INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director, Field Operations

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Subsidiary =
Businesses =
a =
b =
c =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =

Date 11 =
Date 12 =
Date 13 =
Employee =
Amount a =
Amount b =
Amount c =
Amount d =
Amount e =
Amount f =
Amount g =
Amount h =
Amount i =
Amount j =
Amount k =
Amount l =
Amount m =
Amount n =
Amount o =
Amount p =
Amount q =
Amount r =
Amount s =
Amount t =
Amount u =
Amount v =
Amount w =
Amount x =
Amount y =

ISSUES:

(1) Whether any portion of a lump-sum settlement payment made to settle claims arising under the False Claims Act, 31 U.S.C. §§ 3729-33 (2000), constitutes a nondeductible fine or penalty within the meaning of § 162(f) of the Internal Revenue Code.

(2) Whether any portion of a lump-sum settlement payment made to settle claims arising under the False Claims Act constitutes compensatory damages attributable to costs incurred by the government while investigating and settling the alleged false claims (*e.g.*, investigation costs, amounts paid to relator, and pre-settlement interest).

CONCLUSIONS:

(1) Under the facts and circumstances of this case, Amount s constitutes a nondeductible fine or penalty pursuant to § 162(f).

(2) Under the facts and circumstances of this case, no portion of the lump-sum settlement payment in excess of Amount y constitutes compensatory damages.

FACTS:

During the years at issue, Taxpayer's Subsidiary owned and operated numerous Businesses, which performed a wide range of tests on *a* and *b*. In Year 1, the United States began to suspect that Subsidiary and other Businesses had billed the United States for unauthorized and unnecessary *c*. As a result, the United States began an investigation of Subsidiary under the False Claims Act. 31 U.S.C. §§ 3729-33 (2000) (FCA).

On Date 1, Employee of Subsidiary filed a *qui tam* action against Subsidiary under the FCA.[1] Two other *qui tam* actions were filed subsequently against Subsidiary and were consolidated with the first *qui tam* action. After each *qui tam* action was filed, the government widened the scope of its investigation to a series of new claims that had not been part of its original investigation.

On Date 3, the government and Subsidiary began settlement discussions. In a letter setting out the framework for these settlement discussions, attorneys for the government provided an initial estimate of the government's damages for losses incurred by one federal agency of Amount a and stated that they "settle False Claims Act cases prior to litigation for a sum equal to triple damages, with appropriate penalties."[2] The letter then provided detailed descriptions of the amount and types of the government's estimated actual damages. From Date 4 to Date 11, Subsidiary's attorneys met with attorneys and investigators for the United States at least monthly in a

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[1] The FCA encourages private citizens to assist in the detection of fraud against the government by providing that a private citizen with knowledge of fraud may file suit against the wrongdoer on the government's behalf and to retain a portion of any recovery, whether or not the government intervenes and takes over prosecution of the action. 31 U.S.C. § 3730(d). The *qui tam* plaintiff's share of any recovery is calculated based on a sliding scale of 0 to 25% of the settlement or judgment proceeds, depending on whether the *qui tam* plaintiff was an "original source" of information, the amount of assistance he or she provided to the government in the investigation or prosecution of the case, and whether or not the government intervenes and takes over prosecution of the action. *See* 31 U.S.C. § 3730 (d)(1). A person who files a *qui tam* lawsuit under the Act is called a "relator."

[2] The FCA allows the government to recover multiple damages--three times the amount of its actual damages, plus a fixed penalty of not less than $5,000 and not more than $10,000 per claim, and its costs. 31 U.S.C. § 3729(a). Amounts in excess of the government's actual damages are referred to in this ruling as multiple damages.

series of settlement meetings. Representatives of the agencies that had been billed for allegedly unauthorized and unnecessary *c* attended these meetings and also participated in the government's investigation to determine the amount of their actual damages. During a meeting on Date 6, the government reiterated its initial estimate of actual damages (Amount a), and Subsidiary countered with a settlement proposal of Amount b, representing Subsidiary's own estimate of the government's actual damages. By Date 7, the government increased its actual damages estimate slightly to Amount c and included in this amount estimated actual damages sustained by other agencies that had also been harmed by Subsidiary's conduct.

During a Date 9 meeting, the government reduced its total settlement demand (actual damages trebled in accordance with the recovery allowed by statute) for the first time from Amount d to Amount e.[3] On Date 10, the government further reduced its total settlement demand to Amount f. During the next month, the parties reached a preliminary, oral agreement on a total settlement figure of Amount g. During this time period, the government circulated a spreadsheet detailing how the Amount g settlement proceeds would be allocated between compensatory and punitive damages. According to this spreadsheet, Amount h in compensatory damages would be allocated to the agencies harmed by Subsidiary's conduct, and the balance of the proposed settlement proceeds represented multiple damages of Amount i times the amount of compensatory damages on each category of claims. According to a letter written by the attorney who negotiated the settlement on behalf of the federal government, this spreadsheet was prepared before the settlement amount was finalized in order to obtain the consent of the affected agencies. Because these agencies would only be entitled to receive reimbursement of the compensatory damages allotted to them in the settlement, it was important for each affected agency to approve the total settlement amount and its respective share of compensatory damages.

During the process of obtaining agency approval of the proposed settlement amount, the government realized that its actual damages estimate was based on figures for periods before Date 2. The government brought this issue to Subsidiary's attention, and over the next several months, the parties negotiated an additional Amount j to resolve claims arising after Date 2. The parties agreed that Amount j represented compensatory damages only, with no additional amount for multiple damages.

The additional Amount j brought the total settlement figure to Amount k. On Date 12, the government (including each harmed agency), Subsidiary, and the relators signed a Settlement Agreement and Release reflecting the oral agreement reached on Date 11. Pursuant to this Settlement Agreement, Subsidiary agreed to pay the Amount k in exchange for the government's release of all present and future liability for all of the conduct underlying the government's FCA investigation. The Settlement Agreement provides that Subsidiary "specifically denied" any wrongdoing or liability in connection

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[3] The parties never discussed the issue of the separate, per-claim fixed penalty, and the Settlement Agreement does not appear to include any allotment for such a penalty.

with the claims asserted by the government. It further does not allocate the lump sum payment of Amount k between the government's specific claims, nor characterize it for purposes of the Internal Revenue Code.

The settlement funds of Amount k had been placed in a court-supervised interest-bearing escrow account pending final execution and court approval of the Settlement Agreement. While the settlement proceeds were held in this escrow account, they earned interest and the fund increased from Amount k to Amount l. On Date 13, the court ordered disbursement of the settlement proceeds (including the earned interest). The government disbursed a total of Amount m plus interest to the affected agencies (including several state agencies). A dispute had arisen between the government and two of the relators regarding their appropriate share of the settlement proceeds. This issue was litigated and ended with a separate settlement agreement under which the government agreed to pay these relators a total of Amount n. The balance of the settlement proceeds, Amount o, was placed in an account for future law enforcement usage.

Taxpayer deducted the full Amount k settlement payment on its consolidated income tax return for Year 4. Taxpayer contends that the full Amount k is deductible under § 162(a) of the Internal Revenue Code as an ordinary and necessary business expense. The field argues that Amount p of the settlement payment is not deductible, because this amount represents multiple damages and constitutes a fine or other similar penalty within the meaning of § 162(f).

LAW AND ANALYSIS:

Sections 162(a) and 162(f)

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business. An amount expended by a taxpayer engaged in a trade or business to settle litigation may be deductible as an ordinary and necessary business expense. *See, e.g,*. *Ditmars v. Commissioner*, 302 F.2d 481, 485 (2d Cir. 1962); *Old Town Corp. v. Commissioner*, 37 T.C. 845 (1962), *acq.* 1962-2 C.B. 5. Because deductions are a matter of legislative grace, a taxpayer must show that it comes squarely within the terms of the law conferring the benefit sought. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

Section 162(a) must be read in conjunction with § 162(f), however, which prohibits the deduction of any "fine or other similar penalty paid to the government for the violation of any law." Treasury Regulation § 1.162-21(b)(1) defines a fine or other similar penalty to include any amount (i) paid pursuant to a conviction or a plea of *nolo contendre* for a crime in a criminal proceeding; (ii) paid as a civil penalty imposed by federal, state, or local law; (iii) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (iv) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. The regulations further provide that compensatory damages paid to a government do not constitute a fine or penalty. § 1.162-21(b)(2).

Section 162(f), enacted in 1969, was intended to codify the public policy grounds previously used by courts to deny deductions for fines or penalties if allowing the deduction would frustrate a sharply defined national or state policy. Joint Committee on Internal Revenue Taxation, “General Explanation of the Tax Reform Act of 1969,” at 234, JCS-16-70 (December 3, 1970); *Tank Truck Rentals v. Commissioner*, 356 U.S. 30 (1958)(denying trucking company’s claimed deduction for payment of penalties for violating state maximum weight laws because such a deduction would frustrate a sharply defined state policy to protect its highways from damage and to insure the safety of all persons using them). The purpose of this public policy doctrine was to prevent favorable tax treatment from “blunting the sting” of a validly imposed penalty by allowing the taxpayer a deduction for federal income tax purposes. *Atzingen-Whitehouse Dairy, Inc. v. Commissioner*, 36 T.C. 173, 183 (1961). Thus, the Service and the regulations follow the prior case law adopting the public policy doctrine and distinguish between punitive and compensatory payments.

When a civil settlement payment is at issue, it is first necessary to determine whether the payment constitutes a fine or penalty, or some other type of damages. If the payment does constitute a fine or penalty, then the purpose of the payment must be analyzed to determine whether it is punitive or remedial in nature, because only punitive fines fall within the scope of § 162(f):

> [t]he Congress, by use of the word “similar,” [as in “fine or other *similar* penalty”] was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties. If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is “similar” to a fine. However, if the civil penalty is 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, it does not serve the same purpose as a criminal fine and is not “similar” to a fine within the meaning of section 162(f).

S. Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980).

Thus, under the punitive vs. remedial test, a payment imposed for purposes of enforcing the law or as punishment for its violation is not deductible, while a payment imposed as a remedial measure to compensate the government or another party is deductible, even if it is labeled as a fine or penalty. *See, e.g.*, *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 385-86 (9th Cir. 1997); *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983); *Middle Atlantic Distributors v. Commissioner*, 72 T.C. 1136, 1145 (1979); Rev. Rul. 88-46, 1988-1 C.B. 76 (nonconformance penalty assessed by the Environmental Protection Agency falls outside of the scope of § 162(f) because it is not punitive in nature). In order to determine the purpose of a payment under the punitive vs. remedial test, courts first look to legislative intent, including the language of the statute or ordinance in question, its legislative history, and other court decisions construing the statute or ordinance. *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d at 1047; *Huff v. Commissioner*, 80 T.C. 804 (1983).

If it is unclear whether a statute imposing a penalty serves punitive or compensatory purposes, or if the statue serves both purposes, it is necessary to determine which purpose the payment was intended to serve. *Talley Indus., Inc. v. Commissioner*, 116 F.3d at 385-86; *S & B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226, 1232 (1980); *Middle Atlantic Distributors v. Commissioner*, 72 T.C. at 1145. In order to evaluate the parties' intent, courts and the Service look to the facts and circumstances of the specific payment at issue and the manner in which it was calculated. *Talley Indus., Inc.*, 116 F.3d at 385-86; *S & B Restaurant, Inc.*, 73 T.C. at 1232 (1980); *Middle Atlantic Distributors,* 72 T.C. at 1145 (1979).

In order to evaluate the deductibility of a settlement payment, it is necessary to examine the origin and character of the liability giving rise to the claim. *See, e.g. Ostrom v. Commissioner*, 77 T.C. 608 (1981). That is, the character of the claim from which the settlement arose is examined to determine whether it arose in connection with a business matter, and, if so, whether it is ordinary and necessary within the meaning of § 162(a).[4] Here, conduct underlying the FCA claims arose from Subsidiary's business of providing *c* to the federal government and others. Subsidiary's settlement payment would ordinarily be deductible under § 162(a) unless all or a portion of it constitutes a fine or penalty within the meaning of § 162(f). In order to determine whether any portion constitutes a fine or other similar penalty, we must determine whether the multiple damages provision of the FCA serves a compensatory or punitive purpose, or both.

False Claims Act

The FCA allows the government to recover damages from those who make, or cause to be made, false claims for money or property upon the United States, or who

[4] The characterization of a payment under § 162 depends on the origin of the liability giving rise to the payment, not the taxpayer's motive for making the payment or the character of the assets used to satisfy the claim. Thus, it does not matter if a taxpayer denies liability for any wrongdoing or if a taxpayer makes a payment in order to avoid further investigation. See *United States v. Gilmore*, 372 U.S. 39, 48-49 (1963); *Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985).

submit false information in support of those claims. 31 U.S.C. § 3729 (2000). The government is authorized to recover three types of damages under the Act: (1) a civil penalty of at least $5,000 and not more than $10,000 for each false claim; (2) three times the amount of actual damages sustained (reducible to double damages for cooperative defendants); and (3) costs of investigating and prosecuting any alleged violation of the Act. 31 U.S.C. § 3729(a).[5]

This statute was originally enacted in 1863 to combat rampant fraud in Civil War defense contracts. Senate Rep. No. 99-345, 99th Cong., 2d Sess. at 8. The first major amendments to the Act in general occurred in 1986, when the Congress revised the liability standard, burden of proof, *qui tam* provisions, and expanded the damages available to the government in response to concerns that fraud in government procurement was severe and on the rise. *Id.* at 2. Prior to 1986, the amount of the per-claim fixed penalty was $2,000, and the government was entitled to recover only double damages. The legislative history of the 1986 amendments contains several references to the damages provision, stating that increasing the damages available is necessary both to make the government "completely whole" for all of its losses and to deter fraudulent conduct. Senate Rep. No. 99-345, 99th Cong., 2d Sess at 2, 17 (July 28, 1986); H.R. Rep. No. 99-660, 99th Cong., 2d Sess., at 16, 20 (June 26, 1986). Thus, according to the legislative history, the multiple damages provision serves both punitive and compensatory purposes.

The Supreme Court has long held that the multiple damages provisions of the FCA serve dual purposes of compensation and deterrence. *United States v. Bornstein*, 423 U.S. 303, 314-15 (1976). In *Bornstein*, the Court noted that the [then] double damages provision was intended to make sure that "government would be made completely whole" and was also intended to deter fraudulent conduct. *Id*. at 317 (quoting *United States v. Hess*, 317 U.S. 537, 551-52 (1943)).

The Court has recently examined the multiple damages provisions in more detail, and has stated that the current version of the FCA (authorizing treble damages) "imposes damages that are essentially punitive in nature." *Vermont Agency of Natural Resources v. United States ex rel.Stevens*, 529 U.S. 765, 784 (2000). The Court stated, "[t]he very idea of treble damages reveals an intent to punish past, and to deter future, unlawful conduct, not to ameliorate the liability of wrongdoers." *Id.* at 786. However, several years later, the Court refined its "essentially punitive" observation in *Cook County, Illinois v. United States ex rel. Chandler*, 538 U.S. 119, 130-32 (2003). In *Chandler*, the Court considered whether the multiple damages provision is compensatory or punitive in order to determine whether a local government may be a "person" subject to a *qui tam* action under the FCA. Cook County argued that it could not be such a "person" in light of the fact that the multiple damages provision is punitive in nature, and municipalities may not be subjected to punitive damages (treble damages

[5] The statutory penalty is adjusted upward for inflation and is currently $5,500 to $11,000. 28 U.S.C. § 2461 (2000); 28 C.F.R. § 85.3(a)(9) (2004).

are mandatory under the FCA if the government sustains any actual damages). *Id.* The Court rejected Cook County's argument, admonishing "it is important to realize that treble damages have a compensatory side, serving remedial purposes in addition to punitive objectives." *Id.* at 130. The Court continued:

> [w]hile the tipping point between payback and punishment defies general formulation, being dependent on the workings of a particular statute and the course of particular litigation, the facts about the FCA show that the damages multiplier has compensatory traits along with the punitive.

Id. For example, the Court noted that some portion of a multiple damages award might be used to compensate the government for the costs, delays, and inconveniences occasioned by fraudulent claims which are outside the category of actual damages, including pre-judgment interest, consequential damages, and the possibility of diverting up to 30% of the government's award to a relator who began the action. *Id.* at 130-31. Thus, the Court concluded that, while the FCA's treble damages remedy is "punitive" in that recovery will exceed full compensation in some cases, the force of its punitive nature is not as "robust" as if it were a pure penalty in all cases. *Id.* at 131-32.

We interpret the *Chandler* decision to stand for the proposition that because treble damage awards may sometimes compensate the government for its losses and costs beyond the actual damages allowed by the FCA, the multiple damage provision is not a pure penalty like classic punitive damages. Because *Chandler* refines *Stevens* without overruling it, however, the Court's position is that the treble damages provision is punitive, but not purely or automatically so, and in some instances may serve compensatory purposes.

The next step is to apply these holdings in the context of a lump-sum settlement payment. Because the treble damages provision of the FCA may serve either a compensatory or punitive purpose, or both, it is necessary to determine which purpose(s) the parties to the settlement intended the payment to serve. *Talley Indus., Inc. v. Commissioner*, 116 F.3d at 385-86 (9^{th} Cir. 1997); *S & B Restaurant, Inc.*, 73 T.C. at 1232 (1980). Ordinarily, the language of the settlement document is the most important factor in making this determination. *Middle Atlantic Distributors,* 72 T.C. at 1145 (1979). Language in the settlement document indicating that the payment was compensatory would be highly significant as would language indicating that the payment was attributable to a fine or penalty or intended to serve a deterrent purpose. *See* Rev. Rul. 80-334, 1980-2 C.B. 61.

Where an agreement is silent or ambiguous concerning the compensatory or deterrent nature of a settlement payment, an investigation into the facts and circumstances surrounding the settlement may indicate the parties' intent concerning the character of the payment. Correspondence between the government and the taxpayer in the settlement negotiation as well as various other documents or testimony by individuals involved in the negotiation may help to evidence the purpose of the settlement payment. Surrounding facts and circumstances may also be indicative of an appropriate methodology for allocating settlement amounts. *See* Rev. Rul. 75-230, 1975-1 C.B. 93. Pursuant to Rev. Rul. 75-230, we will use the best evidence available to determine the intent of the parties at the time they reached the settlement agreement.

Although it pre-dates both the *Stevens* and *Chandler* decisions, the *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382 (9th Cir. 1997) decision provides a comprehensive example of how to analyze a lump-sum settlement payment in a FCA case. In *Talley*, the lump-sum payment was $2.5 million and the parties stipulated that $1.56 million of the payment, representing the government's estimated actual losses, was deductible under § 162(a), less $1,885 that the Tax Court found to be nondeductible criminal restitution. *Id.* at 385. The parties disagreed as to characterization of the remaining $940,000 of the settlement payment. The taxpayer contended that it represented additional compensation to the government, and the government contended that it was a "fine or similar penalty" within the meaning of § 162(f). *Id.*

The Ninth Circuit held that the damages provision of the FCA serves dual purposes of compensation and deterrence. 116 F.3d at 387. Because the parties had offered conflicting evidence concerning their respective intent as to the purpose of the disputed portion of the settlement payment, the Ninth Circuit remanded the intent issue for a factual determination, instructing the Tax Court to engage in a two-step inquiry. *Id.* First, to determine whether the $940,000 was intended to represent compensation to the government for its losses. If so, it was not a fine or similar penalty. Second, if the payment was intended to represent double damages,[6] then the Tax Court was to determine whether the parties intended for the double damages to provide additional compensation for the government (deductible), or to punish and deter the taxpayer (not deductible). *Id.*

The Ninth Circuit also held that the government was not required to show it characterized the payment as punitive during the settlement negotiations, because the burden is on the taxpayer to "demonstrate 'entitlement to a particular deduction.'" *Id.* (quoting *Norgaard v. Commissioner*, 939 F.2d 874, 877 (9th Cir. 1991)). The court warned, "[i]f evidence to establish a deduction is lacking, the taxpayer, not the government, suffers the consequence." *Id.* at 387-88. Finally, the court concluded that the fact that the contested portion of the payment was less than double the amount of estimated actual damages did not mean that it was compensatory. The court noted that, in a settlement, the government might have bargained away the maximum amount of damages it could have recovered at trial. *Id.* at 388.

[6] At the time of the *Talley* decision, the FCA provided for the recovery of double, not treble damages.

On remand, the Tax Court determined that the parties intended the settlement amount to include double damages because their various offers and counteroffers repeatedly referred to the settlement as including double damages. T.C. Memo. 1999-2000. The court then turned to the determination of whether the purpose of the $940,000 double damages payment was to compensate the government for its losses or to punish and deter the taxpayer. It found that the parties did not agree as to the characterization of the amount in dispute: the taxpayer had characterized its settlement offers as compensation only, and the government had rejected those characterizations and had characterized its counteroffers as including double damages for punitive purposes in its internal documents concerning the settlement negotiations, although it had never communicated those characterizations to the taxpayer. The parties never clarified the purpose of the payment during their communications with each other, and they signed a settlement agreement that was silent on the issue. Under the Ninth Circuit's mandate that the taxpayer "suffer the consequences" if the evidence failed to establish entitlement to a deduction, the Tax Court held that the taxpayer had failed to carry its burden of proof and disallowed a deduction for the $940,000 in dispute.

<u>Facts and Circumstances</u>

In the instant case, we are faced with evaluating a lump-sum settlement payment where the settlement agreement is silent concerning whether any portion of the payment was meant to constitute multiple damages, and, if so, whether there was a punitive or compensatory purpose behind those multiple damages. Because the agreement is silent as to the intended purpose of the payment, we look to the facts and circumstances surrounding the parties' settlement negotiations in order to determine whether any portion of Amount <u>k</u> is a nondeductible fine or other similar penalty. We use the best evidence available to determine the proper allocation of this lump-sum settlement payment. Rev. Rul. 85-98, 1985-2 C.B. 51 (concluding that the ratio of punitive to compensatory damages sought in the plaintiff's complaint was the best evidence of how to allocate a lump-sum settlement payment where there was no other evidence concerning how the allocation should be made).

According to the field, the government initially estimated its actual damages to be Amount <u>a</u>. The government communicated this estimate to Subsidiary in a letter dated Date 3. This letter also contained the warning about the government's settlement position, "[w]e settle False Claims Act cases prior to litigation for a sum equal to triple damages, with appropriate penalties."

During the settlement meetings that occurred during the Winter of Year 2 and Year 3, the government's internal documents indicated that its total estimated actual damages were approximately Amount <u>c</u>. The government's minutes from a Date 9 settlement meeting indicate that Subsidiary "has also been previously apprised of [the government's] position that [the government's] total figure represents one-third of [Subsidiary's] final civil liability." Thus, beginning with the government's settlement demand of Amount d that was pending on Date 9, the government's total settlement demand included an amount representing multiple damages. Although Subsidiary repeatedly argued that the government's actual damages were far less than Amount c, it did not question the government's entitlement to multiple damages. In fact, in a letter dated Date 5, counsel for Subsidiary stated, "we are, of course, aware of the penalty calculation methodology set forth in the Civil False Claims Act . . . ."

Further, after subtracting the additional Amount j payment, the final settlement amount of Amount g was approximately Amount q over any of the government's estimates of its actual damages during its investigation and during the settlement negotiations. After examining the correspondence between the parties as well as the government's internal documents, there is ample evidence that the government's purpose in ensuring that the settlement figure included multiple damages was to punish Subsidiary for its wrongdoing, not to obtain additional compensation for the harm caused by Subsidiary's conduct.

Taxpayer contends it did not intend any portion of the settlement payment to constitute punitive damages; it intended solely to compensate the government fully for its losses, which includes amounts in excess of the government's estimated actual damages.[7] Taxpayer has not provided any correspondence between the parties, affidavits or statements of any persons involved in the settlement negotiations, or any other evidence in support of its assertion. In fact, the correspondence provided to us belies that assertion, as Taxpayer conceded it understood that the government was seeking multiple damages and that Taxpayer "was aware" of the "penalty calculation methodology" in the FCA in a letter written by its counsel during the settlement negotiations.

Even if Taxpayer had provided such evidence, then the evidence concerning the parties' intent would be conflicting because the field has supplied documents evidencing the government's intent that a portion of the settlement would serve a punitive purpose. Under the holding in *Talley*, a taxpayer who cannot establish that both parties intended for a FCA settlement payment to be purely compensatory "suffers the consequences" and is not entitled to a deduction for any disputed portion.

Allocation Between Compensatory and Punitive Purposes

Having determined that a portion of the Amount k settlement payment is a nondeductible fine or penalty, we now turn to the issue of what amount is nondeductible. We start with the assumption that Amount j is deductible, as the field has conceded that this amount, negotiated for post-Date 2 claims after the global settlement had been reached on all other claims, represented compensatory damages

[7] Taxpayer's position is based, in part, on its claim that the amount of the government's estimated actual damages were higher than Amount c. We address this contention below in the allocation analysis.

only, with no multiplier. Thus, the remaining Amount g must be allocated between compensatory and punitive damages.

The field contends that Amount p, the amount in excess of what was eventually disbursed to the harmed agencies, is the nondeductible portion of the settlement payment. Taxpayer contends that no portion is nondeductible because (1) the government's estimated actual damages were higher than Amount c, the number contained in the spreadsheet attached to the minutes of the Date 8 settlement meeting, and (2) the balance of the settlement payment was intended to compensate the government for relator fees, pre-settlement interest, and other investigation costs. We do not believe either position is correct.

First, we agree with Taxpayer that, under *Talley* and *S&B Restaurants*, the relevant inquiry is the parties' intent at the time the settlement agreement was reached. It is clear from the documents provided to us that the government spent a considerable amount of time and resources investigating the claims against Subsidiary and attempting to quantify the amount of its actual losses caused by Subsidiary's conduct. As discussed above, representatives of the federal agencies allegedly harmed by Subsidiary's conduct actively participated in the investigation and in the monthly settlement meetings with Subsidiary. During several of the settlement meetings, the government provided detailed spreadsheets to Subsidiary outlining estimates of its actual damages organized by category of claim.[8] During the Winter of Year 2 and Year 3, the lowest estimated actual damages amount was Amount r and the highest amount was Amount c. On Date 9, the government reduced its total settlement demand from Amount d to Amount e, and then reduced it again to Amount f. We note that the Amount d figure is approximately three times an estimated actual damages figure of Amount c. Taxpayer claims that the government based this reduction entirely on multiple damages concessions—it agreed to accept less than treble damages on some categories of claims. Thus, according to Taxpayer, the government's estimated actual damages figure remained constant while it conceded only the multipliers.

However, there is evidence that the government decreased its actual damages estimate prior to the final settlement. During two Date 11 settlement meetings, Subsidiary's settlement figure climbed and the government's dropped until the parties reached a tentative oral agreement to settle all claims for Amount g. In preparation for its formal acceptance of a settlement offer, the government prepared a spreadsheet detailing how the proceeds would be allocated between compensatory and multiple damages, detailed by category of claim. According to this spreadsheet, Amount h would be allocated to the defrauded agencies in compensation for their actual losses, and the remaining Amount s represented multiple damages (Amount i times the amount of each category of actual damages). Based on the allocations in this final, pre-

[8] We have been provided with two spreadsheets, dated Date 7 and Date 8, as well as an earlier outline of the parties' respective settlement positions, outlining actual damages by category of claim, dated Date 6. The latter document was apparently prepared by Subsidiary.

settlement spreadsheet, the government accepted Subsidiary's settlement offer of Amount g.

We believe that the final, pre-settlement spreadsheet, dated Date 11, is the best evidence of the government's intent concerning how it intended the settlement payment to be allocated between compensatory and punitive damages because it was drafted contemporaneously with the oral settlement agreement. *See* Rev. Rul. 80-334, 1980-2 C.B. 61; Rev. Rul. 75-230, 1975-1 C.B. 93. Prior to the final, pre-settlement spreadsheet, the spreadsheet closest in time to Date 11 was dated Date 8, which was over six weeks before the agreement and which was drafted during a time when the government's total settlement demand was Amount d. Based on the allocations in this final, pre-handshake spreadsheet, Amount h represents compensatory damages and Amount s represents the punitive, or deterrent portion of the settlement.

Taxpayer contends that the government's estimated actual damages were Amount t after the conclusion of the Date 11 settlement meeting, and that it relied on this estimate in reaching the agreement to settle for Amount g. Amount t is based on a spreadsheet prepared by the government that was apparently used during a Date 8, not a Date 11, settlement meeting. This spreadsheet actually shows Amount r in estimated actual damages. It contains various handwritten notes of various figures and percentages, and Taxpayer apparently relied on these handwritten notes in reaching the Amount t figure. We are unable to substantiate the Amount t figure. We do note, however, that the minutes summarizing the Date 8 settlement meeting state that the government advised Subsidiary that the estimated actual damages for a particular agency were Amount u and the actual damages for all other federal programs would be an additional Amount v of that figure. Based on these statements, the government's estimated actual damages could have been as high as Amount w as of Date 8. Even if these documents support the proposition that the government's estimated actual damages were as high as Amount t or Amount w, this spreadsheet was prepared at least six weeks before the parties reached a settlement agreement. The parties had numerous settlement meetings during those six weeks, and the parties' settlement offers and counter-offers changed dramatically during that time. It is clear that both parties had deviated substantially from their respective Date 8 settlement positions by the time they reached a final agreement.

On the issue of reliance, Taxpayer contends it should be entitled to rely on the government's representations concerning the amounts required to reimburse the harmed agencies. The "representation" at issue is Taxpayer's claim that the government's estimated actual damages were as high as Amount t during the course of the settlement negotiations. There are several problems with Taxpayer's contention. First, the spreadsheet Taxpayer relies on to support this figure is not close in time to when the parties actually reached an agreement. Second, the documents provided to us show that Subsidiary, and not the government, requested that the parties switch from analyzing the government's losses on an issue-by-issue basis to negotiating a settlement based on a "single, comprehensive number." Taxpayer cannot now claim it did not understand the government's intent concerning how much of the settlement would be allocated to compensatory vs. punitive damages when Subsidiary was the party responsible for switching to negotiating based on a lump-sum figure. Third, the documents provided to us also establish that, during the settlement negotiations, Subsidiary's attorneys understood that Subsidiary and the government had differing views on the penalty calculations, stating that the settlement might end up being "an agreed number with each side seeing the rationale differently."

Taxpayer also attempts to use the fact that the parties stipulated that the additional Amount j consisted solely of compensatory damages to support its position that the parties also intended for the entire Amount g settlement payment to consist solely of compensatory damages. We believe it supports the opposite position. That is, if the parties had shared an understanding that the Amount g settlement payment was to be allocated only to compensatory damages, then there would be no need to specify that the additional Amount j would also be compensatory. The fact that a stipulation was necessary for Amount j supports the position that the Amount g payment was to be allocated to both compensatory and punitive damages.

Taxpayer's final contention on the issue of the amount of the government's actual damages is that it intended for any amounts in excess of Amount t to compensate the government for relator fees, pre-settlement interest, and the government's investigatory costs. We agree with Taxpayer, in theory, that such amounts could constitute compensatory damages under the Supreme Court's holding in *Chandler*. However, as we did when considering the parties' intent concerning the purpose of the settlement payment, we must evaluate Taxpayer's claim as of the time the parties agreed to settle. Taxpayer has not provided any evidence in this case that either party intended for a portion of the settlement payment to be allocated to such items. There is no mention of pre-settlement interest, reimbursement of investigatory costs, or relator fees in any of the correspondence or summaries of settlement meetings that have been provided to us. The settlement agreement does not allocate any of the settlement proceeds for any of these items.[9] Because there is no evidence concerning the parties' intent and because Taxpayer signed a settlement agreement that is silent on this issue, it has failed to establish it is entitled to a deduction for these amounts.

Finally, we turn to the field's position that the amount of the government's actual damages should be calculated solely with reference to the amount actually disbursed by the government to the harmed federal and state agencies. The field contends that Amount m, representing the government's disbursements to the harmed agencies, constitutes its actual damages. This calculation leaves Amount p as the nondeductible,

[9] Further, the only evidence of the government's intent regarding the relator fees is from a later time period when the government and the relators were battling over the amount of those fees in a separate lawsuit. Clearly, the government's post-settlement intent was not to pay the relators a fee at all.

punitive damages portion of the settlement amount. As discussed above, the final, pre-settlement spreadsheet prepared by the government shows that it intended to allocate Amount h to the harmed agencies as compensation for actual losses. The harmed agencies concurred in this calculation, and signified their agreement to it by signing the settlement agreement. As it turned out, when the government actually disbursed the funds nearly one year later, the harmed agencies received Amount m, approximately Amount x more than the amount contemplated by the final, pre-settlement spreadsheet.[10] We do not believe that the government's actual use of the settlement proceeds is relevant in this case to determine its intent concerning the purpose of the payment at the time of the settlement because there is more contemporaneous information available in the form of the final, pre-handshake spreadsheet. Nor would our conclusion be different if the government had disbursed less to the harmed agencies, since the proper allocation depends on intent at the time the settlement was reached, not on events occurring after that time.

Based on our review of the facts and circumstances in this case, we conclude that a portion of the settlement amount represented multiple damages and that the purpose of those multiple damages was to punish Subsidiary. Accordingly, the portion of the settlement amount that constitutes multiple damages is a nondeductible fine or penalty within the meaning of § 162(f). Based on the facts and circumstances of the settlement negotiations, the government intended for Amount y to constitute compensatory damages and for Amount s to constitute multiple damages at the time it agreed to the total settlement amount of Amount k.[11] Further, Taxpayer has failed to establish entitlement to a deduction for any portion of Amount s. Accordingly, we conclude that, in this case, based on the facts and circumstances presented, Amount y is deductible as an ordinary and necessary business expense pursuant to § 162(a), and Amount s constitutes a nondeductible fine or penalty pursuant to § 162(f).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[10] The Amount x difference is net of Amount j, the additional amount negotiated separately for post-Date 2 claims.

[11] Amount y is the sum of Amount h (the initial settlement amount) and Amount j (the additional amount negotiated for claims arising after Date 2).