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US District Court Rejects *Talley* and Permits a Business Expense Deduction for Part of Double Damages Payment Under the False Claims Act

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In a taxpayer-favorable decision earlier this month, the US District Court for the District of Massachusetts, following a jury verdict, entered judgment for a corporation in a tax refund suit permitting a business deduction for payments made to the government to resolve potential liability under 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. US*, 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 \$50,420,512.00 plus interest. The award reflected the jury’s finding that the majority of double damages payments that the IRS claimed were punitive and therefore ineligible for a deduction 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 Indus., 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 had 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 initially moved for summary judgment, but the motion was denied. Fresenius had asserted that the plain language of the civil settlement agreements identified the payments as non-punitive, and therefore, not a penalty within the meaning of Section 162(f). However, 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. Fresenius' argument was predicated on language in the agreement stating that "[Fresenius entities] further agree nothing in this agreement is punitive in purpose or effect." The government argued that the agreement contained no provision governing how the United States should allocate the settlement funds. The settlement agreement provided, "Nothing in this agreement constitutes an agreement by the United States concerning the characterization of the amounts paid hereunder for purposes of any proceeding under Title 26 of the Internal Revenue Code." After the judge denied the summary judgment motion, the case proceeded to trial.

In a motion for judgment as a matter of law filed before the jury began deliberations, the government argued that Fresenius had not proven that the \$126 million represented compensatory payments. The government's argument rested on US Supreme Court precedent and the *Talley* decision. The US Supreme Court held in *US v. Cook County*, 538 US 119 (2003) that the multiple damages provision of the FCA is both penal and compensatory. The government took the position that if the payment serves both purposes, the fact that one purpose is penal disqualifies it as a deduction under Section 162(f), unless the government agrees to strip the penal aspect from the payments. In reply and in support of its own motion for judgment as a matter of law, Fresenius argued that the Supreme Court in *US v. Bornstein*, 423 US 303 (1976) held that the compensatory purpose of the multiple damage provision of the FCA included the recovery of prejudgment interest, and that the Supreme Court's ruling in *Cook County* held that triple damages under the FCA are both compensatory and punitive, but double damages (which Fresenius paid under the settlement agreements) are merely compensatory. The district court denied the parties' motion for judgment as a matter of law and allowed the case to proceed to verdict.

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 concluding 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 by 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 court's opinion rejected the analysis in *Talley*. Judge Woodlock noted that throughout the litigation, the government relied heavily on *Talley* for the proposition that the parties must agree on the purpose of the settlement payment in order to characterize the payment as compensatory for tax purposes. 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 the taxpayer “failed to establish entitlement to a deduction for the disputed portion of the settlement.” Judge Woodlock concluded “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.”

Fresenius opens the door for corporations to seek deductions for the double damages portion of FCA awards. Care in documenting settlement negotiations with the government should be taken to improve one’s chances of sustaining award deductions.

Should you have any questions, you may contact Lawrence M. Hill, Laurence M. Bambino, Thomas D. Johnston or your regular Shearman & Sterling contact person.

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