Compensatory Settlement Payments in False Claims Act Cases are Deductible.

While business expenses are generally deductible, fines and penalties are not. In False Claims Act cases, the government is awarded treble damages; to what extent are these payments deductible? The First Circuit addressed that question last week in *Fresenius Medical Care Holdings, Inc. v. United States*, 2014 U.S. App. 15536 (1st Cir. 2014) (pagination not provided by LEXIS).

Fresenius was a refund case; it grew out of a settlement of a variety of claims, including claims under the False Claims Act and criminal fines. Significantly, the taxpayer and the government were unable to agree on the appropriate tax treatment of the entire settlement. The parties agreed that the criminal fines were non-deductible. They also agreed that an amount equal to single damages, one half of the $385,147,344 paid to resolve the False Claims Act claims, was deductible. This left the treatment of the other half of the civil settlement in dispute.

The taxpayer filed an amended return that took no deduction for this segment of the payment. In the course of an administrative appeal, the government conceded that the amounts paid to the *qui tam* relators and their counsel were deductible, leaving around 127 million dollars in dispute. The taxpayer filed a refund action, and, following a jury trial, was awarded a 50 million dollar refund, based on the jury's determination that 95 million dollars of the disputed payment was deductible. As the government was dissatisfied with this outcome, it appealed.

The First Circuit began its analysis by noting that multiple damages were necessary to put the government in the same position that it would have been absent the fraudulent conduct, as single damages would not cover the costs of litigation and other associated expenses. Consistent with this approach, the taxpayer's evidence at trial and the district court's jury instructions focused the inquiry on the extent to which the disputed payments were needed to provide the government with compensation.

The government, in contrast, argued that in the absence of an agreement on the tax characterization of the payments, the taxpayer was not entitled to *any* additional deduction for the disputed payments. The First Circuit rejected this proposition.

- First, the court noted that the government's approach gave it too much control over deductibility.
- Second, the court posited that that government's insistence that only an agreement would trigger deductibility was inconsistent with the normal rule that tax characterization of a transaction focus upon its substance, not the form.
- Third, the court also reasoned that the government's position was inconsistent with the normal rule that the tax consequences of settlement payments should be as the tax consequences of payments in the case of litigation to judgment.

This is a well-reasoned opinion that rejects a facially unsound position. It appears the government seriously overreached here.

Jim Malone is a tax attorney in Philadelphia; he focuses his practice on federal, state and local tax controversies.