Adding Insult to Injury: Tax Consequences of FCPA Violations

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This article explores federal tax fraud charges that may result from investigations into alleged violations of the Foreign Corrupt Practices Act (FCPA). The authors explain how both civil and criminal tax charges are a logical outgrowth of FCPA enforcement actions, examine why those charges have not been more prevalent, and warn companies engaged in international business transactions of the monetary consequences that could result from the inclusion of tax charges in future FCPA enforcement actions.

The views set forth in this article are the personal views of the authors and do not necessarily reflect the opinions of Jones Day, its clients, or any other organization with which the authors are associated.

In the past five years, the Justice Department's Fraud Section has intensified its enforcement of the Foreign Corrupt Practices Act (FCPA), resulting in the imposition of approximately $1.3 billion in criminal penalties in 2010 alone.[1] FCPA enforcement actions have brought other serious charges with them, including mail and wire fraud, money laundering, and RICO violations. Tax fraud charges appear to be another logical outgrowth of FCPA violations, as section 162(c) specifically prohibits the deduction of payments that run afoul of the act.[2] Nevertheless, criminal tax charges (and corresponding hefty fines[3]) have been notably absent from most FCPA-related indictments.

This article explores criminal and civil tax consequences that could result from FCPA violations. Part A discusses the FCPA, the recent enforcement boom, and the accompanying charges triggered by FCPA investigations. Part B explains how tax consequences flow from FCPA violations and examines FCPA enforcement actions, particularly the recent conviction on FCPA and related tax charges in *United States v. Green*, on appeal before the Ninth Circuit.[4] Finally, Part C identifies likely reasons criminal tax charges have not been more prevalent in FCPA enforcement actions before explaining why tax consequences should remain a concern for companies engaged in international business transactions.

A. Overview of the FCPA and Related Laws

In 1977 Congress enacted the FCPA in the wake of investigations prompted by the Watergate scandal that uncovered illegal or questionable payments to foreign government officials and political entities in excess of $300 million.[5] For years, the FCPA was lightly enforced. Enforcement actions have spiked over the past decade, however. In 2010 a combined 31 enforcement actions were initiated by the DOJ, compared with just five in 2004.[6] In 2010 alone, those two agencies, the SEC and the DOJ, imposed a total of approximately $1.8 billion in criminal fines and civil disgorgement related to FCPA violations.[7]

The FCPA prohibits U.S. citizens and corporations from bribing foreign officials (anti-bribery provisions) and requires publicly traded companies to account for all financial dealings, including those that may violate the FCPA (accounting provisions).[8] Specifically, the anti-bribery provisions prohibit all domestic concerns and issuers of securities registered in the United States from paying, or offering or promising to pay, money or anything of value to

[1]R. Christopher Cook et al., "Trends in FCPA and Anti-Corruption Enforcement," Practical Law Co. (2011), *available at* http://us.practicallaw.com/4-504-9099.

[2]Section 162(c)(2).

[3]Penalties for felony tax crimes can include up to five years in jail, plus fines up to $500,000 ($100,000 for individuals) and the costs of prosecution for each separate tax crime. Sections 7201 and 7206; Suneel J. Nelson and Rollo C. Banker, "Tax Violations," 46 *Am. Crim. L. Rev.* 1099, 1136-1138 (2009).

[4]*United States v. Green*, No. 08-59(B)-GW (C.D. Cal. Aug. 12, 2010).

[5]DOJ, "Lay-Person's Guide to FCPA," *available at* http://www.justice.gov/criminal/fraud/fcpa/docs/lay-persons-guide.pdf.

[6]*See* http://www.justice.gov/criminal/fraud/fcpa/cases/2010.html (as of Mar. 11, 2011).

[7]Cook et al., *supra* note 1, at 2.

[8]Cook and Stephanie L. Connor, "The Foreign Corrupt Practices Act: An Overview," Jones Day (Jan. 2010), *available at* http://jonesday.com/foreign_corrupt_practices_act_overview/.

a foreign official to obtain or retain business.[9] The accounting provisions require all companies listed on a U.S. exchange to ''make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions'' of their assets.[10] In other words, it is an independent FCPA violation for a publicly traded company to record illegal payments as commissions or consultant fees on its books.

FCPA enforcement authorities often couple FCPA charges with alleged violations of other federal statutes.[11] Federal money laundering statutes list felony FCPA violations as predicate offenses.[12] In its ''Lay-Person's Guide to FCPA,'' the DOJ cautions that conduct violating the anti-bribery provisions also may run afoul of the mail and wire fraud statutes and the Travel Act.[13] The guide also specifies that conduct violating the anti-bribery provisions may give rise to a private cause of action under RICO.[14] The DOJ does not, however, discuss another source of potential liability: criminal and civil tax fraud charges.

B. FCPA as a Predicate for Criminal Tax Charges

1. Improper deductions of payments that violate the FCPA. The code permits taxpayers to deduct from income ''all ordinary and necessary expenses incurred in the operation of a trade or business.''[15] The code, however, specifically prohibits taxpayers from deducting direct or indirect payments made to any official or employee of any foreign government agency that would violate the FCPA.[16] Despite the code's seemingly blanket prohibition, criminal tax charges have been filed only in a handful of FCPA enforcement actions.[17]

In August 2010 the U.S. District Court for the Central District of California sentenced movie producer Patricia Green to 19 concurrent six-month sentences for FCPA violations, money laundering, and criminal tax fraud.[18] On SASO Entertainment Co.'s 2004 income tax return, Green claimed $303,074 in sales ''commissions'' deductible from SASO's gross income that were actually bribes paid to the governor of the Tourism Authority of Thailand.[19] Green and her husband, Gerald, made those payments to obtain $14 million in contracts to manage and operate the Bangkok International Film Festival. Patricia also was charged with filing a false federal income tax return for 2004 while purporting to be the president of Film Festival Management.[20] That year, Patricia falsely reported $140,503 of those improper payments as deductible commissions. A jury convicted Patricia on both tax counts and on FCPA charges filed against both her and Gerald.[21] The Greens appealed their convictions to the Ninth Circuit; briefs are due later this month.[22]

In 2005, before the DOJ stepped up its FCPA enforcement efforts, Titan Corp. pleaded guilty to FCPA charges and one felony count of aiding and assisting in the filing of a false tax return in violation of section 7206(2). Titan, a company specializing in supplying communication products and services to intelligence agencies, falsely claimed more than $2 million in bribes paid to the president of the Republic of Benin as deductible business expenses in its 2002 federal income tax return.[23] In total, Titan paid $13 million in criminal fines and $15.4 million in disgorgement and prejudgment interest in a related civil suit filed by the SEC under the FCPA.[24] Denise Rubin, the IRS Criminal Investigation division special agent who headed the tax investigation, used the Titan plea to reinforce the notion that ''tax laws apply to all entities,'' saying the investigation underscored CI's commitment to combat corporate fraud.[25]

In an early attempt at filing tax fraud charges contemporaneously with FCPA charges, the DOJ filed three tax fraud counts as part of a 19-count indictment against Richard H. Liebo in connection with alleged bribes to Niger government officials in an effort to obtain military supply contracts. In 1991

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[9]15 U.S.C. section 78dd-1(a), 78dd-2(a), and 78dd-3(a).

[10]15 U.S.C. section 78m.

[11]*See, e.g.*, Information, *United States v. Innospec Inc.*, No. 1:10-CR-00061 (D.D.C. Mar. 17, 2010) (alleging conspiracy, wire fraud, and FCPA violations); Indictment, *United States v. Tillery*, No. H-08-022 (S.D. Tex. Jan. 17, 2008) (indicting on FCPA, conspiracy, and money laundering conspiracy); Indictment, *United States v. Jefferson*, No. 1:07-CR-209 (E.D. Va. June 4, 2007) (indicting on charges of FCPA violations, wire fraud, money laundering, obstruction of justice, RICO, and conspiracy, among other charges).

[12]18 U.S.C. section 1956(c)(7)(B)(iv).

[13]''Lay-Person's Guide,'' *supra* note 5, at 1.

[14]*Id.*

[15]Section 162(a).

[16]*Id.*

[17]Potential criminal tax charges include violations of sections 7201 (attempt to evade or defeat tax), 7206(1) and (2) (fraud and false statements), 7207 (fraudulent returns), and 7212 (attempt to interfere with administration of tax laws). *See* sections 7201, 7206(1) and (2), 7207, and 7212.

[18]DOJ release (Sept. 14, 2009), *available at* http://www.justice.gov/opa/pr/2009/September/09-crm-952.html.

[19]Second Superseding Indictment at para. 31, *United States v. Green*, No. 08-59(B)-GW (C.D. Cal. Mar. 11, 2009).

[20]*Id.*

[21]Judgment as to Patricia Green, No. 08-59(B)-GW (2010).

[22]*See United States v. Green*, No. 10-50524 (9th Cir.); *United States v. Green*, No. 10-50495 (9th Cir.).

[23]Plea Agreement, *United States v. Titan Corp.*, No. 05-CF-314-BEN (S.D. Cal. Mar. 1, 2005).

[24]DOJ release (Mar. 1, 2005), *Doc 2005-4209*, *2005 TNT 40-27*.

[25]*Id.*

a jury eventually convicted Liebo of violating the anti-bribery provisions for purchasing airline tickets for a Niger official and his fiancée but acquitted him on all three tax fraud counts.[26]

2. Concealing kickbacks received in connection with FCPA violations. While the tax charges in *Green*, *Titan Corp.*, and *Liebo* involved taxpayers taking improper deductions for FCPA prohibited payments labeled as ''business expenses,'' the DOJ also has filed contemporaneous criminal tax charges in FCPA actions that resulted from the taxpayers' failure to disclose improper payments received or interests in foreign bank accounts used to effectuate those payments.

In the past decade, individuals in two unrelated actions pleaded guilty to violating both the FCPA and the code in connection with concealing kickbacks received for their roles in securing foreign business. Most recently, Leo Winston Smith was charged with tax fraud in addition to violations of the anti-bribery provisions, conspiracy, and international money laundering.[27] The 2007 indictment claimed that Smith, as an executive at defense contractor Pacific Consolidated Industries (PCI), paid the project manager at the U.K. Ministry of Defense more than $71,350 and financed the purchase of a $275,000 Spanish villa. In return, the project manager awarded PCI more than $11 million in defense contracts. The tax charges stemmed from Smith's failure to report $500,000 in kickbacks he received for his role in facilitating the payments from PCI's account. Ultimately, Smith was sentenced to six months in prison and ordered to pay a $7,500 fine after pleading guilty to a two-count superseding indictment charging him with conspiracy to violate the FCPA and corruptly impeding the due administration of the tax laws.[28]

In 2003 ExxonMobil Corp. senior executive J. Bryan Williams was charged with filing false income tax returns and conspiracy to defraud the IRS by concealing more than $7 million in kickbacks received for assisting ExxonMobil in purchasing an interest in the Tengiz oil field.[29] Williams pleaded guilty to a two-count information charging him with evading taxes on the unreported income, held in Swiss bank accounts. He was sentenced to 46 months in prison and ordered to pay $3.5 million in restitution for tax evasion.[30] In a related case also initiated in 2003, James Giffen was charged with subscribing to false tax returns as part of a 64-count indictment relating to Giffen's alleged payment of $78 million to Kazakhstan officials in violation of the FCPA to obtain work in the Tengiz oil fields for his company, Mercator Corp.[31] In what was ultimately billed an unsuccessful prosecution, Giffen pleaded guilty in November 2010 to a single misdemeanor tax violation for failing to report his interest in an offshore account he held for the benefit of a Mercator senior executive who assisted Giffen in Mercator's dealings with the Kazakh government.[32]

C. Practical Tax Consequences

Given the explicit reference to the FCPA in section 162(c)(2), any FCPA prosecution seemingly carries with it the potential for tax law concerns. If a company is prosecuted for violating the anti-bribery provisions, it can expect that the tax treatment of the improper payment will be scrutinized. And the improper characterization of a bribe as a ''commission''[33] or ''consultant services'' fee[34] on a company's books in violation of the FCPA's accounting provisions seemingly could lead to a subsequent violation of section 162(c) if that fee has been deducted as an ordinary business expense.[35]

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[26]*United States v. Liebo*, 923 F.2d 1308 (8th Cir. 1991).

[27]Indictment, *United States v. Smith*, No. 08-CR-069-AG (C.D. Cal. Apr. 25, 2007).

[28]*See* Amended Judgment, *Smith*, No. 07-CR-069-AG (C.D. Cal. Dec. 2, 2010); Plea Agreement, *Smith*, No. 07-CR-069-AG (C.D. Cal. Aug. 28, 2009).

[29]Superseding Information, *United States v. Williams*, No. 03-CR-406-HB (S.D.N.Y. June 12, 2003).

[30]*See* DOJ release (Sept. 18, 2003), *available at* http://www.justice.gov/criminal/fraud/fcpa/cases/williamsjb/09-18-03williams-pressrelease.pdf.

[31]Second Superseding Indictment as to Giffen, *United States v. Giffen*, No. 03-CR-404-WHP (S.D.N.Y. Aug. 4, 2004); *see also Giffen*, 326 F. Supp.2d 497 (S.D.N.Y. 2004).

[32]Judgment as to Giffen, *Giffen*, No. 03-CR-404-WHP (S.D.N.Y. Nov. 23, 2010). Giffen's generous plea deal appears to be largely due to his role as a conduit for U.S. government communications to the Soviet Union during and after the Cold War. In sentencing Giffen to ''time served'' for his misdemeanor tax charge, U.S. District Judge William Pauley praised Giffen for his service to America during the Cold War and for his role in advancing U.S. interests in Kazakhstan while serving as an adviser to the Kazakh president after the fall of the Soviet Union. Throughout the seven-year prosecution, Giffen claimed classified documents would prove that the U.S. intelligence agencies sanctioned his payments to Kazakh leaders.

[33]*E.g.*, Information at paras. 27-28, *United States v. Baker Hughes Servs. Intl.*, No. H-07-129 (S.D. Tex. Apr. 11, 2007).

[34]*E.g.*, Deferred Prosecution Agreement at para. 8, *United States v. Monsanto Co.*, No. 05-CR-008-ESH (D.D.C. Jan. 6, 2005).

[35]The chances of a company improperly characterizing a deduction on its books and then later not claiming it as a deductible business expense appear slim. Suffice it to say, there are few, if any, advantages to mischaracterizing an improper payment on a company's books. Unlike when reporting profits for tax purposes, a company may deduct improper payments under U.S. generally accepted accounting principles when reporting worldwide profits. Because differences between book and tax treatment of business expenses may trigger suspicion, a

(Footnote continued on next page.)

Several factors, however, may help explain the lack of attendant tax charges in FCPA enforcement actions. First, courts apply a more exacting state of mind requirement for criminal tax violations than for FCPA violations.[36] Second, both the DOJ and the IRS impose strict controls and several additional layers of review in criminal tax cases, which do not otherwise apply in the prosecution of FCPA and other nontax violations. With the draconian penalties available for the nontax criminal violations,[37] prosecutors seldom need to further complicate their cases by adding tax counts.

That few criminal tax charges have been filed in connection with FCPA violations does not imply that deductions for improper payments are freely allowed. In addition to disallowing the deduction,[38] tax examiners may levy a civil tax penalty equal to 75 percent of the underpayment attributable to a taxpayer's fraudulent deduction of payments that violate the anti-bribery provisions.[39] According to the IRS's "Civil Fraud Handbook," civil penalties will be assessed when there is "clear and convincing evidence" that the taxpayer underpaid with intent to evade the assessment of the tax he believed was owed.[40] Because civil fraud charges carry a lower burden of proof than that required for successful FCPA prosecutions, a company or individual corporate officer may be acquitted of any FCPA charges and still lose the deduction and suffer a 75 percent civil tax penalty.

Further, the apparent resolution of FCPA charges may not necessarily put an end to a company's tax problems. In deference to the exclusive responsibility of the DOJ's Tax Division for criminal tax cases, the plea agreements, Non-Prosecution Agreements and Deferred Prosecution Agreements (DPAs) commonly used by the fraud section to settle criminal FCPA cases typically exclude "criminal tax violations" from the charges resolved by the agreement.[41] And in DPAs, the fraud section excludes proceedings relating to code violations when agreeing not to use any information gathered during the investigation of the FCPA charges.[42]

What all this should tell companies dealing with foreign officials is that although not frequently employed, federal tax charges can serve as another weapon at the government's disposal in its renewed FCPA enforcement efforts. Mischaracterizing payments made in violation of the FCPA has implications for the accuracy of computed taxable income, and the government appears more eager than ever to scrutinize tax returns when investigating FCPA violations. To reduce the likelihood of code violations, corporate counsel must remain alert in monitoring both book and tax accounting of all fees, commissions, rebates, discounts, and gifts given in connection with foreign business transactions. Finally, counsel should be aware during FCPA settlement negotiations that even after resolution of the FCPA claims, real tax issues may still exist that directly relate to the underlying FCPA violation.

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company likely would not mischaracterize an improper payment as an ordinary business expense on its books and then properly characterize that expense as nondeductible on its tax return.

[36]Culpability under the criminal tax laws "requires the Government to prove that the law imposed a duty on the defendant, that the defendant knew of that duty, and that he voluntarily and intentionally violated that duty." *Cheek v. United States*, 498 U.S. 192, 201 (1991) (also explaining that the government carries the burden of negating a defendant's claim that he was ignorant of or misunderstood the law). The government can prove an FCPA violation, however, without proving that the defendant knew of the specific statute he was violating. *United States v. Kay*, 513 F.3d 432, 446-448 (5th Cir. 2007).

[37]*See* 18 U.S.C. section 3571(d) providing for criminal fines up to "twice the gross gain" from the offense.

[38]The government bears the burden of proof on whether the payment is unlawful under the FCPA. Section 162(c)(1).

[39]Section 6663(b).

[40]Internal Revenue Manual, section 25.1.6, *available at* http://www.irs.gov/irm/part25/irm_25-001-006.html.

[41]*See, e.g.*, Non-Prosecution Agreement at 1, *In re Textron Inc.* (Aug. 21, 2007).

[42]*See, e.g.*, Deferred Prosecution Agreement at para. 7, *United States v. Daimler AG*, No. 10-CR-063-RJL (D.D.C. Mar. 24, 2010).