on getting information from DoJ or EPA lawyers suggests interagency collaboration after the fact. Indeed, it may mean that the IRS has a chance to help mold the tax position in arrears and to help frame what the intent of the settlement might have been.

It is troubling to think that, although Senator Grassley cannot compel DoJ personnel to consider tax issues in framing settlements, the IRS can help the DoJ (and the EPA) do so later. Couple this with the fact (often repeated in the IDD) that the burden is on the taxpayer to establish deductibility, and the resulting mix foreshadows a more subtle assault on the deductibility of government settlements.

Perhaps the IDD is a direct response to the widely publicized discussions about the lack of cooperation between the IRS and the DoJ and to the criticism that government lawyers (inappropriately) failed to take tax considerations into account in reaching settlements. Still, it does not seem an unfair reading of the IDD to suggest that, rather than an up-front tax discussion at settlement time, the IRS gets to determine intent after the fact. The IRS can then rely on the systematic advantage of the rule that the taxpayer has the burden of proving that *any* portion of the settlement is deductible. In any event, the IDD may portend increased future scrutiny on settlements and deductibility.

IRS Cracking Down on Government Settlements - footnotes

[1] LMSB-04-0507-042 (5/30/07).

[2] The Government Accountability Office (GAO) suggests that most taxpayers deduct the entire civil settlement amount, although DoJ records reveal that almost every settled case includes substantial penalties. Settlement may be all about issues of perception. Plainly, the payor and the payee settling a dispute may not agree on everything, including the payor's degree of exposure for potential fines and penalties.

[3] The IDD elevates deductions that are claimed for FCA and EPA cases (discussed below) to Tier I issue status. Tier I issues are of high strategic importance to the LMSB and are supposed to have a significant impact on one or more industries. The fact that the IDD now treats these settlement deductions as Tier I issues is significant and makes the IDD of greater importance.

[4] See Pasztor, "Boeing to Settle Federal Probes for $615 Million," Wall Street Journal, May 15, 2006, p. A1.

[5] See Wayne, "3 Senators Protest Possible Tax Deduction for Boeing in Settling US Case," New York Times, July 7, 2006, p. C3.

[6] Id.

[7] Government Accountability Office, "Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments," GAO-05-747, A Report to the Committee on Finance, U.S. Senate, September 2005 (www.gao.gov/new.items/d05747.pdf).

[8] Doc 2006-13587, 2006 TNT 138-17.

[9] Letter from Assistant Attorney General William Moshella to Sen. Charles Grassley, July 14, 2006, quoting GAO, "Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments," GAO-05-747, September 2005, p. 26.

[10] See LMSB-04-0507-042 (5/30/07), Attachment I.

[11] Regs. Sec 1.162-21(b)(1).

[12] Regs. Sec. 1.162-21(b)(2).

[13] IRS TAM 200502041 (1/14/05).

[14] IRS TAM 200629030 (3/31/06).

[15] Talley Indus., Inc., TC Memo 1994-608, rev'd and remanded, 116 F3d 382 (9th Cir. 1997).

[16] Talley Indus., Inc., 116 F3d 382, 387 (9th Cir. 1997).

[17] Talley Indus., Inc., TC Memo 1999-200.

[18] Talley Indus, Inc., 18 F App'x 661 (9th Cir. 2001).

[19] Allied-Signal, TC Memo 1992-204, aff'd, 54 F3d 767 (3d Cir. 1995).

[20] Id. at p. 45.

[21] LMSB-04-0507-042 (5/30/07), Attachment I.

[22] Id.