

Is This Bribe Deductible? Tax Implications Of the U.S. Foreign Corrupt Practices Act

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According to a recent study prepared by the University of Syracuse, there has been a 27 percent drop in white-collar criminal prosecutions in the United States since 2000,¹ yet cases brought under the Foreign Corrupt Practices Act (FCPA), which averaged one to two successfully prosecuted cases per year since its enactment in 1977 for a total of 40 prosecutions by 2000,² surged 400 percent to 58 prosecutions since 2000,³ with 8 of them taking place during 2006 at a time when more than 50 additional investigations were under way.⁴ The surge in the number of successfully prosecuted cases and investigations under the FCPA are likely to continue as both the Securities Exchange Commission and the Department of Justice — both of which are responsible for enforcing FCPA's antibribery and record-keeping provisions — are using the FCPA to clamp down on illegal bribery and other forms of business corruption (improper payments) at multinational companies. The current caseload is “just the tip of the iceberg,” according to Mark Mendelsohn, deputy chief of the Fraud Section of the DOJ, whose assertions are supported by a recent survey prepared by the Economist Intelligence Unit and a report prepared by former U.S. Federal Reserve Chair Paul Volcker, which details the manipulations of the United Nation's humanitarian Oil-for-Food program. While as many as 80 percent of all senior executives of multinational companies surveyed admit to either having experienced or being aware of

fraud within their firms during the past three years,⁵ according to the Volcker report, 2,200 multinational companies from 40 countries are identified as having colluded with Saddam Hussein's regime in Iraq to bilk the Oil-for-Food program out of \$1.8 billion by paying bribes and kickbacks from corporate slush funds.⁶

There are several other parallel but independent anticorruption investigations initiated by U.S. congressional committees, the Department of Defense's Defense Criminal Investigative Service (DCIS), the Treasury Department's Financial Crimes Enforcement Network (FINCEN), the Office of the Comptroller of the Currency (OCC), a federal grand jury in Manhattan, global organizations, and fraud squads of several foreign countries, which are fueling the FCPA caseload.

Some of the ongoing anticorruption investigations are solely focused on Iraq. Seeing that probes initiated by the U.N.'s former Independent Inquiry Committee into the Oil-for-Food program with the assistance of the U.S. State Department, the Federal Bureau of Investigation's Criminal and Counterintelligence Division (CCD), the U.S. Treasury Department's Office of Foreign Assets Control (OFAC), and the U.N. Office of Legal Affairs exposed systemic corporate and individual FCPA violations,⁷ Rep.

⁵“Economist Intelligence Unit Kroll Global Fraud Report 2007/2008,” Economist Intelligence Unit Overview, p. 4; Heide B. Malhotra, “Fraud and Illegal Acts? They're Just Business as Usual, Study Shows Fraud Affecting More Businesses, Faster Than Ever Before,” Oct. 7, 2007, *Epoch Times*, p. 1.

⁶See <http://www.iic-offp.org/documents.htm>.

⁷“Texas Oilman Enters Mid-Trial Guilty Plea To Charges Of Conspiring To Make Illegal Payments To The Former Government Of Iraq,” Oct. 1, 2007, Department of Justice United States Attorney Southern District of New York press release, available at http://www.usdoj.gov/usao/nys/press_releases/October07/Wyatt%20Plea%20PR.pdf; Benjamin N. Gordon, “Textron to Settle Bribes Case for \$4.6 Million,” *Providence Journal Bulletin*, Aug. 24, 2007, p. 1; Roy Henry, “Textron Settles Iraq Case/Aircraft and Finance Company to Pay \$5 Million Over Oil-for-Food Program Charges,” *Houston Chronicle*, Aug. 24, 2007, p. 1.

¹See <http://www.trac.syr.edu/tracreports/crim/184/>.

²“Feds probe alleged Enron bribes,” CNNMoney.com, Aug. 5, 2002.

³“Crime: Lawyers Call for DoJ Guidance to Bring Consistency to Corporate Fraud Outcomes,” *Securities Law Daily*, Sept. 7, 2007, p. 1.

⁴Danforth Newcomb, “The Foreign Corrupt Practices Act: Coping with Heightened Enforcement Risks,” *Practising Law Institute*, Fall 2007.

Henry A. Waxman, D-Calif., is exploring the scope of corruption in Iraq's current government.⁸ Waxman is pressuring the U.S. State Department, which implemented a national strategy to internationalize efforts against kleptocracy,⁹ for transparency about Iraq's contracts with U.S. multinational companies after the leading Iraqi anticorruption official unearthed massive fraud¹⁰ and Waxman uncovered U.S. tax evasion by a U.S. government contractor doing business in Iraq.¹¹

Other global anticorruption efforts are pursued by:

- the U.N. and the World Bank's joint effort to help developing countries recover assets stolen by corrupt foreign officials using the U.N.'s Convention Against Corruption (UNCAC) network signed by 130 countries (including the United States), which entered into force on December 14, 2005;¹²
- the European Union's Convention on the Protection of European Communities' Financial Interests, the Organization of American States' Inter-American Convention Against Corruption (OAS), the African Union's Convention on Preventing and Combating Corruption, the Pacific Basin Economic Council's Statement on Stan-

dards of Transactions between Business and Government, and the IMF;¹³ and

- the fraud squads of countries that share information through a network of international treaties' mutual legal assistance treaty (MLAT)¹⁴ provisions as soon as they spot bribes hidden in a multinational company's financials.¹⁵ (See table for a list of U.S. MLAT agreements and countries investigating companies for FCPA violations.)

The increased global anticorruption scrutiny is subjecting multinational companies to a blizzard of simultaneous or sequential multijurisdictional FCPA investigations that are more aggressive than at any other time since the statute's enactment, resulting in larger fines. These investigations may also shed light on a U.S. multinational company's tax evasion if the income that is financing improper payments is excluded from a company's taxable income, or on the mischaracterized improper payments that can run into the hundreds of millions of dollars are deducted legally for tax purposes under the OECD convention¹⁶ but illegally under U.S. tax laws. Such findings may potentially subject a company to civil or criminal penalties under U.S. and foreign tax laws, penalties under the Racketeer Influenced and Corrupt Organizations Act (RICO) that now applies to a taxpayer that has deprived a foreign government of tax revenue,¹⁷ and potential private FCPA civil claims made under the civil provisions of RICO.¹⁸

I. Foreign Corrupt Practices Act

The FCPA was enacted by Congress in 1977 on the heels of the Watergate scandal.¹⁹

In the mid-1970s, simultaneous investigations undertaken by a number of U.S. attorney's offices, the Internal Revenue Service, the SEC, and other

⁸"House Chides U.S. Officials on Iraqi Corruption," Reuters, Oct. 16, 2007, p. 1; Sue Fleming and Susan Cornwell, "Corruption is Pernicious in Iraq, says U.S. Official," Reuters, Oct. 15, 2007, p. 1; "Pressure Grows on State Department Over Iraq," *CIOB International News U.K.*, Oct. 18, 2007, p. 1; "Iraq Demands Blackwater's Dismissal," *Press TV*, Oct. 21, 2007, p. 1; Frank Rich, "Suicide Is Not Painless," *New York Times*, Oct. 21, 2007, p. 1; Elise Castelli, "Representative Waxman Continues Probe into Blackwater," *Federal Times.com*, Oct. 19, 2007; Glenn R. Simpson, "Inside the Greed Zone: Lt. Col. Gutierrez Was a Whistleblower, Was He Also Tainted by Corruption Around Him?" *The Wall Street Journal*, Oct. 20-21, 2007, p. 1; Bill Scanlon, "Fed agency involved in raid typically investigates terror — Lafayette firm makes lasers for military, others," *Rocky Mountain News*, Oct. 16, 2007, p. 1.

⁹David M. Luna, "On Strategies To Fight Kleptocracy," U.S. State Department press release, Sept. 28, 2007.

¹⁰Sarah Baxter, "Iraq's Ousted Corruption Buster Seeks Asylum in America," *Times Online U.K.*, Oct. 21, 2007.

¹¹S.A. Miller, "Waxman Says Blackwater May Have Evaded Taxes," *The Washington Post*, Oct. 23, 2007, p. 1; Stephanie Kirchgassner, "Blackwater Accused of Tax Evasion," *Financial Times*, Oct. 23, 2007, p. 1.

¹²The text of UNCAC and a list of signatory countries can be found at <http://www.unodc.org/unodc/en/treaties/CAC/signatories.html>; Margaret Ayres, John Davis, Nicole Healy, and Alexandra Wrage, "Developments in U.S. and International Efforts to Prevent Corruption," *The International Lawyer* (ABA section on International Law), Summer 2006; Richard Lloyd Parry, "Lloyd's Rejects Fraudulent North Korea Claim," *The Australian*, Jan. 27, 2007, p. 1.

¹³Andrea Dahms and Nicolas Mitchell, "Foreign Corrupt Practices Act," *Am. Crim. L. Rev.*, Spring 2007; Danforth Newcomb, "The Foreign Corrupt Practices Act: Coping with Heightened Enforcement Risks," *Practising Law Institute*, Fall 2007, p. 4.

¹⁴The DoJ and U.S. State Department have MLAT agreements in force with a number of countries; see <http://www.state.gov/documents/organization/86744.pdf>. See also <http://www.USDOJ.gov/tax/readingroom/2001ctm/41ctax.htm>.

¹⁵"International Developments: Lawyers Counsel Weariness in Deciding When to Report FCPA Allegations Overseas," *Securities Law Daily*, Oct. 18, 2006, p. 1.

¹⁶Dahms and Mitchell, *supra* note 13, p. 8.

¹⁷*Pasquantino v. United States*, 541 U.S. 972 (2004)

¹⁸Dahms and Mitchell, *supra* note 13, p. 7.

¹⁹See http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/47mcrim.htm.

federal authorities regarding allegation of illegal campaign contributions made by Lockheed Aircraft Corp to former U.S. president Richard Nixon shed light on widespread corruption among high government offices all over the world and top management in over 400 large publicly held U.S. companies. During these investigations, many U.S. multinational companies were found to have made unlawful lobbying payments overseas through commercial and political bribes, illicit rebates, and commission and kickback payments. These illicit payments, which were in excess of \$300 million, were made from corporate slush funds tucked away in offshore bank accounts and hidden in falsified corporate books and records.

In response to these revelations, Congress enacted the FCPA, the first antibribery legislation ever adopted by a nation, to restore public confidence in the integrity of the American business system. The FCPA criminalized the bribery of foreign officials by U.S. companies and individuals pursuing business in other countries (antibribery provisions)²⁰ and required publicly held corporations to create and maintain proper accounting controls and accurate records of their financial dealings (accounting and record-keeping provisions), giving the SEC authority over the entire financial management and reporting requirements of publicly held corporations.²¹ (See table for a list of OECD convention countries.)

The FCPA was amended by the International Anti-Bribery and Fair Competition Act of 1998 to achieve symmetry with the OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions. The FCPA as amended criminalized the bribery of foreign officials, outlined appropriate sanctions for violations, and agreed to extradite those charged with a bribery offense. This expanded the FCPA's reach worldwide to within the OECD convention's network countries of 37 members, subjecting violators of the FCPA to civil and criminal penalties and the risk of losing the benefits of doing business with a U.S. government agency.²²

²⁰Dahms and Mitchell, *supra* note 13, pp. 1-30.

²¹Stuart H. Deming, "The Potent and Broad-Ranging Implications of the Accounting and Record-Keeping Provisions of the Foreign Corrupt Practices Act," *Journal of Criminal Law and Criminology*, Winter 2006, pp. 1-40.

²²See <http://www.oecd.org>; OECD convention network country ratification status, available at <http://www.oecd.org/dataoecd/59/13/1898632.pdf>; Sesto E. Vecchi and Kevin C. Chua, "The War Against Corruption Goes International," *Journal of International Taxation (WG&L)*, Vol. 12, No. 3, March 2001, pp. 1-11.

II. Consequences of FCPA Violations

A. Jurisdiction

A U.S. company²³ may be investigated for tax evasion stemming from making improper payments to foreign officials in foreign jurisdictions as long as U.S. courts have personal jurisdiction over a company's books and records to compel it to produce these records and documents under an IRC section 7602 summons²⁴ or a grand jury subpoena. A company that operates globally through subsidiaries in several foreign jurisdictions and its books and records physically located outside the U.S. that the company controls are subject to the personal jurisdiction of the U.S. district courts.²⁵ Even if a foreign corporation's²⁶ books and records are not otherwise within the jurisdiction of the U.S. courts, it may be validly summoned under section 7602 or a grand jury subpoena when a company under the jurisdiction of the U.S. courts owns²⁷ or controls more than 50 percent of a foreign entity²⁸ (which can be either a corporation²⁹ or a foreign partnership³⁰). These books and records may be obtained from a foreign jurisdiction through an exchange of information request (article 26 of OECD model treaty) under a tax treaty³¹ or tax

²³A domestic corporation is one that is created or organized in the United States or under the laws of the United States or of any state; IRC section 7701(a)(4).

²⁴*U.S. v. Manufacturers and Traders Trust Company*, 703 F.2d 47 (2d Cir. 1983); under the Canada-U.S. tax treaty, the IRS could obtain information requested by Canada to help determine a Canadian taxpayer's liability to it, even though that information would also be used by criminal investigators and prosecutors in Canada.

²⁵*First Nat'l City Bank of New York v. IRS*, 271 F.2d 616 (2d Cir. 1959), *cert. denied*, 361 U.S. 948 (1960); *In re Rivera*, 79 F. Supp. 510 (S.D.N.Y. 1948); *U.S. v. Held*, 435 F.2d 1361, 1365 (6th Cir. 1970), *cert. denied*, 401 U.S. 1010 (1971).

²⁶A foreign corporation is one that is not created or organized in the United States or under the law of the United States or of any state under IRC section 7701(a)(4) and (5); the U.S. income tax laws are applicable to foreign corporations as decided in *Matter of Marc Rich & Co., A.G.*, 707 F.2d 663 (2d Cir. 1983).

²⁷*U.S. v. Vetco Inc.*, 691 F.2d 1281 (9th Cir. 1981), *amending* 644 F.2d 1324, *cert. denied*, 454 U.S. 1098 (1981).

²⁸Selva Ozelli, "Shareholder Leverage in the Face of Corporate Inversions," *Tax Notes Int'l*, Feb. 17, 2003, p. 661 (U.S. shareholders may access the accounting and tax records of foreign companies that meet CFC provisions through exchange of information treaty).

²⁹*U.S. v. Vetco Inc.*, 691 F.2d 1281 (9th Cir. 1981), *amending* 644 F.2d 1324, *cert. denied*, 454 U.S. 1098 (1981).

³⁰*U.S. v. Hayes*, 722 F.2d 723 (11th Cir. 1984).

³¹*U.S. v. A.L. Burbank & Co., Ltd*, 525 F.2d 9 (2d Cir. 1975); *Yun v. U.S.*, 2001-1 USTC para. 50,313 (C.D. Cal. 2000); *Lidas, Inc. v. U.S.*, 99-1 USTC para. 50,309 (C.D. Cal. 1999), *aff'd*, 238 F.3d 1076 (9th Cir. 2001); *U.S. v. Stuart*, 489

(Footnote continued on next page.)

information exchange agreement³² that would also allow contracting parties to obtain information from banks, financial institutions, and persons acting in an agency or fiduciary capacity.³³

Once the books and records are obtained, a company under a simultaneous examination program (SEP) could be investigated concurrently in multiple jurisdictions for tax evasion stemming from the use of offshore bank accounts, tax shelters, cross-border financing, asset transfer, or excessive fixed or determinable annual or periodical (FDAP) income payment transactions that lack business purpose, improper payments, and slush funds.³⁴ (See table for a list of U.S. tax treaties, SEPs, and TIEAs.)

B. Improper Payments

While improper payments are allowed as an expense deduction under GAAP in arriving at a company's worldwide earnings and profits,³⁵ these payments, which can run in the hundreds of millions of dollars, cannot be claimed as tax deductions on a company's tax returns, which may give rise to significant book-tax differences.³⁶

U.S. 353 (1989); Calvin J. Allen, "United States Should Expand Tax Treaty Network in Sub-Saharan Africa," *Tax Notes Int'l*, Apr. 5, 2004, p. 57; Michael I. Saltzman and Jean-Claude M. Wolff, "The Growing Role of Information Exchange in U.S. Tax Treaties," *Tax Notes Int'l*, Dec. 8, 2003, p. 943. For list of the countries in the U.S. tax treaty network, see <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html>.

³²See <http://www.oecd.org>; "The OECD's Project on Harmful Tax Practices: The 2007 Progress Report," Oct. 12, 2007; available at http://www.oecd.org/document/48/0,3343,en_2649_37427_39482288_1_1_1_37427,00.html; OECD, "Improving Access to Bank Information for Tax Purposes: The 2007 Progress Report," available at <http://www.oecd.org/dataoecd/24/63/39327984.pdf>. The list of U.S. TIEAs can be found at IRB 2207-18, Rev. Rul. 2007-28; Bruce Zagaris, "The Role of International Organizations in Fighting Cross-Border Tax Crimes," *Tax Notes Int'l*, Mar. 27, 2006, p. 1073.

³³David E. Spencer, "OECD Information Exchange Recommendations Are a Significant First Step in Resolving Tax Evasion," *Journal of International Taxation (WG&L)*, Aug. 1997, pp. 1-15.

³⁴Robert T. Cole, John Venuti, Richard A. Gordon, and James E. Coker, Jr., *BNA Portfolio 940: Income Tax Treaties — Administrative and Competent Authority Aspects*, "Section B — Exchange of Information Under Tax Treaties," "Subsection B(3)(a), (b), (c) & (d) Simultaneous Examination Programs," pp. 7-9.

³⁵Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, Warren, Gorham & Lamont (WG&L) of RIA, 7th ed., Vol. 1, para. 8.03(6), pp. 8-31, 8-32.

³⁶Notice 2006-6, 2006-5 IRB 385; IR 2006-6, Jan. 6, 2006; the IRS removed transactions with significant book-tax differences as a category of reportable transactions under the

A company that is taxed on its worldwide income may deduct all ordinary and necessary business expenses under section 162(a) in arriving at gross income, without subtraction of amounts disallowed under section 162(c),³⁷ which specifically disallows any payments made, directly³⁸ or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment satisfies one of two conditions.

For these purposes, the first condition is satisfied if the payment constitutes an illegal bribe or kickback.³⁹ The prohibition doesn't extend to illegal payments other than bribes or kickbacks. Thus, for example, gifts to government employees that violate government regulations regarding acceptance of gifts from vendors, although illegal, will be deductible unless the gifts are bribes or kickbacks.

Violation of 18 USC 201(f), which makes it a crime to give, offer, or promise anything of value to any public official for or because of any official act

tax-shelter reporting regulations. Following Notice 2006-6, proposed regulations issued in November 2006 eliminate the category of transactions with a significant book-tax difference from the categories of reportable transactions that otherwise would have been disclosed on or after January 6, 2006, regardless of when the transaction was entered into.

³⁷Treas. reg. section 1.61-3(a).

³⁸Robert Schmidt, "Former Schnitzer Executive Pleads Guilty in U.S. Bribery Case," Associated Press, June 7, 2007; James Rowley, "Former Willbros Group Employee Accused of Bribery," Bloomberg.com, July 23, 2007; *U.S. v. Leo Winston Smith* (No. 8:07-cr-00069) (C.D. Cal. April 2007); *U.S. v. Steven J. Ott*, Crim. No. 07-608 (D.N.J. July 2007); *U.S. v. Roger Michael Young*, Crim. No. 07-609 (D.N.J. July 2007); *U.S. v. Yaw Osei Amoako*, Case No. 3:05-mj-01122-JJH (GEB) (D.N.J. 2005); *SEC v. Yaw Osei Amoako*, Case No. 3:05-mj-01122-JJH (D.N.J. 2005); *SEC v. Steven J. Ott and Roger Michael Young*, Case No. 3:06-cv-04195 (D.N.J. 2006); *U.S. v. Si Chan Wooh*, No. 07-cr-244-KI (D. Or. June 2007); *SEC v. Si Chan Wooh*, 07-cv-957-ST (D. Or. June 2007); *U.S. v. SSI Int'l Far East, Ltd.* (No. CR 06-398-KI) (D. Or. 2006); *In the Matter of Schnitzer Steel Indus., Inc.*, SEC Administrative Proceeding File No. 3-12456 (Oct. 16, 2006); *U.S. v. William J. Jefferson* (No. 1:07-cr-00209) (E.D. Va. June 2007); *U.S. v. Viktor Kozeny, Frederic Bourke, Jr. and David Pinkerton* (Cr. No. 05-518) (S.D.N.Y. October 2005); *U.S. v. Hans Bodmer* (Cr. No. 03-947) (S.D.N.Y., August 2003); *U.S. v. Omega Advisors, Inc.*, matter resolved through nonprosecution agreement (June 2007); *U.S. v. Clayton Lewis* (Cr. No. 03-930) (S.D.N.Y., July 2003); *U.S. v. Thomas Farrell* (Cr. No. 03-290) (S.D.N.Y., March 2003); *U.S. v. DPC (Tianjin) Co. Ltd.*, No. CR 05-482 (C.D. Cal. 2005); *In the Matter of Diagnostic Products Corporation*, SEC Administrative Proceeding File No. 3-11933 (May 20, 2005).

³⁹IRC section 162(c)(1).

(Footnote continued in next column.)

performed or to be performed by that public official, is an illegal bribe for purposes of this rule.⁴⁰

The second condition is satisfied if the payment is made to an official or employee of a foreign government unlawfully under the FCPA⁴¹ that provides the sole legal standard for restricting deductions for improper payments to foreign officials or employees.⁴²

The FCPA makes it illegal for any individual who is a U.S. citizen, national, or resident, and any corporation, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship having its principal place of business in the United States or organized under the laws of a state, territory, possession, or commonwealth of the United States or issuer who has certain classes of securities registered or is required to file certain reports,⁴³ or for any officer, director, employee, or agent of such domestic concern, or any stockholder thereof acting on behalf of such domestic concern, to engage in certain acts in order to assist such domestic concern in obtaining or retaining business for or with any person or in directing business to any person.⁴⁴

The FCPA bans using the mails or any means or instrumentality of interstate commerce corruptly in furtherance of a direct or indirect⁴⁵ offer, payment, promise to pay, or authorization of the payment of any money, offer, gift, promise to give, or authorization to give anything of value to any foreign official, foreign political party, or official thereof, or any candidate for foreign political office for the purposes of:

- influencing any of his or its acts or decisions in his or its official capacity, or inducing him or it to do or omit to do any act in violation of his or its lawful duty; or
- inducing him or it to use his or its influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality.⁴⁶

⁴⁰Field Service Advice 988, Vaughn No. 988.

⁴¹IRC section 162(c)(1).

⁴²See S. Rep. No. 404, 97th Cong., at 164-65 (1981), and any future amendments to the FCPA that would include the international antibribery act of 1998 amendment — Rep. No. 97-494, Vol. 1, 97th Cong., 2d Sess. at 165 (1982); General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the Staff of the Joint Committee on Taxation for H.R. 4961, P.L. 97-248, at 423 (1982).

⁴³15 U.S.C.A. section 78dd-1.

⁴⁴15 U.S.C.A. section 78dd-2.

⁴⁵15 U.S.C.A. section 78dd-2(a)(3).

⁴⁶15 U.S.C.A. section 78dd-2(a).

However, payments made when expediting or securing the performance of routine governmental action by a foreign official, foreign political party, or foreign party official are not banned under the FCPA.⁴⁷

Treasury regulations⁴⁸ define “an official or employee of a government” (foreign official) as any individual officially connected with a governmental entity in whatever capacity, whether on a permanent or temporary basis and whether or not serving for compensation, regardless of the individual’s place of residence or post of duty.⁴⁹ A “governmental entity” is the governments of the United States, states, territories, and possessions of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.⁵⁰ “Foreign countries” (foreign country) can be any foreign nation, whether or not accorded diplomatic recognition by the United States.⁵¹ It is not material whether those individuals control such foreign nation, agency, or instrumentality and whether or not such individuals are accorded diplomatic recognition. A group in rebellion against an established government is treated as officials or employees of a foreign country.⁵² An “indirect payment” to an individual includes any payment that inures to his benefit or promotes his interest, regardless of the medium in which the payment is made or the identity of the immediate recipient or payer.⁵³

Thus, a payment made to an agent,⁵⁴ a relative,⁵⁵ an independent contractor of an official,⁵⁶ an employee, a broker,⁵⁷ a consultant,⁵⁸ or a contractor⁵⁹

⁴⁷15 U.S.C.A. section 78dd-1(b), -2(b).

⁴⁸Treas. reg. section 1.162-18 has not been further amended to reflect the TEFRA amendments made to IRC section 162(c)(1) and are only effective to the extent that they do not conflict with the FCPA.

⁴⁹Treas. reg. section 1.162-18(a)(3).

⁵⁰Treas. reg. section 1.162-18(a)(3)(i).

⁵¹Treas. reg. section 1.162-18(a)(3)(ii).

⁵²Treas. reg. section 1.162-18(a)(3).

⁵³Treas. reg. section 1.162-18(a)(2).

⁵⁴Baker Hughes, SEC, Washington, Apr. 26, 2007, press release, 2007-77.

⁵⁵See <http://usinfo.state.gov/ei/Archive/2004/Jul/19-959526.html>; <http://www.fincen.gov/riggsassessment3.pdf>.

⁵⁶*Id.*

⁵⁷Joe Carroll, “Tidewater Expands Scope of Internal Nigeria Probe,” Bloomberg.com, Oct. 4, 2007; “Transocean Widens Nigerian Bribery Probe,” Reuters, Aug. 14, 2007, p. 1.

⁵⁸*U.S. v. Baker Hughes Services International, Inc.* (No. H-07-129) (S.D. Tex. April 2007); *In Matter of Baker Hughes Incorporated*, SEC Administrative Proceeding File No. 3-10572 (Sept. 12, 2001); *SEC v. Baker Hughes Incorporated and Roy Fearnley*, No. H-07-1408 (S.D. Tex. Apr. 26, 2007);

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may be treated as an indirect payment to the foreign official if such payment inures, or will inure, to the company's benefit, promotes, or will promote, the company's financial or other interests including securing a preferential business contract,⁶⁰ influencing a foreign political election result,⁶¹ lowering a company's foreign taxes,⁶² or repealing an environmental rule⁶³ and will be treated as a indirect payment by the company to the foreign official or

SEC v. KPMG-SSH (Civil Action No. H-01-3105) (S.D. Tex. 2001); *SEC v. Eric Mattson and James W. Harris* (Civil Action No. H-01-3106) (S.D. Tex. 2001); *U.S. v. Christian Sapsizian and Edgar Valverde Acosta* (No. 1:06-cr-20797) (S.D. Fla. 2006); *U.S. v. Titan Corporation* (Cr. No. 05-314), (S.D. Cal. 2005); *U.S. v. Steven Lynwood Head* (No. 06-cr-01380) (S.D. Cal. June 2006); *SEC v. Titan Corporation*, D.D.C. 2005 (05-CV-04111); *U.S. v. Textron Inc.* (August 2007), matter resolved through nonprosecution agreement; *SEC v. Textron, Inc.* (No. 07-CV-01505) (August 2007); *U.S. v. Monsanto Company*, matter resolved through nonprosecution agreement (January 2005); *SEC v. Charles Michael Martin* (No. 07-cv-00434) (D.D.C. 2007); *SEC v. Monsanto Company* (05-cv-14) (D.D.C. 2005); *U.S. v. York International Corp.*, matter resolved through deferred prosecution agreement (October 2007); *SEC v. York International Corp.*, 07-cv-1750 (D.D.C. 2007); *U.S. v. Micrus Corporation*, matter resolved through nonprosecution agreement (March 2005).

⁵⁹*U.S. v. Vetco Gray Controls Inc., Vetco Gray Controls Ltd., Vetco Gray UK Ltd.* (No. 4:07-cr-00004) (S.D. Tex. February 2006); *U.S. v. Aibel Group Ltd.* (no. 4:07-cr-00005) (S.D. Tex. February 2006).

⁶⁰*U.S. v. Baker Hughes Services International, Inc.* (No. H-07-129) (S.D. Tex. April 2007); *In Matter of Baker Hughes Incorporated*, SEC Administrative Proceeding File No. 3-10572 (Sept. 12, 2001); *SEC v. Baker Hughes Incorporated and Roy Fearnley*, No. H-07-1408 (S.D. Tex. Apr. 26, 2007); *U.S. v. Titan Corporation* (Cr. No. 05-314), (S.D. Cal. 2005); *SEC v. Titan Corporation*, D.D.C. 2005 (05-CV-04111); *U.S. v. Textron Inc.*, matter resolved through nonprosecution agreement (August 2007); *SEC v. Textron, Inc.* (No. 07-CV-01505) (August 2007); *U.S. v. SSI Int'l Far East, Ltd.* (Cr. No. 06-398-KI) (D. Or. 2006); *In the Matter of Schnitzer Steel Indus., Inc.*, SEC Administrative Proceeding File No. 3-12456 (Oct. 16, 2006); *U.S. v. Viktor Kozeny, Frederic Bourke, Jr. and David Pinkerton* (Cr. No. 05-518) (S.D.N.Y. October 2005); *U.S. v. Hans Bodmer* (Cr. No. 03-947) (S.D.N.Y., August 2003); *U.S. v. Omega Advisors, Inc.*, matter resolved through nonprosecution agreement (June 2007); *U.S. v. Clayton Lewis* (Cr. No. 03-930) (S.D.N.Y., July 2003); *U.S. v. Thomas Farrell* (Cr. No. 03-290) (S.D.N.Y., March 2003).

⁶¹*U.S. v. Titan Corporation* (Cr. No. 05-314), (S.D. Cal. 2005); *SEC v. Titan Corporation*, D.D.C. 2005 (05-CV-04111).

⁶²*U.S. v. InVision Technologies, Inc.*, matter resolved through nonprosecution agreement (February 2005); *SEC v. David M. Pillor* (Case No. 1:06-C-4906) (N.D. Cal. 2006); *SEC v. GE InVision, Inc.* (3:05-CV-00660) (N.D. Cal. 2005);

⁶³*U.S. v. Monsanto Company*, matter resolved through nonprosecution agreement (January 2005); *SEC v. Charles Michael Martin* (No. 07-cv-00434) (D.D.C. 2007); *SEC v. Monsanto Company* (05-cv-14) (D.D.C. 2005).

employee.⁶⁴ For these purposes, the agent or contractor hired by the company is treated merely as a conduit for the improper payment, made by the company to the foreign official. A payment directly made by the company into the general treasury of a foreign country of which the beneficiary is a foreign official is treated in the same manner.⁶⁵

The impropriety of payments made by a company to foreign political parties will depend on the relationship of the party to the foreign government. The governmental structure of each country will have to be examined to determine whether a payment to the party or a party official is, in effect, a payment to a foreign official. For example, in a one-party totalitarian country the party and the government may be identical. However, in a multiparty democracy this might not be true.⁶⁶

The impropriety of payments made by a company to foreign government-owned or partly government-owned businesses will depend on whether these businesses are agencies or instrumentalities of the foreign government.⁶⁷ There are no precise and controlling standards to determine when an entity is to be treated as an instrumentality of a foreign government. It is well known that many foreign governments engage in enterprises that would be carried on by private interests in the United States. The forms of participation by these foreign governments vary significantly from entity to entity and from government to government. The applicability of section 162(c)(1) to businesses in which a foreign government has a proprietary interest will be tested best in a case-by-case approach.⁶⁸

For the disallowance of a deduction under section 162(c)(1), no conviction under the FCPA is necessary — the relevant criteria is whether the improper payment violates the FCPA.⁶⁹ The IRS, however, has the burden of proving fraud under section 7454 by showing that the company knew its return was false when it made it and intended to evade paying the proper tax by making a false return. The fraud, whether as to deficiencies or for additions to tax (that is, fraud penalties), must be proven by clear and convincing evidence. A mere preponderance of the evidence will not suffice. Because this is a lesser

⁶⁴Treas. reg. section 1.162-18(a)(2).

⁶⁵"Illegal Bribes, Kickbacks and Other Payments," Dec. 22, 1976, General Counsel Memorandum, Internal Revenue Service GCM 36962, 1976 WL 39199 (IRS GCM).

⁶⁶*Id.*

⁶⁷Treas. reg. section 1.162-18(a)(3)(iii); LTR 8435004.

⁶⁸GCM, *supra* note 65.

⁶⁹15 U.S.C. sections 78 dd-1, et seq. reg. section 1.162-18(a)(1)(ii), which makes reference to 1.162-18(a)(4).

burden than proving guilt beyond a reasonable doubt, which must be established in a criminal case,⁷⁰ a company may be found not guilty in a criminal bribery case and still lose the deduction if the IRS is able to meet the lesser burden in the tax case.⁷¹

C. Financing Improper Payments Through Slush Funds

A company makes improper payments to foreign officials to obtain an economic benefit that will boost the company's earnings and profits, which in turn will enhance top management's incentive pay. For these purposes, the company typically uses slush funds to finance these improper payments. A slush fund can exist at the parent company or can be created when funds are secretly transferred from parent to the foreign subsidiary in the form of capital contributions, cross-border asset transfers, various artificial tax reduction motivated intercompany financings, or corporate restructuring transactions; the form of ownership of assets from parent to foreign subsidiary may change, but a significant continuity of the economic substance of the ownership of the slush funds remains. These slush funds may be hidden in foreign bank accounts⁷² and may not be reported as income by the company for both financial and tax purposes, which can cast doubt on the integrity and reliability of the corporate books and records. The IRS may use section 482's transfer pricing rules to redress these intercompany slush fund financings with the effect of disallowing some deductions claimed by the parent company under section 162(c)(1).

D. Improper Payments by Foreign Subs

A company may fund an improper payment through its foreign subsidiaries within a foreign country. In such cases, the applicability of section 162(c)(1) to the improper payment will depend on whether the foreign subsidiary qualifies as a fully

owned foreign subsidiary, a controlled foreign corporation, or a less than 50 percent controlled entity.

1. 100 Percent Owned Foreign Sub

If the improper payment is made by the company's 100 percent owned foreign subsidiary corporation formed to comply with foreign law that has a section 1504(d) election in effect, the foreign subsidiary is treated as a domestic corporation, is included in a company's consolidated return, and is subjected to subtitle A of the code; therefore, any improper payments may be disallowed under section 162(c)(1).

2. More Than 50 Percent Owned CFC Sub

If a company's foreign subsidiary qualifies as a CFC⁷³ in determining the CFC's taxable income for subpart F purposes, Treas. reg. section 1.952-2(b)(1) provides that, in general, the computation is to be made as if the CFC were a domestic corporation taxable under section 11 and to which the principles of section 63 applies. This would result in the disallowance of the improper payment as a deduction or an increase in a deficit in the CFC's earnings and profit computations under section 964(a). Section 952(a)(4) subjects U.S. shareholders of a CFC to current U.S. income taxation as a deemed dividend an amount equal to the amount of any improper payment paid directly or indirectly to a foreign official by or on behalf of a CFC during the tax year. Special rules may apply to CFCs that operate in a boycott⁷⁴ or sanctioned⁷⁵ countries. (See Table 1.)

3. DISC

If a company's domestic international sales corporation (DISC) makes an improper payment directly or indirectly to a foreign official, such a payment is made on the DISC's behalf, and the amount of the payment is a deemed dividend distribution to the DISC's shareholders. The legality of payments made to foreign government officials, employees, or agents in fact is determined under the FCPA.⁷⁶ For these purposes an improper payment is made by the DISC when it is made by any officer, director, employee,

⁷⁰*Lashells, R.W. Est v. Com.* (1953, CA6), 44 AFTR 827, 208 F.2d 430, 54-1 USTC para. 9102.

⁷¹*East New York Sanitary Bagel Bakery Inc.*, (1957) T.C. Memo. 1957-144, PH TCM para. 57144, 16 CCH TCM 624; *Miller-Pocahontas Coal Co* (1931), 21 BTA 1360.

⁷²31 CFR section 103.24 31; CFR section 103.24 — a company that has a financial interest in or signature or other authority over bank accounts, securities accounts, or other financial accounts in foreign countries must make a report on these accounts for each calendar year during any part of which the aggregate value of the accounts exceeded \$10,000. The failure to report the existence of a foreign bank account may subject the company to civil fraud penalties. See *Shokai, Alexander Inc v. Com.* (1994, CA9), 74 AFTR 2d 94-6150, 34 F.3d 1480, 94-2 USTC para. 50460, *aff'g* (1992) T.C. Memo. 1992-41, PH TCM para. 92041, 63 CCH TCM 1870.

⁷³For a full discussion of the CFC rules, see *Federal Tax Coordinator*, 2d, RIA, Vol. 19, O (part 1), paras. O-2300 through O-2959.4.

⁷⁴IRC section 999(c)(2); for a list of boycott countries, see 72 *Fed. Reg.* 39895, July 20, 2007; 72 *Fed. Reg.* 15934, Apr. 3, 2007; 72 *Fed. Reg.* 843, Jan. 8, 2007; for further discussion of tax sanctions applicable to boycott operations, see *Federal Tax Coordinator*, 2d, RIA, Vol. 19, O (part 1), Deck O-3500.

⁷⁵IRC section 901(j) — a CFC operating in a sanctioned country is denied foreign tax credit (or deduction) for taxes paid because that foreign country doesn't have diplomatic relations with the U.S., or supports terrorism, etc.; for a list of sanctioned countries, see Rev. Rul. 2005-3, IRB 334.

⁷⁶IRC section 995(b)(1)(F)(iii); IRC section 162(c).

shareholder, or agent of the DISC for the DISC's benefit under principles of section 162(c).⁷⁷

4. Less Than 50 Percent Owned Foreign Sub

If the company's foreign subsidiary is not a CFC, it may nevertheless have effectively connected income (ECI) with a U.S. business within the meaning of section 882. In that case, the foreign subsidiary would compute its deductions under section 882(c)(1)(A). Also, a foreign corporation may have three categories of income, or loss, or their economic equivalents, which may be treated as ECI with the conduct of a U.S. trade or business under section 864(c)(4)(A), which includes interest and dividend equivalents received by the foreign corporation in the active conduct of a U.S. banking, financing, or similar business, or a corporation whose principal business is trading in stocks or securities for its own account and certain income from inventory sales and its equivalents that are attributable to a U.S. sales office.⁷⁸ In these instances, if the improper payment to the extent it is ECI with a U.S. business is claimed as a deduction by the foreign subsidiary, such a deduction could be disallowed under section 162(c)(1).

Identifying slush funds and improper payments in a company's books and records can be challenging because these transactions may be mischaracterized.

If the company's foreign subsidiary qualifies as a passive foreign investment company,⁷⁹ under prop. reg. 1.1291-2(e)(1) the PFIC's nonexcess distributions to its U.S. shareholders is taxed under the general rules applicable to corporate distributions under subtitle A of the code.⁸⁰ Therefore, any deductions made for improper payments in arriving at the PFIC's nonexcess distribution could be disallowed under section 162(c)(1).

A company's foreign subsidiary alternatively could be treated as a "conduit" for the improper payments made to the foreign official for the benefit of the parent company because a parent corporation is allowed to deduct payments made on behalf of its subsidiary when the parent has an independent

business reason for making the expenditure.⁸¹ The IRS may redistribute or reallocate income, deductions, credits, or allowances between or among two or more affiliated organizations when it determines that the internal transactions are not on an arm's-length basis, and the reallocation more clearly reflects income or prevents the evasion of taxes through the section 482 transfer pricing rules. Such a related-party reallocation under section 482 could result in a constructive dividend for the parent⁸² or even subject the foreign subsidiary to taxation under the CFC rules when in the absence of arm's-length negotiations or board approval, aggregate U.S. shareholders of a foreign corporation own more than 50 percent of the total earnings and profit allocated to the blocks of stock held by all U.S. shareholders under a private benefits analysis that is used in valuing U.S. shareholders' claim to the earnings and profit of the foreign corporation.

Under the private benefits analysis, a premium is attributed to the valuation of U.S. shareholders' shares when the holder of the block of shares has the ability to arbitrarily shift income to the exclusion of other shareholders by receiving higher salaries, increased management fees, royalty payments, backdated stock options, commission income, and corporate profits; or to charge above-market transfer prices for their shares.⁸³ For these purposes, foreign corporations managed by U.S. directors who have equity interests in the company and who use corporate assets as their personal piggy banks by paying themselves large bonuses, especially in stock options, without board of directors approval, may be deemed to have an increased U.S. ownership interest in the foreign corporation to the level of it qualifying as a CFC.

E. Identifying Mischaracterized Payments and Slush Funds

Identifying slush funds and improper payments in a company's books and records can be challenging because these transactions, often with the help of an army of accountants, auditors, lawyers, compliance

⁸¹*Cal-Far Ins. Co. v. U.S.*, 647 F. Supp. 1083 (E.D. Cal. 1986); *Central Bank of the South v. U.S.*, 646 F. Supp. 639 (N.D. Ala. 1986).

⁸²*The Challenger, Inc. v. Comr.*, 458 F.2d 631 (9th Cir. 1972), *aff'd* T.C. Memo. 1970-74, 29 T.C.M. 318 (1970), *cert. denied sub nom. Graves v. Comr.*, 410 U.S. 928 (1973); *Framatome Connectors USA Inc*, 118 TC 32 (2002), *aff'd on other issue* (2004, CA6), 94 AFTR 2d 2004-5820; Rev. Rul. 69-630, 1969-2 CB 112.

⁸³*Framatome Connectors USA Inc*, 118 TC 32 (2002), *aff'd* (2004, CA6) 94 AFTR 2d 2004-5820.

⁷⁷Treas. reg. section 1.995-2(a)(6).

⁷⁸IRC section 864(c)(4)(B).

⁷⁹IRC sections 1291 through 1298. For further discussion of PFICs, see *Federal Tax Coordinator*, 2d, RIA, Vol. 19, O (part 1), Deck O-2200.

⁸⁰IRC section 301(a).

officers, and corporate general counsels,⁸⁴ may be mischaracterized in violation of the FCPA's record-keeping provisions,⁸⁵ which could cast doubt on the integrity and reliability of the company's books and records that serve as the starting point for the preparation of the corporate tax returns.

Improper payments may be mischaracterized as a rebate, a sales surcharge,⁸⁶ a kickback,⁸⁷ an expense reimbursement,⁸⁸ a reinsurance contract payment,⁸⁹ a rent,⁹⁰ a royalty,⁹¹ a commission,⁹² a services fee,⁹³

an honorarium,⁹⁴ a consultancy fee,⁹⁵ a referral fee,⁹⁶ an education expense payment,⁹⁷ a charitable contribution,⁹⁸ a suspect charge documented by a fake invoice,⁹⁹ a stock option,¹⁰⁰ or an investment in an investment fund.¹⁰¹

In such cases, it is the true nature of the payments, not their labels or bookkeeping entries, that will be determinative for tax deductibility.¹⁰² When evaluating a mischaracterized improper payment for purposes of disallowance under section 162(c)(1), the applicability of other tax provisions should also be considered.

1. Rebates/Surcharges/Kickbacks

A company may make improper payments in the form of rebates, sales surcharges, or kickbacks, which may be viewed either as deductions from gross income in arriving at taxable income or as exclusions from gross revenues offsetting gross income. When a deduction for improper payments could be disallowed under section 162(c)(1), the gross income of the taxpayer should be determined without subtraction of such payments¹⁰³ since no business expense deduction is permitted for improper payments that are illegal under U.S. law.¹⁰⁴

⁸⁴Nanette Byrnes, Louis Lavelle, and Howard Gleckman, "The Corporate Tax Game: How blue-chip companies are paying less and less of the nation's tax bill," *BusinessWeek*, Mar. 31, 2003, p. 1; U.S. Senate Report prepared by Minority Staff of the Permanent Subcommittee of the Committee on Investigations of the Committee on Governmental Affairs, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals," Nov. 18 and 20, 2003, available at <http://levin.senate.gov/newsroom/supporting/2003/111803TaxShelterReport.pdf>; U.S. Senate Report prepared by Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, "The Role of Professional Firms in the U.S. Tax Shelter Industry," Apr. 13, 2005, available at <http://levin.senate.gov/newsroom/supporting/2003/111803TaxShelterReport.pdf>; http://www.quatloos.com/Tax_Shelter_Industry_Firms.pdf; Selva Ozelli, "The troublesome loans that brought down Refco's chief," *Accounting Today*, Nov. 28, 2005, p. 1.

⁸⁵Stuart H. Deming, "The Potent and Broad-Ranging Implications of the Accounting and Record-Keeping Provisions of the Foreign Corrupt Practices Act," *Journal of Criminal Law and Criminology*, Winter 2006, p. 1.

⁸⁶*U.S. v. Textron Inc.*, matter resolved through nonprosecution agreement (August 2007); *SEC v. Textron, Inc.* (No. 07-CV-01505) (August 2007).

⁸⁷*U.S. v. York International Corp.*, matter resolved through deferred prosecution agreement (October 2007); *SEC v. York International Corp.*, 07-cv-1750 (D.D.C. 2007).

⁸⁸Global Industries, Ltd., a Louisiana-based company that provides offshore construction, engineering, project management, and support services to the oil and gas industry, announced that it is conducting an internal investigation of its West African operations, focusing on the legality under the FCPA and local laws, of one of its subsidiary's reimbursement of certain expenses incurred by a customs agent in connection with shipments of materials and the temporary importation of its vessels into Nigeria. See <http://www.djacobsonlaw.com/2007/07/foreign-corrupt-practices-act-in-news.html>.

⁸⁹Richard Lloyd Parry, "Lloyd's Rejects Fraudulent North Korea Claim," *The Australian*, Jan. 27, 2007, p. 1; Jung Sung-ki, "N. Korea Faces Suspicion of Reinsurance Fraud," *Korea Times*, Dec. 6, 2006, p. 1.

⁹⁰U.S. Senate Permanent Subcommittee on Investigations, "Money Laundering and Foreign Corruption: Enforcement and Effectiveness of FCPA, Case Study Involving Riggs Bank," July 14, 2004, available at <http://hsgac.senate.gov/files/ACF5F8.pdf>.

⁹¹*Id.*

⁹²*U.S. v. Baker Hughes Services International, Inc.* (No. H-07-129) (S.D. Tex. April 2007).

⁹³See *supra* note 90.

⁹⁴*U.S. v. Micrus Corporation*, matter resolved through nonprosecution agreement (March 2005).

⁹⁵*U.S. v. Monsanto Company*, matter resolved through nonprosecution agreement (January 2005).

⁹⁶*U.S. v. Syncor Taiwan, Inc.* (Cr. No. 02-1244) (C.D. Cal., December 2002); *SEC v. Monty Fu* (No. 07-CV-01735) (Sept. 27, 2007); *SEC v. Syncor International Corporation* (Cr. No. 02-1244) (D.D.C. December 2002).

⁹⁷*U.S. v. Micrus Corporation*, matter resolved through nonprosecution agreement (March 2005).

⁹⁸*SEC v. Schering-Plough Corp.*, Case No. 1:04CV00945 (D.D.C. June 9, 2004); *In the Matter of Scheing-Plough Corp.*, Administrative Proceeding File No. 3-11517, Rel. No. 49838, June 9, 2004.

⁹⁹*SEC v. The Dow Chemical Company*, Civil Action No. 07CV00336, (D.D.C. February 2007); *U.S. v. Titan Corporation* (Cr. No. 05-314), (S.D. Cal. 2005); *SEC v. Titan Corporation*, D.D.C. 2005 (05-CV-04111).

¹⁰⁰*U.S. v. Micrus Corporation*, matter resolved through nonprosecution agreement (March 2005).

¹⁰¹Peter Maas, "A Touch of Crude: American Bankers Handled His Loot," *Mother Jones*, Jan. 1, 2005, p. 1; "Mills, politically-linked lawyer dragged into Italian scandal," *Agence France Presse English Wire*, Oct. 30, 2006; "Memo hints Jowell knew about 'bribe,'" *Sunday Times (U.K.)*, May 28, 2006, p. 1.

¹⁰²Foretravel, (1995) T.C. Memo. 1995-494, RIA T.C. Memo. para. 95494, 70 CCH TCM 1007.

¹⁰³Treas. reg. section 1.61-3(a).

¹⁰⁴Treas. reg. section 1.162-18(a); LTR 8435004.

2. FDAP Payments or Withholding Tax Avoidance Transactions

The case study involving Riggs Bank regarding the enforcement and effectiveness of the FCPA revealed companies made direct improper payments to foreign officials' secret bank accounts, which were mischaracterized as rent or royalty payments. U.S.-source rent or royalty payments are FDAP income subject to withholding under section 1441.¹⁰⁵ Section 1441 generally requires a withholding agent to withhold a tax of 30 percent from the gross amount of the U.S.-source FDAP payment, unless the tax is reduced or eliminated under a U.S. tax treaty. Therefore, when evaluating cross-border improper payments that may be paid directly by the parent or imputed to the parent for purposes of section 162(c)(1) excludability, these transactions should also be evaluated for the applicability of withholding tax rules.¹⁰⁶

While scrutinizing corporate records for FCPA violations, special attention should be placed on transactions that divert corporate funds that excessively benefit the executive.

Alternatively, a company may try to avoid the payment of withholding taxes on cross-border improper payments to a foreign official, or on cross-border slush fund transfers to a foreign subsidiary, by structuring it in the form of a notional principal contract (NPC), which is foreign sourced to the recipient, therefore escaping the withholding tax provisions, and is reported in a company's financial statement in footnote disclosure. When evaluating cross-border improper payments structured as NPCs for purposes of IRC section 162(c)(1) excludability, attention should be given to Notice 2002-35, which states that the IRS will challenge these transactions under Rev. Rul. 2002-30 and other grounds.

3. Reinsurance Contract Payments

A company, through an offshore insurance subsidiary, may issue a cross-border reinsurance contract payment to disguise an improper payment to a foreign official. When evaluating the improper payment structured as a reinsurance contract for purposes of section 162(c)(1) excludability, if the reinsurance contract is found not to cover any insurance risk (as many were discovered not to during former New York Attorney General Eliot Spitzer's reinsur-

ance company investigation, which shed light on widespread offshore reinsurance contract abuse¹⁰⁷), not only may the company lose the tax deduction, but the IRS indicated that the reinsurance arrangement could be ignored for tax purposes, subjecting the company's offshore insurance subsidiary to taxation under subchapter L as if it were a domestic corporation.¹⁰⁸

4. Stock Options

When a company makes an improper payment to a foreign official in the form of a nonstatutory stock option, the services-related transfer rules under section 83 apply and a company is allowed, as a deduction under section 162, the difference between the exercise price and trading price of the stock when the amount is included in the gross income of the recipient.¹⁰⁹ The delayed tax expensing of stock options, the open nature of the transaction, coupled with the fact that the recipient of the stock option may be located in another tax jurisdiction, may complicate the evaluation of improper payments for purposes of section 162(c)(1) excludability.

5. Bargain Sales

Other problems may arise when a company makes an improper payment to a foreign official in the form of a bargain sale of an asset for either less than its fair market value or at a loss.

For example, if the company owns stock with a basis of \$50 but a fair market value of \$100 and sells the stock to a foreign official at a bargain price of \$70, the company would be treated as receiving the full appreciated value of the securities in the sale and would have gross income of \$50 but would receive no corresponding section 162(c)(1) deduction for the bargain element of \$30 because the taxpayer's payment would constitute an improper payment.¹¹⁰ If the company sells the same stock to the

¹⁰⁷Judy Greenwald, "Finite reinsurance market survives, but in a diminished form: Probes of deals led to big settlements, exits by top executives," *Business Insurance*, Jan. 1, 2007; Sally Roberts, "Marsh unit faces conspiracy suit — Reinsurance business targeted in latest probe," *Business Insurance*, Oct. 15, 2007; Alistair Barr, "SEC files fraud case against 3 former RenRe execs: Company smoothed earnings using 'sham' reinsurance, regulator alleges," *MarketWatch*, Sept. 27, 2006; Rupal Parekh and Mark A. Hofmann, "Gen Re charges expanded — Prosecutors indict another former executive," *Business Insurance*, Sept. 25, 2006; Alistair Barr, "SEC probing GenRe finite deals with Pru, St. Paul — Former execs of Berkshire unit questioned by regulator, filing says," *MarketWatch*, Aug. 17, 2006.

¹⁰⁸Notice 2003-34, 2003-23 IRB 990.

¹⁰⁹IRC section 83(h).

¹¹⁰Rev. Rul. 69-181, 1969-1 C.B. 196. In this situation an employer transferred appreciated portfolio securities to an employee as compensation for services. The Service held that

(Footnote continued on next page.)

¹⁰⁵IRC section 1441(b).

¹⁰⁶Central de Gas de Chihuahua, SA (1994), 102 TC 515.

foreign official for \$35 and then claims a loss of \$15 on the transaction under section 165, the loss could be disallowed under a public policy argument by the IRS.¹¹¹

F. Diversion of Improper Payments for the Benefit of Top Management

Companies suspected of or charged with FCPA violations often lack good corporate governance. This can cast doubt on the integrity and reliability of the company's books and records, which may be manipulated by corporate executives in favor of showing higher earnings and profits and lower corporate taxes to boost the company's share price since they receive enormous performance-based bonuses in the form of incentive stock options (ISO) or nonstatutory stock options (NSO), which grants them the right to buy company shares in the future at the price on the day the option was issued.¹¹²

While corporate scandals of Enron, Tyco, Global Crossing, Refco, and Hollinger have demonstrated how far accounting manipulations by executives and illegal tax sheltering of executive compensation can go,¹¹³ the ongoing stock option backdating scandal has shown how executives manipulate stock option grant dates in favor of lower ones to boost the profits they may get when the option is exercised.¹¹⁴ This

the employer was in receipt of taxable income equal to the excess of the fair market value of the securities transferred over their adjusted basis in the employer's hands at the time of the transfer. *See also International Freightling Corp. Inc. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943), and *Tasty Baking Company v. United States*, 393 F.2d 992 (Ct. Cl. 1968).

¹¹¹*See, e.g., Ing, Richard v. U.S. et al.* (1993, DC HI), 73 AFTR 2d 94-592, 94-1 USTC para. 50031, *aff'd* (1995, CA9), 77 AFTR 2d 96-625, 73 F.3d 369; Lincoln, James D. (1985) T.C. Memo. 1985-300, PH T.C. Memo. para. 85300, 50 CCH TCM 185.

¹¹²Siobhan Hughes, "Cheney Testified to SEC," *Dow Jones*, Oct. 3, 2007.

¹¹³Paul Taylor, "Global Investing: Millionaire shelters no longer a gimme," *Financial Times U.K.*, July 3, 2003; Paul Taylor, "Global Investing: IRS red flag mars havens' blue skies," *Financial Times U.K.*, Apr. 24, 2003.

¹¹⁴Paul Taylor, "Global Investing: The battle heats up over stock options," *Financial Times U.K.*, June 12, 2003; Ross Kerber, "Backdating Cases Called Tough to Pursue," *Boston Globe*, Oct. 23, 2007.

could result in tax problems for the company and its executives since the exercise price for the stock option must be no less than the fair market value of the stock when the option is issued for the executive not to be taxed on the receipt or the exercise of ISOs or NSOs.¹¹⁵

Thus, while scrutinizing corporate records for FCPA violations, special attention should be placed on transactions that divert corporate funds that excessively benefit the executive since it might result in charges of both corporate and personal tax evasion.¹¹⁶ Executives might be deemed to receive a constructive dividend under IRC section 316 not only for diverted corporate funds but also for deductions made by the company for director and officer insurance policies that do not cover FCPA violations.

III. Conclusion

As the FCPA celebrates its popularity among investigative bodies around the globe that are probing companies for the endemic corporate practice of improper payments made to foreign officials, especially in poorer countries where the public sector dominates the economy, the consequences of such practices should also be evaluated for U.S. tax evasion purposes for the company and their executives.¹¹⁷ ♦

(See table on next page)

¹¹⁵IRC section 422(b)(4); Treas. reg. section 1.422-2(a)(2)(iv).

¹¹⁶*See, e.g., U.S. v. Schenck*, 126 F.2d 702 (2d Cir. 1942), *cert. denied*, 316 U.S. 705 (1942); *James v. U.S.*, 366 U.S. 213 (1961).

¹¹⁷Transparency International (TI) recently released its 2007 Corruption Perception Index (CPI), *available at* <http://www.transparency.org/content/download/23972/358236>; Sylvia Westall, "Multinationals fuel graft in poor states," *Reuters*, Sept. 26, 2007; "Bribery at Dar port highest in EAC — Study," *Daily News*, Oct. 17, 2007.

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Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
Angola						Baker Hughes; Global Industries Ltd.; GlobalSantaFe; ABB
Anguilla			X			
Antigua		X	X			
Armenia	X					
Argentina			X	X		Thales; BJ Services Company
Aruba		X				Oil-for-Food
Australia	X/SEP		X	X		Oil-for-Food; the Australian Wheat Board; AWB; Woodside Petroleum
Austria	X		X	X		BAE Systems
Azerbaijan	X					Omega Advisors
Bahamas		X	X			
Bangladesh	X					Textron
Barbuda		X	X			
Barbados	X	X	X			
Belarus	X				S	
Belize			X			
Belgium	X			X		
Benin						Titan Corp
Bermuda		X				Tyco; Nabors (also stock option backdating); Ingersoll-Rand
Bolivia						Wilbros; Enron; Bolivia-Brazil Pipeline; Bolivian State Oil Company
Brazil			X	X		Gtech Holdings; McDonalds; Tidewater, Inc; Cisco (tax evasion)
British Virgin Islands		X	X			
Bulgaria				X		
Burma					S	
Cameroon						GlobalSantaFe; Igate Incorporated
Canada	X/SEP		X	X		Petro-Canada
Cayman Islands		X	X			
Chile				X		BAE; RDM

Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
China	X					Tyco, McKinsey; Fidelity National Financial, Inc. et al; UTStarcom; Schnitzer Steel Industries; York International Corp.; Paradigm BV; InVision Technologies, Inc.; IBM; Cisco; NCR; Hitachi; Diagnostic Products Corporation; BearingPoint Inc.; Oil-for-Food
Columbia			X			Chiquita Brands International
Congo					S	Global Industries, Ltd.
Costa Rica						Alcatel-Lucent
Cuba					B/S	Weatherford International
Cyprus	X		X			Nafta Petroleum Company; Mednafta Trading Company Ltd.; Serenco, SA
Czech Republic	X		X	X		BAE Systems
Denmark	X			X		Oil-for-Food; Novo Nordisk A/S
Dominica		X	X			
Dominican Republic		X				AES
Ecuador						Wilbros Group
Equatorial Guinea						Consumers Energy Co.; Exxon Mobil Corporation; Marathon Oil Corporation; Amerada Hess Corporation; Chevron Texaco Corporation; Devon Energy Corporation; Vanco Energy Co.; Triton; Igate Inc.
Estonia	X		X	X		
European Union			X			
Egypt	X		X			Textron
Finland	X		X	X		TeliaSonera AB
France	X/SEP		X	X		Technip/Halliburton; Total SA
Gabon						GlobalSantaFe
Georgia	X					
Germany	X/SEP		X	X		Bristol Meyers, DaimlerChrysler, Thyssen; Ferrostaal; U.N. Oil-for-Food Program; GlaxoSmithKline; Philips; Micros Corp.; Siemens AG
Ghana						Igate Incorporated
Greece	X		X	X		Siemens; Chiquita Brands International
Grenada		X	X			

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Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
Guernsey		X				Baker Hughes; Thales
Guyana		X				
Haiti						America Rice Inc.
Honduras		X				
Hong Kong SAR			X			
Hungary	X		X	X		Siemens; Magyar Telecom
Iceland	X			X		
India	X		X			Xerox; Oil-for-Food; Dow Chemicals; UTStarcom; York International Corp.; AT Kearney
Indonesia	X					Freeport; Monsanto; Textron; Baker Hughes; Paradigm BV
Ireland	X		X	X		Ingersoll-Rand
Iran					B/S	Total SA; Statoil SA; Ford Motor Co.; Weatherford International
Iraq					B/S	International Corp; Textron; El Paso Corp. (Coastal Corporation); Halliburton; Tyco; Wyeth; Baker Hughes; DaimlerChrysler AG; Novo Nordisk; Innospec Inc; Flowserve Corp.; ABB Ltd.; Siemens AG; Total SA; Beckman Coulter Inc.; Immunotech, SAS; Midway Trading; Bay Oil; Nafta Petroleum Company; Mednafta Trading Company Ltd., Serenco, SA; Bulf Oil
Isle of Man		X				Baker Hughes
Israel	X		X			
Italy	X/SEP		X	X		Immucor, Inc.; United Defense Industries, Inc. (UDI); Enelpower/Siemens; ABB; Dimon Inc.; Ingersoll-Rand; GlaxoSmithKline; Pfizer; Novartis; AstraZeneca; Recordati; Universal Corporation; Deltafina SPA; Oil-for-Food
Ivory Coast					S	
Jamaica	X	X	X			
Japan	X/SEP		X	X		
Jersey		X				
Jordan						Oil-for-Food

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Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
Kazakhstan	X					Baker Hughes; Panalpina; ABB; Paradigm BV
Korea	X/SEP		X	X	B/S (North)	Schnitzer Steel Industries
Kuwait					B	
Kyrgyzstan	X					
Latvia	X		X			
Lesotho						Acres International Limited; Lahmeyer International GmbH; Impregilo
Liberia					S	
Libya					B	
Liechtenstein			X			Siemens; Oil-for-Food
Lithuania	X		X			
Lebanon					B	
Luxembourg	X		X	X		
Malaysia						Oil-for-Food
Mexico	X/SEP		X	X		Tidewater Inc.; Paradigm BV
Moldavia	X					
Mongolia						UTStarcom
Montserrat			X			
Morocco	X		X			
Namibia						Sasol; National Liquid Fuels
Netherlands	X		X	X		Philips
Netherlands Antilles		X				
New Zealand	X			X		
Nigeria						Halliburton/KBR (also tax evasion); Noble Corp; Baker Hughes; Vetco International; Tidewater; Nabor; Panalpina; Transocean; Cameron International Corp; GlobalSantaFe Corp; Noble Corp.; Willbros Group Inc.; Global Industries Ltd; York International Corp.; ABB; Bristow Group Inc.; Paradigm BV; ITXC Corp.; Igate Incorporated
Norway	X/SEP			X		Siemens
Pakistan	X					
Panama			X			Oil-for-Food

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Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
Philippines	X/SEP		X			CNF Inc./Con-Way Inc.; InVision Technologies, Inc.
Poland	X		X	X		Eli Lilly & Co.; Schering Plough Corporation
Portugal	X			X		
Principe						Igate Incorporated
Qatar					B	
Romania	X		X			BAE Systems
Russian Federation	X		X			Baker Hughes; Metromedia International Group, Inc.; Oil-for-Food
Rwanda						ITXC Corp.
Saint Kitts & Nevis			X			
Saint Lucia		X	X			
Saint Vincent & the Grenadines			X			
Sao Tome						Igate Incorporated
Saudi Arabia					B	Panalpina, BAE Systems; Accenture Ltd; Lucent Technologies, Inc.; Healthsouth
Senegal						ITXC Corp.
Slovak Republic	X			X		
Slovenia	X			X		
South Africa	X		X	X		Oil-for-Food; BAE Systems; Thyssen; Ferrostaal; Thales
Spain	X		X	X		Micros Corp.; Oil-for-Food; Pacific Consolidated Industries LP
Sri Lanka	X					
Sudan					B/S	Ford Motor Co.; Weatherford International
Sweden	X/SEP		X	X		Oil-for-Food; BAE Systems; ABB, Ltd.; TeliaSonera AB
Switzerland	X		X	X		BAE, Siemens, Baker Hughes; Halliburton; Alcor Chemie Vertriebs GmbH; Oil-for-Food
Syria					B/S	Ford Motor Co.; Weatherford International; Oil-for-Food
Taiwan						Fidelity National Financial Corp.; Syncor International Corp.
Tajikistan	X					

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Country	Tax Treaty and SEP	TIEA	MLAT	OECD Convention	Sanctioned/Boycott Countries	FCPA Investigation
Tanzania						BAE Systems
Thailand	X		X			Menlo Worldwide Forwarding Limited; InVision Technologies, Inc.
Tobago		X	X			
Trinidad	X	X	X			
Turkey	X		X	X		Delta & Pine; Micros Corp.; Oil-for-Food
Turkmenistan	X					German Banks
Turks & Caicos Island			X			
Ukraine	X					
U.S.S.R.	X					
United Arab Emirates					B	Textron; York International Corp.; Oil-for-Food
United Kingdom	X/SEP		X	X		BAE; Oil-for-Food
Uruguay			X			
Uzbekistan	X					Baker Hughes
Venezuela	X		X			Chemoil Corporation; Westport Petroleum, Inc.; Glencore International AG; Oil States International, Inc.
Vietnam					B	Oil-for-Food
Yemen					B	
Zimbabwe					S	

Sources: <http://www.sec.gov>; <http://www.doj.gov>; <http://usinfo.state.gov/ei/archive/2004/jul/19-959526.html>; <http://www.fincen.gov.riggsassessment3.pdf>; <http://www.iic-offp.org/documents.htm>; *Securities Law Daily*; *New York Times*; Reuters; Bloomberg.com; *The Wall Street Journal*; Dow Jones; Market Watch; *The Atlanta Journal-Constitution*; *Houston Chronicle*; *The Guardian*; company press releases; *Businessweek*; *Fortune*; *LA Times*; *Mercury News*; *Journal of Criminal Law and Criminology*; <http://www.iol.co.za>; *International Herald Tribune*; and *Defense Daily*.