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Antibribery Laws and the Tax Treatment of a CFC's Payments to Foreign Government Officials and Employees

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In the last several years, multinational companies have become the subject of increased scrutiny for violations of the Foreign Corrupt Practices Act (FCPA) in the U.S. and similar antibribery and anticorruption laws in foreign countries. This scrutiny places additional pressure on U.S. companies with operations abroad to ensure that they understand the U.S. taxation of payments that may become the focus of investigation. Companies failing to do so may be at increased risk for the potential application of civil and/or criminal penalties for tax evasion. This article focuses, in particular, on the tax treatment of illegal payments made to foreign government officials or employees by controlled foreign corporations.

Overview

Section 162(c) disallows deductions for certain payments that would otherwise be deductible under section 162(a) as ordinary and necessary business expenses. Among the payments covered by section 162(c) are those made to an official or employee of a foreign government that are unlawful under the FCPA, which bans many, but not all, payments made to a foreign government official or employee for the purpose of influencing that person's acts or decisions. For instance, certain payments for "facilitating" routine governmental action are allowed. For further discussion of the deductibility of such payments, see Charles Gnaedinger, *Facilitating Payments Are Deductible in U.S.*, 2008 TNT 27-3 (Feb. 8, 2008).

For improper payments made through a foreign subsidiary, the U.S. tax consequences will depend on the ownership form used. The U.S. tax consequences that result when a controlled foreign corporation (CFC) makes an illegal payment to a foreign government official or employee are discussed below. For further discussion regarding the U.S. tax consequences of improper payments made by less than 50 percent owned foreign subsidiaries, by certain wholly owned foreign subsidiaries, and by domestic international sales corporations (DISCs), see Selva Ozelli, *Is This Bribe Deductible? Tax Implications of the U.S. Foreign Corrupt Practices Act*, 48 Tax Notes Int'l 1131 (Dec. 17, 2007).

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Tax Treatment of CFC Payments

Any illegal bribe, kickback, or other payment to a foreign government official or employee made directly by or on behalf of a CFC constitutes subpart F income if the payment would be illegal under the FCPA if the CFC were a U.S. person. Section 952(a)(4); Treas. Reg. § 1.952-1(a)(4). No exceptions apply to this category of subpart F income, so the entire amount of the currency paid to, or the full fair market value of the property or services given to, the foreign government official or employee will be included in subpart F income. *Id*. Therefore, a U.S. shareholder of the CFC (*i.e.*, a U.S. person who owns 10 percent or more of the CFC) generally must include his pro rata share of the payment in his gross income for the taxable year. Section 951(a)(1)(A)(i). The U.S. shareholder will escape current taxation on the full amount of the CFC's illegal payment only if section 952(c), which provides that a CFC's subpart F income for a taxable year cannot exceed its current earnings and profits, applies.

To further discourage illegal payments of this kind, section 964(a) denies a reduction in earnings and profits for the illegal payment. Section 964(a) was enacted at the same time as Section 952(a)(4), in 1976. Before that time, illegal payments by CFCs reduced earnings and profits, even though they were not deductible. *See* Rev. Rul. 77-442, 1977-2 C.B. 264. A reduction in earnings and profits equal to the amount of the illegal payment would be consistent with the general approach to computing earnings and profits for dividend purposes, which is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions, and illegal payments made by domestic corporations and foreign corporations are generally considered to reduce earnings and profits. *Id*. Therefore, section 964(a) seems to be a purely punitive measure, with multiple negative effects for the U.S. shareholder. For instance, by preventing the reduction of earnings and profits, section 964(a) makes it less likely that section 952(c) will apply to limit subpart F income in the year of the illegal payment, so the illegal payment is more likely to be included in the current income of the U.S. shareholder. In addition, the denial of a reduction in earnings will reduce the amount of foreign tax credits that could otherwise be claimed by a U.S. shareholder with respect to subsequent actual or deemed distributions from the CFC or, potentially, from other foreign corporations. Sections 902(a), 960(a) (the denial of a reduction in earnings results in an increase in the denominator of the fraction set forth in section 902(a), and therefore a reduction in the size of the credit).

On the other hand, in general, income that is deemed distributed to a U.S. corporation as a subpart F inclusion may carry with it an indirect foreign tax credit for foreign taxes deemed paid by the U.S. corporation under sections 960(a) and 902(a). Although the payment of an illegal bribe by a CFC is the only situation in which an expense item, rather than income, triggers subpart F treatment, there is no indication in the Code or Treasury Regulations that the subpart F income in this category may not give rise to a deemed paid credit. This contrasts with the treatment of income attributable to a CFC's participation in an international boycott, which is included in subpart F income under section 954(a)(3), but for which foreign tax credits are specifically denied under section 908.

Allowance of a foreign tax credit with respect to subpart F income resulting from a CFC's illegal payments seems inconsistent with the punitive intent of sections 952(a)(4) and 964(a), and it is unclear whether it was the intent to allow such a credit. Nonetheless, it appears that an illegal payment by a CFC may result in the acceleration of the U.S. shareholder's foreign tax credits by giving rise to a deemed paid credit upon the deemed distribution of the subpart F income. Presumably, the illegal payment, although it is actually an expense item, would be considered general basket income for purposes of the section 904 limitation on foreign tax credits. Section 904(d)(3)(B); Treas. Reg. § 1.904-5(c)(1). In addition, to the extent the foreign country denies a deduction to the CFC for its illegal payment (an action supported by the OECD in its Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials, adopted on April 11, 1996, and accepted by full participants of the 1997 OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions), the foreign tax credit will be increased because the foreign taxes will increase.

Conclusion

Given the increasing focus on activities that may fall within the category of bribery or corruption, both in the U.S. and abroad, U.S. multinationals should be aware of the U.S. tax issues that may arise with respect to such activities. In particular, U.S. corporations should take steps to determine whether any payment made to a foreign government official or employee by or on behalf of a CFC is an illegal payment that should be included in subpart F income, and they may wish to seek guidance from the Service regarding the appropriate path to follow with respect to any foreign tax credits that may arise from that subpart F inclusion. In addition, this would be an opportune time for the Service and the Treasury Department to provide general guidance on such issues under current law and consider whether any change in law with respect to these issues would be recommended. ■