What Every CONTRACTOR Should Know About the TAX IMPLICATIONS of Settling a FALSE CLAIMS ACT Case

The top 10 tips for the deductibility of compensatory FCA settlement amounts.

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Companies that do business with the U.S. federal government should know about the False Claims Act (FCA) and its broad scope of liability. Cases alleging procurement fraud are being filed against government contractors in record numbers. In fiscal year 2013, the government recovered a record $890 million in procurement fraud FCA cases. Given the prevalence of these investigations and suits, government contractors should be aware of all the financial implications of defending and resolving FCA claims.

Because FCA cases are often settled, government contractors must understand the issues involved in settling an FCA case. One key issue, which is frequently overlooked during the negotiation process, is the tax deductibility of the settlement amount. Because FCA settlements can involve many millions of dollars, the deductibility of even a portion of the amount can save—or cost—a government contractor a lot of money.

In August 2014, the U.S. Court of Appeals for the First Circuit decided Fresenius Medical Care Holdings, Inc. v. United States,¹ the first appellate decision addressing the tax deductibility of FCA settlements since 1997. This case has significant implications for FCA defendants entering settlement negotiations with the Department of Justice (DOJ) and highlights some best practices to ensure maximum deductibility of compensatory settlement payments.

Only compensatory portions of an FCA settlement are deductible. Whether settlement amounts are deductible turns on whether they are compensatory or punitive. Section 162(a) of the Internal Revenue Code allows a taxpayer to deduct all ordinary and necessary business expenses, but 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. Compensatory damages paid to a government, however, are explicitly excluded from the definition of fines and penalties.² Accordingly, a company may deduct for tax purposes the amount of a civil FCA settlement characterized as compensatory.

In the FCA context, single damages and relators’ fees are considered compensatory and therefore deductible.¹ However, because...
the multiple damages provisions of the FCA serve dual purposes of compensation and punishment, determining to what extent any payments above the government’s estimated actual losses and the relators’ fees are compensatory—and therefore deductible—can prove challenging.

In Fresenius Medical Care Holdings, Inc. v. United States, the U.S. Court of Appeals for the First Circuit upheld a jury verdict allowing the deduction of a significant portion of an FCA settlement amount beyond single damages. Although the government had contended that an FCA defendant must show an explicit agreement between the parties as to the tax characterization of the settlement amount, the Fresenius Court held that the “economic realities” of FCA settlement payments determine whether the amounts are compensatory and therefore deductible. Under this approach to deductibility, the entirety of the record related to settlement negotiations will be relevant to determining what is compensatory.

10 TIPS FOR DEDUCTIBILITY OF COMPENSATORY FCA SETTLEMENT AMOUNTS

While every settlement involves unique issues and circumstances, the following 10 tips can help FCA defendants ensure that they benefit from deductibility of all FCA settlement payments that may be considered compensatory:

During Settlement Negotiations
1 | Be mindful throughout the settlement process as to how settlement offers are characterized. Under Fresenius, the entirety of the record related to settlement negotiations can be relevant to determining what is compensatory.

2 | To the maximum extent possible, make clear that your settlement offer is intended to compensate the government for actual losses, plus other amounts to make the government whole. These include relator fees, pre-judgment interest, investigation costs, and other consequential damages.

3 | Introduce evidence, such as underlying calculations, analysis, and narrative descriptions to support the compensatory purpose of nonpunitive settlement payment amounts.

4 | Cite any relevant provisions in the underlying contract, such as language requiring interest on overpayments provisions.

In the Settlement Agreement
5 | Verify that DOJ has not labeled any payments as “penalties” in the agreement. This would be a departure from its current policy of refusing to characterize settlement amounts for tax purposes, but DOJ may change course in light of Fresenius.

6 | Ensure that the portion of the settlement that will be paid to a relator, if any, is spelled out in the agreement. Relator payments are compensatory and sometimes—but not always—specified in settlement agreements.

After an IRS Audit
7 | Be prepared for an IRS challenge. Despite Fresenius, the IRS will likely continue to take the position that the significant portions of FCA settlements are not deductible. The IRS often bases its determination on internal tracking forms prepared by DOJ—which are not shared with an FCA defendant—that categorize a settlement amount as “compensatory damages,” “relator fees,” and “investigation costs and penalties.”

8 | Be willing to litigate. Under the “economic realities” approach adopted by Fresenius, the tracking forms and the absence of a tax characterization between the parties are not determinative. As Fresenius demonstrates, FCA defendants can successfully challenge IRS determinations, allowing millions of dollars in additional tax deductions.

9 | Choose the right forum. FCA defendants may administratively protest an adverse IRS examination finding at the IRS Appeals Office. If unsuccessful there, the company may litigate a deficiency action in the U.S. Tax Court or pay the tax and file a refund action (as in Fresenius) in the relevant federal district court or the U.S. Court of Federal Claims. The defendant in Fresenius opted for a jury trial in federal district court. Notably, however, this path requires that the company first make full payment of the tax, which may be impractical in some cases in light of the amount involved.

10 | Be mindful of the different approaches for calculating the compensatory and punitive amounts. The government will likely contend that a settlement discount should apply evenly across the compensatory and punitive portions. However, the residual approach—where settlement amounts are first allocated to compensatory amounts such as actual losses, relator fees, pre-judgment interest, and the remaining amount, if any, is deemed punitive—maximizes the amounts considered compensatory and therefore deductible. Companies can draw on the district court decision in Fresenius as well as the IRS’ own guidance to advocate the use of this computation.

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ENDNOTES
2. 26 C.F.R. 1.162-21(b)(2).
3. 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); and 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”).
4. 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, Ill. 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’rer, 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); and 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).
5. In 1995, the IRS issued a “Field Service Advice” memorandum finding that the residual approach should be used to determine the non-deductible amount of an FCA settlement. See 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. (Ibid., at *18). See also 1997 FSA LEXIS 130 (looking to how much a settlement amount exceeds the amount actually lost by the government to determine deductibility); and 2001 FSA LEXIS 236, at *8 (“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.”).