# Some Fines and Penalties Are Deductible, And It Just Got Easier

By Robert W. Wood • Wood LLP • San Francisco

Are fines and penalties tax deductible? The Code says that no deduction can be taken for any fine or similar penalty paid to a government for the violation of any law. For this purpose, a "fine" includes civil penalties as well as amounts paid in settlement of potential liability for any nondeductible fine or penalty.

That may sound straightforward, but the regulations and case law make it less so. The regulations say that compensatory damages paid to a government *do not* constitute a fine or penalty. Moreover, only some fines and penalties are meant to punish.

Other "fines" and "penalties" are really designed to be remedial, not penal. Even if called a fine or penalty, they may be paid into a fund to be used for remediation. Such amounts are really more like damages or restitution, so they are allowable as deductions. In short, like so much else in the tax law, one cannot go by name alone.

If tax advisers and businesspeople can be confused about these nuances, so too can lawyers and judges. That may help to explain the case of *Fresenius Medical Care Holdings, Inc.*, decided by a District Court [*Fresenius Medical Care Holdings, Inc.*, DC-Mass., 2013-1 USTC ¶50,323] and more recently on appeal by the First Circuit [*Fresenius Med. Care Holdings, Inc.*, CA-1, 2014-2 USTC ¶50,416]. The case concerns the tax deductibility of amounts paid to the government to resolve a Federal False Claims Act (FCA) case.

Fresenius' is a terribly important case, not only in the First Circuit but beyond. Defendants who are able to compromise with the government should be happy. But they should also get busy, for *Fresenius* suggests they can improve the odds that they can deduct their settlements.

The FCA allows the government to recover treble damages from those who make false claims against the United States. Treble damages tend to be viewed as punitive in nature, thus invoking the tax question regarding the deductibility of anything beyond compensatory damages.

## *Fresenius*

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

The company made and deducted the civil settlement payments in 2000 and 2001. The IRS disallowed 50 percent of the deduction as a nondeductible penalty. The IRS later allowed the company an additional deduction of approximately $69 million, which the settlement agreement labeled as relator fees to the whistleblower.

Fresenius claimed that there was *no* nondeductible penalty and sued for a refund. Fresenius asserted that the lump-sum settlement was only double the government's single damages, so it was all compensatory.

> that the undisputed evidence elicited at trial in this matter establishes that the United States is made completely whole in a False Claims Act case only by recovery of a damage amount in excess of the "single" or "actual" damage amount representing the repayment of claims alleged to be false or inaccurate. Fresenius also submits that U.S. Supreme Court precedent makes clear that "double" damages are remedial in nature and the evidence elicited during trial in this matter establishes that the double damages were not punitive [Mot. for Summ. J., Aug. 15, 2012, ECF. No. 128].

The *Fresenius* settlement agreement specifically stated: "Nothing in this Agreement constitutes an agreement by the United States concerning the characterization of the amounts paid hereunder for [tax] purposes." The government argued that to deduct the payments, Fresenius had to prove the parties had actually *agreed* that the damages were compensatory at the time of settlement. However, the court asked the jury to decide whether Fresenius had established that the

civil settlement was not punitive. The jury returned a verdict allowing Fresenius to deduct $95 million, still less than the $126 million the company had sought.

## IRS Guidance on Settlement Deductibility

The IRS has become more sensitive to legal settlements, both on the income and deduction sides of the equation. In 2007, the IRS issued an industry director directive (IDD) on the deductibility of government settlements [*see* LMSB-04-0507-042, *Doc 2007-13682, 2007 TNT 111-7*]. In 2008, the IRS issued a coordinated issue paper (CIP) on the deductibility of FCA settlements [*see* LMSB-04-0908-045, *Doc 2008-19051, 2008 TNT 174-54*].

The CIP deals only with FCA settlements. The IDD covers FCA settlements with the Department of Justice (DOJ), as well as Environmental Protection Agency settlements for supplemental or beneficial environmental projects. Yet the preamble to the IDD 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 nondeductible under Code Sec. 162(f). The ambiguity is mostly about intent, said the IRS, because the government may have a punitive or compensatory penalty. Historically, if the settlement agreement is not explicit, divining that intent is not easy.

The burden of proof may decide the case. That is one lesson from one of the leading cases, *Talley Industries, Inc.* [68 TCM 1412, Dec. 50,285(M), TC Memo. 1994-608, *rev'd and remanded*, CA-9, 97-1 USTC ¶50,486, 116 F3d 382]. There, a company and its executives were indicted for filing false claims with the government.

As a result of the company's actions, the U.S. Navy lost some $1.56 million. However, Talley and the DOJ settled on a $2.5 million figure. When Talley deducted the settlement, the IRS claimed it was a nondeductible fine or penalty. The Tax Court held that the settlement was indeed 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 was not intended to be penal or punitive. The IRS appealed, and the Ninth Circuit reversed and remanded, holding that *Talley* had failed to establish the compensatory nature of the settlement [*see Talley Industries, Inc.*, CA-9, 2001-2 USTC ¶50,654, 18 FedAppx 661, Doc 2001-29836, 2001 TNT 232-6, *aff'g* 77 TCM 2191, Dec. 53,422(M), TC Memo. 1999-200]. Talley's entire deduction was rejected.

In *Fresenius*, additional authorities discussed included *Bornstein* [*United States v. Bornstein*, SCt, 423 US 303 (1976)] and *Stevens* [*Vermont Agency of Natural Resources v. United States ex rel. Stevens*, SCt, 529 US 765 (2000)]. These cases use a formulaic approach to treating the first third of FCA liability—the single damages—as direct compensation for the government's losses. The second third are categorically compensatory under *Bornstein*. The last third would be categorically punitive under *Stevens*.

However, in *Cook County v. United States ex rel. Chandler* [SCt, 538 US 119 (2003)], the Supreme Court strayed from the categorical. The Court emphasized that the FCA's damages multiplier has compensatory traits along with the punitive. After all, 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."

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 decried easy line-drawing and said that it all depends. Multiple damages can serve remedial purposes rather than purely punitive goals. The facts of the particular litigation must be considered.

## Settling Up

In *Fresenius*, the government argued that *Talley* meant the parties had to agree on the purpose of a settlement payment for it to be deductible. However, the district court ruled that an agreement is not necessary for payments to be nonpunitive. Because the FCA does not categorically determine the purpose of the payments, a fact-finder must determine the extent to which multiple damages are compensatory.

How does one do so? We know that a settlement agreement is relevant. Yet a settlement agreement is not the only avenue. Besides, the DOJ had *refused* to characterize the settlement payments for tax purposes as part of the settlement.

The government actually had the audacity to argue in *Fresenius* that, since the DOJ had refused to agree on taxes, it foreclosed Fresenius' tax deduction. The district court did not like this position and could not agree. Settlement language and negotiations are relevant, but so is other evidence regarding the purpose and application of the payments.

The settlement agreement stated that Fresenius and its subsidiaries "agree that nothing in this Agreement is punitive in purpose or effect." However, it was not clear that this line had anything to do with taxes. Besides, other provisions in the settlement agreement expressly stated that they did not characterize the settlement payments as nonpunitive for tax purposes.

## Other Evidence

What else is relevant? The district court in *Fresenius* considered negotiations and statements by various advisers and participants. None of the statements established as a matter of law that the settlement payments were *not* compensatory, but they did not do the reverse either.

This evidence also did not indicate that Fresenius' lawyers knew what expenses the government incurred to investigate the FCA violations. Such items would help to evaluate the trebling question. Plus, none of the statements established 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 on its tax case, Fresenius emphasized language in the settlement agreement indicating that the payments were not punitive. It argued that the multiple damages were designed to compensate the government, primarily for pre-judgment interest. Given all the mixed evidence, the court in *Fresenius* left the case to the jury. The jury found that $95 million of the disputed $126,796,262 in settlement payments was compensatory and therefore deductible.

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

## First Circuit

On appeal, the IRS repeated the argument that the absence of an explicit tax characterization in the settlement agreement defeated Fresenius' claim of deductibility. The IRS relied upon *Talley*. In the absence of explicit tax language, deductibility in *Talley* depended on "whether the parties intended the payment to compensate the government ... or to punish" the taxpayer.

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 said that a rule that requires a tax characterization agreement for deductibility would give the IRS the unfettered ability to defeat deductibility by merely refusing to agree—no matter how arbitrarily—to the tax characterization of a payment.

Instead, the First Circuit ruled that a court may consider factors beyond the mere presence or absence of a tax agreement between the government and the taxpayer. In any event, the *Fresenius* court insisted, courts should look to substance and economic reality of the particular transaction, not just to form or language. These broad tax doctrines apply not only to transactions, but to settlement payments too.

The court reiterated the fact that the intent of the payor of a settlement, although not dispositive, is often the most persuasive evidence of the nature of claims settled. If the government and a defendant settle an FCA claim and specifically agree how the settlement will be treated for tax purposes, it is hard to envision any reason why a reviewing court should not honor that agreement. However, if there is no agreed tax characterization, a court's inquiry should shift to the economic realities of the transaction.

The court also pointed out that the IRS's proposed "no agreement, no deduction" rule conflicted with what the court saw as another fundamental tenet of tax law. That is, a settlement payment should receive the same tax treatment as a judgment. If an FCA case is tried and not settled, there would obviously be no tax characterization agreement.

Nevertheless, when the defendant paid the judgment, a portion beyond single damages may still have a compensatory purpose and thus would be deductible even on a judgment. The same result must apply to settlements. The First Circuit even sought to explain and reconcile *Talley* with its decision in *Fresenius*. On remand following the Ninth Circuit's decision in *Talley*, the Tax Court appeared open to considering the economic substance of the settlement.

The *Talley* court on remand could not follow through because the parties had not developed an appropriate factual record. In contrast, Fresenius had developed just such a record. In any event, said the court, if *Talley* stands for the proposition asserted by the IRS, then *Talley* was incorrectly decided.

Accordingly, the *Fresenius* court considered the economic substance surrounding the payment. Single damages are plainly compensatory and deductible. But this conclusion can apply to more than single damages, too. An enforcement action following a fraud brings new costs and delays and requires a recovery of more than single damages to make the government whole. Thus, the First Circuit affirmed the district court's holding that $95 million was deductible.

## Conclusion

*Fresenius* should open a whole new discussion about what settlement documentation to keep, what to create and how to position legal settlements for deduction. Hopefully such documentation will satisfy the IRS in audit or at Appeals. If it is necessary to go beyond that, settlement deductions with appropriate backup should help reduce the expense and uncertainty of a tax dispute.

**Article Submission Policy**

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodLLP.com*. THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.