

## II. *Lack of Coordination Among U.S. Federal Agencies*

*The 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).*

Under the Foreign Corrupt Practices Act (FCPA), it is illegal for a U.S. company to pay foreign officials for the purpose of obtaining or keeping business. It is also illegal to make payments to a third party, while knowing that all or a portion of the payment will go directly or indirectly to a foreign official. U.S. companies are expected to exercise due diligence and take precautions in developing business relationships to avoid being held liable for corrupt third-party payments.<sup>80</sup>

The Department of Justice (DOJ) is responsible for enforcement of these provisions of FCPA. The Securities and Exchange Commission (SEC) plays a coordinating role, enforcing other provisions that require companies to keep accurate records and to maintain accounting systems that assure management's control over assets and taking certain actions against individuals or firms charged or convicted of FCPA violations.

### **Internal Revenue Service Actions**

The IRS is an organization with 100,000 employees worldwide. If a taxpayer is under IRS audit, he typically deals with a Revenue Agent from the IRS Examination division. If the taxpayer disputes the decision of the Revenue Agent, the taxpayer may file a petition with the U.S. Tax Court or ask for the IRS Appeals division to review the case. The IRS Criminal Investigation Division (CID) investigates violations of the tax laws.

The size and complexity of the IRS organization and mission may have contributed to the apparent delay in investigating Enron's questionable payments to Sun King. Specifically, Enron/PQPC's classification of the payments to Sun King occurred four years before the IRS investigation and referral to the DOJ and SEC.

On March 31, 1995, the Houston, Texas division of the IRS CID interviewed a confidential informant, who provided four Enron memoranda.<sup>81</sup> Houston CID forwarded their findings to the Houston Examination division on December 12, 1995.<sup>82</sup> The following timeline tracks IRS actions regarding the audit of Enron's questionable payments to Sun King:

June 17, 1997	Examination team leader evaluates the informant's information
July 8, 1998	Enron/PQPC's 1996 tax return is pulled from "unopened" inventory

<sup>80</sup> U.S. DEP'T OF JUSTICE, FOREIGN CORRUPT PRACTICES ACT ANTI-BRIBERY PROVISIONS (Mar. 15, 2002), at <http://www.usdoj.gov/criminal/fraud/fcpa/dojdocb.htm>; See also Michael V. Seitzinger, Congressional Research Service, American Law Division, *Foreign Corrupt Practices Act*, RL30079 (Mar. 3, 1999) (This report includes the history and analysis of the 1977 Foreign Corrupt Practices Act (FCPA) and the 1988 amendments to FCPA.).

<sup>81</sup> Gerald A. Richards, International Examiner, Internal Revenue Service (September 23, 2002) [hereinafter IRS Timeline].

<sup>82</sup> IRS Timeline, *supra* note 81.

July 16, 1998	International Examiner interviews informant
July 30, 1998	Tentative decision to open 1995 Enron/PQPC tax return for separate audit
August 10, 1998	Decision to delay opening; consent given to develop facts as an issue surrounding the Enron Corp. 1995 and 1996 tax returns but not as a separate audit, thus limiting the type of information requested.
March 16, 1999	Request to Houston District Disclosure Office to make referrals to DOJ and SEC regarding potential violation of FCPA
March 16, 1999	Houston District Counsel authorizes further development of issues
May 5, 1999	Notice of Proposed Adjustments presented to Enron Corp. <sup>83</sup>
May 1999	IRS makes referrals to DOJ and SEC

On examination of Enron's tax returns, the IRS identified the transactions related to Sun King and Centrans as questionable with respect to their tax treatment. The IRS disallowed the \$333,000 and \$800,000 amortization expenses (under IRC section 197) that Enron claimed in 1995 and 1996 for the \$12 million payment to Centrans.<sup>84</sup> The IRS also disallowed the deduction of the \$1,534,539 as cost of goods sold (under IRC section 162) in 1995 (the monthly payments of 6 percent from Enron/PQPC for eventual payment to Sun King), arguing that the expense was not an ordinary and necessary business expense.<sup>85</sup> The IRS also argued, and Enron agreed, that the \$192,681 short-term capital loss claimed on the 1996 sale of Enron/PQPC to Centrans was a \$1,827,828 short-term capital gain.<sup>86</sup>

On November 12, 1999, Enron's counsel, Vinson & Elkins, filed a petition with the United States Tax Court for 1995 and 1996 tax deficiencies determined by the IRS for Enron/PQPC in the amounts of \$375,368 and \$160,000, respectively.<sup>87</sup> On December 21, 1999, the IRS's Houston District Examination Division responded in writing to Enron's Tax Court Petition.<sup>88</sup> The IRS's Houston District Counsel referred the case docket to the IRS's Houston District Appeals division. The Appeals division decided not to pursue the deficiencies. In light of the fact that Appeals determined the IRS could not use the four memoranda from Enron in court, thus presenting "insurmountable hazards in pursuing" the IRS's basis for its deficiency assessment.<sup>89</sup> No further attempt to address the \$800,000 annual amortization expense into 1997 and subsequent tax periods are indicated.

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83 IRS Timeline, *supra* note 81.

84 Tax Court Petition, *supra* note 7. In general, the purchase price allocated to intangible assets acquired in connection with the acquisition of a trade or business must be capitalized and amortized over a 15-year period under Internal Revenue Code section 197.

85 Tax Court Petition, *supra* note 7.

86 IRS Notice of Proposed Adjustment, *supra* note 9.

87 Tax Court Petition, *supra* note 7.

88 Memorandum from Gerald A. Richards, International Examiner, Internal Revenue Service, to Bill Bissell, Houston District Counsel, Internal Revenue Service (Dec. 21, 1999) (Exhibit 41).

89 Appeals Memo and Case Memo, *supra* note 18; *See also* Internal Revenue Service, Case Decision Data, IRS Appeals, Schedule of Adjustments 10 (Oct. 10, 2000) (Exhibit 42); Puerto Quetzal Power Corp. v. Commissioner, Docket No. 17311-99 (Nov. 11, 1999) (Exhibit 43) (On September 28, 2000, the U.S. Tax Court ordered and decided no deficiencies or overpayment based on an agreement of the parties.).

## Internal Revenue Service Referral Procedures

In May 1999, the IRS referred its concerns about potential violations of FCPA to the DOJ<sup>90</sup> and the SEC<sup>91</sup> as provided in section 6103 of the Internal Revenue Code (IRC). The IRS specifically requested further communication in the referral letter, stating:

In order for us to properly assess the usefulness of the information we are providing, we would appreciate knowing the final disposition of any action taken as a result of this referral. Our need for feedback on matters such as this is not diminished or affected by the passage of time.<sup>92</sup>

Both agencies promptly acknowledged the referral,<sup>93</sup> but it does not appear that either agency took any further action. Perhaps this inaction is exacerbated by Section 6103, the provision in the IRC that protects taxpayer confidentiality. Specifically, Section 6103 requires additional steps in the information gathering process to ensure taxpayer privacy protection.

Prior to 1976, tax returns were considered public records, subject to disclosure by executive order. In 1976, following the actions of the Nixon White House, IRC section 6103 was amended in the Tax Reform Act of 1976<sup>94</sup> to protect tax returns and tax return information from misuse.<sup>95</sup>

Section 6103 embodies the policy that returns are confidential, and provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in section 6103. Section 6103 also contains a number of exceptions to this general rule of nondisclosure which authorize disclosure in particular circumstances. Section 6103 imposes recordkeeping and safeguard requirements to protect the confidentiality of returns and return information. Criminal and civil sanctions apply under the Code to the unauthorized disclosure or inspection of returns and return information.<sup>96</sup>

There are exceptions to the general rules of nondisclosure. One exception permits disclosure of returns and return information to officers and employees of Federal agencies for the administration of Federal non-tax criminal laws subject to the restrictions imposed by section 6103(i)(1) through (i)(7). Section 6103(i)(3)(A) permits the IRS to disclose in writing, return information (other than taxpayer return information) which may constitute evidence of a

<sup>90</sup> Letter from Paul Cordova, District Director, Department of Treasury, Internal Revenue Service, to The Honorable Janet Reno, Attorney General (May 21, 1999) (Exhibit 44) [hereinafter IRS Letter to DOJ].

<sup>91</sup> Letter from Paul Cordova, District Director, Department of Treasury, Internal Revenue Service, to The Honorable Arthur Levitt, Chairman, Securities and Exchange Commission (undated) (Exhibit 45) [hereinafter IRS Letter to SEC].

<sup>92</sup> See IRS Letter to DOJ, *supra* note 90; IRS Letter to SEC., *supra* note 91.

<sup>93</sup> See Letter from Peter Clark, Deputy Chief, Fraud Section, United States Department of Justice, to Paul Cordova, District Director, Internal Revenue Service (undated but stamped received by the IRS June 29, 1999) (Exhibit 44); Letter from Kevin J. Horn, Attorney, Division of Enforcement, United States Securities and Exchange Commission, to Paul Cordova, District Director, Internal Revenue Service (June 9, 1999) (Exhibit 45).

<sup>94</sup> Pub. L. No. 94-455 (1976).

<sup>95</sup> JOINT COMMITTEE ON TAXATION, STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME I: STUDY OF GENERAL DISCLOSURE PROVISIONS, 3-4 (Jan. 28, 2000) [hereinafter JOINT COMMITTEE 6103 STUDY].

<sup>96</sup> JOINT COMMITTEE 6103 STUDY, *supra* note 95, at 3-4.

violation of a Federal non-tax criminal statute to the extent necessary to apprise the head of the appropriate Federal agency charged with enforcement responsibility.

Based on the above provisions, the IRS established specific procedures and guidelines for referrals to other Federal agencies. The IRS procedure in effect when the Enron referral was made to DOJ and the SEC was set forth in Order No. 156 (Rev. 15) Chief Counsel Directives Manual (30)30 and Internal Revenue Manual Handbook 1.3.28.7 Service Initiated Disclosures of Return Information Concerning Nontax Criminal Violations.

Conversely, if a Federal agency seeks information from the IRS, section 6103(i)(1) authorizes disclosure of return or return information. The Federal agency must be enforcing a non-tax criminal law and must obtain an ex parte court order. The Attorney General, Deputy Attorney General, Assistant Attorney Generals, any U.S. attorney, Independent Counsels, or an attorney in charge of an organized crime strike force may authorize an application to a Federal district court judge or magistrate for such an order. The judge or magistrate may grant the order if he determines on the basis of the facts submitted in the application that:

- (1) there is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed;
- (2) there is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act; and
- (3) the return or return information is sought exclusively for use in a Federal criminal investigation or proceeding concerning such act, and the information sought cannot be reasonably obtained, under the circumstances, from another source.<sup>97</sup>

Thus, in order for agencies to obtain additional information from the IRS, they must comply with section 6103 (i)(1), and obtain court approval. Disclosures under section 6103(i)(1) included the following:<sup>98</sup>

<b>Federal Agency</b>	<b>Number of Disclosures in 2000</b>	<b>Number of Disclosures in 2001</b>
U.S. Attorneys	39,760	1,313
Drug Enforcement Agency	767	668
Federal Bureau of Investigation	2,845	2,300
Other	4,175	2,140
<b>Total</b>	<b>47,547</b>	<b>6,421</b>

<sup>97</sup> IRC section 6103(i)(1)(B).

<sup>98</sup> Internal Revenue Service, Disclosure Report for Public Inspection for Calendar Year 2000 and 2001.

Additionally, as a condition for receiving returns and return information under section 6103(i), recipients (e.g., referral agencies) are required, among other things:

[to] restrict, to the satisfaction of the Secretary [of the Treasury], access to returns and return information only to persons whose duties and responsibilities require access and to whom disclosure may be made under the provisions of this title [Title 26].

Finally, IRC section 6103(b)(8) defines disclosure as the “making known” of a return or return information. Therefore, when tax returns and tax information originate with the IRS, there is no “disclosure” (within the meaning of IRC section 6103(b)(8)), in returning information to the IRS. Thus, it is within the law for an agency receiving information from the IRS to discuss such information with IRS personnel.

### **Department of Justice Procedures For Handling Referrals from the IRS**

The DOJ does not have procedures or timelines for handling criminal referrals from the IRS or any other agency.<sup>99</sup> Nonetheless, the DOJ’s Criminal Resource Manual 1015 provides that:

Allegations of criminal violations of the Foreign Corrupt Practices Act (FCPA) are generally investigated by the Federal Bureau of Investigation (FBI), under the supervision of the Fraud Section of the Criminal Division. Investigations of allegations of civil violations of the record keeping and antibribery provisions by issuers may be investigated by the United States Securities and Exchange Commission (SEC). These civil investigations may result in a criminal referral to the Criminal Division.

It is important to realize that although the FBI is the primary investigative agency authorized to conduct investigations of FCPA allegations and is required by its internal regulations to bring any allegation of a violation of the FCPA to the Criminal Division, FCPA allegations may arise in a number of contexts, including agency audits, such as those conducted by the Department of Defense and the inspectors general of other agencies. When such allegations are brought to the attention of any Department of Justice attorney, including Assistant U.S. Attorneys, they must immediately be referred to the Fraud Section of the Criminal Division.<sup>100</sup>

### **Securities and Exchange Commission Procedures For Handling Referrals from the IRS**

While the SEC does have the authority to “investigate past, ongoing, or prospective violations of the Federal securities laws, SEC rules or regulations, and self-regulatory organizations,”<sup>101</sup> the SEC could not provide any procedure for handling IRS referrals.

<sup>99</sup> Telephone Interview with Faith Burton, Special Counsel, Office of Legislative Affairs, Department of Justice (Sept. 12, 2002).

<sup>100</sup> U.S. Department of Justice, Criminal Resource Manual, at [http://www.usdoj.gov:80/usao/eousa/foia\\_reading\\_room/usam/title9/crm01015.htm](http://www.usdoj.gov:80/usao/eousa/foia_reading_room/usam/title9/crm01015.htm).

<sup>101</sup> Securities and Exchange Commission, Enforcement Training Program I (2001) *reprinted within* William McLucas et al., *A Practitioner’s Guide to the SEC’s Investigative and Enforcement Process*, 70 TEMP. L. REV. 53 (1997) [hereinafter SEC Enforcement, Law Review ].

The staff of the SEC Enforcement Division conducts SEC investigations. At the beginning of an investigation, they will:

- Obtain information about the individuals or entities connected with the investigation from public and internal sources including: public filings, such as registration statements, annual and quarterly reports and Forms 3, 4, and 5; SEC and national stock exchange computer surveillance systems; news stories; Who's Who; Standard & Poor's; and the Internet
- Gather and analyze relevant facts
- Analyze applicable legal theories
- Develop a plan of investigation<sup>102</sup>

The SEC conducts financial fraud and financial statement investigations. "These investigations focus on frauds accomplished through the use of false financial information and the failure to disclose material facts relating to a public company's financial condition."<sup>103</sup> The investigation generally includes gathering the independent public accountants' relevant workpapers, and the company's relevant documents. Additionally, investigators subpoena documents from banks, creditors, customers, and others with a business relationship with the issuer. After analysis of such documents, the staff takes testimony from appropriate personnel of the issuer and the independent public accountants.<sup>104</sup>

The law contemplates communication between the SEC and the DOJ. Federal securities laws allow parallel proceedings for both civil and criminal enforcement. In practice, SEC investigations and proceedings occur simultaneously with DOJ or other Federal and State agency enforcement activity.<sup>105</sup>

### **Possible Explanations for Apparent Failure to Act**

The Department of Justice and the Securities and Exchange Commission apparently failed to act on the IRS referral and failed to reply to the IRS's request for information regarding the final disposition of the referral. The DOJ and the SEC may not have investigated the IRS referrals because of: (1) a lack of specified procedure and (2) a possible lack of understanding of IRC section 6103. As previously stated, section 6103 enables an agency responding to an IRS referral to gather more information from the IRS, with minimal obstacle, while still protecting taxpayer privacy.

<sup>102</sup> SEC Enforcement, Law Review, *supra* note 101, at 62.

<sup>103</sup> SEC Enforcement, Law Review, *supra* note 101, at 64.

<sup>104</sup> SEC Enforcement, Law Review, *supra* note 101, at 65.

<sup>105</sup> SEC Enforcement, Law Review, *supra* note 101, at 100.