Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:TL-N-5575-00
JJBoyle/MJFritz

date: APR 20 2001

to: Revenue Agent Brad Keltner, Bowling Green, Kentucky
LM:NR:Grp. 1403

from: Associate Area Counsel (LMSB), Cincinnati
CC:LM:MCT:CIN:2

ubject: [redacted]
Settlement Payments Issue

This memorandum responds to your oral request for advice concerning the deductibility of $[redacted] that [redacted] paid in [redacted] to the United States and the State of [redacted], and the deductibility of $[redacted] of reported attorneys' fees. This memorandum should not be cited as precedent.

ISSUES

1. Under the circumstances of this case, is the deductibility of payments made by the taxpayer to the United States and the State of [redacted] in settlement of a civil claim[1] necessarily governed either by the characterization or disposition of the payments as contained in a written Settlement Agreement or by the characterization or disposition of the payments as contained in the United States Attorney's "Health Care Fraud Tracking Form"?

2. Under the facts as presently known to the examination team, how much of the total $[redacted] in payments by the taxpayer to the United States and the State of [redacted] appears to be deductible and how much appears to be nondeductible pursuant to I.R.C. § 162(f)?

3. Under the facts as presently known to the examination team, what portion, if any, of the taxpayer's attorneys' fees relating to the Settlement Agreement will be deductible?

---

[1] Apparently, the matter was settled before a lawsuit was actually filed on behalf of the United States and the State of [redacted] against the taxpayer and others.

CONCLUSIONS

1. The Federal income tax deductibility of the payments to the United States and the State of [redacted] is not necessarily controlled by the characterization or disposition described in the two relevant documents.

2. Based on the presently known facts, it appears that $[redacted] of the $[redacted] paid in settlement will be nondeductible pursuant to section 162(f).

3. Based on the presently known facts, the taxpayer appears to be entitled to a deduction for attorneys' fees in the amount of $[redacted], as claimed on its [redacted] return.

FACTS

The Settlement Agreement

On or about [redacted] [redacted] or "the taxpayer"), through its subsidiary, [redacted], entered into a written "Settlement Agreement and Release" ("the Settlement Agreement") with the United States Attorney for the [redacted] and with the State of [redacted]. The Settlement Agreement related to [redacted]'s potential liability for health care fraud, under the False Claims Act (31 U.S.C. § 3730) and other statutory and non-statutory theories of liability.

The Settlement Agreement required [redacted] to pay the United States and the State of [redacted] a total of $[redacted]. The Settlement Agreement contained the following apportionment:

$[redacted] dollars to the United States and the State of [redacted] as "restitution";

$[redacted] dollars to the Crime Victim Fund as a "settlement payment";

$[redacted] as a "civil payment";

$[redacted] to the [redacted] as a "civil payment";

$[redacted] to the [redacted] as "reimbursement for investigative costs"; and

$[redacted] to the various Federal and State agencies as "reimbursement for investigative costs."

In exchange for payment of the $[redacted], the Settlement Agreement provided, with the exception of six individuals, that:[2]

(1) The United States would release [redacted], [redacted] and their current and former directors, officers, employees, and agents ("the Released Parties") from any civil, criminal, or administrative charges or monetary claims the government had or may have had under the False Claims Act (31 U.S.C. § 3729 et seq.), the Civil Monetary Penalties Law (42 U.S.C. § 1320a-7a), the Program Fraud Civil Remedies Act (31 U.S.C. § 3801-3812), and specified common law theories, for any conduct of which the Government was presently aware;

(2) The Office of the Inspector General of the United States Department of Health and Human Service ("HHS-OIG") would release the Released Parties from administrative actions or monetary claims for any conduct of which the Government was presently aware, and not seek their exclusion from the State health care program or the Medicare program;

(3) The State of [redacted] ("the State"), upon payment and execution of an attached Corporate Integrity Agreement, would release the Released Parties from any civil, criminal, or administrative charges or monetary claims that the State had or may have had under [redacted] laws or regulations for any conduct of which the State was presently aware;

(4) The [redacted] would release the Released Parties from any civil or administrative charges or monetary claims that the [redacted] may have under [redacted] laws or regulations for any conduct of which the [redacted] was presently aware, and not seek their exclusion from the [redacted] Medicaid programs; and

(5) The [redacted], upon payment and execution of an attached Consent Order, would release the Released Parties from any civil or administrative charges or monetary claims which the [redacted] may have under [redacted] laws or regulations for any conduct of which the [redacted] was presently aware.

The Settlement Agreement further specified that: (1) [redacted] was

---

[2]These individuals included [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted]. [redacted] and [redacted] owned [redacted] until its purchase by [redacted] in [redacted], and they subsequently managed [redacted] until [redacted].

not released from any claims arising under Title 26; (2) it was solely for the benefit of the Released Parties and did not constitute an admission by any individual or entity; (3) it was binding on the parties, their successors, assigns, and heirs; (4) it became binding only on execution of all parties and could not be changed, altered, or modified except in writing, signed by all parties; and (5) [redacted] was prohibited from recovering any settlement payments either directly or indirectly from the United States or any State Medicaid program.

Payment of the $[redacted]

The taxpayer paid the total $[redacted] settlement amount in [redacted]. On [redacted], taxpayer made a civil debt payment through the U.S. Attorney's office in the amount of $[redacted]. The taxpayer also made a separate payment of $[redacted] which was designated in the Settlement Agreement as a "civil payment," directly to the [redacted].

The Health Care Fraud Tracking Form

On an internal Department of Justice document entitled "Health Care Fraud Tracking Form," the United States Attorney's Office which received the $[redacted] payment from the taxpayer accounted for its disposition as follows:

$ [redacted] for a relator (whistleblower) fee.[3]

[redacted] for HHS-OIG investigation costs

---

[3] The False Claims Act ("FCA"), one of the potential bases for charges against the taxpayer, provides for the imposition of a civil penalty of between $[redacted] and $[redacted], plus three times the amount of damages which the Government sustains, against anyone who knowingly makes a false claim against the United States government. See 31 U.S.C. § 3729(a). The FCA allows a private person (known as a "qui tam relator") to bring a civil action for violation of section 3729. See 31 U.S.C. § 3730(b). The Government may or may not elect to intervene and proceed with the action. Where the Government chooses to intervene in the qui tam action, a relator is eligible to receive between 15 and 25 percent of the proceeds of the action or settlement claim, as well as reasonable expenses and attorneys' fees. 31 U.S.C. § 3730(d). In this case, according to the Health Care Fraud Tracking Form, but not mentioned in the Settlement Agreement, the relator fee amounted to $[redacted], or approximately [redacted] percent of the total $[redacted] settlement.

[redacted] for actual/compensatory damages, Medicaid Federal Share

[redacted] for actual/compensatory damages, Medicaid State Share

[redacted] for [redacted] State police investigation costs

[redacted] for penalties and damages excluding actual/compensatory damages, relator's fees, investigative costs, and court[4]

The "Crime Victims Fund" Portion of the Payment

Assistant United States Attorney [redacted] who represented the United States in the litigation and who signed the Settlement Agreement on behalf of the Government, has indicated to the examining revenue agent that the $[redacted] allocated in the Settlement Agreement for payment to the "Crime Victims Fund" represented punitive damages. According to [redacted], the U.S. Attorney intended for the $[redacted] to go to the "Crime Victim Fund," so that it could be used to assist crime victims in the [redacted]. However, it was later determined that such an application was inappropriate since [redacted] had not been convicted of any crime, because, by statute, deposits to the Crime Victim Fund are limited to "fines that are collected from persons convicted of [criminal] offenses against the United States."

Taxpayer's Income Tax Reporting of the Payment

On its [redacted] consolidated return, the taxpayer claimed a $[redacted] of deductions relating to the [redacted] settlement. Based on information provided by [redacted], the accounting firm responsible for [redacted]'s tax accounting, we know that the deduction was comprised of the $[redacted] reflected in the Settlement Agreement, plus attorneys' fees of $[redacted]. It is our understanding, however, that [redacted], the accounting firm responsible for the taxpayer's financial accounting, had concluded that none of the $[redacted] settlement amount was deductible. However, the basis for this

---

[4] Despite the admonition on the Form itself to "check your figures," it appears to us that the total of these figures is only $[redacted], rather than the total of $[redacted] shown on the from. We cannot explain the discrepancy.

conclusion is unknown because of [redacted]'s stated reluctance to seek information from [redacted].

DISCUSSION

General Principles of Law

I.R.C. § 162(a) allows a deduction of "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 162(f), though, provides that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." Treas. Reg. § 1.162-21(b)(1) defines a *nondeductible* fine or penalty as, inter alia, an amount paid as a civil penalty imposed by Federal, State, or local law or an amount paid in settlement of a taxpayer's actual or potential liability for a fine or penalty (civil or criminal). Section 1.162-21(b)(2) makes clear, however, that compensatory damages paid to the government do not constitute a fine or penalty for purposes of I.R.C. § 162(f).

Ultimately, whether a payment constitutes a "fine" or a "penalty" which is not deductible on a Federal income tax return depends on the purpose the specific "fine" or "penalty" was meant to serve. Civil "penalties" imposed for purposes of enforcing the law and as punishment for violation of the law are not deductible for Federal income tax purposes. Talley Industries, Inc. v. Commissioner, 116 F.3d 382, 385-386 (9th Cir. 1997), citing Southern Pacific Trans. Co. v. Commissioner, 75 T.C. 497 (1980). On the other hand, civil "penalties" imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party for expenses incurred as result of the violation, are deductible because they do not serve the same purpose as a criminal fine and are not "similar" to a fine within the meaning of section 162(f). Id. See also Colt Industries, Inc. v. United States, 880 F.2d 1311, 1313 (Fed. Cir. 1989). The taxpayer has the burden of establishing the deductibility of any payment or portion thereof. Talley Industries, Inc., 116 F.3d at 387.

Issue 1

In discussing with the examining agent the deductibility of the $[redacted] in payments, the taxpayer's representatives take the position that the amount of any deduction should be computed based on the Settlement Agreement as written. As between the purpose for payment stated in the Settlement Agreement and the purpose for payment stated in the Health Care Fraud Tracking Form, the taxpayer would argue, the former would govern.

Furthermore, there is no indication that the taxpayer would think that anything outside the Settlement Agreement would matter in determining the deductibility of the payment.[5]

The deductibility of a payment for purposes of section 162(f) turns on the origin of the liability giving rise to it. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985) (payment applied as restitution in the settlement of a class action suit against a corporation and its officers was not deductible because the origin of the payment was a fine imposed by a district court on one of the corporation's officers for violation of a consent order with the FTC). Thus, neither a payment's characterization nor its disposition necessarily controls its deductibility for purposes of section 162(f). See Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd without published opinion 850 F.2d 611 (9th Cir. 1988) (payment characterized as "restitution" was not deductible where it was made on condition that the court would stay execution of the taxpayer's prison sentence); Allied Signal, Inc. v. Commissioner T.C. Memo. 1992-204, aff'd, 95-1 USTC ¶ 50,151 (3d Cir. 1995) (unpublished opinion) ($8 million designated for payment to a state environmental endowment fund was not deductible because it was an involuntary payment made with the expectation of a quid pro quo from the court).

To compute the penalty component in circumstances such as those presented in this case, all facts and circumstances relevant to ascertaining the true substance and nature of the claims actually brought or only threatened, and then settled and released, must be determined and quantified. The opinion of the Tax Court in McKay v. Commissioner, 102 T.C. 465, 482-83 (1994), vacated and remanded on other grounds, 84 F.3d 433 (5th Cir. 1996), is instructive in how to go about making such determination:

---

[5] We note that the Settlement Agreement provides that "this Agreement may not be changed, altered or modified except in writing, signed by all parties." This provision does not preclude the Internal Revenue Service's looking to the Health Care Fraud Tracking Form (or any other relevant evidence) to determine the deductibility of the payments. The provision speaks to the respective rights of the parties to the Agreement, for the purposes of the Agreement. It specifically does not speak to "claims arising under Title 26."

> If no lawsuit was instituted by [or, in [redacted]'s case, against] the taxpayer, then we must consider any relevant documents, letters, and testimony as we did in Fitts v. Commissioner, [T.C. Memo. 1994-52]. If a lawsuit was filed but not settled, or if settled but no express allocations among the various claims are contained in the settlement agreement, we must consider the pleadings, jury awards, or any Court orders or judgments as we did in Miller v. Commissioner, [T.C. Memo. 1993-49, supplemented by T.C. Memo. 1993-588]. If the taxpayer's claims were settled and express allocations among the various claims are contained in the settlement agreement, we carefully consider such allocations. See Byrne v. Commissioner, [90 T.C. 1000, 1007 (1998), rev'd and remanded, 883 F.2d 211 (3d Cir. 1989)] (quoting Metzger v. Commissioner, [88 T.C. 834, 837 (1987), aff'd without published opinion, 845 F.2d 1013 (3d Cir. 1988)]; Bent v. Commissioner, [87 T.C. 236, 244 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987)]; Glynn v. Commissioner, [76 T.C. 116, 120 (1981), aff'd without published opinion, 676 F.2d 682 (1st Cir. 1982)]. As stated above, however, in order to be respected, the express allocations must be negotiated at arm's length between adverse parties.

Issue 2

Based on its reading of the Settlement Agreement, the taxpayer is currently willing to concede that $[redacted] of the $[redacted] settlement amount, as well as a corresponding [redacted] percent of the attorneys' fees that it deducted on its [redacted] return,[6] are not deductible. The $[redacted] concession consists of the $[redacted] and $[redacted] amounts reflected in the Settlement Agreement as "a civil payment" and as "a civil payment to the [redacted]." The view expressed by the taxpayer is that, since those payments were undesignated in the Settlement Agreement, they are not deductible under the Tax Court's decision in Talley Industries v. Commissioner, T.C Memo. 1999-200, taxpayer appeal pending (9th Cir. No. 00-70089).[7]

---

[6] Of the total $[redacted], $[redacted] amounts to approximately [redacted] percent. See the discussion below regarding our view of the deductibility of these attorneys' fees.

[7] Talley also involved the taxpayer's settlement of potential liability under the False Claims Act. As noted, the Talley case is currently on appeal. The taxpayer has indicated that it will withdraw its $[redacted] concession if Talley is reversed on appeal. To date, the appellate briefs have been

Otherwise, the taxpayer maintains that the remaining $[redacted] is deductible. The $[redacted] reflected in the Settlement Agreement as reimbursement of state and federal investigative costs and the $[redacted] reflected in the Settlement Agreement as restitution to the United States and the State of [redacted] are said to be deductible because "[t]he restitution and reimbursement payments are, by their very definition, remedial and compensatory." The taxpayer also maintains that because the Settlement Agreement directed payment of the remaining $[redacted] to the "Crime Victims Fund," that amount is deductible. We think the taxpayer's analysis fails.

As noted above, if no lawsuit was instituted, courts deciding the nature of the payments will consider any relevant documents, letters, and testimony, not just the settlement agreement, if one exists. Further, where claims have been settled and express allocations among the various claims are contained in the settlement agreement, the courts will carefully consider, but not necessarily be bound by, such allocations. The failure to call a payment by a particular deductible name does not prevent its deduction, and the use of a deductible name does not automatically make it deductible.

Contrary to the taxpayer's claims, the characterization of a payment as "restitution" does not necessarily mean that it is a deductible expense. See Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd without published opinion, 850 F.2d 611 (9th Cir. 1988). If a remedial purpose were enough to take a civil penalty out of the ambit of section 162(f), then virtually no civil penalty would be subject to section 162(f). The term "remedial" is not used in either section 162(f) or in the definition of "fine or similar penalty" in Treas. Reg. § 1.162-21(b). "Remedial" has a meaning which is different from "compensatory damages." Compensatory damages can be remedial in the sense that they discourage wrongful conduct, but remedial payments are not compensatory when they are based on factors other than the resulting damage or diminution in value and serve some purpose other than making the victim whole. Colt Industries, Inc. v. United States, 86-2 USTC ¶ 9749 (Cl. Ct. 1986), aff'd, 880 F.2d 1311, 1313 (Fed. Cir. 1989).

Looking beyond the labels (or lack of labels), though, we conclude, based on currently available facts, that a part of the total payments is deductible. All indications are that the potential claims and the settling parties' actual agreement with regard to them would support the conclusion that the $[redacted] earmarked as "restitution" was, in reality, made to the United

---

filed, but oral argument has not yet taken place in Talley.

States and the State of [redacted] as compensation for losses caused by the taxpayer's behavior. Similarly, the State of [redacted] and the United States had actual claims for reimbursement of costs of investigating the taxpayer's behavior and pressing their claims, and it appears that the respective payments of $[redacted] and $[redacted] are reasonable estimates of those costs. Thus, we think that $[redacted] is deductible.[8]

The taxpayer is willing, for the time being, at least, to concede that the $[redacted] and $[redacted] payments described in the Settlement Agreement as "civil payments" are not deductible. Because we are aware of no facts supporting the theory that these payments were made in respect of "non-penalty" claims, we see no reason for you to reject that concession.

Finally, we remain unconvinced that $[redacted] payment designated in the Settlement Agreement as a "settlement payment ... to the Crime Victims Fund" falls outside the scope of I.R.C. § 162(f). The taxpayer argues that the $[redacted] designated for payment to the "Crime Victims Fund," is deductible on two grounds. First, while, by statute, payments to this fund consist of "fines collected from persons convicted of offenses against the United States," neither [redacted] nor [redacted] was ever charged with, let alone convicted of, any offense against the United States. Second, in any event, payments to the Crime Victims Fund should be treated as compensatory because Crime Victims Fund (42 U.S.C. § 10601) is part of Chapter 112 of Title 42, which is entitled "Victim Compensation and Assistance" and the next

---

[8] This conclusion is supported directly by the Settlement Agreement entered into by the taxpayer, the United States, and the State of [redacted]. It also is roughly supported by the United States Attorney's own post facto allocation, which referred to (1) $[redacted] as actual/compensatory damages, Medicaid Federal Share; (2) $[redacted] as actual/compensatory damages, Medicaid State Share; (3) $[redacted] for HHS-OIG investigation costs; (4) $[redacted] for [redacted] State police investigation costs; and (5) the $[redacted] relator fee, for a total of $[redacted]. Payment of a "relator fee" as part of a settlement generally would be deductible, because the qui tam provisions are remedial in nature and in no way act to penalize a False Claims Act defendant. See United States v. NEC Corporation, 11 F.3d 136, 139 (11th Cir. 1994). The question in this case, though, is not whether a payment for or in respect to a relator's fee is deductible, or even whether a relator ultimately received a fee. The question is whether the settlement payment included some amount for the relator fee. The only evidence on that matter is the Health Care Fraud Tracking Report completed by the attorney for one party to the three-way settlement.

section, 42 U.S.C. § 10602 is headed "Crime Victim Compensation."

These arguments also fail. In our view, the fact that the parties to the Settlement Agreement (albeit unsuccessfully) designated the Crime Victim Fund as recipient of this payment indicates to us a meeting of the minds that the payment was in the nature of a fine or penalty, although not technically so under Title 42. The references in Title 42 to "Victim Compensation" are also unavailing to the taxpayer since the victims of *its* behavior were the United States and the State of [redacted], neither of which itself is a "victim" eligible to receive benefits under the relevant provisions of Title 42. See generally 42 U.S.C. chapter 112.

Issue 3

Our review of available information leads us to conclude that I.R.C. § 162(f) would not prevent deduction of the $[redacted] of attorneys' fees reported by the taxpayer in connection with defense and settlement of the claims of the United States and the State of [redacted]. See Treas. Reg. § 1.162-21(b)(2). Accord Commissioner v. Heininger, 320 U.S. 467 (1943); Greene Motor Co. v. Commissioner, 5 T.C. 314 (1945). Likewise, we see no reason to think that the fees were not "ordinary and necessary" for purposes of I.R.C. § 162. Consequently, it appears that the taxpayer is entitled to the entire $[redacted] deduction claimed for attorneys' fees on the [redacted] return.

* * * * * * * *

This writing may contain privileged information. Any disclosure of this writing may have an adverse effect on privileges such as the attorney client privilege. If disclosure becomes necessary. please contact this office for our views.

If you have any questions or concerns regarding this memorandum, please contact Senior Attorney John J. Boyle at (513) 684-6144.

MATTHEW J. FRITZ
Associate Area Counsel (LMSB)