

## Tax Litigation Issues

## Expert Analysis

# Bribery vs. Extortion: The Deductibility of Illegal Payments

It is a fact of life that many companies make dubious payments in order to get business. The line between legitimate business expenses and commercial bribery can be a fine one, and while businessmen who are prosecuted for having crossed that line are rightfully most concerned with the loss of liberty and stigma associated with a criminal conviction, lawyers and accountants representing them need to be mindful of the tax consequences of their clients' conduct.

The Internal Revenue Code allows companies to deduct expenses that are ordinary and necessary to the operation or maintenance of a business, unless they were illegal bribes or kickback payments. See 26 U.S.C. §§162(a), (c)(2). However, not all payments made to obtain business are

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illegal bribes and the deductibility of payments will turn first on whether they were ordinary and necessary given the specific industry at issue, and second on whether they were illegal under the applicable state or federal law.

### Ordinary and Necessary

Under §162(a), business expenses are deductible if they are both “ordinary” and “necessary.” See 26 U.S.C. §162(a). Expenses are “ordinary” if they are “customary or usual within a particular trade, business, or industry or relate[] to a transaction ‘of common or frequent occurrence in the type of business involved,’” and they are “necessary” if they meet the minimal requirements of being “appropriate and helpful” for

the development or operation of the taxpayer’s business. *Lingren v. Comm’r*, 112 T.C.M. (CCH) 569, 2016 WL 6879632, at \*1 (T.C. 2016) (quoting *Deputy v. Dupont*, 308 U.S. 488, 495 (1940)). Courts have emphasized that these are fact-specific inquiries that depend on the facts and circumstances of each particular case. *Brizell v. Comm’r*, 93 T.C. 151, 158-60 (1989); see also IRS, Field Service Advisory, 1996 WL 33320948 (Sept. 18, 1996).

### Violation of Enforced Law

If a taxpayer meets the burden of showing that payments made to secure business were ordinary and necessary, the IRS can nonetheless disallow the deduction if, by clear and convincing evidence, it proves: (1) that the payment was illegal under the applicable state or federal law, subjecting the payor to criminal penalty or loss of license or privilege to engage in a business; and (2) that the law governing the

payment was generally enforced. See 26 U.S.C. §162(c)(2).

A law is “generally enforced unless it is never enforced or the only persons normally charged ... are infamous or those whose violations are extraordinarily flagrant.” 26 C.F.R. §1.162-18. However, the mere absence

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of an “aggressive criminal prosecution or license revocation program” is insufficient to show that a statute was not “generally enforced.” *Boucher v. Comm’r*, 77 T.C. 214, 218-19 (T.C. 1981).

In *Boucher*, the taxpayer deducted “premium discounts” that he provided to customers to induce them to purchase insurance from him. The IRS disallowed the deduction and the taxpayer challenged the resulting deficiency in Tax Court. The taxpayer did not dispute that such bribes were in direct violation of Washington state’s rebate statute and therefore illegal. Rather, he argued that the relevant law was not generally enforced based on testi-

mony by the state’s deputy insurance commissioner that his office had made no attempt to discover violations of the statute and that he was unaware of any criminal prosecutions or license revocations resulting from such violations. The court rejected this argument, explaining that the lack of criminal prosecutions or license revocations appeared to be due to a lack of manpower in the commissioner’s office rather than a conscious decision not to enforce such violations. The court held that the law was generally enforced because the evidence showed “that the rebate statute would have been enforced ... if a violation had been brought to the attention of appropriate enforcement authorities.” Indeed, it is the rare case that a law will be found not to be generally enforced, even where violations of it are not adequately investigated or prosecuted,<sup>1</sup> and the deductibility of payments made to secure business will more often turn on whether the payments were, in fact, illegal.

### Not All Payments Are Illegal

Under New York law, bribery is the voluntary conferral of a benefit upon an employee without the employer’s consent and with the intent to influence the employee’s conduct. See N.Y. Penal Law §180.00.

By contrast, extortion is the conferral of a benefit made under duress, including when a person obtains property from another by instilling in him fear of harm to his business if such property is not delivered. See N.Y. Penal Law §155.05(e)(ii).<sup>2</sup> Significantly, extortion is a complete defense to a charge of bribery and a payment made in response to an extortionate demand is not illegal. E.g., *Kraft Gen. Foods v. Cattell*, 18 F. Supp. 2d 280, 284-85 (S.D.N.Y. 1998); *Brizell*, 93 T.C. at 162.

In *Brizell*, a printing company that produced advertising materials made substantial payments to purchasing agents for several of its customers in order “to ensure business patronage.” The funds to make these payments were generated through a false invoice scheme and the printing company recorded and deducted the payments as “purchases.” After a criminal investigation, the company pled guilty to one count of conspiracy to defraud the United States and file false corporate tax returns, and the company’s principal shareholders pled guilty to causing the company to file false returns. After the conclusion of the criminal case, the IRS disallowed the deduction of the payments and one of the shareholders challenged the resulting deficiency.

In upholding the deduction, the Tax Court first found that the bribes were ordinary and necessary business expenses based on considerable evidence that such payments were common in the printing industry and they clearly helped the company maintain a substantial portion of its business. The burden then shifted to the IRS to prove that the payments were illegal under New York law. The court noted that the taxpayer had presented substantial evidence that payments had been extorted through implicit and “less-than-implicit” threats that caused the company to “believe[] that failure to make the payments would result in material harm to its business” through the loss of customers. The court “acknowledge[d] that the record contain[ed] evidence suggesting that [the company] was not the victim of extortion and ... volunteered to pay” in order to obtain business. However, the court recognized that the purchasing agents had “an incentive to mischaracterize events, rather than confess to extortion,” and explained, “[i]f the record is inconclusive or otherwise falls short of being clear and convincing, [the IRS] must lose on this issue.” Accordingly, when New York law governs, the IRS must show by clear and convincing evidence that

a taxpayer made the payment in question voluntarily because he believed it would promote his business, and not in response to any implicit threat of economic loss.

The IRS’s ability to meet this high standard may depend on the specific allegations in the criminal case. Thus, in *Zecchini v. Commissioner*, 63 T.C.M. (CCH) 1717, 1992 WL 812, the taxpayer was in the business of finding securities brokers who would engage in stock loan transac-

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tions. In order to secure business, the taxpayer made payments to stock loan managers at several brokerage firms. The taxpayer was charged with conspiracy to commit commercial bribery in violation of the laws of New York and other states, as well as tax evasion. Unlike *Brizell*, the charges in *Zecchini* specifically alleged that the payments in question were bribes that the taxpayer had made without fear or threat of any kind, and the Tax Court held the taxpayer was estopped from denying that the payments in question constituted

unlawful bribes in violation of New York law.

## Conclusion

Individuals prosecuted for offenses relating to payments made to obtain business will generally have bigger problems than the possibility that they owe additional taxes. However, their lawyers and accountants need to carefully evaluate the facts and circumstances surrounding the payments and should not assume the payments are not deductible. Rather, their tax treatment will require consideration of the applicable state and federal laws and an assessment of whether the payments actually constituted illegal bribes.

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1. See *Brown v. Comm’n*, 63 T.C.M. (CCH) 1866, 1992 WL 6894 (T.C. 1992) (finding law not generally enforced where state department stipulated it would not revoke or suspend permits due to violations and IRS did not show evidence that failure to enforce was due to lack of resources).

2. Courts in New York have further held that extortion does not require an express threat, but may instead merely consist of “innuendo or suggestion” of harm to the victim’s business. *Brizell*, 93 T.C. at 162 (quoting *People v. Dioguardi*, 203 N.Y.S. 2d 870, 878 (1960)).