The New Framework for Characterizing the Deductibility of FCA Settlement Payments

March 13, 2018 Stacy Brainin, Taryn McDonald

In addition to its certain impact within the general realm of finance and business, the December 2017 passage of the Tax Cuts and Jobs Act may have somewhat less obvious, but equally important, implications for the delivery of healthcare and the industry as a whole. Some of the new law's key healthcare policy changes relate to the individual mandate, medical expense deductions, and the Orphan Drug Tax Credit; however, the particular implications of these changes are largely speculative at this time. On the other hand, the change to the deductibility of settlements with government agencies under Internal Revenue Code (Code) § 162(f), though not specifically aimed at healthcare, may nonetheless have the most immediate impact on industry operations.

Section 162 and its Storied History with FCA Settlements

In general, Section 162 of the Code allows for deductions of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade of business."[1] Payments made in settling claims brought against any business may constitute such ordinary and necessary expenses under Section 162. For taxpayers settling False Claims Act (FCA) actions, the tax treatment of amounts paid to settle is significant, but the application of Section 162 has not always been clear in this context.

Historically, the Code prohibited deducting as a business expense any fines, penalties, or other amounts paid to the government or to a governmental entity for the violation of any law or the investigation by the government into the potential violation of any law.[2] The Treasury regulations defined a "fine or similar penalty" to include amounts "[p]aid as a civil penalty imposed by Federal, State, or local law" and amounts "paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."[3] However, "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty."[4] In an effort to clarify how these rules apply to FCA settlements, the IRS issued a memorandum in 1972, explaining that single damages paid under the FCA would be deductible, but any additional amounts paid as penalties would not be deductible.[5] Distinguishing compensation from penalties has proven difficult for FCA defendants, as the FCA's treble damages provision serves both remedial and punitive purposes, depending on the parties' intent.[6]

Courts have also weighed in on the subject. In 2001, the Ninth Circuit affirmed a tax court's decision that the absence of a tax characterization agreement, when a settlement agreement was silent on the issue and the parties disagreed, was fatal to the taxpayer's desired deduction.[7] The tax court instructed that it was the taxpayer who suffered the consequences if he did not establish "entitlement to the disputed deduction."[8] However, in 2014, the First Circuit expressly rejected any "rule that requires tax characterization as a precondition to deductibility," as such would give the government unprecedented power in that it "could always defeat deductibility by the simple expedient of refusing to agree—no matter how arbitrarily—to the tax characterization of a payment."[9] The burden remained on the taxpayer to prove deductibility, but the Department of Justice (DOJ) has historically refused to take a position on which portion of an FCA settlement

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payment is compensatory and which is punitive. Accordingly, settling FCA defendants have faced uncertainty as to which portion of a settlement payment is compensatory and therefore deductible, especially in cases settled for a much smaller figure than the Department of Justice initially requested.

The New Tax Law

The new tax law looks to put an end to some of this uncertainty by amending Section 162(f), but not without consequence to FCA defendants. As amended, Section 162(f) states that, absent certain exceptions:

> [N]o deduction otherwise allowable shall be allowed under this chapter 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.[10]

The first exception excludes any amounts paid as restitution if (i) the taxpayer establishes that the amounts constitute restitution or that the amounts are paid to come into compliance with the law that was violated or otherwise involved in the investigation or inquiry, and (ii) the amounts are identified as restitution or amounts paid to come into compliance with such law *in the court order or settlement agreement*. Importantly, the law indicates that "[t]he identification alone [in the settlement agreement or court order] is not sufficient to establish the amounts as restitution."[11]

Under the new tax law, settling FCA defendants must (i) establish that the amounts they wish to deduct constitute restitution or were paid to come into compliance with any law which was violated or otherwise involved in the investigation, and (ii) ensure that those amounts are identified as such in the relevant court order or settlement agreement. The law also includes a requirement that the appropriate official of any government or entity involved in such a settlement make a return that sets forth: (i) the total amount to be paid, (ii) the portion of the amount that constitutes restitution or remediation of property, and (iii) the portion of that amount required to be paid to come into compliance with any law that was violated or involved in the investigation.[12] The return must be filed at the time the agreement is entered into. The law further requires that the government or entity making the return provide a written statement to each person who is a party to the suit or agreement containing the information supplied in the return.

Conclusion

For FCA defendants, the primary effect of the new tax law's amendment to Section 162(f) is that characterization of amounts paid will be a key term in the negotiation of any settlement. Settling defendants should be able to demonstrate which amounts constitute "restitution or an amount paid to come into compliance," and those amounts should be agreed to by both parties and identified as such in the settlement agreement. In any event, the new tax law will, at least, alter the nature of FCA negotiations, as the DOJ may now have to take a position as to the characterization of amounts paid for tax purposes.

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[1] 26 U.S.C. § 162(a).
[2] 26 U.S.C. § 162(f).
[3] 26 C.F.R. § 1.162-21(b)(1).

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[4] 26 C.F.R. § 1.162-21(b)(2).

[5] 1972 TM LEXIS 15, at *8 (July 25, 1972).

[6] *See Cook Cnty. V. U.S. ex rel. Chandler*, 538 U.S. 119, 130-31 (2003).

[7] *See Talley Indus., Inc. v. Comm'r*, No. 27826-92, 1999 T.C. Memo, LEXIS 237, at *23 (June 18, 1999), aff'd 18 F. App'x 661 (9th Cir. 2001).

[8] *Id.*

[9] *Fresenius Med. Care Holdings, Inc. v. United States*, 763 F.3d 64, 70 (1st Cir. 2014).

[10] H.R. REP. NO. 115-466 § 13306(a) (2017) (Conf. Rep.).

[11] *Id.*

[12] *See id.* § 6050X(a).

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