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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ATTORNEY LMSB

FROM: Heather C. Maloy
Associate Chief Counsel CC:ITA

SUBJECT:

This Field Service Advice responds to your memorandum February 13, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection.

Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative. The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

- Taxpayer =
- Country 1 =
- Country 2 =
- A =
- B =
- C =

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X	=
Y	=
Z	=
Date 1	=
Year 1	=
Year 2	=

ISSUES

Whether arms sales commission payments are not deductible, pursuant to the provisions of I.R.C. § 162(c)(2), because such payments are considered to be “essential elements” of criminal offenses.

CONCLUSIONS

I.R.C. § 162(c)(2) does not disallow a deduction for arms sales commission payments.

FACTS

The taxpayer is in the business of designing and selling defense systems and weapons. During the course of its business, the taxpayer made payments to A in Country 1, to procure and service Country 1 military contracts, and to four agents in Country 2, to secure Country 2 military contracts. Taxpayer alleges that neither A nor the Country 2 agents were foreign government officials. The Taxpayer did not disclose the commission payments to the Country 1, Country 2, or U.S. governments, and Taxpayer falsely described in its books, records, and Federal Income Tax Returns the commission payments as either X, Y, or Z.

The commission payments became the focus of a grand jury investigation, in which the United States Department of Justice filed an Information and Plea Agreement in the United States District Court for the Central District of B. The Taxpayer pled guilty to three counts, which charged: conspiracy to defraud the Internal Revenue Service, the Defense Contract Audit Agency, and Country 1 (18 U.S.C. § 371); making false statements (18 U.S.C. § 1001, 2(b)); and mail fraud (18 U.S.C. § 1341).

The Taxpayer is audited pursuant to the coordinated examination program (CEP). Exam is currently auditing the Year 1 through Year 2 tax years. The amount of commission expenditures is believed to be approximately C.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code provides in general that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(c)(2) provides in general that no deduction shall be allowed under subsection (a) 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

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law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, kickback includes a payment in consideration of the referral of a client, patient, or customer.

Exam argues that the case, Bilzerian v. United States, 41 Fed. Cl. 134 (1998), provides a basis for not allowing the Taxpayer to deduct the commission payments. Specifically, Exam points to the language in Bilzerian which states that if a payment is the “essential element” of the crime, the payment is itself illegal. Id. at 140.

However, the Bilzerian court did not rely on this “essential element” argument, and the court ruled that the taxpayer’s conviction for criminal activity did not make payments, connected with that activity, illegal. The general principle is that a payment must be illegal, in and of itself, for it to be disallowed as a deduction under § 162(c)(2). Bilzerian at 139. The fact that the payment was connected to illegal activity does not suffice to disallow the deduction of the payment under § 162(c). Commissioner v. Sullivan, 356 U.S. 27 (1958) G.C.M. 39813 (March 19, 1990).

The taxpayers in Commissioner v. Sullivan operated an illegal gambling operation, and sought to deduct wages paid to workers who helped operate the gambling establishment, and rent for the use of the premises where the establishment was located. The Tax Court held that the amounts paid for wages and rent could not be deductible since those deductions were for expenditures made in connection with illegal acts. However, the Supreme Court reversed the Tax Court and held that the payments for wages and rent were deductible as ordinary and necessary business expenses.

In the present case, the commission payments made by the Taxpayer to foreign agents were not “in and of themselves” illegal. The Taxpayer was sanctioned for not disclosing and for concealing the payments, not for the payments themselves. While the Taxpayer would not have been sanctioned if it had not made the payments, we cannot find authority to apply the “essential element” theory to this case.

Please call Nicole E. Francis at 202-622-4950 if you have any further questions.

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