Penalizing Bribery of Foreign Officials Through The Tax Laws: A Case for Repealing Section 162 (c)(1)

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In 1958, Congress inserted a provision into the Internal Revenue Code disallowing business deductions for bribes and kickbacks paid to foreign officials. Prior to the enactment of this provision, section 162(c)(1), the Internal Revenue Service (IRS) had permitted a tax deduction for such bribes and kickbacks, but only when these payments were necessary to protect the taxpayer's business interests. Section 162(c)(1) seemed likely to remain obscure, but in 1975 it began to receive increased attention due to a dramatic upsurge in concern over worldwide corporate payoffs and political contributions. Administratively, this development is marked by

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1 I.R.C. § 162(c)(1) was originally I.R.C. § 162(c), enacted as part of the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 5(a), 72 Stat. 1608 (1958). At that time it read:

(c) Improper Payments to Officials or Employees of Foreign Countries—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.

In the Tax Reform Act of 1969, Pub. L. No. 91-172, § 902(b), 83 Stat. 710 (1969), Congress amended § 162(c) so as to embrace payments to domestic as well as foreign governments. This operative version of § 162(c)(1) appears in the text below. See note 15 and accompanying text infra.

The scope of this article is limited to payments to officials of foreign governments because of the uniqueness the conceptual origins (see notes 36-40 and 52-61 and accompanying text infra) and the peculiarities of economic impact due to the patterns of foreign taxation (see notes 62-86 and accompanying text infra) of the disallowance of a deduction for foreign payments.

2 Bribes or kickbacks to foreign officials, like any other business expenditures, were deductible under § 162(a) only if they were "ordinary and necessary" to the taxpayer's trade or business. See notes 37-39 and accompanying text infra. The IRS had taken the position that the payments would be regarded as "ordinary and necessary," and hence deductible, only if the taxpayer was compelled to make the payment to protect his business interests:

Where, however, it is the foreign government itself which demands or acquires expenses in the payment, so that legal recourse is not available to the taxpayer in the operation of his legal business, the Service would find it difficult to sustain the position that the expenses were not ordinary and necessary to the taxpayer's business.


3 From 1972 to 1975, for example, the Internal Revenue Service initiated action in only 62 cases involving bribes or slush funds, and this figure includes cases involving domestic payments. Letter from Donald C. Alexander, Comm’r, I.R.S., to Congressman Robert N.C. Nix (September 29, 1975), reprinted in Hearings on the Activities of American Multinational Corps. Abroad Before the Subcomm. on Int’l Econ. Policy of the House Comm. on Int’l Relations, 94th Cong., 1st Sess. app. 7 at 225 (1975) [hereinafter cited as House Hearings on Activities of Multinationals].

4 In 1975, the IRS placed 111 companies under investigation for improperly reporting United States income tax as a result of making foreign payments or manipulating foreign accounts to conceal domestic payments. House Hearing on the Activities of Multinationals.
the institution of stringent IRS audit techniques,\(^5\) including the controversial "eleven questions."\(^6\) Legislatively, the increased concern was evidenced by the Tax Reform Act of 1976, which provides that the sum of section 162(c)(1) payments made by a controlled foreign corporation (CFC)\(^7\) or domestic international sales corporation (DISC)\(^8\) constitutes a constructive dividend includable in the gross income of the corporation’s shareholders.\(^9\) In addition, the Act bars corporate taxpayers from reducing their earnings and profits by amounts paid as bribes or kickbacks.\(^10\) In light of these changes, it can be argued that section 162(c)(1), as have the securities laws\(^11\) and the antitrust laws\(^12\), has become an instrument for

\(^{supra}\) note 3, at 53 (statement of Donald C. Alexander). The intensity of Congressional interest in § 162(c)(1) is evident from the statements and dialogues printed in the House Hearings on the Activities of Multinationals, at 35-57.

\(^5\) Manual Supplement 42 G-348, 2 INT. REV. MAN. 7381 (CCH 1976). Prior to the institution of these techniques, the IRS, through its large case audit program, routinely conducted in-depth audits of major American corporations (those with gross assets in excess of $250 million or, if a bank, savings and loan, or utility, with gross assets in excess of $1 billion). The new guidelines call for the examination of corporate officers’ individual tax returns simultaneously with the audit of the corporate return; the examination of the books and records of American companies abroad by the IRS Office of International Operations; the use of summons, where necessary, to secure access to taxpayers financial records; the tracing of international transactions of multinational corporations; and the creation of a special liaison with the Securities and Exchange Commission. See also Department of the Treasury News Release, Feb. 10, 1976, N3000.51, Appendix 1; House Hearings on the Activities of Multinationals, supra note 3, at 43-46 (statement of Donald C. Alexander).

\(^6\) The “eleven questions” are directed to top corporate officers and key employees and ask if they have knowledge of any bribe, political contribution, or manipulation of foreign bank accounts by the company. The responses must be written and signed by the respondent in either affidavit form or under a written declaration that the answers have been made under the penalties of perjury. See Manual Supplement 42 G-348, 2 INT. REV. MAN. 7381-1 to 3 (CCH 1976). Two of the “eleven questions” are reprinted at note 91 infra. One commentator has described these questions as “a radical departure from past practices. Many believe it is unauthorized by law. And many more believe it is a major threat to the self-assessment system, which has so far served us very well.” Hickman, Tax Aspects of “Sensitive Payments”, 54 TAXES 865, 866 (1976).

\(^7\) Section 957(a) of the Internal Revenue Code defines a “controlled foreign corporation” as any foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote is owned by United States shareholders on any day during the taxable year of such foreign corporation.

\(^8\) Domestic international sales corporations, as their appellation suggests, are domestic corporations engaged in the export of American goods. To qualify as a DISC, at least 95% of the corporation’s assets must be export related and at least 95% of the corporation’s gross income must arise from export sale or lease transactions and other related activities. I.R.C. §§ 992-993. Congress first provided for DISCs in the Revenue Act of 1971, Pub. L. No. 92-178, § 501, 85 Stat. 497 (1971), in order to encourage the increase of exports by American enterprise.


\(^10\) Tax Reform Act of 1976, § 1065(b); I.R.C. § 964(a).

\(^11\) The Securities Act of 1933, §§ 7, 10, Schedule A, 15 U.S.C. §§ 77g, 77j, 77aa (1970) and the Securities Exchange Act of 1934, §§ 12(b), 13, 14a, 15 U.S.C. §§ 78b(1), 78m, 78n(a) (1970), compel major corporations to disclose “material” facts of interest to investors and shareholders. The SEC has taken the view that bribes and kickbacks may be “material” because they reflect on the quality and integrity of corporate management, as well as the stability of the business earnings:

Implicit in such disclosure requirements is the assumption that corporations conduct their business and sell their products on the basis of quality and price rather than bribes or kickbacks. . . .

. . . The disclosure system is oriented toward the basic interests of investors, but
regulating the morality of overseas business operations.

Most commentary on these congressional attempts to use tax laws to control the ethics of overseas enterprises has centered either on the effectiveness of these provisions or on the burdens and difficulties involved with their implementation.\(^{13}\) This article, while discussing these issues, is concerned primarily with the conceptual justifications and the direct economic effects of these tax provisions. The article contends that section 162(c)(1) and the pertinent provisions of the Tax Reform Act of 1976 are disguised penalties which often operate arbitrarily and unfairly and concludes that they should be repealed in favor of more equitable and effective deterrents.

I. SECTION 162(c)(1)

A. Operation of Section 162(c)(1)

Section 162(c)(1), as drafted by the Treasury Department\(^{14}\) and adopted by Congress, reads in pertinent part:

\begin{quote}


However, as Phillip A. Loomis, Commissioner, Securities and Exchange Commission observed: "it should be borne in mind that the Commission's function in this regard is to seek disclosure. We have no mandate from the Congress to act, at least directly, as the guardians of corporate morality." House Hearings on Activities of Multinationals supra note 3, at 36 (statement of Phillip A. Loomis). The SEC's views have attracted a welter of commentary. See, e.g., Herlihy & Levine, Corporate Crisis: The Overseas Payment Problem, 8 LAW & POL. INT'L BUS. 547, 569-94 (1976); Lowenfels, Questionable Corporate Payments and the Federal Securities Laws, 51 N.Y.U.L. REV. 1 (1976); Solomon & Linville, Transnational Conduct of American Multinational Corporations: Questionable Payments Abroad, 17 B.C. IND. & COM. L. REV. 303, 313-19 (1976); Note, Disclosure of Payments to Foreign Government Officials Under the Securities Act, 89 HARV. L. REV. 1848, (1976); Note, Securities Regulations —Bribes to Foreign Officials by Multinational Corporations: Disclosure Under the Federal Securities Laws, 49 TEMP. L.Q. 428 (1976).

\(^{12}\) See, e.g., McManis, Questionable Corporate Payments Abroad: An Antitrust Approach, 86 YALE L.J. 215 (1976). The author concludes that the Sherman and Clayton Acts can be used to halt such payments and that this approach would be preferable to other solutions, since it would affect only those payments that have the most serious economic consequences for American firms and would permit private parties to seek redress for injuries caused by the payments.

\(^{13}\) The effectiveness of the changes made by the Tax Reform Act of 1976 has not yet been critically analyzed. Several articles have pointed out, however, that prior to 1976, IRS inquiry and action could be easily avoided by carefully structuring the transmission of payments so that there were no improper deductions or unlawful tax benefits. See, e.g., Herlihy & Levine, supra note 11, at 595-99; Note, Securities Regulation, supra, note 11, at 428-34. These works commonly cite the example of Gulf Oil which, by funneling illicit payments through a Bahamian subsidiary and claiming the payments as capital investments in the subsidiary, generated no unlawful business deductions. These discussions seem to miss the mark: the crucial question is whether the § 162(c)(1) disallowance by itself deters bribery of foreign officials, such that IRS scrutiny is unnecessary.

\(^{14}\) The Treasury Department drafted the 1958 version of § 162(c)(1), which scarcely differs
No deduction shall be allowed under [section 162(a)] for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.15

Under section 162(c)(1), deductions are disallowed for both domestic and foreign payments so long as they would be illegal if made in the United States16 and are paid to a governmental rather than to a private entity. In enacting this provision, Congress apparently intended to equalize the treatment of domestic and foreign payments17 and to disallow deductions which would promote illegality.18 However, bribery of foreign governments is perfectly lawful in the United States19 and is often lawful in foreign nations as well.20 Allowing a deduction for these expenses would

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15 I.R.C. § 162(c)(1).
16 The burden of proof with respect to whether a foreign payment would be unlawful under United States law is on the Commissioner of Internal Revenue, who must demonstrate illegality by clear and convincing evidence. I.R.C. § 162(c)(1); Treas. Reg. § 1.162-18(a)(5) (1960).

For the purpose of construing the statute, "laws of the United States," consist solely of federal laws which threaten criminal or civil penalties; state laws may be invoked to demonstrate the illegality of a payment only if they are assimilated into federal law. Treas. Reg. § 1.162-18(a)(4) (1960). Federal statutes are quite stringent; the mere gift of a gratuity to an official or employee for or because of an official act invites criminal prosecution, even when there is no specific intent to corrupt. 18 U.S.C. § 201(f) (1970).

17 Congress's purpose in attempting to equalize the tax treatment of American businesses active in this country and those active abroad is discussed below. See notes 37-61 and accompanying text infra. Rep. Robert N.C. Nix, Chairman, House Subcomm. on Int'l Econ. Policy, said of the foreign payments "Permitting such payments abroad by whatever device would penalize domestic businesses which must operate within the law here at home." House Hearing on the Activities of Multinationals, supra note 3, at 35.

18 This statement is a shorthand formulation of the "public policy doctrine," the original theory on which a deduction was denied for domestic bribes and kickbacks. See e.g., Commissioner v. Heininger, 320 U.S. 467, 473 (1943); Easton Tractor & Equip. Co. v. Comm'r, 35 B.T.A. 189 (1936). The relationship between the public policy doctrine and § 162(c)(1) is discussed at notes 54-59 and accompanying text infra. The notion that the tax deduction could actually encourage illegal behavior has been sharply criticized. See Comment, Business Expenses, Disallowances and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 YALE L.J. 108, at 110-15 (1962).

19 The federal bribery, graft, and conflicts of interest laws apply only to United States officials and employees. Bribery, Graft and Conflicts of Interest Act, § 1(a), 18 U.S.C. §§ 201-224 (1970). Legislation has been introduced in Congress which would make bribery of foreign officials a crime. For example, Rep. Stephen J. Solarz has proposed the amendment of the Bribery, Graft and Conflicts Act to prohibit payments by any American company or by its officials or employees made with intent to influence the official acts of any foreign government, official, or political organization. Violations of the law could result in a maximum penalty of $10,000, one year in prison, or both. H.R. 7539, 94th Cong., 1st Sess. (1975). See House Hearings on Activities of Multinationals, supra note 3, at 4 (statement of Hon. Stephen Solarz.) Sen. William Proxmire has proposed the amendment of the Securities and Exchange Act of 1934 to require issuers of securities registered pursuant to § 12 of that Act to refrain from offering, giving, or promising anything of value to foreign officials, political candidates or organizations, or any person who would influence foreign officials or politicians. S. 305, 95th Cong., 1st Sess., § 30A (1970).

20 Only 22 of the developed countries of the world have statutes similar to United States laws.
not in any way accord government approval to civilly or criminally punishable behavior. Nevertheless, section 162(c)(1) disallows the deduction.21

In applying section 162(c)(1) to specific factual situations,22 several major interpretative problems have arisen. One problem is that in many foreign countries, it may be difficult for business taxpayers to distinguish government officials or employees from private citizens. Although the statute itself furnishes no guidance on this point, the meticulous detail of the treasury regulations has provided some direction. The regulations adopt an expansive definition of "official or employee" of a foreign government, including all individuals "officially connected with"23 the


21 On its face, § 162(c)(1) would seem to embrace all types of unlawful payments, including corporate political contributions which transgress the Federal Elections Campaign Act Amendments of 1976, Pub. L. No. 94-283, § 321, 90 Stat. 490 (1976). Such a construction would be significant, since political donations comprise a sizable portion of all questionable overseas payments and involve millions of dollars for some companies. See Solomon & Linville, supra note 11, at 304 n. 3. A deduction for these payments might also be disallowed under § 162(e), which covers lobbying and political expenses, but does not expressly include foreign payments.

Section 162(c)(1) was originally entitled "Improper Payments to Officials or Employees of Foreign Countries," suggesting no limitation as to the type of payment. In the 1969 modification to cover domestic payments, Congress changed the heading of the section to "Bribes and Illegal Kickbacks," suggesting a more restricted scope. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 710, § 902(b) (1969). The statute obtained its present heading "Illegal Bribes, Kickbacks, and Other Payments" only after the present § 162(c)(3), dealing with kickbacks, bribes, and rebates under medicare and medicaid, was added in 1971. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 525, § 310(a)(2) (1971).

According to the language of § 162(c)(1), domestic payments to government officials are nondeductible only if they constitute an illegal bribe or kickback. If Congress wanted to enforce equality of treatment between domestic and foreign payments, the same rule would apply for payments to foreign officials. It should be noted, however, that § 162(c)(1) renders nondeductible any payment that is illegal in the United States.

22 One commentator observed of § 162(c)(1):

But when you export our laws to a foreign country, you are immediately in a "let's pretend" world. The statutory descriptions don't fit the persons, the jobs or the events. You have to guess how our federal law should apply to situations for which they were never designed in the first place.

Hickman, supra note 6, at 873.

23 The phrase "officially connected with," is not defined in the treasury regulations. This is a serious omission for two reasons. First, it leaves the taxpayer with no guidance regarding the identification of persons "officially connected with" the foreign government. The taxpayer's task is made all the more difficult by the fact that the regulations do stipulate that the capacity of the individual's service is immaterial. Treas. Reg. § 1.162-18(a)(3) (1975). Thus, an individual could be "officially connected with" the government even though he received no pay.

Second, the federal statutes proscribing certain domestic payments, on which § 162(c)(1) is based, define a violation exclusively in terms of official responsibilities or duties. If a bribe is paid in connection with the government official's private undertakings, no violation arises and § 162(c)(1) is not applicable. By failing to define the phrase "officially connected with" the regulations increase the probability that a deduction will be denied in situations where there is in fact no official act. For example, one observer has suggested the troublesome hypothetical of a government official who "moonlights" by arranging for government approval from agencies other than his own. Such an official would receive payments not for favorable actions taken in his official capacity, but for the exercise of his personal contacts. Hickman, supra note 6, at 874. In theory, payments to this official for such services should
national government, with its political subdivisions, or with any entity serving as an agency or instrumentality of the national government or its subdivisions. The nature of the individual's service, whether on a temporary basis or without pay, is irrelevant. Also, payments to persons who purport to act on behalf of a government or as government employees or officials are also nondeductible, regardless of whether the recipients in fact control the nation or have been accorded diplomatic recognition. Thus, groups in rebellion against an established government receive the same treatment as the officials or employees against whom they are revolting.

An equally difficult interpretative problem created by section 162(c)(1) has arisen from the use of the term "indirect payment." Again, however, the Treasury regulations have clarified the meaning of otherwise undefined statutory language. An indirect payment to an official or employee of a foreign government includes "any payment which inures to his benefit or promotes his interests regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor." Accordingly, if a multinational corporation uses a "consultant" to transmit monies to a foreign official, any amounts received by the official constitute a nondeductible business expense to the corporation. Similarly, if, for the purpose of rewarding a foreign official, a corporation hires his agent, relative, or independent contractor, this expense is an indirect payment and is nondeductible under section 162(c)(1). Even if be deductible, at least as far as § 162(c)(1) is concerned, since he is not being bribed in connection with any official duty or position and consequently no United States law is violated. Under the present regulations, however, the official's private efforts to arrange for approval might constitute the necessary official connection with the government, and payments to him for his actions in this capacity would therefore be nondeductible.

25 Id.
26 Id. In United States v. Rexach, 331 F. Supp. 524 (D.P.R. 1971), rev'd, 482 F.2d 10 (1st Cir. 1973), cert. denied, 414 U.S. 1039 (1973), the taxpayer, believing his payments had preceded the effective date of § 162(c) in 1958, openly admitted making kickback payments to the dictator Trujillo in the Dominican Republic. After deciding against the taxpayer on the accounting date for the payment, the court addressed his argument that Trujillo, who had seized power unlawfully, was not an official or a foreign government within the meaning of the statute. The court held that payments to dictators were to be treated no differently from payments to elected officials. 482 F.2d at 21 n. 8.
29 It would seem appropriate also to deny a deduction for the whole amount of the consultant's salary if he acted solely as a conduit for bribes. See Comment, Payments to Foreign Officials by Multinational Corporations: Bribery or Business Expense and the Effects of United States Policy, 6 CAL. W. INT. L.J. 360, 372 (1976).

In practice, multinational corporations frequently have used "consultants" to transmit nondeductible payments to foreign officials. The Northrup Corp., for example, has admitted that it gave a Middle East businessman $450,000 to pass on to two Saudi Arabian generals in 1972 and 1973. Pentagon documents indicate that five foreign agents have received $18.7 million in fees for $500 million in military sales in Jordan, Kuwait, Israel, and Saudi Arabia since mid-1973. The Triad Financial Establishment operated by controversial entrepreneur Adnan M. Khashoggi, procured the biggest fee of $8.886,000. Solomon & Linville, supra note 11, at 306 n. 12, 308 n. 22.
the agent or relative of the foreign official provides legitimate services to
the corporation and receives a reasonable compensation, a deduction
would probably still be denied, since payments to such recipients would
always promote the foreign official's "financial or other interests".31
Under such circumstances, the regulations seemingly embody a conclu­
sive and unfair presumption against the company.32

An additional interpretative problem with the term "indirect payment"
is whether such a payment includes bribes made on behalf of the taxpayer
not by employees or officers, but by independent third parties, such as
independent contractors. In Farnsworth v. Commissioner,33 the Tax
Court refused to uphold a deficiency assessment based on an IRS claim
that the company's gross income should include amounts paid as bribes
by its independent contractor. Farnsworth can be viewed as having
created a loophole in the Treasury's otherwise comprehensive definition
of indirect payment, since it enabled businesses to pay and deduct an
inflated contractor's fee as a section 162(a) business expense, and then
have the contractor make the actual payment to the foreign official. In
1975, however, the Treasury amended its definition of indirect payment to
include any "payment made by an agent or independent contractor of the
taxpayer which benefits the taxpayer."34 Although the Treasury has not
fully explained the purpose of this amendment,35 the plain language of the
change strongly suggests that bribes paid by independent third parties are
covered.

B. The Policy Implications of Section 162(c)(1)

Viewed from the perspective of conventional tax policy, the enactment
of section 162(c)(1) was unprecedented: it marked the first time that
Congress declared an "ordinary and necessary" business expense to be
nondeductible.36 Since 1913, the principle of taxation of net business

31 Id. (emphasis supplied). Of course, in this situation, the taxpayer would claim that the
expense, though concedely an indirect payment under Treas. Reg. § 1.162-18(a)(2), is not in
whole or in part a payment that would be unlawful under United States law if it were
applicable.
32 For example, the sons of many foreign officials are likely to have received college and
graduate education in America. Although they would be highly qualified, a corporation
could not hire them, for the salary expense might be nondeductible and too costly to the
company.
33 32 T.C.M. 902 (1973).
35 The amendment was proposed in 1971, two years before Farnsworth was litigated. In
the notice of proposed rulemaking, the purpose of the complete set of changes was explained
as "to reflect the amendment of the Internal Revenue Code by section 902 of the Tax
525)." 37 F.R. 25936 (Dec. 6, 1972). The statutory modifications, however, did not mention
bribes by an agent or independent contractor of the taxpayer.
36 The purpose of § 162(c)(1) was to render nondeductible those bribes and kickbacks to
foreign officials the IRS had found were "ordinary and necessary" and deductible under §
162(a). See letter from Russell C. Harrington, Comm'r, I.R.S., supra note 2. The Senate
Finance Committee report on the proposed amendment stated its belief that the bribes,
kickbacks, or improper payments to foreign officials should not be treated as properly
income had governed the deductibility of all business expenses. This standard was codified by Congress in section 162(a) of the Internal Revenue Code, which authorizes the taxpayer in computing taxable income to subtract the amount of any expenditure that was both "ordinary and necessary" and "directly connected with or relating to the taxpayer's trade or business." In enacting section 162(c)(1), Congress consciously abandoned this standard; for by disallowing a deduction for bribes which previously were deductible as "ordinary and necessary" business expenses under section 162(a), Congress reached beyond business profits and taxed the gross income of the enterprise.

To justify the elimination of a deduction for bribes and kickbacks paid to foreign officials, proponents of section 162(c)(1) relied primarily on three policy rationales: administrative convenience, maintenance of amicable diplomatic relations, and morality. While these rationales may affirm the need to discourage foreign bribes, they do not justify the use of the tax laws to achieve this objective.

1. Administrative Convenience—The administrative convenience expected to be derived from an absolute rule disallowing deductions for bribery of foreign officials was colorfully explained by Senator John J. Williams, the legislative sponsor of section 162(c)(1): since no one would be "fool enough to give receipts for bribery which was paid in cash,"

37 An excellent historical analysis of the "net income" standard appears in Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, 1954, So. CAL. TAX. INST. 715, 723-31 (1954). Referring to the initial grant of the business deduction in the 1913 Revenue Act, the author concludes: "The legislative discussion readily indicates that in authorizing a deduction for business outlays, Congress did not seek to police, prohibit, or punish by withholding tax deductions." Id. at 723.

38 I.R.C. § 162(a).

39 Politically, the enactment of § 162(c)(1) was in part motivated by a desire to halt the repeated shakedown of United States contractors in the Dominican Republic by the dictator Rafael Trujillo. By rendering the kickbacks nondeductible, Congress hoped businessmen would be less inclined to acquiesce to the practice. In his remarks in support of his proposed amendment, Sen. Williams, failed to cite any cases of illegal kickbacks other than those to the government of Rafael Trujillo. 104 CONG. REC. 2028, 2029 (1958). The first case arising under § 162(c)(1) some thirteen years later concerned a payment to Trujillo. United States v. Rexach, 331 F. Supp. 524 (D.P.R. 1971).

businesses would usually be unable to prove to the IRS that a bribe was actually paid. Consequently, granting a deduction for bribes paid to foreign officials would be, at best, an empty gesture and, at worst, an invitation to taxpayers to falsify records in order to document clandestine payments.

This argument apparently assumes that companies will usually transmit bribes in untraceable cash forms to recipients unwilling to confirm the payment. In many nations, however, payments regarded as bribery under the law of the United States are lawful and customary. Where such transactions occur openly and routinely, suitable records may be available to certify the payments. Moreover, even when the payments are transferred surreptitiously, the taxpayer should still be given the opportunity to substantiate the expense. For all other business expenses, the general rule is that a deduction will be denied only if the taxpayer cannot adequately detail the existence and amount of the expense. Section 162(c)(1), however, forecloses a deduction regardless of the taxpayer's ability to adduce tangible proof of the bribe.

2. Maintenance of Amicable Diplomatic Relations—Proponents of section 162(c)(1) also contended that tax recognition of foreign bribes as legitimate business expenses would be tantamount to official approval and that this approval would undermine international respect for the United States. The harsh international repercussions that have accompanied public disclosure of such payments bolster this argument.

41 Id.
42 Id. In fact, it is common for foreign officials in nations where bribery is illegal to disavow involvement. For example, investigation of a $1.25 million bribe paid by the United States Brands Co. to obtain a reduction of the Honduran banana export tax implicated Jose A. Bennaton Ramos, then the Economics Minister of the Honduras. Ramos, however, denied that he was a recipient of the tainted money. Mr. Kim Comes Calling, NEWSWEEK 66 (May 26, 1975). Former Prime Minister Tanaka of Japan also denied accusations that he had accepted bribes from the Lockheed Aircraft Corporation. N.Y. Times, Jan. 28, 1977, at 4, col. 1.
43 In Arab nations, for example, it is traditional for companies to pay money to low-level government officials who may refuse to perform their normal governmental responsibilities unless compensated. Griffith, Payoff is Not "Accepted Practice," FORTUNE 122, 202 (Aug. 1975). See also Gwirtzman, Is Bribery Defensible?, N.Y. TIMES MAGAZINE 102 (Oct. 5, 1975).
44 Underwood v. Comm'r, 56 F.2d 67, 72-73 (4th Cir. 1932). But cf. Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930) (where taxpayer is unable to substantiate expense deductions through adequate records or other proof, the courts may make an estimate of the deductible amount, provided the taxpayer is entitled to some deduction).
45 Sen. Williams, arguing in support of § 162(c)(1), said, "Certainly our government cannot afford to be on record as recognizing under any circumstances the legitimacy or the propriety of an American corporation or individual bribing an official or employee of a foreign government when soliciting contracts with that country." 104 CONG. REC. 2029 (1958).
46 Bribery charges were filed against the Honduran United Brands subsidiary for the payments it allegedly made to government officials. Investigations, Winks and Roars, NEWSWEEK 61 (June 2, 1975). Bolivia incarcerated a Gulf representative and initiated criminal prosecutions against the company when it allegedly contributed $460,000 to the late President General Rene Barrientas. Note, Securities Regulation supra note 11, at 431. In the wake of the sensational Lockheed scandals, Japan and Italy abruptly broke their contracts with the corporation. The Big Payoff, TIME 28 (Feb. 23, 1976); The Spreading Uproar Over Lockheed Payoffs, U.S. NEWS & WORLD REP. 20 (Feb. 23, 1976); Payoffs: The Growing Scandal, NEWSWEEK 26 (Feb. 23, 1976).
The existence of a tax deduction for the cost of bribing foreign officials could potentially lower the world prestige of the United States in two ways. First, the business deduction might have the effect of subsidizing the bribes, thereby increasing the probability that bribery would occur and encouraging a commercial practice which has already elicited sharp international criticism. However, the notion that tax deductions constitute government subsidies has long been discredited.\(^{47}\) Granting a deduction for all "ordinary and necessary" business expenses may be properly regarded as "tax neutrality," the maintenance of a disinterested posture with respect to all modes of producing income.\(^{48}\)

The availability of a tax deduction could also diminish world respect for the United States if foreign sovereigns perceived the deduction as a subsidy, even though it was, in fact, not a subsidy. There is no evidence, however, that foreign governments regarded the deduction as a subsidy prior to the enactment of section 162(c)(1) in 1958.\(^{49}\) Moreover, even if they had entertained this view, an adverse international reaction to permitting a deduction would have been unlikely. Countries in which bribery was legal or pervasive probably favored a deduction for the expenses.\(^{50}\) On the other hand, in nations where such payments were not demanded or were uncommon, the IRS did not permit deductions, since the bribes could not be classified as "ordinary and necessary" business expenses.\(^{51}\)

3. Morality: Section 162(c)(1) As a Penalty—The most significant rationale presented in support of section 162(c)(1) is that bribes and kickbacks to foreign governments are morally wrong and should not be acknowledged as legitimate costs of carrying on a business.\(^{52}\) In response

\(^{47}\) See Note, An Argument Against the Doctrine that Deductions Should be Narrowly Constricted As a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943); Comment, supra note 18, at 114-15 (1962).

\(^{48}\) See Griswold, supra note 47, at 1147.


\(^{50}\) Indeed, they are more likely to view § 162(c)(1) as a form of U.S. arrogance. Compare the reasoning of the State Department:

> It would not only be presumptuous but counterproductive to seek to impose our specific standards in countries with differing histories and cultures. Moreover, enforcement of such legislation—and I think this is the most important point—would involve surveillance of the activities of foreign officials as well as U.S. businessmen and would be widely resented abroad. Extraterritorial application of U.S. law—which is what such legislation would entail—has often been viewed by other governments as a sign of U.S. arrogance or even as interference in their internal affairs. U.S. penal laws are normally based on territorial jurisdiction and, with rare exceptions, we believe that is sound policy.

House Hearings on the Activities of Multinationals, supra note 2, at 24 (Statement of Mark Feldman).

\(^{51}\) Letter from Russell C. Harrington, Comm'r I.R.S., supra note 2.

\(^{52}\) Sen. Williams stated, "It has always been my understanding that the payment of a bribe or kickback under any circumstances is wrong and that under no circumstances can its recognition as a legitimate expense of doing business be justified." 104 Cong. Rec. 2028 (1958). But cf. statement of Mark Feldman, supra note 50 (suggesting that disallowance of a deduction may be resented abroad as an imposition of U.S. standards of conduct).

\(^{53}\) See, e.g., Hickman, supra note 6, at 865-67.
to this argument, some commentators have criticized Congress for exporting morality abroad and for failing to recognize the diversity of foreign cultures, some of which condone the payments.53 Quite apart from this fundamental political question, however, there is the narrower question of whether Congress should use the tax laws in particular to discourage conduct which it finds unethical or immoral.

Insofar as section 162(c)(1) relies on a moral justification, it is analogous to the judicially promulgated "public policy doctrine."54 Under that doctrine, a business expense would not be "necessary" within the requirements of section 162(a) if "allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."55 This definition constituted a marked departure from previous interpretations of "ordinary and necessary" which required only that the expense be "appropriate and helpful" to the taxpayer's profit-seeking venture and not unique in the taxpayer's line of business.56 By imposing the additional Congress cannot legislate morality for another country. Of course, Congress can regulate the conduct of United States businesses, but an attempt to impose local moral standards on a business enterprise functioning abroad in an entirely different social setting would be tantamount to legislating morality for the particular foreign nation. A business does not function in a vacuum, but must interact with different elements in different nations.

Note, Securities Regulation, supra note 11, at 434.

54 The development of the public policy doctrine followed a torturous course, disallowing deductions for commercial bribery of domestic government officials, Easton Tractor & Equip. Co. v. Comm'r, 35 B.T.A. 189 (1936); commercial kickbacks, Lilly v. Comm'r, 343 U.S. 90 (1952); fines and penalties regularly incurred in the conduct of a legal business, Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30 (1958); and even the legal expenses of defending businessmen against criminal prosecutions for actions taken in the conduct of the business, see Commissioner v. Tellier, 383 U.S. 687 (1966) (overruling prior cases and granting the deduction). Congress intended § 162, as amended by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 902(b), to supercede the doctrine. The Senate Report stated that the statutory coverage "is intended to be all inclusive" and that "[p]ublic policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions." S. REP. NO. 91-552, 91st Cong., 1st Sess. 274 reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2027, 2311. However, disputes may still arise over the question of whether a particular expense satisfies the statutory requirement of "ordinary and necessary." See United Draperies, Inc. v. Comm'r, 340 F.2d 936 (7th Cir. 1964). For criticisms of the public policy doctrine, see generally Gordon, The Public Policy Limitation on Deductions from Gross Income: A Conceptual Analysis, 43 IND. L.J. 406 (1968); Lindsay, Tax Deductions and Public Policy, 41 TAXES 711 (1963); Paul, supra note 37; Reid, Disallowance of Tax Deductions on Grounds of Public Policy—A Critique, 17 FED. B.J. 575 (1957); Taggart, supra note 36; Note, Public Policy and Federal Income Tax Deductions, 51 COLUM. L. REV. 752 (1951); Note, Public Policy and the Deductibility of Kickbacks Under § 162(c)(2), 35 OHIO ST. L.J. 686 (1974); Comment, supra note 18.

55 Commissioner v. Heininger, 320 U.S. 467, 474 (1943). Thus, federal and state statutes banning domestic bribes and kickbacks to government officials would render such payments nondeductible. Easton Tractor & Equip. Co. v. Comm'r, 35 B.T.A. 189 (1936). The public policy doctrine, however, could not encompass bribery of officials and employees of foreign governments because these payments are lawful in the United States and are not proscribed by any federal or state statutes.

56 Welch v. Helvering, 290 U.S. 111 (1933). The legislative history of the Revenue Act of 1913, which first introduced the deduction for "ordinary and necessary" business expenses, indicates that the phrase was used only to achieve a tax on net income, the taxpayer's actual profit during the year: "Congress did not seek to police, prohibit, or punish ..." Paul,
requirement that payments not promote illegality, the public policy doctrine inappropriately introduced moral considerations into the calculation of taxable income. 57

It has been argued cogently that the public policy doctrine inflicted a penalty on taxpayers. 58 Based solely on a policy inferred from a primary, nontax statute, the doctrine deprived the taxpayer of deductions for expenses which were otherwise ordinary and necessary to the taxpayer's business. As a result, the tax laws amplified the "sting" of the penalty exacted by the primary statute. 59

Section 162(c)(1) also creates a tax penalty, for it too denies a business deduction for expenses which were in fact ordinary and necessary to the taxpayer's enterprise. 60 Moreover, section 162 (c)(1) does not rely upon a statement of policy originating outside the tax laws to justify its disallowance of deductions, for the section contains the only declaration of federal policy against the bribery of foreign officials. Consequently it imposes the penalty directly, without the mediation of other statutes. 61

supra note 54, at 723-28. Most commentators have argued that the IRS and the courts should look to the actual practices of businessmen to determine whether a particular expenditure is "ordinary and necessary," for otherwise they assume the status of management experts reviewing the business decisions of the taxpayer. See Paul, supra note 54, at 727; Comment, supra note 18, at 113 n. 20. The author of the latter reasoned:

Under the present treatment of unlawful expenditures, the problem is often cast in terms of whether the expenses are ordinary and necessary. When the Treasury disallows penalties paid for an industry wide practice of violating burdensome maximum weight laws; or even protection payments paid by a gambling establishment to avoid prosecutions, on the ground that it is never "ordinary," or at least "necessary" to violate the law in conducting a business, however, it is clear that the meaning of these terms is distorted to meet the demands of the public policy rationale.

It is the fact of illegality and not the ordinary criteria of "ordinary and necessary"—whether such expenditures are generally incurred in the taxpayer's type of business—that is determinative under the public policy rationale.

Comment, supra note 18, 113 n. 20.

57 Section 162(c)(1)'s reliance on morality is not subject to some of the criticisms that surround the public policy doctrine. Since § 162(c)(1) was created by Congress and not by the courts, there is no doubt, as there may be with the public policy doctrine, that Congress intended to establish this exception to the usual policy of taxing net income. Moreover, unlike the public policy doctrine, § 162(c)(1) possesses established, well-defined boundaries and is not susceptible to unexpected expansion.

In addition, § 162(c)(1) does not contravene the principles of federalism, since it purports to regulate commerce with foreign nations and not activities of state concern. The public policy doctrine, however, often involved activities illegal under state law. By disallowing the deduction, the national government added a sanction to that penalty imposed by the state. Since the federal government administered this additional penalty, it also assumed some control over what was once a matter exclusively of state discretion. Critics of the public policy doctrine claimed that this amounted to an unwarranted interference with state autonomy.

58 See, e.g., Gordon, supra note 54; Comment, supra note 18.

59 Id.

60 See Letter from Russell C. Harrington, Comm'r, I.R.S., supra note 2 (stating that, in limited circumstances, bribes and kickbacks to foreign officials would be found "ordinary and necessary"). The sole impact of § 162(c)(1) was to render nondeductable those bribes and kickbacks to foreign officials the IRS had found were ordinary and necessary and thus deductible under § 162(a). Indeed, it can be argued that most bribes paid to foreign officials are "ordinary and necessary," since they are legal in the United States, not uncommon, and "appropriate and helpful" to the taxpayer's business. Cf. note 56 supra.

61 Upon first reading, it might appear that § 162(c)(1) does rely on declarations of
Characterizing section 162(c)(1) as a penalty has the advantage of being conceptually accurate in describing the purpose underlying Congress' enactment of the disallowance. It also provides a useful standard against which the statute's actual performance can be measured. Functioning as a penalty, section 162(c)(1) has four disadvantages: limited scope; inability to deter foreign bribery; unfairness in application; and negative impact on tax law administration.

1. Scope—As used in this article, the term "scope" refers to the mechanical efficiency of section 162(c)(1); that is, the extent to which the penalty produces some disincentive for all the payments it seeks to eliminate. Because of the structure of the tax laws, the scope of section 162(c)(1) is limited to bribes paid by domestic companies. Payments from controlled foreign corporations (CFCs), the overseas subsidiaries of domestic taxpayers, will usually elude the disincentive. This deficiency arises from the basic nature of a disallowance; it can increase tax liability only if a tax is imposed on the income against which the deduction is to be taken. The income of domestic corporations, including foreign branch operations, is subject to current federal taxation. The income of CFCs, however, so long as it is derived from sources outside the United States, is not taxed at the corporate level and remains untaxed until it is repatriated to domestic shareholders in the form of dividends. Thus, disallowing a deduction allocable to the foreign source earnings of a CFC produces no impact because this income is not subject to taxation.

One notable exception to this rule exists for the Subpart F income of CFCs. Congress enacted Subpart F of the Internal Revenue Code in 1962 chiefly to curtail the use of overseas subsidiaries as “tax havens.” Prior to this reform, many domestic corporations attempted to minimize their taxes by selling their goods to a foreign subsidiary which would then sell the goods to the ultimate purchaser. If the price charged by the parent

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62 Controlled foreign corporations are defined in note 7 supra.
63 I.R.C. § 11(a).
64 I.R.C. § 882 imposes a tax on the income of foreign corporations which is effectively connected with the conduct of a trade or business within the United States.
65 I.R.C. § 11(f).
66 I.R.C. § 61(a)(7). No deduction is allowed to a domestic corporation for amounts received as dividends from foreign corporations. I.R.C. § 243(a).
corporation to the subsidiary was reasonable and title to the products passed outside the United States, the sales income of the subsidiary was not subject to a federal tax until it returned to the United States as dividends. The realized income upon the sales was taxable only in the foreign country where the subsidiary was located, and this country was usually selected for its extremely low tax rates.

Subpart F provides that the income realized by a CFC from the sale to or a purchase from a related party, when the property transferred is produced and sold for use outside the country of the CFC's incorporation, is to be treated as a pro rata distribution to all United States shareholders who own ten percent or more of the voting stock of the CFC. This income is taxed currently as a constructive dividend to these shareholders, although the CFC itself still pays no tax. Other transactions which give rise to Subpart F income include the performance of services abroad by a CFC on behalf of a related corporation when the services are rendered outside the country of the CFC's incorporation and the holding by a CFC of properties which produce passive income.

Insofar as the scope of section 162(c)(1) is concerned, Subpart F is important for the very reason that income of the CFC attributed to shareholders is taxed currently. Disallowing a deduction allocable to Subpart F income generates a larger deemed pro rata distribution to ten percent shareholders and a concomitant increase in their tax liability. As a consequence, the section 162(c)(1) penalty creates some disincentive for bribery of foreign officials by overseas sales subsidiaries. However, there is no impact whatsoever upon domestic shareholders when Subpart F is inapplicable as, for example, when the foreign subsidiary sells the product inside rather than outside its country of incorporation.

Even when Subpart F is applicable, it may have little value as a deterrent. Consistent with the usual treatment accorded dividends, Subpart F income cannot exceed the earnings and profits of the CFC for its taxable year, and any amounts above this ceiling are not deemed to be distributions to United States shareholders. Prior to 1976, it was still possible to treat section 162(c)(1) payments, though nondeductible, as legitimate expenses to be subtracted in computing the fund of earnings and profits available for distribution to the shareholders. Subtraction of

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68 I.R.C. § 952(a)(2); I.R.C. § 954(a)(2), (d).
69 I.R.C. § 951(a).
70 I.R.C. § 951(b).
71 I.R.C. § 954(a)(3), (e).
72 I.R.C. § 954(a)(1), (c).
73 Under § 954(b)(5) of the Internal Revenue Code, the corporation must take into account all deductions properly allocable to that income when computing its taxable Subpart F income. Treas. Reg. § 1.954-1(c) (1964) and Treas. Reg. § 1.952-2(b)(1) (1964) in conjunction require that allowable deductions be determined according to the provisions of the Code, so that payments within section 162(c)(1) are nondeductible.
74 I.R.C.§ 954(d)(1)(B).
75 I.R.C.§ 952(c).
76 Prior to the enactment of the Tax Reform Act of 1976, § 964(a) specified that the earnings and profits of any foreign corporation were to be determined according to rules substantially similar to those applicable to domestic corporations. Although it was generally
these expenses lowers the ceiling on Subpart F income and thus mitigates the impact of the penalty generated by the disallowance.

2. Deterrence—As a practical matter, the circumscribed scope of section 162(c)(1) virtually assures that there will be no tax deterrent to bribery of foreign governments by United States controlled foreign corporations. But even apart from the problems with the scope of section 162(c)(1), the disallowance of deductions would probably still not constitute an effective deterrent, because the severity of the penalty bears no relation to the amount of gain realized from making the payment. Where the payment is required in order to continue doing business or where economic gain from making the payment substantially outweighs the attendant tax liability, the section 162(c)(1) disallowance will probably be treated merely as an additional cost of doing business. For example, the potential penalty for a domestic corporation with taxable income in excess of $50,000 remains at a fixed level equal to the marginal tax rate, which is approximately forty-eight percent, times the aggregate amount of nondeductible payments. If the profit directly attributable to making the payment plus the cost of the bribe itself surpasses this penalty, the taxpayer is unlikely to be deterred from making the payment. In addition, the more effective the bribe is in generating profits, the less effective the penalty will be since it remains pegged at one level.

Despite these limitations, section 162(c)(1) does have some value as a deterrent. By imposing a high additional cost, section 162(c)(1) encourages companies to switch from bribery to an alternative, more productive method of generating income. The larger the bribe and the smaller the profit margin, the more likely it will be that the extra tax cost will tip the balance in favor of the congressionally desired pattern of behavior.

3. Fairness—Of all the shortcomings of section 162(c)(1) as a penalty, perhaps the most telling is its manifest unfairness. There are three separate aspects to this unfairness. One aspect arises from the fact that the value of the deductions disallowed by section 162(c)(1) varies with a taxpayer’s income. As a result, taxpayers in higher brackets encounter a larger penalty than taxpayers in lower brackets for payments of equal amount and offensiveness. Thus, the “sting” of the disallowance is greater for unincorporated enterprises, whose tax brackets may rise to seventy percent, than for corporations, whose highest bracket is forty-eight percent. Moreover, since the Internal Revenue Code grants spe-
cial tax benefits to certain types of corporations, the section 162(c)(1) penalty will vary among incorporated businesses. For example, since 1971, the Code has accorded beneficial tax status to domestic international sales corporations (DISCs), which are predominately the sales subsidiaries of domestic parent corporations. Until 1976, DISCs were taxed currently on half of their income; the DISCs paid no tax at all, much like the CFCs, but DISC shareholders paid their pro rata share of a tax on half of each dollar of income. Because only half of a disallowed deduction was subject to taxation, the section 162(c)(1) sanction for DISCs was only half the penalty imposed on standard domestic corporations. In the Tax Reform Act of 1976, Congress limited DISC benefits to export sales in excess of sixty-seven percent of the average gross receipts for a four-year base period. DISCs with taxable income of $100,000 or less are totally exempt from the new rules, and the exemption phases out at $150,000. This new incremental treatment means that section 162(c)(1) penalties will vary even among DISCs, depending on their income.

One final example of this aspect of the unfairness of section 162(c)(1) can be seen in the operation of CFCs. Only domestic shareholders who own at least ten percent of all the shares suffer increased tax liability as a result of a CFC's foreign bribe. A wealthy individual shareholder in the seventy percent tax bracket will lose seventy cents on each dollar of payments within section 162(c)(1), whereas a corporate shareholder in the forty-eight percent bracket will lose only forty-eight cents. Furthermore, a ten percent shareholder who lacks effective control over the daily management of the CFC may be penalized for a business practice which he never authorized.

A second aspect of the unfairness of section 162(c)(1) is that its sanction is always determined with reference to the dollar amount of the bribe rather than to the particular circumstances surrounding each payment. Arguably, a bribe made with intent to corrupt should draw greater punishment than a gift made only to assure performance of official duties. Under section 162(c)(1), however, assuming the payments are of equal amount, the penalty is the same for both. In addition, section 162(c)(1) permits no discretion in the initial decision to apply a penalty. No provision is made for situations in which bribery may be morally justifiable, such as in cases involving extortion.

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80 I.R.C. § 995. Domestic international sales corporations are defined in note 8 supra.
81 I.R.C. § 995(a), (b)(1).
84 Under the federal antibribery statutes, bribery with intent to corrupt or influence is punishable by a maximum fine of $20,000 or three times the monetary equivalent of the bribe, whichever is greater, or no more than fifteen years imprisonment. 18 U.S.C. § 201(b), (e).
85 If extortion raised a defense to federal bribery prosecutions, the payments would not be
The third aspect of the unfairness of section 162(c)(1) lies in its failure to establish a maximum sanction which accurately reflects society's judgment of the offensiveness of the conduct. Under most federal criminal statutes, penalties have an established upper limit. When punishment is applied through the tax laws, however, there is no ceiling on the potential severity of the sanction.\textsuperscript{86}

4. Impact on Administration of the Tax Laws—Section 162(c)(1) works inequity upon taxpayers in its daily, routine operation, but in the long run, it may be the Internal Revenue Code and the Internal Revenue Service that suffer most. If the Internal Revenue Code becomes an instrument for punishment, a backlash may occur not only against the legitimacy of the particular Code provision,\textsuperscript{87} but also against the broad investigatory powers of the IRS.\textsuperscript{88} Tolerance for both taxation and the Service's investigatory techniques depends upon recognition of the importance of the revenue-collecting function and the procedural necessities which this function entails.\textsuperscript{89} When the objective of the tax laws is shifted away from gathering needed monies to punishment, compliance may diminish and enforcement efforts may become strongly resented. That the Service found it necessary to establish new audit techniques to ensure compliance with section 162(c)(1)\textsuperscript{90} and that these new techniques, particularly the

unlawful under United States law and would be deductible. However, in two cases where the defendant could not make the requisite showing that economic harm was actually threatened, the courts never reached the issue of whether extortion constitutes an affirmative defense to the bribery proscribed by 18 U.S.C. § 201. United States v. Miller, 340 F.2d 421, 425 (4th Cir. 1965); United States v. Kabot, 295 F.2d 848, 854 (2d Cir. 1961), cert. denied, 369 U.S. 803 (1961).

\textsuperscript{86} For example, a $1 million payment to a foreign official for the performance of legitimate official duties would generate, under § 162(c)(1), an increased tax liability of 48% (the marginal tax bracket for domestic corporations) times $1 million (the amount of the disallowance), or $480,000. By contrast, the maximum criminal penalty for a similar offense under federal law is $10,000. 18 U.S.C. § 201(f).

There is one federal antibribery law which does not have a fixed maximum penalty. When a bribe is made with intent to corrupt, the maximum fine is three times the amount of payment. 18 U.S.C. § 201(b). Unlike § 162(c)(1), however, this statute is limited to the most egregious types of payoffs.

\textsuperscript{87} Business taxpayers might resent § 162(c)(1) for the more obvious reason that the disallowance boosts their tax liability if they bribe foreign officials or employees. In addition, business taxpayers must be concerned with potential criminal liability under §§ 7201-7207 for intentional violation of the § 162(c)(1) disallowance. They may avoid criminal liability by not taking any impermissible deductions, but often it is unclear whether a particular payment actually falls within § 162(c)(1). See notes 22-35 and accompanying text supra. To ensure the secrecy of the payments, companies often record them on corporate books as routine business expenses. See Solomon & Linville, supra note 11, at 311 n. 33. Moreover, as a result of either negligence or greed, payments are sometimes claimed as legitimate business expenses for tax purposes. See House Hearings on the Activities of Multinationals, supra note 3, at 48-57 (Discussion by Donald C. Alexander, Singleton Wolfe, and members of the Subcomm. on Int'l Econ. Policy).

\textsuperscript{88} The same prediction was made for the public policy doctrine. See Gordon, supra note 54, at 415-17. However, consequent limitations on the freedom of the IRS never materialized, suggesting that the uproar over section 162(c)(1) might also subside without substantial impact.

\textsuperscript{89} Cf. Gordon, supra note 54 at 416.

\textsuperscript{90} See note 7 supra. Donald C. Alexander, Comm’r, I.R.S., explained the reason for new audit techniques:

All the efforts which I have just discussed, Mr. Chairman, are in response to a wide
"eleven questions,""9¹ quickly attracted stiff criticism,⁹² may indicate that this process has already begun.

II. EXPANSION OF THE SECTION 162(c)(1) PENALTY BY THE TAX REFORM ACT OF 1976

Given the serious inadequacies of section 162(c)(1) as a penalty, Congress should have repealed the statute and ceased using the tax laws to implement its moral judgments. Instead, when Congress enacted the Tax Reform Act of 1976, it strengthened the tax deterrent to bribery of foreign government officials and employees. The new legislation was clearly designed to effect a penalty. Senator Harry C. Byrd, the sponsor of the provisions, declared that his proposals would go ""a long way toward eliminating abuses which have been disclosed in recent months.""⁹³

variety of evidence, both formal and informal, which suggests the existence of previously undetected abuses of the tax system. . . . [T]he common denominator in these schemes has been the use of foreign bank accounts, foreign affiliates and other entities to disguise the sources for these slush funds. The diversity of techniques used in these schemes is practically unlimited. Illegal payments have been reflected as legal services, loans, advances to subsidiaries, insurance expense, unclassified expenses, commissions, and corporate officers' bonuses. Erroneous invoices and supporting data have been created for these expenditures. Collusion by corporate officers has aided in the disguise of these payments. House Hearings on the Activities of Multinationals, supra, note 3, at 44-45 (Statement of Donald C. Alexander).

⁹¹ Illustratively, two of the ""eleven questions"" to be asked of key corporate officials and the corporation's outside auditors are as follows:

1. During the period from _____ to _____, did the corporation, any corporate officer or employee or any third party acting on behalf of the corporation, make, directly or indirectly, any bribes, kickbacks or other payments, regardless of form, whether in money, property, or services, to any employee, person, company or organization, or any representative of any person, company or organization, to obtain favorable treatment in securing business or to otherwise obtain special concessions, or to pay for favorable treatment for business secured or for special concessions already obtained?

4. During the period _____ to _____, was corporate property of any kind donated, loaned, or made available, directly or indirectly, to or for the use or benefit of, or for the purpose of opposing, any government or subdivision thereof, political party, candidate or committee, either domestic or foreign.


³ Three fundamental criticisms have been leveled at the ""eleven questions."" First, they are burdensome to answer. Second, a mistaken or careless answer may invite prosecution under the Internal Revenue Code sections dealing with false statements. I.R.C. § 7206. Finally, the questions are vague and overly inclusive: ""[T]he questions are so broad and sweeping that it is hard for answers to be meaningful at all, and anyone who answers them with a flat 'no' would in most cases be committing perjury."" Hickman, supra note 6, at 868.


Four major benefits are accorded to United States taxpayers to promote the export of United States manufactured products and to increase competition with foreign-owned businesses: the deferral of tax on the earnings of foreign sub-subsidiaries; the deferral of tax on the earnings of domestic international sales corporation; the foreign-tax credit for foreign taxes paid (I.R.C. §§ 901-905); and the earned income exclusion for United States citizens working overseas (I.R.C. §§ 861-864). Sen. Byrd originally proposed to deny the first three benefits to income derived from bribery. The fourth benefit for employee's earned income
A. Additions to the Section 162(c)(1) Penalty by the Tax Reform Act of 1976

The overall effect of the enacted modifications is to expand the scope of the section 162(c)(1) penalty to reach payments made by overseas subsidiaries of domestic companies. Under section 1065(a) of the new Act, Subpart F income includes the sum of illegal bribes, kickbacks, and other payments within the meaning of section 162(c)(1)\(^\text{94}\) paid by or on behalf of CFCs.\(^\text{95}\) As a consequence, payments allocable to the foreign source earnings of CFCs, which previously were unaffected by the disallowance penalty of section 162(c)(1),\(^\text{96}\) are now taxed currently to ten percent shareholders. With respect to payments previously allocable to other types of Subpart F income,\(^\text{97}\) the new Act creates a dual penalty: the taxpayer must include these payments in Subpart F income but is nevertheless denied a corresponding deduction for the expense.

Taxation of DISCs under the 1976 Act follows a similar pattern; the sum of all payments under section 162(c) paid by or on behalf of the DISC are now regarded as distributions to the shareholders of the DISC.\(^\text{98}\) Thus, in addition to the sanction suffered from disallowance of the deduction,\(^\text{99}\) shareholders of DISCs, like ten percent shareholders of CFCs, will be taxed on section 162(c)(1) payments made by their subsidiaries.

Finally, the Tax Reform Act of 1976 expressly prohibits a CFC from subtracting the amount of section 162(c) payments in computing its earnings and profits.\(^\text{100}\) Congress apparently intended this change to complement the inclusion of section 162(c)(1) payments in Subpart F income, and the change does ensure that Subpart F income, which is limited to the earnings and profits of the CFC,\(^\text{101}\) will not reflect deductions for proscribed payments. Despite this narrow purpose, the redefinition of earnings and profits will also have ramifications on other sections of the Internal Revenue Code. Most notably, it reduces the value to a domestic corporation of the foreign tax credit (calculated on an overall basis) was retained, since its elimination would penalize employees rather than the offending employer. To ensure effective enforcement, the original proposal called for stringent reporting of § 162(c)(1) payments and the income derived therefrom. Willful failure to make the required reports would have been punishable by a fine of not more than $25,000, imprisonment for not more than one year, or both. The maximum fine for the felony of tax evasion, in contrast, is only $10,000. I.R.C. § 7201. It is significant that Senator Byrd's sanction was computed on the basis of the income derived from making a bribe, not on the size of the bribe itself. 122 Cong. Rec. S. 3427-29 (daily ed. March 16, 1976) (remarks of Sen. Harry F. Byrd, Jr.), S. Rep. No. 94-938, 94th Cong., 2d Sess. 287 (1976), reprinted in [1976] U.S. Code Cong. & Ad. News 3717.

\(^{94}\) The provisions of the new Act embrace § 162(c)(2) payments as well as § 162(c)(1) expenses. They also expressly encompass third party bribes paid on behalf of the taxpayer. See notes 33-35 and accompanying text supra.

\(^{95}\) Tax Reform Act of 1976, § 1065(a)(1); I.R.C. § 952(a)(4).

\(^{96}\) See notes 62-66 and accompanying text supra.

\(^{97}\) See notes 67-76 and accompanying text supra.


\(^{99}\) See notes 80-83 and accompanying text supra.

\(^{100}\) Tax Reform Act of 1976, § 1065(b); I.R.C. § 964(a).

\(^{101}\) See notes 75-76 and accompanying text supra.
received for foreign taxes levied upon a foreign subsidiary's income. A domestic corporation owning ten percent of the voting stock of a CFC receives a tax credit for a proportion of the foreign taxes actually paid by the CFC. This proportion is equal to the ratio of dividends actually received from the CFC, to the CFC's accumulated profits, which are determined by reference to earnings and profits,\textsuperscript{102} or to the ratio of the dividends deemed to have been received from the CFC under Subpart F, to the CFC's earnings and profits.\textsuperscript{103} By preventing a CFC in computing earnings and profits from deducting amounts expended as section 162(c)(1) payments, the new Act inflates the denominator in these ratios, lowers the amount of the foreign tax credit, and thereby imposes an additional penalty on the taxpayer.

\textit{B. Implications of the 1976 Amendments}

Although the Tax Reform Act of 1976 broadens the scope of the section 162(c)(1) sanction to encompass all bribes and kickbacks paid to foreign officials regardless of the domicile of the taxpayer, the new measures actually aggravate, rather than ameliorate, the other defects inherent in the section 162(c)(1) penalty. As a result of the expanded scope, deterrence has increased, but so has the arbitrariness of the penalty. There are now four distinct ways in which corporate bribery of foreign officials and employees may result in the tax punishment of a domestic corporation. These tax penalties, which may vary in amount, are based not on the heinousness of the payment but on the Internal Revenue Code classification of the bribing taxpayer and its income.

The penalty imposed upon a domestic corporation which itself makes a section 162(c)(1) payment is equal to the amount of the disallowance (the dollar value of the bribe) times the appropriate tax rate (usually forty-eight percent). If a foreign subsidiary of the domestic corporation transmits the bribe, the same penalty arises, but the tax code effects it through the mechanism of an increase in the Subpart F income deemed distributed to the corporation as a domestic shareholder.

The second way in which a domestic corporation may be penalized arises when payments are made by its DISC. These section 162(c)(1) payments cause the domestic parent corporation to suffer a nearly twofold increase in tax liability: a deduction for the payments is disallowed, and the deemed distribution under section 995(b)(1)(F)(iii) is increased by the amount of the bribes. The intended impact of the disallowance is muted, however, because only a part of the DISC's taxable income is subject to a current tax. The third way in which tax punishments may be incurred by a domestic corporation results when its CFC makes a section 162(c)(1) payment that could have been deducted in the

\begin{footnotesize}
\textsuperscript{102} I.R.C. § 902; Treas. Reg. § 1.902-3(c)(5) (1965). In § 1031 of the Tax Reform Act of 1976, Congress amended §§ 904, 901(a), 901(b), and 960(b) of the Internal Revenue Code to require taxpayers to determine the foreign tax credit limitation on an overall basis; no longer may taxpayers elect determination of the limitation on a per-country basis.

\textsuperscript{103} I.R.C. § 960. See also note 102 supra.
\end{footnotesize}
computation of the CFC's Subpart F income. Here, the disallowance of the deduction, added to the deemed distribution of the amount expended as a bribe as Subpart F income under section 952(a)(4), imposes a double penalty on the domestic taxpayer. Finally, a domestic corporation may also be penalized by the reduction in its foreign tax credit due to the redefinition of earnings and profits of the CFC brought about by the 1976 Act. The exact amount of this penalty will vary according to the ratio governing the calculation of the credit.

Besides exacerbating the arbitrariness of the section 162(c)(1) penalty, the new Act also poses a less obvious but potentially more troublesome problem. By redefining Subpart F income and deemed distributions to DISC shareholders so as to include amounts identified as section 162(c)(1) payments, the Act in essence classifies taxpayer expenses as income. The conceptual novelty of this policy shift is worth noting, but there are also practical consequences of great importance.

The policy shift is likely to generate two practical side effects. First, it may significantly alter the relationship between the IRS and corporate taxpayers. When bribes were simply nondeductible, the IRS passively checked deductions to see that the expenditures were not reported and subtracted from gross income. Under the 1976 Act, however, the Service must act affirmatively to make sure that these expenses are properly listed on tax returns. Detailed information about each section 162(c)(1) payment must be gathered to enable the Service to verify the reported income and to assure that the United States Treasury receives the proper tax levy. This change results in both a more burdensome workload for the IRS and increased surveillance of foreign taxpayers and domestic shareholders. Domestic shareholders who neglect to report the expenses of their CFCs or DISCs as income will be civilly liable for tax avoidance and criminally liable for fraud or tax evasion if the failure to report is willful. The net result may be heightened resentment toward these provisions of the Tax Reform Act of 1976 and toward the IRS.

Second, the new Act effectively compels mandatory disclosure of corporate bribery of foreign officials and employees, because section 162(c)(1) payments by CFCs or DISCs must now be reported as income. This form of disclosure is more comprehensive and pervasive than that demanded by the securities laws, since it requires no threshold limitation of "materiality." Moreover, information disclosed under the tax laws

104 Tax Reform Act of 1976, § 1065(b); I.R.C. § 964(a).
105 Suppose, for example, a CFC pays a $1 million bribe to a foreign official in order to obtain a sales contract, but, contrary to the corporation's expectations, the cost of the bribe exceeds its gross income. According to I.R.C. § 952(a)(4), there would nevertheless be $1 million in taxable Subpart F income.
106 A taxpayer must not only accurately report the amount of his income, he must also report its source, so that the IRS may check his accounting. Failure to list the proper source, if done willfully, may constitute fraud. United States v. Di Varco, 343 F. Supp. 101 (D.C. Ill. 1972).
107 §§ 7201-7207 of the Internal Revenue Code contain the criminal penalties for tax fraud and tax evasion.
108 See note 11 supra. The SEC has taken the view that the "materiality" of a bribe or kickback to a foreign official will depend upon a number of factors, including legality under
may be subject to public exposure equal to that required by the securities laws. Although information filed in tax returns appears to be confidential, it is in fact available upon request to a vast number of federal and state agencies, and sensational matters such as corporate bribery invite leakage. This threat of public disclosure may, in fact, be the strongest possible deterrent to section 162(c)(1) payments.

III. CONCLUSION

The decision to use the tax laws to deter bribery of foreign officials necessarily rests on two preliminary assumptions. The first assumption, based on political or moral considerations, is that bribery of government officials by United States businesses should be officially condemned regardless of whether it occurs in the United States or abroad. The second assumption is the belief that the tax laws constitute an appropriate and effective means for deterring the bribery of foreign officials.

This article has sharply criticized the second assumption. Relying upon section 162(c)(1) of the Internal Revenue Code to compel moral conduct may in fact produce ethical enterprise overseas, but only at the substantial cost of treating domestic taxpayers unjustly. The multiplicity of tax brackets and incentives contained in the Code precludes the creation of an equitable tax penalty. Disallowing a deduction for ordinary and necessary bribes and kickbacks to foreign officials creates a sanction which varies arbitrarily from one taxpayer to another, leaves no room for mitigating circumstances, and can be inordinately severe. As a consequence, taxpayers may become more resentful of the Internal Revenue Code and the IRS techniques used to enforce the Code. The moral and political goals which Congress sought to realize through the enactment of section 162(c)(1) certainly do not require such an objectionable method of implementation.

In the Tax Reform Act of 1976, Congress extended the section 162(c)(1) deterrent to encompass bribes paid by foreign subsidiaries, by defining the payments to be deemed distributions to the domestic shareholders in the CFC or DISC. In doing this, it further complicated already burdensome tax administration, and rendered the section 162(c)(1) sanction even more capricious. In the future, Congress should repeal section 162(c)(1) and regulate foreign payments through other, more suitable statutes.

—Christopher Alan Lewis