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COURT RULING PROVIDES BLUEPRINT FOR DEDUCTING FALSE CLAIMS ACT DAMAGES

by
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A recent federal court decision creates a roadmap for defendants seeking to obtain a tax deduction for damages paid under the False Claims Act ("FCA"), 31 U.S.C. § 3729, *et seq*. The ruling, *Fresenius Medical Care Holdings, Inc. v. United States*, No. 08-12118, 2013 WL 1946216 (D. Mass. May 9, 2013), underscores that any such defendant must compile as much evidence as possible during settlement negotiations with the Department of Justice ("DOJ") demonstrating that the award is compensatory, not punitive.

The Internal Revenue Code allows a civil defendant to claim a tax deduction for damages paid to compensate the Government for losses, but not for fines or penalties. 26 U.S.C. § 162(a), (f). The FCA subjects a defendant to treble damages, plus statutory penalties. 31 U.S.C. § 3729(a)(1). It is generally accepted that statutory penalties are punitive and not deductible, while *single* damages are deductible compensatory payments. *See*, *e.g.*, IRS Technical Mem., 1972 TM LEXIS 15 (July 25, 1972). Proper treatment of additional damages paid under the FCA's trebling multiplier is less certain. *Fresenius* provides one judge's view of the issue.

Fresenius paid DOJ $385 million to resolve an FCA suit. The Internal Revenue Service concluded that $258 million of that award was compensatory and deductible, but that the remaining $126 million was not. Fresenius claimed the entire award was deductible and filed suit to recover taxes paid on the $126 million.

Under U.S. Supreme Court precedent, FCA damage awards cannot categorically be labeled as compensatory or punitive, but must be assessed on a case-by-case basis. *Cook County v. United States ex rel. Chandler*, 538 U.S. 119 (2003). That is because it is "usually necessary" for an FCA defendant to pay the Government more than single damages to fully compensate it for all losses "occasioned by fraudulent claims," including pre-judgment interest and consequential damages. *Id.* at 130-31. Against this backdrop, *Talley Industries, Inc. v. Comm'r*, 1999 WL 407454 (T.C. 1999), *aff'd* 18 F. App'x 661 (9th Cir. 2001), has provided the leading test for assessing whether the portion of an FCA damages award above single damages is deductible. *Talley* held that a taxpayer seeking to deduct that portion of the award must prove that the parties mutually "intended" it to be a compensatory payment. *Id.* at *5.

The court in *Fresenius* rejected that requirement. 2013 WL 1946216, *6. It emphasized that DOJ's "traditional and customary approach" is to expressly disclaim any view on the tax characterization of damages in FCA settlement agreements. *Id.* at *7. In light of this practice, the court found it unreasonable to insist that FCA defendants prove DOJ's "agreement" on tax characterization because such rule allows "DOJ's unilateral declination to resolve tax matters [to] resolve[] those very same matters in the government's favor." *Id.* Instead, the court held that FCA defendants may prove that a damages award is

compensatory through other evidence, such as "interest calculations, attorneys' billable hours, and expense records." *Id.*

In *Fresenius*, a jury weighed the evidence under that standard and concluded that $95 million of the contested $126 million award was compensatory. *Id.* at *8-11. Although there was no evidence that DOJ agreed to that characterization, the court upheld the verdict as reasonable in light of the evidence, which included settlement correspondence from DOJ advocating multiple damages as necessary to fully compensate the Government for its losses.

It remains to be seen whether *Fresenius*'s roadmap will be adopted by other courts. Indeed, DOJ may well appeal. In the meantime, the ruling underscores the value of compiling as much evidence as possible to show that an award is more appropriately viewed as compensatory.

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