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1st Circ. Allows FCA Defendants To Push For Tax Breaks

By **Dietrich Knauth**

Law360, New York (August 21, 2014, 6:56 PM ET) -- The First Circuit's recent Fresenius decision gave contractors more room to push back against the government's argument that False Claims Act settlements are fines, not tax-deductible business expenses, but contractors should be prepared to give a detailed breakdown of settlement expenses before looking for a tax refund, attorneys say.

The First Circuit ruled on Aug. 13 that Fresenius Medical Care Holdings Inc. was entitled to deduct $50 million from its taxes as a result of a $385 million paid to settle civil allegations it defrauded government health care programs. The appeals court, in upholding a jury verdict in the district court, disagreed with Ninth Circuit precedent and the U.S. Department of Justice's arguments that the absence of an agreement on whether the payments were deductible meant Fresenius couldn't claim they were.

The Internal Revenue Code allows companies to deduct business expenses, including compensatory payments, but not fines or penalties levied by the government. Companies settling liability under the False Claims Act, which allows for treble damages and payments to relators, have disputed the DOJ's assertion that the entirety of such settlements are punitive and not compensatory.

The Fresenius case, which allowed the FCA defendants to claim deductions above and beyond the “single damages” at issue in the case, offers several lessons for companies, according to Brian Kittle of Mayer Brown LLP, who wrote about the case for Mayer Brown's government contracts blog. Although the IRS will likely continue to argue that no portion of an FCA settlement is deductible, companies can cite Fresenius when attempting to counter that argument with evidence of the parties’ intent or of the “economic reality” of the settlement, Kittle explained.

In light of the decision, contractors should be prepared for more nuanced arguments about the treatment of such settlements for tax purposes, beyond simply discussing whether the defendant paid multiple damages or whether there was a tax characterization agreement between the parties, according to David Nadler, a partner withDickstein Shapiro LLP.

“The determination is case-specific and will be based on a variety of factors including the intent of the parties,” Nadler said. “While it will still be difficult to prevail, the case does provide companies an opportunity to argue that some or all of the FCA damages that were paid are deductible as a business expense and were not a fine.”

Because few cases directly address the tax deductibility of FCA settlements, the Ninth Circuit's 1997 decision in Talley Industries Inc. v. Commissioner has carried precedential weight for years, according to

Jay Gallagher of McKenna Long & Aldridge. The Ninth Circuit presumed that anything over single damages was a penalty, and the DOJ and IRS have relied on that case in other tax disputes, including Fresenius.

“This decision flatly rejects the rationale of the Ninth Circuit, so that's very good for contractors,” Gallagher said.

The majority of FCA settlements don't break down what a defendant is paying toward single damages, toward the government's costs of investigation, interest or other potential factors, Gallagher said. Under the rationale laid out in Fresenius, contractors should try to settle close to the “single damages” and clearly characterize any reasonable excess as a deductible expense.

"You're trying to settle a case at single damages plus an interest factor," Gallagher said. “That's the objective, and then you can argue that you've got the government's costs of the investigation, which are not insignificant, plus making them whole, and then you've got the interest factor after that."

The First Circuit acknowledged that it was creating a split with the Ninth Circuit but said that the Talley decision, combined with the government's policy of refusing to address the tax deductibility of settlements, is at odds with tax law.

"Such an exclusive focus would give the government a whip hand of unprecedented ferocity: It could always defeat deductibility by the simple expedient of refusing to agree — no matter how arbitrarily — to the tax characterization of a payment," the court said.

Fresenius, which provides kidney dialysis services, agreed in 2000 to pay a $101 million criminal fine and $385 million in civil payments to settle FCA allegations. It later argued that $126 million in payments were made to compensate the government, which are deductible under the Internal Revenue Code, and sued the federal government in 2008 to claim the deduction.

While Fresenius opens the door for corporations to seek deductions for the double damages portion of FCA, the number of cases that could be affected remains uncertain because disputes are uncommon, according to Nadler.

"As a practical matter, the universe of these cases is going to be very small," Nadler said.

Still, many companies have tried to claim deductions when settling with federal agencies, according to a 2005 report from the U.S. Government Accountability Office.

The GAO surveyed four agencies, and all said they do not negotiate with settling companies about whether settlement amounts are tax deductible, according to the report. While the agencies preferred to leave those matters to the IRS, the IRS doesn't always have complete information about settlements, leading the GAO to recommend more coordination between agencies with large civil settlements and the IRS, to ensure the correct tax treatment of the settlement amounts.

Without having the deductibility of a settlement spelled out, companies tended to seek deductions, GAO said. Twenty of 34 companies responding to GAO's survey said they deducted some or all of their civil settlement payments when their settlement agreements did not label the payments as penalties.

--Editing by Sarah Golin and Philip Shea.