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Tax Act Changes Deductibility of False Claims Act Payments

The new tax law limits the deductibility of False Claims Act settlements and requires that settlement agreements identify the deductible "restitution" amount.

Settlements under the False Claims Act (FCA), which often involve hundreds of millions — or even billions — of dollars, have significant tax consequences for companies facing fraud suits. Previously, FCA settlement amounts were deductible so long as they were not punitive. Some defendants have been able to deduct sizeable amounts of FCA settlements in part because the Department of Justice (DOJ) did not take a position on deductibility in settlement agreements.

The Tax Cuts and Jobs Act (the Tax Act)[1] dramatically changes this landscape. Section 13306 of the Tax Act — which received little attention prior to passage — prohibits deductions for settlements paid to the government (or at the direction of the government), except for amounts defendants can establish were paid as restitution or expended to come into compliance with the law, and that are specifically identified as such in the court order or settlement agreement. Thus, for any settlements entered into on or after December 22, 2017 (the effective date of the law), FCA defendants will be precluded from taking deductions for FCA payments to the government unless the settlement agreement specifies the amount is restitution.

Deductibility of FCA Settlement Payments Under Prior Law

Historically, FCA defendants have been able to deduct amounts paid in FCA suits, as long as they could prove that the amounts were paid to compensate the government for its losses. Such compensatory amounts were deductible as ordinary and necessary business expenses under 26 U.S.C. § 162(a) because they were *not* deemed to be fines or similar penalties (which, under 26 U.S.C. § 162(f), are not deductible).[2] Because FCA damages are often composed of amounts that are compensatory *and* amounts that are punitive, the primary hurdle for FCA defendants seeking to deduct settlement amounts was one of proof.

Until the Tax Act, it was generally understood that single damages and relator's fees were compensatory,[3] while multiple damages might be compensatory, punitive, or both.[4] FCA settlement agreements have typically not specified what part of a settlement constitutes single versus multiple damages, and so FCA defendants could argue that all (or most) of the "unspecified" settlement amounts in agreements with DOJ consisted of single damages.[5] A recent decision by the First Circuit Court of Appeals held that FCA defendants could indeed take this approach with FCA settlements. Specifically,

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the court ruled that an agreement with the government as to deductibility was not required, as the "economic realities" of the settlement governed the deductibility of the amounts paid.[6] The practical effect of this decision was that FCA defendants could more easily meet the required burden of proof to characterize as compensatory and deduct large portions of FCA settlement amounts.[7]

Congressional Push to Reduce Deductions for Settlements With the Government

The origin of the new rules on deducting settlement amounts[8] suggests that Congress aimed to introduce (1) greater transparency regarding the tax treatment of amounts offending businesses pay to the government;[9] (2) more clarity for taxpayers and the government regarding the treatment of settlement payments for tax purposes;[10] and (3) an estimated additional US$218 million in government revenue over a 10-year period.[11]

Apparently, one impetus was a 2015 study by the US Public Interest Research Group Education Fund (PIRG Report), a group founded by Ralph Nader. The study showed that none of the top five agencies that deal with settlements from corporate defendants have publicly announced a policy for how to address the tax status of the settlements they sign.[12] According to the study, neither DOJ nor the Department of Health and Human Services even has internal policies to address tax implications in settlements.[13] The PIRG Report proposed "common sense measures" to streamline tax deductibility, one of which was amending the tax code to "explicitly deny tax deductions for all payments made in connection with alleged corporate wrongdoing, unless otherwise specified in a settlement agreement."[14]

New FCA Deductibility Requirements Under the Tax Act

The Tax Act amends the trade or business expense deduction rules in 26 U.S.C. § 162, expanding the prohibition on deducting "fines or penalties" in subsection (f) of the statute in a way that will limit the deductibility of FCA settlement amounts. The amended Section 162(f) now prohibits, except as specifically provided, deductions "for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law."[15]

In general, four new rules apply to the deductibility of FCA payments:

1. **Only restitution or amounts paid to come into compliance are deductible.** Defendants must be able to demonstrate that the amount (1) "constitutes restitution ... for damage or harm which was or may be caused by the violation of any law or the potential violation of any law," or (2) "is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry."[16] This language clarifies that amounts consisting of civil penalties cannot be taken as deductions, and suggests that FCA defendants will have an uphill battle in laying the groundwork to deduct amounts consisting of damage multipliers.

2. **The agreement or court order must identify the specific amount that is "restitution" or the "amount paid to come into compliance with such law."**[17] This is a critical change for FCA defendants, as it requires the parties to agree at the time of settlement to the specific amount that is deductible. DOJ's long-held practice has been to avoid taking such a position in FCA settlements. Now, parties will be negotiating *two* (likely intertwined) numbers — the total settlement amount *and* the restitution amount — which brings greater complexity to the settlement process.

   Notably, the identification of the amounts "alone" is insufficient to carry the taxpayer's burden under the new law. Section 162(f) requires that defendants separately establish that the amount being taken

as a deduction is, in fact, restitution or the amount paid to come into compliance with the law. In other words, the Internal Revenue Service (IRS) could later challenge the identified amounts unless sufficient documentation exists that supports the deduction as a factual matter.

3. **Investigatory costs are no longer deductible.** The Tax Act excludes amounts "paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation."[18] This is a new restriction on deductibility, which will reduce the amounts FCA defendants have historically taken as deductions. Left unaddressed are costs related to investigation and litigation costs by FCA relators — *i.e.,* third-party whistleblowers that are entitled to reasonable costs and fees under the FCA. How these costs will be treated under the new law remains to be seen.

4. **Government agencies must report the deductible amounts to the IRS at the time of any settlement agreement.** These amounts include (1) the total amount of the settlement; (2) the amount that constitutes "restitution" under Section 162(f); and (3) the amount required to be paid "for the purpose of coming into compliance with any law which was violated or involved in the investigation or inquiry."[19] The information in this report must be provided to defendants.[20]

Key Takeaways for FCA Defendants

It remains to be seen how these changes play out in the FCA settlement process, as well as how DOJ will handle deductibility negotiations — which, until now, DOJ has steadfastly avoided. DOJ may implement bright-line internal rules for breaking down the settlement amount into categories, such as restitution, compliance costs, relator's share, investigation costs, multiplier, and penalties. Perhaps a more likely possibility, particularly in the immediate future, is that parties will negotiate the restitution amount at a high level, much the way settlement amounts are currently negotiated. While DOJ may press for a low restitution amount in order to emphasize the multiples involved, DOJ's agency client may favor a high restitution amount to maximize the amount returned to the agency.[21]

In high-stakes cases, deductibility negotiations will likely now comprise a critical and complex aspect of the path to settlement. Defendants seeking to maximize deductibility should consider taking the following steps when entering FCA settlement negotiations with either the government or a relator.

- ***Negotiate and identify the restitution amount.*** In order to preserve a portion of the settlement amount as tax deductible, FCA defendants must incorporate the restitution amount in the settlement agreement. FCA defendants will now be negotiating two numbers: the total amount of the settlement, as well as the amount that the defendant can take as a deduction. Defendants may have to press DOJ to engage in these discussions considering that, prior to the Tax Act, DOJ policy has been steadfast in *not* taking a position on such amounts. This process may be further complicated by the fact that many FCA settlements have included language indicating the payment is a compromise of a disputed claim — without any admission of liability — and not a punitive fine.

- ***Keep in mind new rules and open issues when characterizing amounts***. Investigative costs and expenses are no longer deductible. Whether amounts other than actual losses can be characterized as restitution is still an open question. For example, relator's fees, interest, and other amounts needed to make the government whole may qualify as deductible.

- ***Create and maintain additional documentation on rationale for restitution amounts.*** Even with a clear settlement agreement identifying the amount that constitutes restitution, defendants must separately document and support the rationale for such an amount to satisfy their burden. Defendants should contemporaneously document the amounts attributed to actual damages during settlement

negotiations, both in internal memos and communications with the government.[22] It is advisable to consult with tax counsel early in the settlement process, particularly in high-dollar cases.

- ***Insist on receiving the required reporting to the IRS****.* FCA defendants should ensure they receive the required IRS reports from DOJ regarding the settlement agreement, which must identify an amount as restitution. Doing so will not only be a helpful check on consistency, but it may serve as additional evidence to support the amount deducted if the IRS later challenges such an amount.

- ***Consider new deductibility rules when establishing reserves and making disclosures regarding ongoing FCA litigation****.* The amount of restitution will now be separately negotiated as part of any FCA settlement. Consequently, FCA defendants should be prepared to consider these new rules when assessing amounts to be held in reserve and in disclosures about the status of ongoing FCA investigations or litigation.

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Endnotes

[1] Pub. L. No. 115-97 (2017). Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the Act no longer bears a short title, although commentators likely will continue to refer to it as the Tax Cuts and Jobs Act.

[2] *See* 26 C.F.R. § 1.162-21(b)(2) ("Compensatory damages . . . paid to a government do not constitute a fine or penalty.").

[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); *Cook Cty. v. United States ex rel. Chandler*, 538 U.S. 119, 131, 123 S. Ct. 1239, 1247 (2003) ("The most obvious indication that the treble damages ceiling has a remedial place under this statute is its qui tam feature with its possibility of diverting as much as 30 percent of the Government's recovery to a private relator who began the action.").

[4] *See Talley Indus. Inc. v. Commissioner*, 116 F.3d 382, 387 (9th Cir. 1997) ("The double damage provision of the FCA has both compensatory and deterrence purposes.").

[5] *See, e.g.*, *Fresenius Medical Care Holdings, Inc. v. United States*, 763 F.3d 64, 67 (1st Cir. 2014); *Talley*, 116 F.3d at 385.

[6] *See Fresenius*, 763 F.3d at 70.

[7] For further discussion, see First Circuit Liberalizes Tax Deductibility Standard of False Claims Act Settlements, Latham & Watkins Client Alert Commentary (Aug. 22, 2014), ***available at*** https://www.lw.com/thoughtLeadership/LW-decision-FCA-settlement-tax-deductibility.

[8] There is no direct legislative history on Section 13306 of the Tax Act, likely because of the compressed time frame between the release of the bill and final passage. However, the text of Section 13306, which was added to the final version of the Tax Act as part of the Senate amendment (*See* Conference Report, H. Rep. 115-466, 430 (Dec. 15, 2017)) appears to have originated from a separate Senate Bill sponsored by Senators Chuck Grassley (R-Iowa) and Jack Reed (D-RI) — the Government Settlement Transparency & Reform Act. *See* 163 Cong. Rec. S2176 (Apr. 3, 2017); *see also* Grassley Press Release, available at https://www.grassley.senate.gov/news/news-releases/bipartisan-bill-prevent-corporate-penalties-becoming-tax-deductions.

[9] *See* 163 Con. Rec. S2177 (The sponsored bill "increases transparency by requiring the government to file a return at the time of settlement that accurately states the tax treatment of amounts to be paid by offending businesses.").

[10] *Id*. at S2176-77 ("The Reed-Grassley bill addresses these problems by amending the Tax Code to require the government and the settling party to reach clear agreements on how settlement payments should be treated for tax purposes.").

[11] *Id.* at S2177 ("Last Congress, it was estimated that this legislation would raise $218 million in revenue over a ten-year budget window.").

[12] *Settling for a Lack of Accountability? Which Federal Agencies Allow Companies to Write Off Out-of-Court Settlements as Tax Deductions, and Which Are Transparent about It*, U.S. Public Interest Research Group Education Fund (Dec. 2015), ***available at*** https://uspirg.org/sites/pirg/files/reports/USPIRG_SettlementsReport.pdf.

[13] *Id.* at 17.

[14] *Id.* at 3.

[15] 26 U.S.C. § 162(f)(1).

[16] 26 U.S.C. § 162(f)(2)(A)(i).

[17] 26 U.S.C. § 162(f)(2)(A)(ii).

[18] 26 U.S.C. § 162(f)(2)(B).

[19] Pub. L. No. 115-97 § 13306(b) (2017) (enacting new 26 U.S.C. § 6050X).

[20] *Id.*

[21] *See, e.g., Apportionment of False Claims Act Recoveries to Agencies,* Memorandum Opinion for the General Counsel Office of Personnel Management and the General Counsel Office of Personnel Management and the General Counsel U.S. Postal Service (March 2004)*, **available at*** https://www.justice.gov/file/18886/download (discussing DOJ's practice of allocating single damages to the agencies).

[22] For additional practice points regarding documenting deductibility during settlement negotiations, see What Every Contractor Should Know About the Tax Implications of Settling a False Claims Act Case, *Contract Management* (Dec. 2014), ***available at,*** *https://www.lw.com/thoughtLeadership/what-every-contractor-should-know-about-tax-implications-of-settling-false-claims-act-case*.