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WNTS Insight*

Focusing on the impact of emerging developments

In this Issue

Deducting False Claims Act settlement payments: The latest from the IRS

The deductibility of False Claims Act (FCA) settlement payments made to the Department of Justice (DOJ) long has been a high-priority issue for the IRS.

That was made clear in March 2007, when the IRS included "government settlements" on its initial list of Tier I issues -- issues that are of "high strategic importance" to the IRS Large and Mid-Size Business Division (LMSB) and "have significant impact on one or more industries."

Since then, the IRS has issued a series of documents providing guidance for IRS examiners regarding this issue that focus on FCA settlement payments. The most important of these documents are LMSB Directive 1 and its attached FCA settlement audit guidelines (May 30, 2007) and an LMSB Coordinated Issue Paper (CIP) (September 5, 2008).

This guidance has made it extremely difficult for taxpayers to sustain deductions for portions of FCA settlements other than single damages, plus certain non-damage amounts such as investigatory costs and whistleblower rewards (see below). The guidance also applies to settlements with any other governmental entity (state, local, and tribal) under authorities other than the FCA.

Despite this guidance, the IRS in particular instances has been willing to settle this issue on terms that are somewhat taxpayer-favorable.

Background

The FCA, first enacted during the Civil War, is one of the government's primary weapons against civil fraud.

The statute allows the government to recover, in addition to its actual losses, multiple damages up to three times actual losses (treble damages), plus civil penalties, for each false payment claim a person knowingly submits or causes to be submitted to the government.

The FCA also includes what is known as a "qui tam" provision under which a whistleblower (formally known as a "relator") can sue on behalf of the government. The government then can choose to intervene in the action; if it does, the case is prosecuted by the DOJ. The FCA authorizes the government to pay whistleblowers in such cases a reward equal to a certain percentage of the amount recovered by the government. Most of the government's annual total recovery from FCA actions comes from whistleblower-initiated lawsuits.

Most FCA actions that the government intervenes in or initiates result in a settlement between the DOJ and the accused. The threat of treble damages (if a case goes to trial and the accused is found to have violated the FCA) and the government's willingness to settle for double damages or even less and to waive penalties have proven to be powerful incentives for accused corporations to settle FCA suits.

The details of a settlement are memorialized in a "Settlement Agreement." Importantly, however, under the DOJ policy of "neutrality" regarding the tax treatment of FCA settlement payments, Settlement Agreements do not allocate settlement payments between compensatory and punitive amounts and do not address the deductibility of settlement payments. Many FCA Settlement Agreements now also include affirmative "tax neutrality" language reflecting that policy. **Observation:** According to congressional testimony by former Deputy Attorney General Paul J. McNulty, the DOJ's neutrality policy "was implemented in coordination with the IRS." This is extremely important, as will be explained below.

The Law on Settlement Deductibility

The general rule of section 162(a) allows corporations to deduct "all ordinary and necessary expenses paid or incurred" during the tax year. One exception to that general rule is section 162(f), under which taxpayers may not deduct "fines or similar penalties." The regulations under section 162 provide that "compensatory damages" do not constitute a fine or penalty for purposes of section 162(f).

The determination of what constitutes deductible compensatory damages, according to the recent CIP, turns on the purpose the payment was meant to serve.

The leading case on this issue is the Ninth Circuit's 1997 decision in *Talley Industries*. That decision distinguishes civil "penalties" imposed to enforce the law and as punishment for violation of the law -- which serve the same purpose as criminal fines (nondeductible) -- from civil "penalties" imposed to encourage compliance with the law or to compensate another party for expenses incurred as a result of the violation -- which do not serve the same purpose as criminal fines (deductible).

One key holding of *Talley* is that the taxpayer bears the burden of proving that both parties intended the payment to be compensatory. The Directive 1 audit guidelines and the CIP both state that "the tax law is clear": the taxpayer bears the burden of proving that it is entitled to deduct any portion of the settlement amount paid.

At issue in *Talley* was the deductibility of \$940,000 of a \$2.5 million lump-sum settlement payment by a Talley subsidiary to the government. DOJ files indicated that the government's actual losses were \$1.56 million, so the IRS agreed that Talley could deduct that amount as compensatory damages. That left the deductibility of the remaining \$940,000 (the so-called "multiplier") at issue.

On remand from the Ninth Circuit, the Tax Court concluded that Talley had failed to establish that both parties mutually intended that the multiplier was compensatory. Talley therefore failed to establish that it was entitled to deduct the \$940,000.

Observations: *Talley* sets the bar for deductibility extremely high. Although *Talley* is still the leading case on this issue, the fact that FCA Settlement Agreements -- at the IRS's request -- now contain "tax neutrality" language may call into question *Talley's* continued relevance, because it is now virtually impossible, as a practical matter, for taxpayers to show that the taxpayer and the DOJ reached a mutual agreement on the proper characterization of the settlement payment for tax purposes.

CIP, Audit Guidelines

The CIP explains that because FCA Settlement Agreements avoid discussion of the tax treatment of settlement payments, IRS agents must "look into these settlements and the facts behind them in order to determine if the settlement includes multiple damages, and, if so,

whether all or a portion of the multiples were intended to be compensation or a penalty."

Observations: Although this approach seems reasonable, at the same time, the position taken in the Directive 1 audit guidelines and the CIP seems to stack the deck in favor of the government by declaring that the DOJ's intent is determinative. The IRS states:

No issue is ever proposed to a taxpayer unless DOJ fully supports the position that the settlement amount includes multiple damages that DOJ intended to serve as a penalty. The Service makes no attempt to interpret the application of the FCA. All interpretation of the FCA as it applies to each case is that of DOJ. In addition, no penalty amount is based on any computation made by IRS. All figures are those of DOJ. The entire issue is based on the facts, figures, documentary evidence and interpretation of DOJ.

In other words, if this is the proper standard, taking the IRS to court on this issue might be an exercise in futility. It is uncertain, though, whether a court will accept this standard, given that it strips the court of all discretion to determine whether a settlement payment is compensatory or not based solely on the intent (expressed or unexpressed, documented or undocumented) of the DOJ attorneys who negotiated the FCA settlement.

Regarding non-FCA settlements, Directive 1 states that the issue "can apply to any settlement between a government entity and a defendant under any law in which a penalty can be assessed." The CIP states, in a parenthetical: "This issue deals with, but is not limited to, FCA settlements with DOJ. In any case in which a taxpayer has entered into a settlement with any other governmental entity under any authority other than the FCA, the facts and law must be analyzed to determine the application of this position."

Latest Developments

On October 3, the IRS issued LMSB Directive 3 on the government settlements issue, announcing that the issue had been removed from the list of Tier I issues under the LMSB Industry Issue Focus Program. The IRS explained that it took this action because field personnel now have guidance under the CIP.

However, on October 28, an IRS official announced that the Service had just issued a clarifying notice to correct Directive 3. The government settlements issue has not been removed from Tier I status; instead, it has been shifted from "active" to "monitoring" status.

According to the official, the issue no longer requires "the continued level of coordination across the enterprise"; field examiners can analyze and resolve the issue in accordance to existing guidance (such as Directive 1 and the CIP).

Observations: Therefore, even though the issue still has Tier I status, it appears that taxpayers may be able to expect examination teams to have more flexibility in resolving (that is, settling) the issue and closing the examination.

What Can Taxpayers Do?

Despite the hard line the IRS takes in Directive 1 and the CIP, the IRS to date consistently has been willing to settle this issue on reasonable terms, and the terms of recent settlements have been even more taxpayer-favorable.

Corporations that plan to deduct some or all of the multiples component of their FCA settlement payments may wish to consider the following:

- When negotiating with the DOJ, make sure the corporation's intent regarding the payment is clearly reflected in its own file;
- Retain documentary evidence to refute any claim by the IRS, based on DOJ documents, that the entire multiplier, or some significant part of it, was meant to be punitive; and
- Be prepared to present objective evidence regarding, for example, the compensatory nature of the payment, the amount of presettlement interest, and a legal analysis of the statute at issue regarding amounts above single damages.
- File FOIA requests or discovery requests to see what is in the DOJ file and obtain evidence of the DOJ investigatory costs.

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