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Recent Case Upholds Deductibility of Payments to Settle False Claims Act Allegations

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Several Lessons Can Be Learned from the *Fresenius* Case

In a recent case of first impression, the First Circuit Court of Appeals upheld a jury verdict as to the deductibility of payments made by a dialysis provider to settle allegations that it had violated the False Claims Act (FCA). At issue was whether the payments made were tax deductible as business expenses or if they should properly have been characterized as governmental fines or penalties, which are nondeductible.

Under the FCA, health care companies that have improperly billed Medicare and other federal payors for services or products can be responsible to repay up to three times the amount improperly collected. Under the federal tax code, compensatory payments are deductible, meaning payments to reimburse a payor for amounts improperly billed and collected by the payment recipient. However, payments of punitive damages and governmental fines and penalties are not deductible under the theory that a violation of a law should not benefit the violator.

In 2000, the taxpayer had agreed to pay a $101 million criminal fine and an additional $385 million to settle multiple civil claims under the FCA. By their terms, the settlement agreements did not address the tax deductibility of the payments made to resolve the claims. During several years that ensued after the settlement of the claims, the taxpayer and the government had agreed that of the $486 million paid, none of the criminal fines were deductible ($101 million) but that a portion of the civil claim ($192.5 million, the so-called single damages claim, *i.e.*, the actual amount improperly billed and collected by the taxpayer) and the payments made by the government to the whistleblowers (another $65.8 million) were deductible.

In 2008, the taxpayer brought suit alleging that the remaining $126.8 million of the $385 million paid to settle the civil claims under the FCA was deductible as a business expense. A jury ultimately awarded the taxpayer a refund based on a $95 million deduction — the jury found that the remaining $31.8 million paid was nondeductible. This resulted in the district court awarding the taxpayer to a $50.4 million tax refund (plus interest on the refund) based on the additional $95 million deduction that was approved by the jury. On appeal, the First Circuit Court of Appeals upheld the jury verdict.

Several lessons can be learned from this case, *Fresenius Medical Care Holdings Inc. v. United States*, No. 13-2144, 2014 U.S. App. LEXIS 15536 (1st Cir. Aug. 13, 2014), the first of which is that in negotiating settlements of FCA allegations, advisors to health care providers, suppliers, hospitals, and professionals should try to include language in the settlement agreement in support of the deductibility of the settlement payments and that they should avoid including any language in the settlement agreement that can be used by the Internal Revenue Service to deny the deductibility of the payments made to settle the dispute.

Advisors should try and limit the amount paid under the settlement to the single damages amount. The closer that the amount paid to settle the claim is to the actual amount that was improperly billed (the so-called single damages amount, which was $192.5 million in the *Fresenius* case), the more likely that the payments will be deductible. Advisors and attorneys should try and add language to the settlement agreement that specifically provides that any excess over the single damages amount is first to be allocated to interest on the improperly collected amount and that that the remaining excess (if any) of the payment over the single damages amount and interest on the amount improperly collected is intended to reimburse the government a reasonable amount for its investigation expenses.

If the actual settlement amount exceeds the sum of these three elements (single damages amount, interest on the amount overpaid, and a reasonable allowance for governmental investigation amounts), deductibility of the excess will definitely be at risk and likely will not be tax deductible as a penalty or fine (not a compensatory payment). At all costs, try and avoid any reference in the settlement agreement to the allocation of any portion of the amounts paid to settle the claims to criminal fines or to penalties under the FCA.

The final lesson of the *Fresenius* decision is to include allocation language in the settlement agreement to the extent that is feasible and permitted by the governmental agency(ies) involved. In the *Fresenius* case, no such language was included; as a result, the government argued that all of the payments to resolve the civil claims were nondeductible. Even if the governmental agency(ies) involved will not allow for allocation language to be included in the settlement agreement, carefully document in communications with government counsel the interest computations and estimates of governmental investigation and attorneys' fees, all of which can help substantiate and increase the compensatory portion of the amounts paid to settle the FCA claims.

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