EDITOR’S NOTE: BE PREPARED
Steven A. Meyerowitz

INSIDER TRADING – BROKER-DEALER COMPLIANCE REQUIREMENTS AND BEST PRACTICES
Daniel A. Nathan, Michael R. Sorrell, and Kall Schellenberg

SHIELDING AGAINST NEW YORK’S “FAITHLESS SERVANT DOCTRINE”: HOW FUND MANAGERS MAY PROTECT THEMSELVES AGAINST A POWERFUL LEGAL WEAPON FOR EMPLOYERS
Joshua H. Epstein and Alicia N. Washington

DATA BREACH PREPAREDNESS: OVERVIEW OF RESPONSE PARTNERS AND ROLES
Michael Brummet

FIRST CIRCUIT LIBERALIZES TAX DEDUCTIBILITY STANDARD OF FALSE CLAIMS ACT SETTLEMENTS
Miriam L. Fisher, Roger S. Goldman, David R. Hazeltone, Anne W. Robinson, Nicole B. Neuman, and Chad D. Nardiello

SEC SETTLES FIRST “PAY-TO-PLAY” ENFORCEMENT ACTION
Kenneth J. Berman, Andrew M. Levine, and Gregory D. Larkin

THIRD CIRCUIT REAFFIRMS THE DIFFICULTY OF BINDING A NON-SIGNATORY TO ARBITRATION
Brian A. Berkley, Jaclyn R. Ruocco, and Matthew H. Adler

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT UPDATE
David A. Elliott, Kristen Peters Watson, E. Jordan Teague, and Seth Muse

AN A.S. PRATT & SONS PUBLICATION
OCTOBER 2014
First Circuit Liberalizes Tax Deductibility Standard of False Claims Act Settlements

Miriam L. Fisher, Roger S. Goldman, David R. Hazelton, Anne W. Robinson, Nicole B. Neuman, and Chad D. Nardiello*

Appellate court affirms $50 million tax refund to FCA defendant, holding that the “economic realities” of settlement payments determine whether they are compensatory.

Introduction

Civil False Claims Act (“FCA”) settlements, which often involve hundreds of millions—or even billions—of dollars, have significant tax consequences for companies facing fraud suits. The First Circuit Court of Appeals’ recent decision in Fresenius Medical Care Holdings, Inc. v. United States1 upheld a jury verdict allowing the deduction of a significant portion of an FCA settlement amount beyond single damages. This is the first appellate decision addressing the tax deductibility of FCA settlements since the 1997 case Talley Industries Inc. v. United States.2

In Fresenius, the First Circuit rejected the government’s reading of Talley, which the government contended required an FCA defendant to show an explicit agreement between the parties as to the tax characterization of the settlement amount. The Fresenius Court held that instead the “economic realities” of FCA settlement payments determine whether the amounts are compensatory and therefore deductible.

The Fresenius decision has significant implications for FCA defendants entering settlement negotiations with the Department of Justice (“DOJ”). Under the First Circuit’s approach to deductibility, the entirety of the record related to settlement negotiations will be relevant to determining what is compensatory. FCA defendants therefore should be mindful throughout the settlement process as to the characterization of the parties’ settlement offers, and should introduce calculations, analysis, and additional evidence indicating that the purpose of all or the majority of the settlement payments is to make the government whole.

* Miriam L. Fisher, Roger S. Goldman, David R. Hazelton, Anne W. Robinson, Nicole B. Neuman, and Chad D. Nardiello are attorneys at Latham & Watkins LLP. They may be contacted at miriam.fisher@lw.com, roger.goldman@lw.com, david.hazelton@lw.com, anne.robinson@lw.com, nicole.neuman@lw.com, and chad.nardiello@lw.com, respectively.


2 No. 13-2144, 116 F.3d 382 (9th Cir. 1997).
Only Compensatory Damages are Deductible

Section 162(a) of the Internal Revenue Code (“Code”) allows a taxpayer to deduct for U.S. federal income tax purposes all ordinary and necessary business expenses paid or incurred by the taxpayer in carrying on any trade or business. Section 162(f) provides an exception to this rule, prohibiting the deduction of fines or similar penalties paid to a government for the violation of any law. A “fine or similar penalty” is defined in part as an amount paid as a civil penalty imposed by law or paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty, whether civil or criminal.4 However, compensatory damages paid to a government are explicitly excluded from the definition of fines and penalties.4 Accordingly, a company may deduct for tax purposes the amount of a civil FCA settlement characterized as compensatory.

In the FCA context, it is undisputed that single damages and relator’s fees are compensatory and therefore deductible.5 However, because the multiple damages provisions of the FCA serve dual purposes of compensation and punishment,6 determining to what extent any payments above the government’s estimated actual losses and the relator’s fees are compensatory and therefore deductible can prove difficult.

The Deductibility of FCA Settlement Payments Under Talley

Prior to Fresenius, the only appellate decision addressing the tax deductibility of an FCA settlement was Talley Industries Inc. v. United States. There, the Ninth Circuit reversed and remanded a Tax Court decision that found the settlement

---

3 26 C.F.R. § 1.162-21(b)(1)(ii), (iii).
4 26 C.F.R. § 1.162-21(b)(2).
5 See 26 C.F.R. § 1.162-21(c) (providing for deductibility of actual damages recovered under a statute analogous to the FCA in Example 1); Character of Relator Fees under the False Claims Act, 2007 GLAM LEXIS 22, at *19 (July 12, 2007) (stating that amounts paid to compensate the government for its obligation to pay relator fees under the FCA are deductible when specifically outlined in the settlement agreement, because “[t]he relator fee is simply another cost to the government of pursuing the action”).
6 See United States v. Bornstein, 423 U.S. 303, 315 (1976) (discussing the make-whole role of multiple damages as “necessary to compensate the Government for the costs, delays, and inconveniences occasioned by fraudulent claims”); Cook Cnty, Il. v. United States ex rel. Chandler, 538 U.S. 119, 130 (2003) (“[T]he facts about the FCA show that the damages multiplier has compensatory traits along with the punitive.”); Grossman & Sons, Inc. v. Comm’r, 48 T.C. 15, 31 (1967) (finding that “the device of double damages plus a specific sum was chosen [by Congress] to make sure that the government would be made completely whole,” and therefore the FCA is partly compensatory and partly punitive); Relator Fees, 2007 GLAM LEXIS 22, at *10-11 (agreeing with the holding in Chandler that treble damages have a compensatory side in addition to their punitive objectives).
amount above the government’s estimated total actual losses was deductible.

A subsidiary of Talley Industries, Stencel Aero Engineering, entered into a civil FCA settlement with the DOJ in 1986 for $2.5 million\(^7\) relating to claims for manufactured ejection seats for military aircrafts.\(^8\) This settlement included $1.56 million in estimated actual losses to the government and $940,000 in excess of those base compensatory damages. Talley deducted the full $2.5 million as ordinary and necessary business expenses on its consolidated federal income tax return. Upon examining the return, the IRS disallowed the deduction of the $940,000. Talley subsequently filed a petition for redetermination with the Tax Court.

The Tax Court sided with Talley, finding the settlement amount above the government’s estimated total actual losses was deductible because that amount was also intended to compensate the government for losses. In reaching this conclusion, the Tax Court relied on the fact that, in negotiating the settlement agreement, the government never suggested that it was attempting to exact a penalty. In addition, the Tax Court noted the settlement amount was substantially less than double the stated estimated losses (the amount of multiple damages under the FCA at that time).

On appeal to the Ninth Circuit, the IRS Commissioner argued that because the $940,000 constituted a payment of multiple damages under the FCA, it was a nondeductible “fine or similar penalty” under Section 162(f) of the Code. Talley asserted that this disputed portion of the settlement was intended to compensate the government for its actual losses, including unknown losses, and was not paid as part of any multiple damages. Talley also argued, in the alternative, that even if the $940,000 qualified as multiple damages, it was still compensatory because the amount was intended only to compensate the government for additional costs and not as a punishment or deterrent.

In its opinion, the Ninth Circuit recognized that while single damages under the FCA are compensatory, some or all of multiple damages may also be deductible because they have both compensatory and penal purposes. As a result, the tax classification of amounts exceeding single damages “depends upon the ‘purpose the [excess portion of the settlement] payment was designed to serve.’”\(^9\)

\(^7\) All values are in US$.
\(^9\) Talley Industries Inc. v. United States, 116 F.3d 382, 387 (9th Cir. 1997) (quoting Waldman v. Comm’r, 88 T.C. 1384, 1387 (1987)).
The Ninth Circuit found genuine issues of material fact as to the characterization of the $940,000 and reversed the Tax Court’s summary judgment award. The Ninth Circuit found that “[n]either the characterization nor purpose of the payment is clarified by the settlement agreement.” In light of such ambiguity, the characterization or purpose of the payment may be resolved by determining the intent of the parties. Because the court found that the record contained conflicting evidence regarding the parties’ intent, the court reversed and remanded, emphasizing that the taxpayer bears the burden to demonstrate sufficient evidence of the compensatory purpose of the amount and thus the taxpayer’s entitlement to the deduction.

On remand, the Tax Court found that Talley failed to establish that it was entitled to the disputed deduction based on the absence of a tax characterization agreement between the parties. The settlement agreement did not characterize the payment and the record contained no other evidence demonstrating that both parties intended for the $940,000 to be compensatory. “It thus follows that petitioner has failed to establish entitlement to a deduction for the disputed portion of the settlement.” The Tax Court accordingly affirmed the IRS’s determination that the $940,000 was not deductible under Section 162(f) of the Code.

**Fresenius Rejects Government’s Interpretation of Talley and Emphasizes “Economic Realities” of Settlement Payments**

In Fresenius, the First Circuit rejected the government’s argument that, under Talley, any amounts in excess of single damages must be treated as punitive fines unless the parties agreed that they were compensatory. Instead, the court held that the economic realities of the settlement amounts should determine whether they were compensatory and therefore deductible.

**Fresenius Background**

In 2000, Fresenius Medical Care Holdings, a company that operates dialysis clinics, entered into a global settlement agreement with the government resolving FCA claims against it and its subsidiaries involving an alleged

---

10 The record included an affidavit from the company’s counsel during settlement negotiations, a declaration from the government’s counsel during settlement negotiations, a memorandum from the government’s counsel to her supervisor requesting approval of the settlement, and the settlement agreement.

conspiracy to defraud Medicare and other federal healthcare programs. The global settlement agreement consisted of a master agreement, three criminal plea agreements and four civil settlements. Fresenius agreed to pay the government approximately $385 million pursuant to the civil agreements. Except for the amount designated for the relators (approximately $66 million), the civil agreements did not include provisions describing or governing how the government would allocate the civil damages. In addition, the civil agreements each stated: “Nothing in this Agreement constitutes an agreement by the United States concerning the characterization of the amounts paid hereunder for purposes of any proceeding under . . . the Internal Revenue Code.”

Fresenius claimed deductions for the full payments under the civil agreements as ordinary and necessary business expenses. However, after an audit the IRS disallowed the deduction of approximately $192.6 million that the IRS deemed to be multiple damages and punitive. The disallowance was based on the Healthcare Fraud Tracking Form, which was prepared by the United States Attorney’s office to describe the government’s internal accounting related to the settlement proceeds. The Tracking Form categorized the amounts as Compensatory Damages, Relator Fees, and Investigation Costs and Penalties.

Fresenius filed a protest of the disallowance in 2005, arguing that it had properly characterized the full civil settlement amounts as compensatory payments. The IRS Appeals Office agreed with Fresenius that the $66 million portion of the settlement for Relator Fees was deductible, but maintained the disallowance of the remaining $126.8 million. Fresenius subsequently filed suit with the U.S. District Court for the District of Massachusetts in 2008 to recover the taxes paid on the $126.8 million.

**District Court Charges the Jury with Characterizing Payment as Compensatory or Punitive**

After trial, the jury issued a verdict finding that $95 million of the $126.8 million exceeding single damages—about 75 percent of the amount at issue—was compensatory, resulting in a refund for Fresenius of approximately $50.4 million plus interest. The court’s order entered final judgment based on the award, and additionally explained its earlier decisions denying the govern-
ment’s summary judgment motion and both parties’ motions for judgment as a matter of law.

The court rejected both parties’ arguments that the terms of the settlement agreements were determinative of the purpose of FCA settlement payments. The court explained that the parties’ joint intent as to the characterization of a payment through an express agreement or lack thereof is not the exclusive means of determining the extent to which multiple damages are compensatory. The court stated that “a manifest agreement is not necessary for Fresenius to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability.” Rather, the amount needed to make the government whole—the compensatory damages—could also be determined through other evidence such as “proof of interest calculations” and investigation costs, such as “attorneys’ billable hours, and expense records.” In other words, the parties’ “negotiations and the eventual settlement agreement will seldom be the sole evidence available to foresighted parties.”

During trial, the jury heard evidence regarding the parties’ negotiations, agreements, the impact of the time value of money on compensation, and methods for calculating interest. The district court then instructed the jury to determine what, if any, portion of the settlement amount at issue was compensatory by deciding what amount was necessary to make the government whole for its losses.

The jury instructions for calculating the deductible amount were based on the “residual approach.” Under such an approach, settlement amounts are first allocated to actual losses, relator fees, pre-judgment interest, and other amounts to make the government whole. The remaining amount, if any, is deemed punitive and nondeductible.

The district court affirmed the jury’s characterization of the multiple damages as compensatory based on the evidence related to pre-judgment interest. The district court held that a reasonable jury could infer that a substantial part of the multiple damages was intended to compensate the government for the delay in payment.

The First Circuit Affirms, “Economic Reality” Determines Purpose

The government appealed the district court’s denial of its motions for judgment as a matter of law and its jury instruction. The First Circuit denied the appeal, holding that—contrary to the government’s argument based on *Talley*—the lower court properly “consider[ed] factors beyond the mere

---

presence or absence of a tax characterization agreement between the government and the settling party” to determine the tax treatment of any amounts beyond single damages.16

Like the Ninth Circuit in Talley, the First Circuit started from the premise that “[s]ingle damages are plainly compensatory and, thus, plainly deductible,” and that some settlement amounts in excess of single damages may also be regarded as compensatory. “This makes good economic sense: 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.”17

The court disagreed with the government’s contention that, under Talley, an FCA defendant can only establish the deductibility of amounts in excess of single damages by showing that an agreement existed between the parties that specified that these amounts were intended as compensation as opposed to penalties.18 The court admonished that “the government assigns talismanic significance to the presence or absence of a tax characterization agreement between the settling parties.”19 Such an approach improperly suggested that “economic reality has no bearing.”

The court stated that though its decision to “consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party” may depart from Talley, it was convinced that “generally accepted principles of tax law compel[ed the court] to part company with the Ninth Circuit.” First, tax law instructs courts to make tax characterizations based on the substance of a transaction over the form,


18 See Opening Brief for United States at 13, 23, Fresenius Med. Care Holdings v. United States, No. 13-2144, 2014 U.S. App. LEXIS 15536 (1st Cir. Aug. 13, 2014), Entry ID 5790129 (“Under the rule established by the Ninth Circuit in Talley, no portion of the multiple damages paid in an FCA settlement is deductible unless the taxpayer demonstrates that an agreement was reached by the parties that the portion was wholly compensatory.”). The government asserted that if an FCA defendant is not able to convince the government to enter into such an agreement, the defendant “can bargain for a lower payment on the assumption that the multiple-damages portion will not be deductible.”

focusing instead on the objective economic realities.\textsuperscript{20} Second, a fundamental tenet of tax law is that the amounts paid or received in settlement should be treated the same as they would have been had the dispute been litigated and reduced to judgment, to the extent practicable. The court found that the government’s focus on a manifest characterization agreement conflicted with this tenet since there would not be any such agreement in litigation.\textsuperscript{21}

Thus, under the court’s “common-sense approach,” in an absence of a clear agreement “a court’s inquiry should then shift to the economic realities of the transaction,” rather than immediately concluding that the amounts at issue are punitive.\textsuperscript{22} To do so, “a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the [G]overnment and the settling party,” including other evidence in the record to determine if the


IRS released guidance regarding the deductibility of multiple damages emphasizes looking to the facts and economic realities to determine how much of the multiple damages at issue are compensatory for actual damages suffered by the government—as opposed to any bright-line rule based on a manifested agreement between the parties. For example, in a 1995 IRS Field Service Advice (FSA) the IRS explained that under the FCA, the compensatory versus penal characterization of award amounts depends on whether the amounts bear a rational relation to the government’s actual losses. 1995 FSA LEXIS 140 (May 26, 1995). In a 2001 FSA, the IRS concluded that, to determine the intent of the parties as to the purpose of the FCA settlement payment—and thus the deductibility of that settlement amount—the factfinder should, if an express characterization of the settlement by the parties is ambiguous or lacking, consider the specific facts surrounding the payment, including the actual damages caused by the conduct. 2001 FSA LEXIS 236 (Nov. 19, 2001); see also 1997 FSA LEXIS 130 (Feb. 4, 1997) (referring to its prior interpretation of FCA settlements to determine whether to disallow claimed deductions under other federal and state statutes and holding that based on its analysis of the FCA, Exam should consider the difference between the actual losses to the government and the amount paid in settlement with respect to each specific loss, as well as how much the government argued that it actually lost due to the taxpayer’s actions and whether any evidence supports that claim). Thus, the approach articulated in Fresenius is in accordance with IRS guidance.

\textsuperscript{21} The court additionally noted that a rule requiring a tax characterization agreement would give too much power to the government, which could always refuse to agree that any damages were deductible, no matter their true nature or the arbitrariness of the government’s stance.

The purpose of the amount is compensatory.23

Finally, the court dismissed the government’s alternative argument that the district court erred by basing the jury instructions on the residual approach. The government asserted that in adopting a residual approach the district court provided the FCA defendant a “windfall deduction” because there is no basis to assume either that settlement payments must be applied to compensatory damages first or that, in settlement negotiations, the government concedes punitive dollars first.24 Although the First Circuit found this argument to have “a patina of plausibility,” it held the argument untimely since the government had not raised the point in the district court. The court therefore refused to address the argument on the merits.25

**Practice Points for FCA Defendants**

The *Fresenius* decision provides companies considering settling FCA litigation several instructive points.

First, companies should keep tax consequences in mind when engaging in settlement negotiations with DOJ. Given that DOJ generally refuses to characterize for tax purposes the payment amounts in the parties’ settlement agreements, courts will look to the record for evidence such as correspondence, calculations, and other facts available to ascertain the purpose of the payments. Thus, FCA defendants should be mindful of how settlement offers are characterized during negotiations. Defendants should frame their settlement offers in terms of seeking to compensate the government for actual losses, relator fees, pre-judgment interest, investigation costs, and other amounts to make the government whole. Defendants should introduce supporting evidence, such as underlying calculations, analysis, and narrative descriptions. Defendants additionally should seek to ensure that relator payments are specified in the settlement agreements.

Second, FCA defendants should be willing and prepared to challenge the IRS’ determination of the deductibility of the settlement amounts. As explained in *Fresenius*, the IRS bases its determination on the Tracking Forms prepared by DOJ. The forms, in which DOJ allocates the settlement payments among categories such as Compensatory Damages, Relator Fees, and Investigation

---

Costs and Penalties, are prepared independent of the settlement agreement and not shared with FCA defendants. Yet such forms, under the “economic realities” approach adopted by Fresenius, are not determinative of the payments’ deductibility. 26 As Fresenius demonstrates, FCA defendants can successfully challenge IRS determinations and receive millions of dollars in tax deductions. FCA defendants can challenge a disallowance in several different fora. They may appeal to the IRS Appeals Office, or if unsuccessful there, may file an action in the Tax Court (as in Talley) or in a refund forum (as in Fresenius)—the relevant federal district court or the Court of Federal Claims.

When litigating the deductibility issue, a company should be prepared that the government may advocate for a settlement discount instead of the residual approach to calculate the compensatory and punitive amounts. As discussed above, the Fresenius court refused to address this issue on its merits, but suggested that the court may agree with the government that settlement discounts should apply evenly across the compensatory and punitive portions of the settlement amount. Companies should draw on the district court decision in Fresenius as well as the IRS’ own guidance27 to advocate the use of the residual approach, which maximizes the amounts considered compensatory and therefore deductible.

26 Interestingly, in a 2001 Chief Counsel Advice (“CCA”), the IRS explained that neither the characterization nor the disposition in a Tracking Sheet controls a settlement payment’s deductibility because the Tracking Sheet could call a payment by an incorrect name. 2001 IRS CCA LEXIS 369 (Apr. 20, 2001). The CCA explained that, instead, “all facts and circumstances relevant to ascertaining the true substance and nature of the claims actually brought or only threatened, and then settled and released, must be determined and quantified.” Id. at *11.

27 In 1995, the IRS issued an FSA finding that the residual approach should be used to determine the nondeductible amount of an FCA settlement. 1995 FSA LEXIS 140, at *17–18 (May 26, 1995) (“[W]e believe that the Commissioner’s secondary argument that the nondeductible amount was the difference between the government’s loss and the amount of the settlement was correct.”). In agreeing with the residual approach, the IRS explained that the key to the question of deductibility is the settlement’s impact on the government, not the taxpayer, so the focus should not be on what the parties may have acknowledged in some agreement to be fines and penalties. Id. at *18; see also 1997 FSA LEXIS 130 (Feb. 4, 1997) (looking to how much a settlement amount exceeds the amount actually lost by the government to determine deductibility); 2001 FSA LEXIS 236, at *8 (Nov. 19, 2001): (“If a payment exceeds the amount needed to compensate the victim, or if it is in addition to a separate compensatory payment, it can often be inferred that the payment had a punitive purpose.”).