The IRS Pre-Filing Agreement Program and Deducting Government Settlements

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The authors review the complex tax issues presented by government settlements under laws including the False Claims Act.

Government settlements, including those under the False Claims Act ("FCA") and Environmental Protection Agency ("EPA") Supplemental or Beneficial Environmental Projects ("SEP"), may or may not be deductible for Federal income tax purposes, depending on whether the amounts paid are attributable to compensatory damages, fees, interest, etc., or represent fines or similar penalties. Section 162(a) of the Internal Revenue Code allows business deductions for compensatory damages, fees, interest and other amounts in defending lawsuits and claims. However, Section 162(f) disallows deductions for "any fine or similar penalty paid to a government for the violation of any law."

The IRS has designated deduction of government settlements as a "Tier I" issue, meaning such settlements receive the highest priority for audit and other purposes at the IRS. In addition, the U.S. Department of Justice ("DOJ"), at the urging of the IRS, has reversed its longstanding practice of allocating deductible, compensatory damages and nondeductible fines or penalties and no longer makes allocations of such amounts in settlement agreements.

As a result of these policies, government settlements present complex

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tax issues, significant uncertainty and potentially burdensome compliance costs. The IRS pre-filing agreement ("PFA") program presents an opportunity to eliminate uncertainty for minimal cost.

IRS ISSUE TIERING

The IRS Large and Mid-Size Business Division (LMSB) adopted the issue tiering strategy in 2006 to ensure that high-risk compliance issues are properly addressed and treated consistently across the division. There are three issue tiers — Tier I (High Strategic Importance), Tier II (Significant Compliance Risk) and Tier III (Industry Risk) — ranging from highest importance and priority to high importance and priority, for audit and other IRS purposes. Certain issues are in "Active Status," meaning the issue requires a continued level of coordination across the enterprise, while others are in "Monitoring Status," meaning the issue can be evaluated and resolved pursuant to guidance from the LMSB issue management team. Read the full list of tiered issues at http://www.irs.gov/businesses/corporations/article/0,,id=200567,00.html.

Government settlements, including FCA and SEP settlements, have been designated Tier I issues and were recently moved from active status to monitoring status. Coordinated Issue Papers for FCA (http://www.irs.gov/businesses/article/0,,id=186486,00.html), and SEP (http://www.irs.gov/businesses/article/0,,id=184480,00.html) settlements have been published, and the IRS has also issued industry directives and audit guidelines, which can be found at http://www.irs.gov/businesses/corporations/article/0,,id=205425,00.html. The LMSB health care technical advisors and the environmental technical advisor must be consulted in connection with these types of settlements during IRS audits.

FALSE CLAIMS ACT

The FCA originally was enacted in 1863 with the principal goal of stopping the massive frauds perpetrated by large contractors against the U.S. government during the Civil War. The FCA, as originally enacted, contained both civil prohibitions and criminal penalties, and it also con-

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tained a qui tam provision, which authorized any person to bring an action on behalf of the United States to recover the damages provided for under the FCA. The criminal penalties were later repealed; however, certain components of the FCA are phrased as "penalties" akin to criminal fines.

The typical FCA award involves actual damages, treble damages, per-false-claim penalties ($5,500 to $11,000 per false claim) and post judgment interest. A nongovernmental individual filing a original claim, called a "relator," is entitled to a substantial portion (25 percent to 30 percent) of the total award, providing an incentive for bringing the suit. Although actual damages are deductible as compensatory damages, it is not clear whether all, a portion or none of the treble damages are deductible. Recent U.S. Supreme Court cases have suggested alternative views as to the nature of double damages (pre-1986 FCA) and treble damages (post-1986 FCA). Thus, it is not clear whether double or treble damages are compensatory and remedial or penal and punitive.

The per-false-claim penalties appear to be nondeductible "fines or similar penalties." Amounts paid to the relator — even if based in part on the per-false-claim penalties award and derivative of and secondary to the judgment, award or settlement — have been determined by the IRS to be deductible.[1] In addition, IRS regulations and case law provide that legal fees and related expenses, including interest — paid or incurred in defending the suit, even if the suit involves a nondeductible penalty or fine — are deductible.

Apart from the nature of treble damages as compensatory or punitive, the other difficulty arises with respect to settlement agreements that do not allocate settlement amounts to actual damages, treble damages and penalties, but rather are a lump-sum amount. Prior to June 2005, the DOJ included in its settlement agreements the following phrase, "The Parties agree that this agreement is not punitive in purpose or effect." The DOJ had intentionally included this phrase because of arguments relating to the double jeopardy clause under the U.S. Constitution. Taxpayers argued that this phrase made it clear that the entire settlement was compensatory. However, the IRS has taken the position that this phrase has no meaning for tax purposes and, in any event, has persuaded the DOJ to stop this practice.

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On the other hand, the IRS also takes the position that the taxpayer bears the burden of proving what the parties intended and, more particularly, what the DOJ intended. The taxpayer generally does not have access to this information. The IRS, on the other hand, does and, as part of its procedures, requires its auditors to consult with the DOJ or EPA lawyers who negotiated the settlements and to collect the relevant documents and information from the DOJ and EPA. In this respect, the audit may become one-sided. If the taxpayer fails to present sufficient proof relating to the deductible and nondeductible portions of the settlement payment, the IRS may take the position that the entire amount is nondeductible.

SUPPLEMENTAL AND BENEFICIAL ENVIRONMENTAL PROJECTS ("SEP")

Similar considerations apply in the context of SEP settlements. Taxpayers may settle an environmental enforcement action, either at the administrative level with the EPA or at the judicial level. A component of the consent decree may involve supplemental or beneficial environmental projects. These projects are voluntary projects incorporated into a consent decree in order to negotiate a significant reduction to the proposed penalty amount. Typically only a portion of the SEP will be used to reduce the penalty amount. The actual amount paid for an SEP and a reduced penalty may be greater than paying the original proposed civil penalty. EPA policy prohibits SEP projects from reducing compensatory or remediation liability. The issue is what portion of the SEP is attributable to a reduction in the penalty amount and is, therefore, nondeductible. The IRS position is that the burden of proof rests with the taxpayer and if the taxpayer fails to prove the deductible portion of the SEP settlement, then the taxpayer may not be able to deduct any of the settlement.

PRE-FILING AGREEMENT PROGRAM

The PFA program is another component of LMSB's issue management strategy. The program encourages taxpayers to request consideration of an issue before filing their return, with an eye to resolving potential disputes

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and controversies earlier in the examination process. The effect of the program is to reduce the cost and burden associated with the post-filing examination, to provide a desired level of certainty regarding a transaction and to make better use of taxpayer and IRS resources.

The PFA process starts with the preparation and filing of an application for a PFA. The request is then reviewed by the PFA program manager, the applicable technical advisors and IRS counsel, for technical and substantive acceptability. The final decision whether or not to accept the request is made by the applicable IRS industry director. Because the PFA program typically involves difficult or complex issues, it is imperative that the request fully covers the relevant facts and applicable law. Since the PFA program's inception in 2001, the IRS has received 329 applications and accepted 212 (in 2008, the IRS received 32 applications and accepted 20). In other words, simply filing the request does not ensure acceptance. Once a request has been accepted the taxpayer is notified and must then pay a $50,000 user fee.

The next step is for the IRS to form a pre-filing team, which includes the IRS exam team, representatives of the taxpayer, IRS field counsel and other appropriate personnel, to examine the issues. Typically, the process is a collaborative one, with the taxpayer and IRS exam team cooperating to develop the facts and to reach an agreement as to the proper tax treatment before the time for filing the taxpayer's tax return. Once an agreement has been reached, the taxpayer and the IRS will execute a closing agreement, which generally resolves the issue without any further compliance costs on the part of the taxpayer. The procedures are set out in a document titled IRS Revenue Procedure 2009-14, available at http://www.irs.gov/pub/irs-drop/rp-09-14.pdf.

CONCLUSION

Government settlements present complex tax issues. On audit and in court, taxpayers bear the burden of proving the portion of any settlement payments that is paid in lieu of compensatory damages and not in lieu of non-deductible fines or similar penalties. It is difficult for taxpayers to meet this burden without a specific allocation. Moreover, the IRS has in-

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dicated that only the government's intentions are relevant with respect to the basis of the settlement. Using the PFA program can provide certainty for taxpayers with respect to deductions prior to filing a return. The PFA process allows taxpayers to avoid controversies that can stretch on for years, even decades, and at minimal cost. The PFA program may not be suited for all tax issues, but, in the context of government settlements, it is a viable option.

NOTE

[1] IRS Office of Chief Counsel Memorandum AM 2007-0015, available at http://www.irs.gov/pub/irs-utl/am2007015.pdf (July 12, 2007).

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