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## First Circuit Rejects Talley and Allows a Business Expense Deduction for Settlement Payments Made Under the False Claims Act

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**On August 13, 2014, the United States Circuit Court for the First Circuit rejected the United States' request to deny Fresenius Medical Care Holdings Inc. from deducting a portion of a settlement payment to settle civil claims brought under the False Claims Act. *Fresenius Medical Care Holdings, Inc. v. United States*, 114 A.F.T.R. 2d 2014 - \_\_\_\_ (1st Cir. 2014) In affirming the Massachusetts federal judge's decision to permit the tax deduction, the First Circuit disagreed with the Ninth Circuit's decision in *Talley Industries Inc. v. Commissioner*, 116 F.3d 382 (9th Cir. 1997), and held, that a court may consider factors aside from the presence or absence of a tax agreement between the government and the settling party in determining the tax treatment of a False Claims Act civil settlement.**

In a taxpayer-favorable decision, the US District Court for the District of Massachusetts, following a jury verdict, entered judgment for Fresenius in a tax refund suit permitting a business deduction for payments made to the government to settle a suit under, *inter alia*, the False Claims Act ("FCA") (31 U.S.C. §§ 3729-3733), and other statutory and common law causes of action. In *Fresenius Medical Care Holdings, Inc. v. U.S.*, 2013 WL 1946216, Case No. 08-12118-DPW (D. Mass. May 9, 2013), Judge Douglas P. Woodlock upheld a jury verdict for Fresenius and awarded the taxpayer a refund of approximately \$50 million plus interest. The award reflected the jury's finding that the majority of double damages payments that the IRS claimed were punitive and, therefore, non-deductible as ordinary and necessary under Internal Revenue Code § 162(a) were, in fact, compensatory and, therefore deductible. In permitting the case to proceed to trial, the district court rejected the test to determine if payments constitute compensatory damages set forth in *Talley Industries Inc. v. Commissioner*, T.C. Memo 1999-200, *aff'd* 18 F. App'x 661 (9th Cir. 2001), and allowed Fresenius to present evidence beyond the terms of the settlement agreements to determine if all or some of the payments were made in settlement of non-punitive FCA liability.

Plaintiff Fresenius filed a tax refund suit against the United States in 2008 seeking recovery of \$126 million of a \$385 million payment to the government as part of a civil settlement,

which resolved Fresenius' potential liability under the FCA. Fresenius claimed that the entire settlement amount was tax deductible as an ordinary and necessary business expense under Internal Revenue Code § 162(a). The IRS agreed that \$258 million was deductible as compensatory, but viewed the remaining \$126 million at issue as a penalty ineligible for deduction under Code Section 162(f). Section 162(f) of the Code prohibits taxpayers from deducting settlement payments made to pay "a fine or similar penalty."

Fresenius moved for summary judgment, but the motion was denied. The district court, applying federal common law to interpret the settlement agreements, found that the agreements contained conflicting language and concluded that the contracts were ambiguous, and that a trial was required. The jury returned a verdict for Fresenius, finding that \$95 million of the \$126 million in disputed settlement payments were compensatory and therefore deductible. In holding that it was reasonable for the jury to conclude that the vast majority of the settlement payments were compensatory, the court referenced the large amount of pre-judgment interest necessary to make the government whole on losses incurred as a result of the fraud. The court also noted that the global settlement included a criminal plea agreement imposing a fine on Fresenius of \$101 million, which the jury reasonably might have concluded was intended to cover the punitive damages against Fresenius for fraud. The district court rejected the analysis in *Talley*. In *Talley*, the Tax Court held that the tax characterization of a settlement payment was ambiguous under the agreement. After a hearing in *Talley*, the Tax Court found that "[t]he record show[ed] that the parties did not agree whether the portion of the settlement in excess of the Government's 'single' damages would constitute compensation to the Government for its losses," and thus that the taxpayer "failed to establish entitlement to a deduction for the disputed portion of the settlement." Judge Woodlock noted "that a manifest agreement is not necessary for Fresenius to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability."

On appeal, the government argued that the absence of an agreement between the parties as to whether the payments were deductible barred Fresenius from asserting that the civil payment to settle the FCA litigation was deductible. Relying on *Talley*, the government argued that the FCA settlement context is special and that economic reality was irrelevant. In addition, the government argued that the district court erred in its jury instructions, but the government did not clearly articulate this argument at trial, and did not properly preserve it for appellate review.

The First Circuit disagreed with the government, stating "[i]n advancing this assertion, the government assigns talismanic significance to the presence or absence of a tax characterization agreement between the settling parties." The First Circuit rejected the government's narrow focus on the parties' expressed intent. "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." Accordingly, courts have a duty "to look beyond the language of the tax treatment of the settlement payment." The First Circuit added that *Talley* "offers an indistinct beacon by where to steer" and held that "[i]f *Talley* stands for the proposition asserted by the government then *Talley* is incorrectly decided and does not deserve our allegiance."

*Fresenius* opens the door for corporations to seek deductions for the double damages portion of FCA awards in the absence of a tax characterization agreement. Care in documenting settlement negotiations with the government should be taken to improve one's chances of sustaining such deductions.

If you would like to know how this may impact you or have any other questions, you may contact Lawrence M. Hill, Lawrence M. Bambino, or your regular Shearman & Sterling contact person.

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