Whistleblower Defense Alert: How To Maximize The Tax Deductible Portion Of An FCA Settlement

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There is good news for FCA defendants out of the First Circuit: According to a recent decision, settlement payments in excess of the government's single damages are tax deductible if the defendant can show that the excess sums are compensatory, rather than punitive. The Internal Revenue Code allows businesses to deduct its "ordinary and necessary expenses" but not "any fine or similar penalty paid to a government for the violation of any law." Applying this guidance to FCA settlements is complicated by the FCA's treble damages provisions, which clearly implicate a punitive damages component. In addition to serving a punitive purpose, however, treble damages have a compensatory component as well, and are designed, in part, to account for the government's litigation costs and interest on the delayed payment of the single damages.

Prior to the First Circuit's holding in *Fresenius Med. Care Holdings, Inc. v. United States*, No. 13-2144, __ F.3d __ (1st Cir. Aug. 13, 2014), it was difficult for FCA defendants to claim a tax deduction for any portion of a settlement agreement in excess of single damages and payment of relators' attorneys' fees. This difficulty traces back to the Ninth Circuit's seminal opinion in *Talley Indus. Inc. v. Commiss.*, 116 F.3d 382 (9th Cir. 1992). In *Talley*, the Ninth Circuit held that settlement payments that exceed the government's single damages constitute non-deductible penalties absent an agreement with the government that characterizes the payments as compensatory. Because DOJ's practices generally preclude any agreement regarding the tax treatment of settlement sums, the result, until now, has been an almost absolute prohibition on the deductibility of settlement payments in excess of the government's single damages.

The First Circuit is the first court of appeals to weigh in on the tax deductibility of FCA settlement payments following the Ninth Circuit's decision in *Talley*. In *Fresenius*, the defendants entered into a complex settlement with DOJ that required Fresenius to pay the government a total of $486,334,232-$385,147,334 of which was allocated to a settlement of the government's civil claims. Fresenius and DOJ agreed that $192,550,517 of that civil settlement amount was compensation for the government's single damages and was deductible. The parties also ultimately agreed that $65,800,555 paid to the relators was deductible. DOJ, however, argued that the remaining $126,796,262 represented non-deductible civil penalties. A jury disagreed, and concluded that $95,000,000 of the disputed amount was deductible.

The DOJ appealed the jury's verdict, asserting that the district court erred by failing to grant its motion for judgment as a matter of law. DOJ argued that, pursuant to *Talley*, none of the $126,796,262 was tax deductible as a matter of law because the settlement agreement did not characterize the settlement amount as compensatory. The First Circuit rejected DOJ's argument, as well as the Ninth Circuit's decision in *Talley*. The First Circuit held that, in accordance with well-established tenets of tax law, the "economic reality" of the payment—rather than the parties' characterization of the payment in the settlement agreement—should govern whether the payments are deductible. The Court noted that "[a] rule that requires a tax characterization agreement as a precondition to deductibility focuses too single-mindedly on the parties' manifested intent in determining the tax treatment of a particular payment." The Court also found that a rule that treats the settlement agreement as dispositive "would give the government a whip hand of unprecedented ferocity" because "it could always defeat deductibility by the simple expedient of refusing to agree—no matter how arbitrarily—to the tax characterization of a payment."

Although the First Circuit's opinion signals an important departure from *Talley*, there are still several issues that FCA defendants should consider before claiming a deduction for a portion of a FCA settlement that exceeds single damages. First, although the First Circuit's decision is well reasoned and persuasive, some courts may continue to follow the precedent set in *Talley*, and look for a written agreement specifying that specific settlement dollars correspond to compensatory damages. Second, assuming that a trend emerges in favor of the First Circuit's approach in *Fresenius*, FCA defendants will still have the burden of proving that settlement payments in excess of single damages are compensatory, not punitive. Finally, there will likely be continued debate over the precise method of apportioning FCA settlements between compensatory and punitive damages components in these cases.

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