Audits Mandatory for Some Settlement Payments, Profile Raised for Others

By Robert W. Wood*

Robert W. Wood examines the government’s latest guidance involving the high stakes topic of government settlement deductibility.

The IRS issues a dizzying array of guidance. There are various types of regulations (final, proposed and temporary), revenue rulings, private letter rulings, field service advice, notices, actions on decision, technical advice memoranda, audit guidelines and so on. All of these pieces of guidance are not of equal weight, of course, and some are, technically speaking, not even treated as authority. Truth is, tax practitioners read and rely on much of this guidance, however it is denominated.

Indeed, it has been more than a quarter century since the U.S. Supreme Court itself cited letter rulings.1 There was considerable hubbub after that, and the IRS has taken steps to try to make it less likely that taxpayers place their reliance on informal guidance. Through a nearly endless series of litigation under the Freedom of Information Act (FOIA), Tax Analysts has done an incredible job of freeing up this information from the IRS when at times the IRS has shown indications it only wants to make certain guidance public.3

The Internet age has given virtually everyone access to an incredible array of official as well as unofficial information. In my own practice, I find today that even fairly unsophisticated clients are reading IRS guidance. Not too many years ago only tax professionals had ready access to this kind of information.

In this marching evolution of information accessibility, there is a tendency to become overwhelmed, and not to wade through certain regulation releases, pieces of proposed legislation, and unofficial guidance, such as audit directives, private letter rulings, etc. The sheer volume of what one can read has a chilling effect on what many of us do read. Becoming a selective reader may be a modern survival skill.

Yet, with the increasing importance of payments made to the government, it would be wise not to opt out of reading the government’s latest foray into the high stakes topic of government settlement deductibility.

Not Freud’s IDD

On May 30, 2007, the IRS released an Industry Director Directive (or “IDD”) on the tax deductibility of government settlements. The directive comes from the IRS’ Large and Mid-sized Business Division (LMSB). It is labeled “Directive Number One,” presumably meaning there may be others.4 Since it is formatted as a memorandum, the “from” line reads “John Risacher, Industry Director, Retailers, Food, Pharmaceuticals and Healthcare.” The memo is directed to “Industry Directors, Director, Field Specialists, Pre-filing and Technical Guidance, Director, International Compliance Strategy and Policy, and Director of Examination, SBSE.”

The IDD provides field direction relating to the deductibility of settlements with a government agency. The battleground is the Maginot line between deductible as a business expense on the one hand, and nondeductible fine or penalty treatment under Code...
Sec. 162(f) on the other. It is hardly surprising that the government would be looking at this question. After all, one cannot walk by a newsstand without the latest government settlement screaming its presence from the headlines. The government likes to trumpet these things, counting on an in terrorem effect on others.

Before we get to the text of the IDD, one interesting thing about it is not clear from its face. The IDD elevates deductions that are claimed for False Claims Act (FCA) and Environmental Protection Agency (EPA) cases to Tier I issue status. Tier I issues are of high strategic importance to LMSB, and are supposed to have a significant impact on one or more industries. The fact that the IDD now treats these settlement deductions as Tier I issues is significant, and makes the IDD of greater importance.

The background of this IRS memorandum sets the stage by noting that settlements are enforcement tools used by governmental agencies to resolve violations of law, and to punish companies short of going to court. According to the IRS, that means the settlement payment can include compensatory amounts, punitive payments, or a combination of the two. The specific types of settlements addressed in this memorandum include settlements with the Department of Justice (DOJ) under the FCA, and with the EPA for supplemental or beneficial environmental projects.

Yet, the preamble to the IDD states that outside the context of DOJ and EPA settlements, its principles can apply to any settlement between a governmental entity and a defendant under any law in which a penalty can be assessed. Note that this penalty “can” be assessed, not that it actually will be assessed or that it has been assessed. That is significant.

It is also not surprising that the Government Accountability Office (GAO) suggests that most taxpayers deduct the entire civil settlement amount, despite the fact that DOJ records reveal that almost every settled case includes substantial penalties. Settlement may be all about issues of perception. Plainly, the payor and the payee settling a dispute may not agree on everything, including the degree of exposure the payor faces for potential fines and penalties.

Publicity Wars

Yet, the IDD also reveals that the government settles cases without regard to the tax consequences of a payment. That hardly seems a revelation. Recall the huge flap that developed over Boeing’s 2006 settlement and its tax benefits. In mid-2006, Boeing settled the largest “penalty” ever imposed on a military contractor for weapons program improprieties. As final details of the $615 million settlement were hammered out, tax issues took center stage. In July 2006, Senators Grassley, McCain and Warner sent a letter to Attorney General Alberto Gonzales expressing outrage at the possibility that Boeing could deduct the $615 million. Allowing the Boeing settlement to be tax deductible, the senators said, would result in “leaving the American taxpayer to effectively subsidize its misconduct.”

The three senators made it clear they are shocked and outraged about the possibility that Boeing could legitimately whittle down the net after-tax “penalty” with a deduction that effectively is a taxpayer’s expense. McCain and Grassley had raised similar concerns in 2003 about a $1.4 billion settlement with several Wall Street firms involved in allegedly biased reports by their research department. Some of that huge settlement was deductible. Indeed, $432.5 million of it went to finance independent research, and $80 million of it was to finance investor education programs.

Interestingly, a GAO study found that four large federal agencies (including the DOJ) do not negotiate with companies over whether settlement payments are tax deductible. Instead, the GAO says the agencies believed that was the IRS’s job.

On July 18, 2006 Senator Grassley questioned Gonzales:

I am very troubled that ... DOJ was completely blind as to the real amount of the penalty, that is, the after-tax amount. To have a situation where the federal government is negotiating a settlement without understanding what the real settlement amount will be, the after-tax amount, is embarrassing. ... I can assure you that the lawyers on the other side of the table ... are very aware of the after-tax amount. ... It means millions of dollars to their client. ... It is actually worse that DOJ doesn’t even know what the tax treatment is of the Boeing settlement. It tells me that DOJ lawyers gave away 35 percent of the store without even knowing it. And let me make sure you understand one matter, the tax law in this area is quite clear: a fine or penalty is not deductible. If the government clearly states it is a fine or penalty, it is not deductible. It is when the lawyers start getting out their sharp pencils to find the gray areas that the trouble starts. But if DOJ wants to make certain that a settlement is not deductible the law gives clear guidance on how that can be accomplished.
The DOJ formally responded to Grassley, saying that the Boeing settlement had been fully signed on June 30, 2006, before Grassley’s complaint was made. The DOJ also notes that as a matter of policy, its agreements are “tax neutral,” leaving the difficult issues of deductibility to the expertise of IRS tax lawyers. In fact, the DOJ letter to Grassley goes on to state that:

It is the Department's policy and practice in settling fraud investigations to remain tax neutral and defer those issues to consideration by the IRS after settlement. The Department and the IRS agreed some time ago that this approach was both practicable and appropriate. ... As a general matter, compensatory damages are deductible while penalties are not. The Department and the IRS have devised a system that routinely provides the IRS information that it needs to ensure that taxpayers are treating their settlement payments properly. Indeed, this information-sharing arrangement is consistent with the Government Accountability Office’s recommendation that the IRS work with federal agencies that reach large civil settlements to develop a cost effective permanent mechanism to notify IRS when such settlements have been completed and to provide IRS with other settlement information that it deems useful in ensuring the proper tax treatment of settlement payments.11

Responding to public attention, Boeing announced that it would not seek tax deductibility for the settlement—even though the bulk of the settlement is arguably deductible. Grassley responded:

It’s good Boeing won’t seek a tax deduction for its $615 million settlement. That’s the right decision. However, Boeing’s lawyers believed the settlement was tax deductible. This tells me Department of Justice lawyers failed to take into account the settlement’s tax treatment and allowed Boeing’s lawyers to effectively negotiate a 35 percent discount. Any junior lawyer knows to look at a settlement’s tax treatment, yet Justice lawyers were asleep at the switch. That’s inexcusable. The Justice Department has to pay attention to the tax treatment of settlements. We can’t depend on having klieg lights from Congress for the right thing to happen. Justice should be doing it right from the beginning. I want to commend Senator McCain for his leadership in the Boeing issue. I’m glad we have this result, but we need the right result every time. For that to happen, the Justice Department has to do a better job of paying attention to the tax consequences of settlements. In the meantime, I’ll keep working to advance my legislation clarifying what is and isn’t deductible in settlements.12

Settlements and Taxes

It is hard to read the IRS’ recent IDD without reflecting on the controversy over Boeing’s 2006 settlement. Perhaps the IRS memorandum stating that the government does not pay attention to tax language is meant to be critical. In any case, the IDD states that settlement language is typically neutral as to whether or not a portion of the settlement constitutes a penalty.

Interestingly, up until some point in 2005, many DOJ settlement agreements apparently included a statement that “The parties agree that this agreement is not punitive in purpose or effect.” As a taxpayer, that would make me think the payment is entirely compensatory. The IRS, on the other hand, suggests that this phrase relates to double jeopardy under the Constitution, and has no bearing on tax issues.13

In a cursory way, the memorandum notes the nature of DOJ and EPA settlements. With respect to the EPA, the IDD notes that a portion of the civil penalty that was proposed for an environmental violation is typically reduced in exchange for the company’s agreement to perform a Supplemental Environmental Project (or “SEP”). The memorandum notes that most defendants will deduct the entire amount of the SEP as a Code Sec. 162 expense, or they will capitalize it and claim depreciation deductions. Treating a portion as a nondeductible penalty is evidently rare.

Turning to the FCA, the stakes are even larger. Settlements and judgments between 1987 and 2006 totaled over $18 billion, with $9 billion of this amount between 2001 and 2006 alone. Here again, the concern is what portion of these whopping payments the defendants are deducting. Over 75 percent of the settled cases involve healthcare fraud. Approximately 14 percent of the FCA cases involve defense contractors. The remaining 11 percent involve a broad range of other industries.

Issue Spotting and Mandatory Audits

The memorandum states flatly that examination is mandatory for FCA settlements of $10 million or more, and for SEP projects of $1 million or larger. That does not mean payments below these thresholds are exempt. Examiners are directed to use a risk analysis
process to determine if settlements and projects below these thresholds merit examination.

Sensibly, the memorandum directs that the government attorneys involved in these settlements should be key contacts, coordinating interviews and request for records relevant to the particular settling taxpayer involved. Since the identity of these companies is typically no secret (the memorandum notes that soon after settlement is reached, most are covered by the media), the memorandum advises consideration to pre-filing agreements with the taxpayer. The pre-filing agreement project may substantially cut back on what the IRS perceives as a trend in favor of immediate and 100-percent deductibility for these settlements.

**Nondeductible Fines and Penalties**

The memorandum reviews the language of Code Sec. 162(f) and its regulations. Code Sec. 162(f) states succinctly that “no deduction shall be allowed ... for any fine or similar penalty paid to a government for the violation of any law.” The regulations define fines and penalties as amounts:

- paid pursuant to a conviction or a plea of guilty (or nolo contendere) for a crime (either felony or misdemeanor) in a criminal proceeding;
- paid as a civil penalty imposed by federal, state or local law; and
- paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (again, civil or criminal).\(^{14}\)

Significantly, legal fees are exempt from this strict regimen. Legal fees and related expenses paid or incurred in defending a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty are deductible.\(^{15}\)

Whether a payment constitutes a nondeductible fine or penalty depends on the purpose the specific payment was meant to serve. That, of course, is a tall order where payments are made in a negotiated settlement. Yet, the IDD mentions several technical advice memoranda, including TAM 200502041.\(^{16}\) That TAM allocates a FCA settlement between a portion treated as nondeductible under Code Sec. 162(f), and a portion deductible as compensatory damages.

In another technical advice memorandum, TAM 200629030,\(^{17}\) the IRS concluded that a portion of the costs incurred for the performance of an environmental project was comparable to a nondeductible fine or similar penalty under Code Sec. 162(f). That meant this portion of the cost of performing the environmental project could not be included in the basis of the assets produced in the project (under Code Sec. 263A or 1012).

Although the IDD cites these TAMs, perhaps as evidence that such nitty-gritty allocation issues can be solved, the line between compensatory and noncompensatory fines can be difficult to discern. Predictably, the taxpayer has the burden of establishing the deductibility of any payment.

**Motive of Payments**

Proving motive is tough, yet it is relevant here. It may be difficult for the taxpayer to show that a fine is imposed with a compensatory motive. Indeed, how does one find out the motive of the government on any subject? How high the stakes are, of course, depends on the size of the fine and the degree to which it is likely to be recurrent.

Several cases are particularly important in exploring the purpose of a payment. The IDD mentions *Talley Industries, Inc.*\(^{18}\) and it is worthy of note. There, a company and several executives were indicted for filing false claims for payment with the federal government. The Navy contracts in question allegedly resulted in a loss to the Navy of approximately $1.56 million. However, because of various potential liabilities, the settlement between Talley and the DOJ was $2.5 million. When the company deducted that amount, the IRS asserted that the settlement was a nondeductible fine or penalty.

The Tax Court granted summary judgment for Talley, holding that the settlement payment was not a fine or penalty, except for a very small amount ($1,885) that was explicitly for restitution. The Tax Court found that the government had never suggested that it was attempting to exact a civil penalty. Noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the settlement was not intended to be penal or punitive, but rather to be compensatory.

Unfortunately for the taxpayer, the Ninth Circuit then reversed and remanded the case, concluding that there was a material issue of fact, and that the matter was not ripe for summary judgment. It is useful to review the instruction the Ninth Circuit gave to the court on remand:

If the $940,000 represents compensation to the government for its losses, the sum is deductible. If, however, the $940,000 represents a payment of double damages [under the False Claims Act], it may not be deductible. If the $940,000 represents
a payment of double damages, a further genuine issue of fact exists as to whether the parties intended payment to compensate the government for its losses (deductible) or to punish or deter Talley and Stencil (nondeductible). 116 F.3d at 387.

The Talley case on remand is extraordinarily detailed, referring to extremely specific findings of fact about many of the developments occurring during the settlement of the case. The Tax Court resolved the question whether the parties intended the settlement to include double damages under the FCA. Even though the settlement agreement was silent on that point, the Tax Court concluded that that was what the parties intended.

Then, the Tax Court turned to the question whether the $940,000 double damage payment was intended to compensate the government for its losses, or to deter or punish. The taxpayer and the government were polarized, the taxpayer arguing that no portion of the $940,000 could be considered a penalty, and the government arguing that the entire amount was a penalty. The issue was whether the amount was intended to reimburse the government for losses. The taxpayer noted that the government’s actual losses exceeded $2.5 million, so the $940,000 was merely a portion of it and had to be regarded as a reimbursement.

Nevertheless, the Tax Court was not persuaded by the wholesale nature of the payment; it noted that the settlement was a compromise of numerous issues. There was correspondence about the settlement offers, and the taxpayer had actually tried to state in the settlement agreement that the amounts would be treated as restitution. That the government rejected this proposal led the Tax Court to conclude that the taxpayer failed to carry its burden of showing that a remediation purpose was intended.

For a second time, the Talley case went to the Ninth Circuit. There, in a brief opinion, the Ninth Circuit reviewed de novo the Tax Court’s conclusions of law, and its factual findings for clear error. Finding no error in the Tax Court’s ruling, the Ninth Circuit again held that Talley failed to establish the compensatory nature of the disputed settlement.19

Nondeductibility was also the order of the day in Allied-Signal.20 As the IDD notes, taxpayers make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of the payments.21 In addition to other payments, Allied-Signal made an $8 million payment into a nonprofit environmental fund. The Tax Court determined that the entire payment to the endowment fund was nondeductible because the payment was made with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least that amount. The Tax Court rejected the company’s argument that the payment was not a fine or penalty because it did not serve to punish or deter, concluding that the payment served a law enforcement purpose, not a compensatory one.

Warning Signal

It is not surprising that the government victory in Allied-Signal features prominently in the IDD. Allied-Signal’s understanding of the proposed $13 million criminal fine would be reduced by the $8 million contribution led the Tax Court to famously hold that the $8 million payment was in substance a fine or similar penalty nondeductible under Code Sec. 162(f). In our current era of increased focus on substance over form, and given the anti-tax shelter rhetoric that often now permeates tax cases, Allied-Signal was ahead of its time.

In fact, the IDD quotes some of Allied-Signal’s rhetoric. The court sounded prophetic in stating that “while the form of the payment does not necessarily fit within the letter of Code Sec. 162(f), in substance petitioner paid a criminal fine. Allowing the taxpayer a deduction, would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”22

Audit Techniques

The audit techniques discussion in the text of the IDD is fairly breezy, noting that the facts and circumstances need to be developed and determined. But, the IDD includes audit guidelines as attachments, one set of guidelines regarding FCA settlements, and another for EPA cases.

False Claims Act Settlements

The audit guidelines begin with the premise that almost every taxpayer deducts the entire amount of each FCA settlement. Yet, the guidelines assert, a portion generally represents a penalty. To determine if a penalty has been imposed and if so how much, the guidelines say two primary questions must be answered:

- Is a portion of the settlement payment a penalty, and therefore not deductible?
- What amount is the penalty?

With these obvious questions, the guidelines exhort the examiner that the taxpayer must bear the burden
of proving that it is entitled to deduct any portion of the settlement amount.

Examiners are told that DOJ press releases are issued on practically every case, available on the DOJ Web site. Plus, national and local newspapers are helpful. The organization “Taxpayers Against Fraud” gets an indirect plug, since examiners are told that the Taxpayers Against Fraud Web site also touts every settlement.

Once the case is identified, there is a procedure for the IRS contacting the DOJ, and the examining IRS employee then liaising with the DOJ attorney who handled the case. Interviews, requests for records, etc., follow. Although the guidelines say that no two cases are identical, the template for document requests suggests that all communications between DOJ and the defendant and its representatives and employees (letters, memos, e-mail, etc.) are needed.

Significantly, the guidelines state that initial letters often formalize the position of DOJ that “multiples” will be included in any settlement that is reached. The critical documents also include all computations and settlement proposals made by either side, and everything that leads up to whatever settlement is ultimately reached. As to the meaning of the term “multiple,” the guidelines make it clear that DOJ uses this term when it means “penalty.”

Predictably, any correspondence which address tax consequences are critical. The guidelines note, though, that “it is rare for this subject to be addressed; however, the request for this type of correspondence needs to be made.” Interestingly, discussions between DOJ and the relator in the FCA case (and relator’s attorney) are also likely to be requested. It is hard to see how the interaction with the relator is relevant, but perhaps the IRS is looking for a reference to “multiples” or other buzz words.

Although audit guidelines need not contain taxpayer arguments, it is noteworthy that these guidelines say that taxpayers frequently argue that a total settlement was to compensate the government for losses such as over-billing. If the settlement is (as almost always occurs) less than the initially publicized amount of the government losses, taxpayers (predictably) argue that since the settlement is less than the losses DOJ reported, all of the settlement must be “singles”, and thus compensatory and deductible.

In response, the audit guidelines state that: “This argument has no real merit as it is not factually based and it is not representative of the final settlement agreement.”

It is at this point in the audit guidelines that they reference the ostensibly red herring phrase included in most DOJ settlement agreements written prior to June, 2005. The offending (and now deleted) phrase is: “The parties agree that this agreement is not punitive in purpose or effect.” Taxpayers understandably argue that this sentence means what it says, but the IRS audit guidelines state that DOJ had included this phrase, relating only to double-jeopardy under the Constitution, and that it has no meaning for tax purposes.

**EPA**

The audit guidelines for environmental violation enforcement settlements begin with a description of the EPA penalty framework. EPA settlements are far more likely to expressly address tax issues than FCA cases. Indeed, there is often a consent decree lodged in federal court that expressly includes three major components: (1) a civil penalty amount that is separately stated, and typically expressly designated as nondeductible for income tax purposes; (2) injunctive relief that covers compliance projects; and (3) Supplemental Environmental Projects (SEPs) that are voluntary projects incorporated into a consent decree in order to negotiate a significant reduction in proposed penalties.

According to the audit guidelines, only a portion of the SEP will typically be used to reduce the penalty amount. That means the actual amount paid for an SEP and a reduced penalty may total to a figure greater than paying the original proposed civil penalty. The big question for the auditor in these cases, then, is to determine the penalty amount that is mitigated (or forgiven) as a result of the taxpayer agreeing to perform a SEP.

Sometimes, the audit guidelines assert, this amount can readily be ascertained in the body of the consent decree. Other times, extensive factual development of the history of negotiations is needed. The audit guidelines suggest that the examiner should contact the Environmental Technical Advisor once it is clear the taxpayer has agreed to perform a SEP. Then, complete copies of files, correspondence are solicited from the taxpayer, the EPA and DOJ. Any penalty exposure computations prepared by the EPA, the taxpayer or the taxpayer’s representative are to be solicited.

Using Allied-Signal as a springboard, the memorandum concludes with the IRS’ summary position the following:

- Taxpayers may not deduct the portion of costs incurred in performing an SEP that is “an amount analogous to a nondeductible fine or similar penalty” under Code Sec. 162(f).
- Taxpayers may not include in the basis of assets it produces the portion of the SEP cost that is “an amount analogous to a fine or similar penalty.”
For FCA cases, the question is whether the settlement includes a nondeductible penalty, and that determination can only be developed through communication, coordination and cooperation between the IRS and the DOJ.

**Conclusions**

These summary conclusions in the IDD are ultimately not very helpful, just snippets. The big question for EPA cases is just what is an amount “analogous” to a fine or similar penalty. With slightly different verbiage, the same question applies with FCA cases. Despite Senator Grassley’s exhortations, if the DOJ (and the EPA) don’t attempt to address the pertinent tax questions, then these issues are probably not going to be any easier to resolve.

The audit guidelines, and the intense focus on factual development, suggest there will be a greater emphasis on the legal background and dynamics of the dispute than ever before. What does seem clear is that the IDD’s focus on getting information from the DOJ or EPA lawyer suggests inter-agency pow-wows after the fact. Indeed, it may mean that the IRS has a chance to help mold the tax position in areas, and to help frame what the intent of the settlement might have been.

I am not suggesting this is improper, but it is a little troubling to think that, although Senator Grassley’s exhortations cannot propel DOJ personnel to consider tax issues in framing settlements, the IRS can help DOJ (and EPA) do so later. Couple this with the obvious fact (often repeated in the IDD) that the burden is on the taxpayer to establish deductibility. The resulting mix, I think, foreshadows a more subtle assault on the deductibility of government settlements.

I do not know if the IDD is a direct response to the widely publicized discussions about the lack of cooperation between the IRS and DOJ, and to the criticism leveled at government lawyers that they were (inappropriately) failing to take tax considerations into account in reaching settlements. Still, it is hard not to connect the dots. It does not seem an unfair reading of the IDD to suggest that, rather than an up-front tax discussion at settlement time, the IRS gets to divine intent after the fact.

Then, the IRS can rely on the systematic advantage represented by the rule that the taxpayer must carry the burden of proving that any portion of the settlement is deductible. In any event, the IDD may portend increased scrutiny on settlements and on deductibility in the future.

**ENDNOTES**

1. See **Rowan Companies Inc.**, 81-1 USTC ¶9479, 452 US 247.
7. Id.
8. Id.
9. See id.
12. U.S. Senate Committee on Finance Memorandum to Reporters and Editors, from Jill Gerber for Grassley, regarding Boeing’s government settlement, potential deductibility, July 26, 2006.
13. See **LMSB-04-0507-042**, supra note 1, at Attachment I.
15. See Reg. §1.162-21(b)(2).
17. **TAM 200629030** (Mar. 31, 2006).
23. See **LMSB-04-0507-042**, supra note 1, at Attachment I.
24. Id.
25. See text accompanying notes 6-12, infra.

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