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More Sticky Strands in the FCPA Web: Tax Rules and Financial Reporting May Drive Disclosure

GEORGE CLARKE AND LINA BRAUDE*

Abstract

With dramatic increases in enforcement of the U.S. Foreign Corrupt Practices Act (FCPA), consideration of whether to voluntarily disclose discovered violations of the FCPA takes on vital importance. That consideration always must take into account whether the information about questionable conduct may become public or fall into the hands of U.S. authorities by other means; however, the interrelationship between the FCPA, U.S. tax laws, and recently promulgated U.S. financial reporting rules affects that disclosure calculus in several easily (and often) overlooked ways. Failure to address these facets of disclosure can leave a company decidedly worse off: with a paper trail establishing that it knew of prior violations, quantified those violations, documented those violations, and yet chose not to disclose those violations to the authorities when it had the chance.

In recent years, the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have dramatically increased the enforcement of the U.S. Foreign Corrupt Practices Act (FCPA). Although the FCPA itself does not require disclosure of violations of its provisions, U.S. securities laws bear heavily on the decision as to whether a disclosure is required or warranted. The introduction of the Sarbanes-Oxley Act, with its series of heightened disclosure requirements and new obligations and corresponding liabilities for senior corporate executives, the board of directors, and legal and accounting advisors, also has increased the number of voluntary self-disclosures of matters related to compliance with the FCPA. In addition, the DOJ and the SEC favor and claim to reward voluntary disclosure of FCPA violations even in situations where such disclosure is not legally required.

In this climate of increasing self-disclosure, companies are faced with tough decisions regarding whether or not to self-disclose. One of the factors to consider is whether the information about questionable conduct may become public or fall into the hands of the U.S. authorities by other means. This article focuses on a specific, often overlooked, in-

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terrelationship of the FCPA with longstanding U.S. tax laws and recently promulgated U.S. financial reporting rules and their effect on disclosure considerations.

I. The FCPA and the Tax Code

The FCPA prohibits U.S. companies and individuals, and non-U.S. companies who trade their shares on U.S. stock exchanges, from corruptly providing anything of value to a foreign government official, to a political party or official thereof, or to a candidate for public office in order to obtain or retain business or gain any improper advantage.[1] Under the FCPA, a foreign official is any officer or employee of any department, agency, or instrumentality of a foreign government, any person acting on behalf of a foreign government, or any official of a public international organization.[2] The FCPA definition of foreign officials is considered to include not only executive branch employees and elected officials, such as judges and parliament members, but also employees of state-owned or controlled entities, even if such employees have purely commercial or managerial functions. Under this definition, the FCPA has been applied to government enterprises such as a Saudi government owned-airline,[3] a quasi-commercial company wholly-owned and supervised by the Saudi government,[4] and other state-owned enterprises.[5] The DOJ has also treated directors of state-owned enterprises as foreign officials.[6]

The FCPA defines "issuers" as public companies with shares traded on the U.S. market; such companies are also subject to the "accounting provisions" of the FCPA. The accounting provisions of the FCPA require issuers to maintain accurate books and records and maintain adequate internal controls, which generally require issuers to keep track of their assets properly and to be able to report financial information accurately and completely.

Penalties under the FCPA are substantial. The FCPA criminal provisions subject firms to fines of up to $2 million per count, and subject individuals to fines of up to $100,000 per violation and imprisonment for up to five years.[7] Each payment can be considered a separate offense, even if multiple payments are made in connection with one transaction. Civil penalties are also substantial and include fines of up to $10,000 per violation against any firm, or any officer, director, employee, agent, or stockholder acting on behalf of the firm.[8] In addition, in an SEC enforcement action, the court may impose an additional fine not to exceed the greater of (1) the gross amount of the pecuniary gain to the defendant as a result of the violation, or (2) a specified dollar limitation ranging from $5,000 to $100,000 for an individual and $50,000 to $500,000 for any legal entity.[9] The largest FCPA fine as of June 2008, $44 million, was imposed on Baker Hughes in April 2007; $11 million was paid in criminal fines, $10 million in civil fines, and $23 million in disgorge-

1. Foreign Corrupt Practices Act, 15 U.S.C. § 78dd (2008).
2. 15 U.S.C. § 78m(f)(1) (2008).
3. FCPA Release 80-04 (Oct. 29, 1980).
4. FCPA Release 93-01 (Apr. 20, 1993).
5. FCPA Release 96-02 (Nov. 1996).
6. FCPA Release 94-01 (May 13, 1994).
7. 15 U.S.C. § 78m(e)(1)-(2) (2008).
8. *Id.*
9. 15 U.S.C. § 78u (2008).

ment of profits.[10] Other consequences for a violation include negative publicity, debarment from public procurement, as well as other sanctions.

The Tax Code[11] specifically references unlawful payments under the FCPA and mandates that such payments, to the extent such unlawful payments are made by a U.S. person, shall be both nondeductible for U.S. income tax purposes[12] and for purposes of computing the earnings and profits of foreign corporations controlled by U.S. interests.[13] The Tax Code further penalizes the making of any such payments by U.S. controlled foreign corporations by providing that any payments made by such corporations shall give rise to taxable income for U.S. purposes equal to the amount of such payments.[14] These nondeductibility and income inclusion provisions apply only to payments that are unlawful under the FCPA and not to payments that might be otherwise unlawful under various other provisions of U.S. law.[15]

When a U.S. organization discovers that it, or one of its affiliates, has engaged in a pattern of behavior that may violate the FCPA, it is obligated to investigate to determine the facts, assess potential liability, and undertake appropriate remediation measures. If the matter is not public, the most significant question after the conclusion of an internal investigation is whether or not to disclose.

The purpose of this article is to outline how the tax aspects of an unlawful payment under the FCPA, including the connections between the tax reporting for that item and the company's financial reporting, affect the decision to disclose.

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10. Press Release, SEC, SEC Charges Baker Hughes with Foreign Bribery and with Violating 2001 Commission Cease-and-Desist Order (Apr. 26, 2007), *available at* http://www.sec.gov/news/press/2007/2007-77.htm.

11. All references to the Tax Code or to various sections thereof are to the Internal Revenue Code of 1986, as amended (United States Code Title 26). All references to Treasury Regulations are to the regulations promulgated under the authority of the Tax Code.

12. I.R.C. § 162(c)(1) (2008).

13. I.R.C. § 964(a) (2008) (applicable to so-called "controlled foreign corporations," essentially those with majority U.S. shareholders). See § 957 for a definition of "controlled foreign corporation."

14. *See* I.R.C. § 952(a)(4); 15 U.S.C. § 78m(b)(2) (2008). It also appears relatively clear that the Tax Code nondeductibility and income inclusion provisions only apply to the anti-bribery provisions of the FCPA and do not apply to the accounting provisions of the FCPA. Although the later provisions would apply to a lawful or unlawful payment (like any other accounting item for a company), the triggering of the accounting provisions of the FCPA does not result in either the payment itself being "an illegal bribe or kickback" or the payment itself being "unlawful under" the FCPA as required for the Tax Code provisions to apply. Even if there is a violation of books and record or internal controls, the payment itself is not the source of the violation; the books and records and the internal controls are the source of the violation. Thus, a violation of the accounting provisions of the FCPA should not give rise to an unlawful payment for purposes of sections 162(c)(1), 952(a)(4), or 964(a). *See* 1995 FSA LEXIS 461; *see also* discussion *infra* note 15, appearing to contemplate only the anti-bribery provisions as triggering the Tax Code provisions mentioned.

15. For examples of other tax nondeductibility provisions, *see, e.g.*, 15 U.S.C. §§ 162(c)(2)-(3) (2008) (barring deductions for various other illegal payments). The Internal Revenue Service (IRS) has itself concluded (albeit in a non-precedential ruling) that it is "virtually certain" that § 952(a)(4) and § 964(a) only apply to payments that are unlawful under the FCPA's anti-bribery provisions. *See* I.R.S. Field Service Advice Memoranda, 1995 FSA Lexis 461 (Dec. 4, 1995).

II. Financial Reporting and Access By Financial Auditors

Assuming an organization has discovered unlawful payments under the FCPA and *remedies*[16] the discovered problem on a going forward basis, the organization can remedy tax concerns triggered by sections 162(c)(1), 952(a)(4), or 964(a) by filing amended tax returns for prior years that report the newly discovered problem. In general, there is no requirement under U.S. law to file an amended return or otherwise to adjust a non-fraudulently filed original tax return.[17] This reporting posture, assuming that the original returns were not fraudulently filed, eliminates most tax concerns. But in the case of large organizations subject to perpetual and never ending audit, the filing of such a return will likely be received by the organization's IRS examination team with a significant degree of interest. Although there are legitimate ways in which such amended returns might be couched to attract less interest from the IRS, many tax directors and most members of management or the organization's board may be uncomfortable filing amended tax returns with the IRS without making a disclosure to the SEC and DOJ.[18] In such a situation, where FCPA payments are discovered but a decision is made not to amend the return, recently promulgated financial reporting rules, add yet more sticky strands to the FCPA web.

A. Financial Accounting Standards Board Interpretation No. 48 ("FIN 48").

All U.S. organizations have two sets of books: tax and financial (a.k.a. generally accepted accounting principles (GAAP) or "book income" books). For purposes of its GAAP books, a company has to reconcile cash tax (real tax based on taxable income) to book tax (a theoretical tax rate applied to GAAP income);[19] the company must reserve for tax benefits claimed on the organization's tax returns that may not materialize on an eventual audit of those returns. It does not take much study to see that the workpapers through which such reconciliation and reservation process is implemented (such workpapers are typically referred to as "tax accrual workpapers") contain information of great interest to the typical IRS examining agent. Deductions taken from taxable income that are not taken from

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16. This article does not consider the alternative. The authors instead cite those curious (and brave) readers to the criminal tax fraud provisions of the Tax Code that are triggered by willful violations of its rules. *See* I.R.C. § 7201 (2008).

17. *See, e.g.*, P.H. Glatfelter Co. v. Lewis, 746 F. Supp. 511, 519 n.23 (D. Pa. 1990) ("There is no clear statutory, regulatory or judicial authority for the proposition that the taxpayer is under a legal obligation to file an amended return upon discovery of a mistake or error on a prior year's return") (quoting 15 Mertens, Law of Federal Income Taxation, § 56.65, Supp. at 6). Although there is no requirement to file amended returns under U.S. law, to the extent an organization files an amended return (whether to report the subject payments or for any other reason) or to the extent the organization makes any representations to the IRS as to the correctness of items on the prior year original returns, such as during an audit of that return, the company may have a duty to disclose errors on those returns and certainly does have a duty to refrain from making misleading statements as to the accuracy of such returns in relevant part. *See, e.g.*, 18 U.S.C. § 1001 (2008).

18. For situations in which an organization does choose to disclose such a matter to their IRS examination team but chooses not to disclose the matter to the SEC and DOJ, the authors direct the reader to the discussion, *infra* at section II.B, of the disclosure rules of the Tax Code which may limit the ability of the IRS to pass such information on to the SEC or DOJ.

19. This reconciliation process results in two kinds of tax assets (benefits) and liabilities (costs): current and deferred. In simple terms, current tax assets or liabilities are those that are recognized in the current financial reporting period, while deferred tax assets and liabilities are those that may be recognized in the future.

GAAP income, income included for GAAP purposes that is not included for tax purposes, and tax benefits taken on the returns but "reserved" out of concern that the IRS may be able to successfully disallow those benefits are the top of the list. Access to such information could result in a road map by which the IRS could navigate a company's tax weak spots.

In an attempt to cause organizations to better account for and better justify these reserves to their auditors, the Financial Accounting Standards Board, on July 13, 2006, promulgated FIN 48. FIN 48 is an interpretation of Financial Accounting Standard (FAS) 109, Accounting for Income Taxes and became applicable to reporting companies for the first quarter of 2007.[20] In essence, FIN 48 defines the criteria that an individual tax position[21] must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. As a part of this essential purpose that applies to all tax positions (whether U.S. or foreign), FIN 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

B. Technical and Practical Application of FIN 48

Under FIN 48, an organization has to analyze two components of each tax position: (1) "recognition" of the tax benefits associated with the position; and (2) "measurement" of those benefits. The test for recognition is the more-likely-than-not standard.[22] While this standard has long been applied by tax lawyers in advising their clients and is a well-known (and often well-disputed) term of art, in applying that standard for purposes of FIN 48, the organization has to assume two key facts: (1) that the tax position will be examined by the relevant taxing authority; and (2) that the taxing authority will have full knowledge of all relevant information.[23] While an organization needs only to disclose the total amount of unrecognized tax benefits, the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate, the total amounts of interest and penalties recognized in the statement of operations, and additional information for positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months of the reporting date, and need not disclose individual tax positions unless they are material, a detailed disclosure of the analysis must be prepared and is likely to be requested by the organization's financial auditors.[24]

Applying FIN 48 in the context of a prior unlawful payment under the FCPA, unless there are substantial doubts as to whether such a payment was actually made,[25] such a tax

20. Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, June 2006, effective for fiscal years beginning after December 15, 2006 [hereinafter FIN 48].

21. A tax position is defined for purposes of FIN 48 as "any position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods." FIN 48 para. 4 (2008).

22. FIN 48 para. 5-8 (2008).

23. FIN 48 para. 7 (2008).

24. FIN 48 para. 21 (2008).

25. Under each of the relevant Tax Code provisions, §§ 162(c)(1), 952(a)(4), and 964(a), the IRS has the burden of proving that a payment did violate the FCPA under the "clear and convincing evidence standard." *See, e.g.*, Carter v. Campbell, 264 F.2d 930, 936 (5th Cir. 1959); Laurins v. Commissioner, 889 F.2d 910, 913

position would likely be considered less likely than not to prevail under the assumption that if it were discovered, and the IRS had full information, the organization will lose the tax benefits associated with sections 162(c)(1) and 964(a) deductions and incur the cost of section 952(a)(4) income inclusion. Based on the practice that is developing by the accounting firms in administering FIN 48,[26] an organization will likely have to provide to its financial auditor a memorandum that sets forth, *inter alia*: (1) a description of the payments (albeit perhaps a brief one); (2) the entity or entities that made the payments; (3) the tax effect of the payments; (4) the tax years at issue; (5) the amount of reserve that is necessary to cover the potential tax loss of benefit and cost; and (6) the interest and any penalties associated with the underlying tax deficiency.

For example, suppose in year two, a company with revenues of $50 billion per year discovers that, in year one, one of its controlled subsidiaries paid bribes in Country A that equaled $10 million. If the company decides to amend Country A's returns to properly reflect the bribes under foreign law and to amend its U.S. return to reflect additional income of $10 million under sections 952(a)(4) and 964(a), as appropriate, then FIN 48 is not implicated. The amendment of these returns could cause foreign and U.S. tax audit inquiry and result in the disclosure of the bribes to the DOJ, SEC, or foreign authorities. But if, whether based on this concern or otherwise, the company decides not to amend these returns, the prior year tax positions (both foreign and U.S.) with respect to the bribes will be "items" for FIN 48 purposes. Although these items are likely not material enough to require separate stating on the company's 10-K ($10 million in bribes for a $50 billion in revenue company), the company's auditors will likely require the preparation of workpapers that set out the reason for the tax item (bribes under sections 952(a)(4) and 964(a)) and require basic information regarding those payments (amount, timing, etc.). If the IRS, or another governmental agency, ever summonses or subpoenas the company's tax workpapers, barring work product protection, those workpapers, the fact of the prior year bribes, and clear evidence that the company knew of those prior year bribes and chose not to disclose them at the time, will be discovered.

III. The Increased Potential for Broader Disclosure

Based on the foregoing, if an organization has a prior year FCPA payment, it will have an obligation to disclose that position to its auditors pursuant to FIN 48, and the practice thus far indicates that such disclosure will take a written form. The real question, there-

(9th Cir. 1989). This standard, the same as the civil fraud standard (*see* § 7454) creates the theoretical opportunity for a company to argue, for FIN 48 purposes, that there is no clear and convincing evidence of such a payment and thus that the FIN 48 test for recognition is met. *See* I.R.C. § 7454 (2008). Setting aside the practical concerns a company may have in finding a tax adviser sufficiently silver-tongued to convince its auditors of this nuance in the face of any significant evidence that payments were made, "making" the position only slightly better than more-likely-than-not will not prevent the organization from having to compile workpapers that contain this analysis and may well result in more potentially disclosable workpapers being prepared rather than less as the financial auditors and the organization's advisers battle back and forth over the correct treatment of the item.

26. Given that FIN 48 has not been under implementation for a full year yet, this "practice" is still varied and in flux. The description provided here represents the experience the authors and others with which they practice have compiled since FIN 48 implementation began at the beginning of this year. Nothing in these statements, or in this article, should be taken as accounting advice whether as to the proper implementation of FIN 48 or otherwise.

fore, is whether and to what extent such a disclosure to one's financial auditors may eventually lead to the disclosure of the information to a governmental agency. While there are several candidates that may seek access to such materials, direct SEC or DOJ access to such materials appears likely only when such an agency is already investigating a potential FCPA concern or other securities or criminal violation.[27] In such a context, the FIN 48 papers may be the least of the organization's concerns. But, given the "road map" nature of FIN 48 papers generally, and the general desire of the IRS to access such materials, initial IRS access to such papers is perhaps most likely.

To the extent the materials prepared by the organization and provided to the auditors are "tax accrual workpapers" as defined by the IRS, although the Supreme Court has previously held that such workpapers may be demanded by the IRS under its administrative summons power,[28] the IRS itself has in place a "policy of restraint" that results in such workpapers not being subject to demand by the IRS.[29] Under that policy, the IRS only requests tax accrual workpapers from a company if that company has engaged in a so-called "listed transaction" (basically, a transaction the IRS alleges is an abusive tax shelter) and then only requests the workpapers with respect to that single listed transaction unless the company has entered into more than one listed transaction in which latter case all workpapers are requested.[30] This policy notwithstanding, in addition to the policy being subject to the discretion of the IRS,[31] and currently subject to review in the context of FIN 48 specifically,[32] the IRS has previously indicated that it does not believe certain workpapers are covered by this policy.[33]

27. This is the best current guess of the authors in an area that is not particularly clear. What is clear is that both DOJ and the SEC have sufficient subpoena/summons authority to request FIN 48 workpapers should they have the desire to see those papers.

28. United States v. Arthur Young & Co., 465 U.S. 805 (1984) (affirming the enforcement of a summons for workpapers prepared by the financial auditor itself, not the organization, but not addressing the question of potential application of attorney-client privilege or the work product doctrine to defend against such enforcement).

29. I.R.S. Announcement 2002-63, 2002-2 C.B. 72 (July 8, 2002).

30. *Id.*

31. In reaching its holding in *Arthur Young*, the Supreme Court did note that "the IRS has demonstrated administrative sensitivity" to requests for workpapers and found such "sensitivity" a factor in determining that such requests for workpapers were not unfair. 465 U.S. 805 at 820-21. While this may indicate that the IRS does not have complete discretion to request all workpapers all the time, the IRS appears to have at least as broad of authority as it is currently using.

32. *See* Memorandum from Deborah Nolan, Comm. of Large & Midsize Bus. Div., FIN 48 and Tax Accrual Workpaper Policy Update (May 10, 2007), *available at* http://www.irs.gov/businesses/corporations/article/0,,id=171447,00.html (explaining that IRS "is evaluating its [policy of restraint] to ensure that it is still appropriate in today's environment.").

33. *See e.g.*, I.R.S. Notice CC-2007-015 (Jun. 20, 2007) (pronouncing the IRS view that tax rate reconciliation workpapers are not tax accrual workpapers for purposes of the policy); I.R.S Notice CC-2004-0105 2004 CCN LEXIS 2 (explaining that only audit workpapers "relating to the tax reserve for current, deferred and potential or contingent tax liabilities" are "tax accrual workpapers" for purposes of the policy of restraint); I.R.S. Notice CC-2008-008 (Jan. 31, 2008) (cancelling 2007-015 without comment). The IRS thus appears to have made (and then retracted) a distinction between workpapers that reconcile tax and GAAP income (not tax accrual workpapers under IRS theory) and workpapers that accrue for tax benefits that may not materialize on audit (tax accrual workpapers under the theory). Which category FIN 48 workpapers fall in under the (apparently still under consideration), IRS theory is not yet clear (although it seems they should be considered tax accrual workpapers even under the IRS theory).

A. How the IRS May Access FIN 48 Workpapers

As a general matter, the way the IRS gets documents from an organization that it is auditing is by the issuance of a so-called "Information Document Request" or "IDR." If the organization refuses to provide the materials, the IRS then may issue an administrative summons under section 7602 for the materials. Given the very broad summons authority possessed by the IRS,[34] its access to such materials is likely only impeded by a claim of attorney-client privilege or work product protection. But, to the extent the FIN 48 workpapers were provided to the financial auditors, the IRS would have a very strong argument that any otherwise existing privilege claims, perhaps associated with attorney advice in preparing the underlying FIN 48 exposure analysis, would be waived.[35]

Notwithstanding attorney-client privilege waiver, the work product doctrine may offer a degree of protection to an organization facing down an IRS summons for its FIN 48 workpapers containing FCPA tax items. Specifically, on August 29, 2007, the District Court for the District of Rhode Island issued its opinion in *United States v. Textron Inc.*[36] That case involved the interrelated questions of: (1) whether the tax accrual workpapers of Textron and one of its subsidiaries were protected by the attorney-client privilege or the work product doctrine; and (2) if so privileged or protected, whether the provision of such workpapers to Textron's external public auditor waived such privileges or protection.[37]

The *Textron* Court found that: (1) the tax accrual workpapers were prepared by lawyers and others involved in the defense of tax positions for Textron to which either the attorney-client privilege, section 7525, or the work product doctrine could apply; (2) the tax accrual workpapers contained opinion material and not pure factual material (the Court described the materials as final and draft issues lists with percentage and dollar exposure estimates as well as notes and memoranda reflecting counsel's views on same); and (3) Textron and its subsidiary had a well-founded belief in the likelihood of litigation with respect to the matters contained in the workpapers. Based on those findings, the Court held that the tax accrual workpapers were privileged and that the workpapers were prepared "because of" the prospect of litigation and thus met the requirement to be protected as work product under First Circuit precedent. Importantly, although the Court then

34. As courts have repeatedly held, "[t]he answer to the claim that the Government is engaged in a fishing expedition" when it exercises its summons authority "is without merit." United States v. Luther, 481 F.2d 429, 432 (9th Cir. 1973). The Tax Code authorizes the Secretary or his delegate "to fish." United States v. Giordano, 419 F.2d 564, 568 (8th Cir. 1969); *see also* United States v. Powell, 379 U.S. 48, 57-58 (1964) ("Reading the statutes as we do, the Commissioner need not meet any standard of probable cause to obtain enforcement of his summons . . . [rather, he must merely] show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed.").

35. In *Diversified Indus., Inc. v. The Honorable James H. Meredith*, 572 F.2d 596 (8th Cir. 1977), the Eighth Circuit, in dicta, indicated that it might allow the attorney-client privilege to continue to apply to legal memoranda and reports even after the disclosure of those materials to the SEC. Every other circuit court to have commented on the matter has rejected this position. *See, e.g.*, United States v. Mass. Inst. of Tech., 129 F.3d 681, 611 (1st Cir. 1997).

36. United States v. Textron, Inc. 507 F. Supp. 2d 138 (D. R.I. 2007)

37. Textron had engaged in multiple transactions which the IRS contended were tax shelters and thus was eligible to have all of its tax accrual workpapers summonsed notwithstanding the "policy of restraint." *Textron*, 507 F. Supp. 2d. at 142.

held that Textron waived the attorney-client privilege by providing the tax accrual workpapers to its financial auditor, consistent with a growing body of precedent,[38] the Court held that this disclosure did not breach work product protection because the role of, and confidentiality protections applicable to, the financial auditor did not make it any more likely that the company's adversary (the IRS) would lay its hands on the materials as a result of the disclosure.[39]

While future application of work product protections to FIN 48 workpapers will rise or fall on the underlying definition of work product and its application to the specific workpapers at issue,[40] an organization likely has a sound argument for work product protection of its tax accrual workpapers associated with reporting to its financial auditors unlawful payments under the FCPA, particularly under the "because of" test, given the high likelihood of litigation should the existence of such payments be discovered by an investigating agency.

B. Limitations on What the IRS Can Do With FIN 48 Workpapers

If the IRS does succeed in accessing an organization's FIN 48 workpapers, there are important restrictions on the ability of the IRS to share such information with other governmental agencies. As an initial matter, there is no procedure for automatic referral of FCPA or other criminal or non-tax matters from the IRS to the DOJ or the SEC. Secondly, section 6103(a) bars, with certain exceptions but with criminal penalties for wrongful disclosure,[41] the disclosure of returns and "return information"[42] by IRS agents and employees. The exception relevant in the case of IRS discovery of non-tax criminal violations, such as FCPA violations, is section 6103(i)(3)(A). Section 6103(i)(3)(A) allows the IRS to disclose return information "which may constitute evidence of a violation of any

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38. *In re* JDS Uniphase Corp. Sec. Litig., 2006 U.S. Dist. LEXIS 76169 (N. D. Cal. 2006) (work product protection not waived when protected board minutes were disclosed to the independent auditor); Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 237 F.R.D. 176 (N.D. Ill. 2006) (because an independent auditor does not have an adversarial relationship with the client, "[d]isclosing documents to an auditor does not substantially increase the opportunity for potential adversaries to obtain the information"); Frank Betz Assocs., Inc. v. Jim Walter Homes Inc., 226 F.R.D. 533, 535 (D.S.C. 2005) (disclosure to independent auditor of documents supporting reserve for copyright infringement litigation did not waive work product protection); Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc., 229 F.R.D. 441, 447 (S.D.N.Y. 2004) (even though an auditor "must maintain an independent role," disclosure to an auditor is not a waiver of work product privilege because there is no likelihood that the independent auditors were a conduit to an adversary . . . or that accounting rules would "mandate public disclosure" of the documents); Gutter v. E.I. DuPont de Nemours & Co., No.: 95-2152-Civ-GOLD, 1998 U.S. Dist. LEXIS 23207 at *9 (S.D. Fl. May 18, 1998) (work product privilege not waived by disclosure to auditor of letters estimating cost of litigation "since the accountants are not considered a conduit to a potential adversary" and "there is an expectation that confidentiality of such information will be maintained by the recipient"); *In re* Pfizer Inc. Sec. Litig., No. 90 Civ. 1260 (SS), 1993 U.S. Dist. LEXIS 18215 at *21 (S.D.N.Y. Dec. 22, 2003) (no waiver of work product privilege because auditor "not reasonably viewed as a conduit to a potential adversary").

39. *Textron* is on appeal to the First Circuit.

40. This will involve, but go beyond, whether the "primary purpose" or "because of" tests for work product protection are at play in the relevant jurisdiction. *Compare* United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998) (espousing the latter test) *with* United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982) (espousing the former, narrower, test).

41. I.R.C § 6103 (2008).

42. "Return information" essentially includes any information the IRS agent receives (from anyone), records, or prepares with respect to a tax return or the determination of a liability. *See* I.R.C. § 6103(b)(2).

Federal criminal law (not involving tax administration) to the extent necessary to apprise the head of the appropriate Federal agency charged with the responsibility of enforcing such law"[43] so long as the information is not taxpayer return information.[44]

In order to disclose the identity of the taxpayer under section 6103(i)(3)(A), the IRS needs only one item appropriate for disclosure, i.e., one item that is non-taxpayer return information, which may constitute evidence of such violation.[45] Not only does this information "indicate that nontax criminal violations may have occurred," provided that such information "sufficiently identif[ies]" the criminal act,[46] the IRS has promulgated guidelines taking the position that information "which has been secured from third parties or other sources as a result of leads that were identified from such taxpayer return information generally will not be classified as taxpayer return information" and thus will be subject to disclosure.[47] Accordingly, information received from third party summonses (unless the third parties are agents or employees of the taxpayer) or from the review of bank account or similar third party records of the taxpayer, even if that review was only instigated based on information received from the taxpayer, can form the basis for a disclosure under section 6103(i)(3)(A).[48]

As to the likelihood of such a disclosure taking place, although the IRS is known, largely perhaps due to section 6103, as an agency that does not "play well will others" particularly when only non-tax issues are at stake,[49] the IRS Disclosure Manual instructs IRS auditors that disclosable violations of non-tax criminal laws should be reported by memorandum through functional channels to appropriate disclosure personnel.[50] That said, in the "typical" FCPA unlawful payment situation, it may be likely that little, if any, non-taxpayer return information that sufficiently identifies the criminal act is accessible pursuant to IRS summons authority. If all such information is, for instance, in the hands of individuals or corporations over which U.S. courts have no jurisdiction, the IRS may have difficulty enforcing a summons for such materials (which it would need to do in order to have non-

43. I.R.C. § 6103(i)(3)(A)(i). *See also* United States v. President, 591 F. Supp. 1313, 1317 (N.D. Ill. 1984) (explaining, in a similar context, that "if the IRS suspected that [the taxpayer's] receipt of Department of Labor funds was fraudulent, 26 U.S.C. Sec. 6103(i)(3) authorizes it to notify the Department of Labor").

44. "Taxpayer return information" essentially includes return information that is provided to the IRS by the taxpayer. *See* § 6103(b)(3).

45. I.R.C. § 6103(i)(3)(A)(ii). The Internal Revenue Manual (I.R.M.) confirms the statutory text that taxpayer identity information cannot be disclosed to the investigating agency unless non-taxpayer return information is also disclosed. I.R.M. 11.3.28.8(7) (Mar. 31, 2003). In other words, the IRS must have at least some non-taxpayer return information in its possession in order to refer a taxpayer for such a potential violation.

46. I.R.M. 11.3.28.7(6) (Mar. 31, 2003).

47. I.R.M. 11.3.28.2(5) (Mar. 31, 2003).

48. *See, e.g.*, I.R.M. 11.3.28.2.2(6) and (12) (Mar. 31, 2003).

49. The blame for this relationship issue does not lie entirely with the IRS. Prior to its infamous meltdown, the IRS referred Enron to DOJ and the SEC for the investigation of potential FCPA violations. After it investigated why this referral did not materialize into such an investigation, the Senate Governmental Investigations Committee concluded that "[t]he U.S. agencies charged with enforcing non-tax criminal laws (the Department of Justice and the Securities and Exchange Commission) apparently failed to act on the non-tax criminal referral made by the Internal Revenue Service (IRS)," and that this failure to act may have resulting from [confusion about I.R.C. § 6103 and a lack of proper procedure]. STAFF OF S. COMM. ON FINANCE, 108TH CONG., REPORT OF STAFF INVESTIGATION OF ENRON CORP. AND RELATED ENTITIES REGARDING THE GUATEMALAN POWER PROJECT (Comm. Print 2003).

50. *See* I.R.M. 11.3.34.2 (May 25, 2005).

taxpayer return information to disclose the violation).[51] In the absence of its summons authority, the IRS would be required to pursue such third party documentation through the provisions in the applicable tax treaty between the United States and the country in which the individual or corporation resides or through the letters rogatory process. Neither of these information gathering means is particularly fast. Thus, although the IRS certainly can pursue such measures, and likely will if the taxpayer is uncooperative, faced with a fully disclosing taxpayer that is optimally cooperative, the average IRS examination team and their counsel may be unlikely to pursue such measures solely in order to gather third party (i.e., non-taxpayer) return information in order to allow a referral to take place.

C. PCAOB and its Potential Role in Disclosing the Content of FIN 48 Papers to the SEC

There is an additional rather obscure but potentially direct SEC avenue to get access to the information disclosed in FIN 48 papers. The Public Company Accounting Oversight Board (PCAOB), an entity created under the Sarbanes-Oxley Act of 2002, is responsible for inspecting registered audit and attest firms.[52] As part of this inspection process, the PCAOB reviews how audit firms audit their clients and publishes inspection reports. When the PCAOB identifies a possible departure from GAAP related to an issuer's financial statements, it is not supposed to publicly disclose that matter but instead to consider the issue and review it with the audit client.[53] If a change is not forthcoming, and if the PCAOB thinks it is material, it will report the change to the SEC.[54] It is unclear whether an FCPA or similar violation discovered by the PCAOB would be subject to the foregoing or a similar referral procedure. Provided that the FIN 48 procedures are followed with respect to such a violation, there is arguably no material misstatement of the issuer's financial statements, no GAAP departure, and thus no basis for PCAOB to disclose to the SEC. That said, there does not appear to be any legal bar on the PCAOB disclosing a potential criminal violation to the relevant authorities.

III. Conclusion

The web of compliance and disclosure provisions woven by Congress and the regulatory agencies seems to get larger and stickier every year. In the case of companies operating in developing countries, with developing legal and regulatory regimes, the opportunities for being caught up in the FCPA strands of that web are clear and present. Understanding the tax and financial reporting aspects of the consequences of the FCPA violations is essential to properly evaluating the risks and rewards of disclosing to the relevant authorities that, although they have managed to catch you in that web, they should let you go rather than bleed you dry.

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51. *See, e.g.*, *In re* Arawak Trust Co., 489 F. Supp. 162 (E.D.N.Y. 1980) (finding no jurisdiction to enforce a subpoena for records over a foreign corporation that merely maintained a United States bank account); *contra*. Marc Rich & Co. v United States, 707 F.2d 663 (2d Cir. 1983) (finding jurisdiction to enforce a subpoena where the acts took place outside of the United States but the harm took place inside the United States).

52. 15 U.S.C. § 7211(a) (2007).

53. PCAOB Release No. 104-2004-1 (Aug. 26, 2004) at 7.

54. *Id.*