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TAX LITIGATION ISSUES

Expert Analysis

Will FCPA Investigations Lead to Tax Charges?

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On April 21, 2012, *The New York Times* published a widely read exposé regarding allegations that Wal-Mart violated the Foreign Corrupt Practices Act in connection with the extraordinary growth of its Wal-Mart de Mexico subsidiary.[1] The story, which combines one of the world's largest corporations and one of the government's leading law enforcement priorities, spread like wildfire.[2] Wal-Mart's stock price dropped 4.7 percent the first trading day after the story was published and a total of 5.5 percent for the week ending April 27. It appears all but certain that Wal-Mart will be facing years of government investigations and civil litigation brought by disgruntled shareholders.

Buried in the Times article was a reference to possible tax violations. Specifically, the article describes allegations that "Wal-Mart de Mexico…'purified' the bribes in accounting records as simple legal fees," that the company purportedly disregarded press reports "that Wal-Mart de Mexico was 'carrying out a tax fraud,'" and that it ultimately paid $34.3 million in back taxes. While FCPA violations are frequently investigated jointly by the Department of Justice, which has jurisdiction over criminal violations of the act, and the SEC, which commonly charges violations of the FCPA under the books and records provisions of the federal securities laws, the Times article raises the specter that companies making corrupt payments to foreign officials could be subject to inquiries by the Internal Revenue Service. Whether such a risk materializes depends in large part on the deductibility of the payments in question.

Tax Charges

The IRS is no stranger to domestic commercial bribery investigations. For many years, prosecutors have charged companies and businessmen with tax violations arising out of payments to their customers' purchasing agents.[3] These investigations commonly give rise to two charges under the federal tax laws.

Where the government can establish that a company improperly deducted payments, and that but for the improper deduction additional taxes would have been due and owing, the defendant can be charged with tax evasion in violation of 26 U.S.C. §7201. However, even if the payments were properly deductible, because companies that pay bribes or kickbacks commonly conceal the illicit nature of such payments on their tax returns, defendants can still be charged with filing false returns in violation of 26 U.S.C. §7206(1) (or aiding in the corporation's filing of false returns in violation of 26 U.S.C. §7206(2)).[4] Thus, the key issue in determining whether an entity paying bribes engaged in tax evasion is whether the payment is deductible under the Internal Revenue Code.

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When Deductible?

Under 26 U.S.C. §162(a), a taxpayer can deduct "ordinary and necessary expenses paid…in carrying on any trade or business." However, §162(c)(2) provides that, even when a payment qualifies as an ordinary and necessary business expense, "[n]o deduction shall be allowed…for any payment…made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced)…." Thus, courts have permitted corporations to deduct payments made to obtain business if the taxpayer can demonstrate that the payments were "ordinary and necessary" and the government is unable to prove by clear and convincing evidence that they were illegal.[5]

For example, in *Brizell v. Commissioner*,[6] the taxpayers owned 90 percent of an S-Corporation engaged in the printing business. In order to get business, the corporation made payments to purchasing agents employed by its clients. These payments were mischaracterized on the corporation's federal income tax returns as "purchases" and deducted from its taxable income. The corporation and its owners were charged with conspiracy and violations of §§7206(1) and (2); the corporation pled guilty to the conspiracy count and the individual defendants pled guilty to preparing materially false corporate tax returns.

After the criminal case, the IRS sought to disallow the corporation's deduction of the payments made to the purchasing agents. The Tax Court rejected this position and upheld the deduction. First, the court found that the corporation had met its burden of showing that the payments were "ordinary" by presenting evidence that such payments were common in the printing industry, and that they were "necessary" by demonstrating that the payments helped the corporation maintain a substantial portion of its business.

The court turned to §162(c)(2) and found that the IRS had failed to prove that the payments were illegal by clear and convincing evidence. Specifically, the court rejected the IRS's argument that the payments constituted commercial bribery under New York law, finding that the purchasing agents had "extorted" the payments by suggesting that the failure to make them would result in material harm to its business.[7]

As *Brizell* makes clear, not all payments made in order to obtain a commercial advantage will qualify as a nondeductible illegal bribe or kickback under §162(c)(2). Significantly, courts have found that defendants who make payments due to either extortion or economic duress may not have the corrupt intent necessary to support a criminal conviction. In *United States v. Barash*, 365 F.2d 395, 401-02 (2d Cir. 1966), a CPA/attorney was charged with making unlawful payments to revenue agents in connection with audits of his clients. At trial, the defendant argued that one of the revenue agents had coerced the payments with threats of economic harm. While rejecting this defense with respect to counts charging unlawful gratuities, the Court of Appeals held that the purported threats

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were relevant to the bribery counts. "The intent to influence accompanying the corrupt giving or accepting of something of value, is an essential element of the offense of bribery…[therefore] if a government officer threatens serious economic loss unless paid for giving a citizen his due, the latter is entitled to have the jury consider this, not as a complete defense like duress, but as bearing on the specific intent required for the commission of bribery."[8]

Thus, read together, *Barash* and *Brizell* stand for the proposition that a taxpayer can deduct otherwise illicit payments, where (a) he can establish that such payments are ordinary and necessary in the industry in which he operates, and (b) the government cannot establish that the payments were illegal because the taxpayer made them due to threats of economic harm.

Application to Payments

Under §162(a), the first step in assessing the deductibility of payments made to foreign officials is an assessment of whether the payment constitutes an ordinary and necessary business expense: whether it is common in the industry and enabled the taxpayer to maintain or increase its business. While this is a fact-intensive inquiry, it is easy to envision industries and countries in which payments to government officials meet this standard.

Assuming the corporate taxpayer can establish these prongs, §162(c)(1) precludes the deduction of "any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the [FCPA]." As with §162(c)(2), the IRS bears the burden of proving by clear and convincing evidence that the payments in question violate the FCPA.

Thus, as with domestic payments, the key issue on deductibility of payments to foreign officials is whether they fall outside the purview of the FCPA. For example, because the FCPA excludes "facilitating payments" made to influence the timing of a routine government action, such payments should be deductible so long as the corporation making them can establish that they were ordinary and necessary. However, unlike *Brizell* and *Barash*, the viability of an economic coercion defense is problematic under the FCPA.

In *United States v. Kozeny*,[9] defendant Frederic Bourke Jr. was alleged to have violated the FCPA by making payments to officials of the Republic of Azerbaijan in connection with the privatization of its state oil company. Relying on a provision of the FCPA that offers an affirmative defense for payments that are lawful under foreign law, Bourke sought to have the jury charged that, under Azeri law, a person who pays a bribe is "relieved from criminal responsibility" if the recipient extorted the bribe. U.S. District Judge Shira A. Scheindlin rejected this argument noting that "[a]n individual may be prosecuted under the FCPA for a payment that violates foreign law even if the individual is relieved of criminal responsibility for his actions by a provision of foreign law."

While Judge Scheindlin went on to hold that Bourke could still argue that "he cannot be guilty of violating the FCPA by making a payment to an official who extorted the payment because he lacked the requisite corrupt intent to make a bribe," she made clear that "while the FCPA would apply to a situation in which a 'payment [is] demanded on the part of a government official as a price for gaining entry into a market or to obtain a contract,' it would not apply to one in which payment is made to an official 'to keep an oil rig from being dynamited,' an example of 'true extortion.'" The court explained that while the bribe payer facing economic extortion "could have turned his back and walked away," that option was unavailable in cases of "true extortion."

> Not all payments made in order to obtain a commercial advantage will qualify as a nondeductible illegal bribe or kickback under §162(c)(2). Significantly, courts have found that defendants who make payments due to either extortion or economic duress may not have the corrupt intent necessary to support a criminal conviction.

The SEC appears to have adopted the same view of the availability of economic duress as a defense in FCPA cases. In *SEC v. Summers*, the complaint included an allegation that Joe Summers' employer had provided valuable services to the Venezuelan company, PDVSA, but was having difficulty collecting the balance due. The SEC further alleged that a PDVSA employee had demanded $30,000 in order to release the funds due," and that Summers had authorized the payment.[10] Despite its apparent acknowledgment that Summers had only paid the money to get a payment to which his employer was entitled, the SEC nonetheless alleged that the payment violated the FCPA.

By contrast, in *United States v. Kay*, the trial court "defined extortion as 'obtaining money or something of value from another person by intimidation, *threats of serious economic loss to a person or a business*, or withholding official action until the official's demands are met.'"[11] In its instructions, the court told the jury that "threats of 'serious economic harm' could be considered in determining whether the defendants acted with corrupt intent." Thus, the court in *Kay* appears to have left open the possibility that economic duress can qualify as a defense to an alleged violation of the FCPA.

Conclusion

The FCPA is likely to continue to be a major enforcement priority of the Department of Justice for many years to come. Practitioners representing companies under investigation for violations of the FCPA should carefully consider both the potential defenses to the allegations and the possibility that the payments taint the corporation's tax returns as well as its books and records.

To the extent economic duress is not a defense to an FCPA violation, or to the extent the defendant is unable to establish the defense, the payment is likely non-deductible, even if it would otherwise qualify as an ordinary and necessary business expense under §162(a). However, where the company is able to avoid criminal charges, counsel should carefully consider whether the company is entitled to deduct the payments in question.

1. David Barstow, "Wal-Mart Hushed Up a Vast Mexican Bribery Case," *N.Y. TIMES*, April 21, 2012, http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?_r=1&emc=na.
2. See e.g. Stephen Gandel, "Not Just Wal-Mart: Dozens of U.S. Companies Face Bribery Suspicions," CNNMoney, April 26, 2012, http://finance.fortune.cnn.com/2012/04/26/walmart-bribery-investigations/.
3. See, e.g., *United States v. Shyres*, 898 F.2d 647, 650-51 (8th Cir. 1989); *United States v. Khemelnitsky*, 2002 WL 461590, **1-2 (S.D.N.Y. March 25, 2002); *United States v. DiGirolamo*, 808 F.Supp. 1445, 1447-48 (N.D. Cal. 1992).
4. If, as is commonly the case, the recipient of the payments fails to report them as income, he or she will separately be subject to tax evasion charges.
5. Under §162(c)(2), the IRS bears "[t]he burden of proof in respect of the issue…as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment…to the same extent as he bears the burden of proof under section 7454." Under Section 7454, the IRS's burden in establishing the fraud penalty is by clear and convincing evidence. See, e.g., *Douge v. Commissioner*, 899 F.2d 164, 167 (2d Cir. 1990).
6. 93 T.C. 151 (1989).
7. See also *United States v. Hawryluk*, 658 F.Supp. 112, (E.D. Pa. 1987) (recognizing the defense of extortion as a valid defense to three counts of tax evasion); *Bondy v. Commissioner*, 1991 WL 220532 (Tax Ct. 1991) (holding cash payments to buyers of textile goods at the end of the year were deductible business expenses; "[t]he fact that employers may have a policy against their [buyers] accepting gifts from manufacturers' representatives does not render the payments nondeductible" where the IRS did not argue that the payments violated a generally enforced state law). Compare *Zecchini v. Commissioner*, 1992 WL 812 (Tax Ct. 1992) (finding kickbacks to employees of a stock loan department were not deductible, even though they were ordinary and necessary, because the payments were not the result of extortion).
8. See also *United States v. Alfisi*, 308 F.3d 144, 151 (2d Cir. 2002) (rejecting an argument that the term "corruptly" in the bribery statute requires evidence that the defendant intended "to procure a violation of the public official's duty," and holding that the danger that "marginally culpable conduct by those facing extortionists will be criminalized…is eliminated or at least minimalized…by the existence of the economic coercion defense"). *Accord United States v. West*, 746 F.Supp.2d 932, 936 (N.D. Ill. 2010) ("defendant could not claim economic duress when he had no right to the contracts that he secured through bribery, nor any right to be protected from competition. The payment of bribes to secure a discretionary act can be contrasted against compliance with an extortionist's demand under a threat to deprive the victim of something to which he has a legal right, like an existing contract").
9. 582 F.Supp.2d 535 (S.D.N.Y. 2008).
10. See Complaint at ¶¶2, 18, *SEC v. Summers*, No. 4:10-cv-02786 (S.D. Tex. Aug. 5, 2010) http://www.sec.gov/litigation/complaints/2010/comp21617.pdf.
11. Philip Urofsky, "Extortionate Demands Under the Foreign Corrupt Practices Act," 26 White Collar Crime Rep., Vol. 3, No. 26 (Dec. 19, 2008) quoting *United States v. Kay*, No.: 4:01-cr-00914 (S.D. Tex.), at 23-24 (emphasis added).

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