



LARGE AND MID-SIZE
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE
DIRECTOR, INTERNATIONAL COMPLIANCE STRATEGY
AND POLICY
DIRECTOR OF EXAMINATION, SBSE

FROM: John Risacher /s/ *John Risacher*
Industry Director
Retailers, Food, Pharmaceuticals and Healthcare

SUBJECT: Tier I Issue: Government Settlements Directive # 1

This directive is intended to provide field direction on a Tier I Issue relating to deductibility of settlements with a governmental agency, whether the settlement is deductible as an ordinary and necessary business expense under Section 162(a) or some portion of the settlement is a non-deductible penalty under Section 162(f).

Background/Strategic Importance

Most administrative or judicial actions brought by a governmental agency against a violator can result in a settlement. Settlements are enforcement tools used by governmental agencies to resolve violations of law and punish companies short of going to court. The settlement amount can include a compensatory payment, a punitive payment or a combination of both. This memorandum addresses the deductibility of amounts paid pursuant to a settlement with the Department of Justice (DOJ) under the False Claims Act (FCA) and the Environmental Protection Agency for supplemental or beneficial environmental projects (SEP or BEP). Although the issue discussed here places emphasis on DOJ and EPA settlements, it can apply to any settlement between a government entity and a defendant under any law in which a penalty can be assessed.

The settlements are negotiated by DOJ or other governmental agencies with the intent to cover restitution of improperly received monies as well as fines and penalties.

Because the government settles these cases without regard to the tax consequences of a payment, the language in settlement agreements is typically neutral as to whether or not a portion of the settlement constitutes a penalty. If the payment or a portion of the payment is determined to be a penalty, it is non-deductible.

Examination experience and a 2005 Government Accounting Office (GAO) report have shown that most taxpayers deduct the entire civil settlement amount. DOJ records have consistently shown that almost every settled case includes substantial penalties.

Environmental enforcement settlements unlike other DOJ/governmental settlements typically reduce to writing a breakdown of various components of the settlement. The breakdown would include:

- 1) An agreed to penalty dollar amount, (payable to the governmental agency).
- 2) Mandatory compliance projects needed to meet minimum environmental laws and regulations.
- 3) A supplemental or beneficial environmental project (SEP or BEP) from here on called (SEP). The subject matter of this directive regarding environmental settlements is limited to the issues surrounding the deductibility and or capitalization of SEP costs.

Although in most cases, a portion of the proposed civil penalty was reduced for agreeing to perform a SEP, experience has shown that generally most defendant/taxpayers deduct the entire amount of the SEP as either a Section 162 business expense or capitalizes such costs with related depreciation deductions.

During the period 1987-2006, there were a total of 5,514 FCA cases referred to DOJ. As of October 2006, there are 915 cases currently under investigation and this number continues to increase. Settlements and judgments during 1987-2006 have totaled just over \$18 billion. Of this total, \$9 billion was recovered in 2001-2006 as individual settlement amounts continue to grow.

Statistics show that over 75% of settled cases involve health care fraud, primarily with Medicare. Approximately 14% of cases involve defense contractors under the Department of Defense. The remaining cases involve a broad range of industries including environmental under the EPA, securities law violations under the SEC, petroleum companies under Minerals Management and contractors with practically every other government department.

Planning and Examination Guidance:

Issue Identification, Planning and Examination Risk Analysis

Examiners should use the risk analysis process to determine if

the settlements and projects below this threshold should be examined. See the attached ATG for issue development.

The first step in examining the FCA issue is to contact the Health Care Technical Advisor who has been designated as the liaison between the exam teams and DOJ for the settlement issues. Cases investigated and settled by a DOJ trial attorney are coordinated through DOJ, Civil Division in Washington, D.C. Those settled by an Assistant U.S. Attorney are coordinated through the Executive Offices for U.S. Attorney's, also in Washington, D.C. Initial contact with DOJ must be made through the Health Care Technical Advisor. This procedure is required by DOJ and is, therefore, mandatory. The Technical Advisor will then put the examiner in touch with the trial attorney or Assistant U.S. Attorney who coordinated the settlement. All field work can then be conducted through that attorney, including interviews and requests for records relevant to each taxpayer.

Where contact with the Environmental Protection Agency is necessary, the Environmental Technical Advisor should be contacted.

Pre-Filing Agreement Consideration

This is an issue that lends itself to consideration of this high priority program. In most cases, the identity of taxpayers who enter into settlements with the DOJ and other government departments is known soon after the settlement is reached, as most of these are covered by the media. There are numerous advantages to both the Service and taxpayers of resolving this issue early. For this reason, consideration should be given to discussing a PFA project with taxpayers as soon as possible after they are identified as having entered into a settlement in a tax year that has not been filed.

Applicable Law and Guidance:

162(f) Fines and Penalties

IRC §162(f) states, "No 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 fines and penalties as an amount:

1. Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding.
2. Paid as a civil penalty imposed by Federal, State, or local law.
3. Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).

Treas. Reg. §1.162-21(b)(2) states, "The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court

costs assessed against the taxpayer. Compensatory damages paid to a government do not constitute a fine or penalty.”

TAM 200502041

In Technical Advice Memorandum 200502041, issued 1-14-2005, the Service concluded that a portion of a lump-sum payment in settlement of claims arising under the False Claims Act is nondeductible under *Section 162(f)* and identified the portion of the settlement payment that constituted compensatory damages.

Case Law

Ultimately, whether a payment constitutes a nondeductible "fine" or a "penalty" depends on the purpose the specific payment 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. See Talley Industries, Inc. vs. Commissioner, 116 F.3d 382, 385-386 (9th Cir.1997), citing Southern Pacific Trans. Co. vs. 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 a 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. vs. 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.

Environmental Settlements Distinguished

TAM 200629030

In Technical Advice Memorandum 200629030, issued 03/31/2006, the Service concluded that a portion of the costs incurred for the performance of a beneficial environmental project is comparable to a non-deductible fine or similar penalty under Section 162(f) and may not be included in the basis of assets produced under Section 263A or of property under Section 1012.

Case Law

In Allied-Signal, Inc. vs. Commissioner, T.C. Memo, 1992-204, affirmed Allied-Signal Inc. vs. C.I.R., 54 F.3d 767 (3rd Cir. 1993) taxpayer was convicted of environmental crimes and was sentenced to a fine in excess of \$13 million. The taxpayer contributed \$8 million to an environmental endowment fund with the understanding from the court that the proposed \$13 million criminal fine would be reduced by the same \$8 million. The Tax Court held that the \$8 million payment was, "in substance," a fine or similar penalty under Section 162(f), reasoning... "that it was imposed for punishment and deterrence." Additionally, the Court states "[w]hile the form of the payment does not necessarily fit within the letter of Section 162(f), in substance petitioner paid a criminal

fine...[t]o allow petitioner a deduction in this case ‘would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.’”

Audit Techniques:

Issue Development

The complexity of this issue requires that the facts and circumstances be determined and developed. Initial contact with DOJ must be made according to the mandatory procedure to which DOJ and the Service have agreed, as noted above.

Audit Evaluation

Audit guidelines are included in this IDD as Attachments. Four basic areas of issue development are covered. (1) What is this issue? (2) How is it identified? (3) How is it developed? (4) Taxpayer arguments. They are designed to give the agent a comprehensive, step-by-step approach from making the decision to examine the issue to the final adjustment proposal.

For environmental settlements audit techniques refer to attachment.

LMSB Current Position:

This FCA issue is based on the settlement of a fraud investigation by DOJ. It relies on their documentation and interpretation of each settlement to determine if it includes a non-deductible penalty. It can only be developed through communication, coordination and cooperation between the IRS and the DOJ.

Environmental Enforcement Settlements Distinguished -- (SEPs)

Taxpayers may not deduct the portion of the costs incurred by the taxpayer for the performance of a SEP, that is, an amount analogous to a non-deductible fine or similar penalty as defined under Section 162(f).

Taxpayers may not include in the basis of assets it produces under Section 263A or as the basis of property under Section 1012 the portion of the SEP costs that is an amount analogous to a fine or similar penalty.

Issue Tracking:

Any cases having this issue should use the following UIL codes:

162.21-17 False Claims Act Settlements with DOJ – Health Care Fraud
162.21-18 False Claims Act Settlements with DOJ – Environmental Fraud
162.21-19 False Claims Act Settlements with DOJ – Aerospace Defense Contractors
162.21-20 DOJ – Fraud Settlements not under False Claims Act

162.21-21 Settlements with Securities and Exchange Commission

162.21-22 Environmental Settlements with Environmental Protection Agency

There are six different codes designed to track the various types of government settlements. This tracking code should be input just as soon as a determination is made that this issue will be examined on a case. For those cases already in process at the time this IDD is issued, the appropriate tracking code should be input immediately.

Effect on Other Guidance:

None

Contact:

Questions regarding all settlements other than environmental settlements should be addressed with the Health Care Technical Advisor team, John Tucker or Danny Zink. John Tucker may be reached at (615) 250-5194 or John.Tucker@irs.gov, while Danny Zink may be reached at (615) 250-5195 or Daniel.Zink@irs.gov.

Examiners with EPA settlements should first contact the Environmental Technical Advisor Greg Pierce to assist in establishing DOJ involvement. For any settlement that involves an environmental issue with the EPA, technical assistance is available from Environmental Technical Advisor Greg Pierce who may be reached at (847) 303-7729 or Gregory.W.Pierce@irs.gov.

This Directive is not an official pronouncement of law and cannot be used, cited or relied upon as such.

Attachments: I Audit Guidelines on Government Settlements
II Audit Guidelines on Environmental Settlements

Cc: Commissioner, LMSB
Deputy Commissioner, Operations
Deputy Commissioner, International
Division Counsel, LMSB
Chief, Appeals
Directors, Field Operations
Director, Performance, Quality and Audit Assistance
Director, Strategy, Research and Program Planning