

# PUBLICATION

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## Tax Reform Impacts Resolutions of FCA Enforcement Actions

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**The tax reform law passed in December 2017 establishes requirements and conditions for the tax deductible treatment of payments made to the government to resolve enforcement actions. See 26 U.S.C. § 162(f) (2018); see also Pub. L. No. 115-97, § 13306, H.R. 1 (Dec. 22, 2017). The new provisions hold important implications for defendants in all types of enforcement actions. Notably, the new law seems to require a departure from long-standing Department of Justice (DOJ) policy *not* to characterize settlement payments for deductibility purposes. Moreover, the law leaves unanswered important questions for cases brought under the federal False Claims Act (FCA). Thus, it remains critical that defendant taxpayers carefully consider the implications of government settlement payments from the outset of a matter.**

Historically, the government has declined to take a position in settlement agreements regarding the tax deductibility of settlement payments. The DOJ's position is consistent with a long line of cases establishing that taxpayers bear the burden of proving deductions to the Internal Revenue Service (IRS). The previous tax provision and case law supported the proposition that amounts paid to compensate the government for its losses were generally tax deductible, but that other items, such as penalties and fines, may be considered punitive and, therefore, not deductible. Thus, it was generally understood that single damages under the FCA were compensatory and deductible, but other amounts paid under the FCA (e.g., multiple damages, government costs, and relator costs and fees) were open to interpretation. This allowed an FCA defendant a certain degree of leeway when marshaling proof to support the tax deductibility of a settlement payment beyond single FCA damages.

The new tax law addresses some of this uncertainty, but not necessarily in a welcome way for FCA defendants. Significant revisions and new provisions include the following:

- The revised law prohibits tax deductibility unless an FCA defendant demonstrates that the payment was either (i) restitution for damage or harm which was or may be caused by the violation of any law or the potential violation of any law, or (ii) an amount paid to come into legal compliance with any law involved in the government's investigation or inquiry. This prohibition will likely hamper an FCA defendant in any effort to deduct those portions of a settlement payment consisting of damage multipliers.
- Either the settlement agreement or a court order must identify the specific amount of the total settlement payment that is considered the restitution amount. Without this specification, an FCA defendant will be precluded from taking *any* tax deduction, even for those payments that may have been considered compensatory, and deductible, under the previous tax law. This is a significant change to the settlement process, especially because the DOJ has traditionally avoided taking any such position in FCA settlements. To date, the DOJ has not signaled how it intends to handle tax deductibility issues in FCA settlement negotiations.
- The DOJ or other government entity is now required to report deductible amounts to the IRS at the time of settlement.
- A new provision in the tax law precludes deductions for amounts paid or incurred as reimbursement to the government for costs associated with its investigation or litigation. The law does not address,

however, the same types of reasonable fees and costs that are typically paid by FCA defendants to FCA whistle-blowers.

Of note, the new law does not change the taxpayer's ultimate burden to prove tax deductibility. When claiming the deduction, the taxpayer must independently establish that the payment is restitution- or compliance-related, even if a settlement agreement identifies an amount as such. The new provision does not necessarily change much of the existing law that guides taxpayer deduction decisions, including what documentation the IRS may require in an audit scenario. However, it does make clear that no payment will be tax deductible without a clear tax characterization statement and, although it remains to be seen exactly how the new law will be implemented by the various implicated government agencies (e.g., DOJ, SEC, IRS, etc.), it should bring many of these issues to the forefront of enforcement litigation and settlement discussions.

As anybody who has dealt with FCA enforcement knows, tax implications are of paramount importance to the resolution of such matters. In the fiscal year ending September 30, 2017 alone, the DOJ obtained more than **\$3.7 billion in settlements and judgments** from civil cases involving fraud and false claims against the government. At a 35 percent corporate tax rate, that equals \$1.295 billion in potential bottom-line impact from tax deductions at stake in the past year alone.

In the face of these recent changes to the tax law, it is more critical than ever that FCA defendants consider the potential tax ramifications of resolution from the outset of an investigation or litigation. They should involve a team of experienced defense and tax counsel to ensure appropriate documentation and to assist in the negotiation and characterization of settlement and restitution amounts.