Office of Chief Counsel
Internal Revenue Service
Memorandum

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CC:LM:
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date: April 12, 2010

to: Team Manager

Attn:

from: Associate Area Counsel (LMSB)
( )

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subject: Income Tax Adjustment for Certain Payments or Discounts made in Violation of the Anti-Kickback Act, 41 U.S.C. §§ 51-58.

This memorandum responds to your request for advice regarding taxpayers engaged in similar and/or related transactions [redacted] You have requested our advice concerning the application of I.R.C. § 162(c)(2) to certain payments or discounts made by vendors which violate the Anti-Kickback Act, 41 U.S.C. §§ 51-58. This advice may not be used or cited as precedent.

DISCLOSURE STATEMENT

This advice may contain taxpayer information subject to I.R.C. § 6103. The advice may also contain confidential information subject to the attorney-client privilege, deliberative process privilege, and other applicable privileges. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

This advice is not binding on the Service and is not a final case determination. The content is advisory and does not resolve any Service position on an issue or provide the basis for closing a case. The determination of the Service in any case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the Anti-Kickback Act of 1986, 41 U.S.C. §§ 51-58 ("Anti-Kickback Act"), applies to amounts paid by a taxpayer to a consultant business pursuant to contractual obligations to provide discounts or to pay referral or other fees to the consultant, such that the taxpayer is barred under I.R.C. § 162(c)(2) from deducting such fees or including such costs as a cost of goods sold.

CONCLUSION

A taxpayer is barred, under I.R.C. § 162(c)(2) and the Anti-Kickback Act, from deducting as an expense a referral, or other fee paid to a consultant if: (1) the payment was made to a consultant who held a prime or a higher-level subcontract with the federal government; and (2) the payment was made for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime or higher level subcontract.

Therefore, where a taxpayer obtains a direct prime contract with the government with the assistance of a third-party consultant who is not acting under the obligations of a separate prime contract with the government, and the taxpayer pays the consultant a related referral fee, the fee is deductible because such fee is not a kickback under the Anti-Kickback Act. However, where a taxpayer subcontracts or provides goods and services to fulfill a prime contract between a consultant and the government, and pays the consultant a related referral fee, the fee is non-deductible as an illegal kickback if the facts demonstrate that the payment was made for the impermissible purpose of improperly obtaining or rewarding favorable treatment. Because it is necessary to demonstrate the purpose of a payment to a consultant, the deductibility of any particular payment will depend on the specific facts [redacted]

As a general matter, I.R.C. § 162(c)(2) does not prevent a taxpayer from including the costs of illegal kickbacks in costs of goods sold, adjusting the purchase price, or otherwise excluding from gross income discounts or rebates paid to a purchaser, where the net selling price is negotiated and agreed by the buyer and purchaser. Furthermore, as relevant here, the Anti-Kickback Act does not apply unless the consultant held a prime or a higher level subcontract with the federal government.

Therefore, where a consultant purchases product from a taxpayer for resale to the government, and the purchase price is discounted to the consultant, or the consultant is entitled to rebates or additional goods from a taxpayer as part of the negotiated sales price between the consultant and taxpayer, the taxpayer is generally entitled to exclude from gross income or make adjustments to costs of goods sold for these amounts even though such conduct may in fact violate the Anti-Kickback Act. Additionally, where the government purchases product directly from a taxpayer, and a consultant is entitled to

"rebates" or goods from taxpayer as part of a separate agreement, the taxpayer is generally not entitled to exclude from gross income or make adjustments to costs of goods sold for these amounts because they will not be true purchase price adjustments. However, such amounts will not be "kickbacks" under the Anti-Kickback Act unless they are paid to a consultant who held a prime or higher level subcontract with the federal government and are made for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime or higher level subcontract.

FACTS

Our understanding of the facts is based on the information currently available to us. If you learn that the facts relied upon here are incorrect, incomplete, or different in any material respect, then our legal analysis may be different. In such case, please contact your local counsel or our office for further advice.

[redacted][1]

The taxpayers are

("Vendors"). Vendors work with various consulting, sales, marketing, and distribution businesses ("Consultants") in marketing, selling and servicing Vendor's ("Products").

Vendors have entered into contractual relationships with various Consultants . Consultants, in turn, have entered into such agreements with various

[1] [redacted]

Vendors.

The specific terms of each contractual relationship vary, but the typical contracts provide that Consultant will market and sell Vendor's Products to customers , and Vendor in turn agrees to sell its Products to Consultant at a discount from the commercially available price. Vendor also typically agrees to pay Consultant a fee for referrals made by Consultant for purchases of Vendor's Products by third parties, including the government. These contracts are sometimes limited to a specific geographic area or customer base.

Consultants market themselves to both Vendors and customers.

Vendors engage in providing to the United States government through two primary avenues: direct contracting with a government agency; and subcontracting through a Consultant.[2] For these purposes, the term "subcontracting" incorporates both: (1) Vendor reaching a written contract with Consultant for services or product in relation to a government contract; and (2) Vendor selling services or product to Consultant which Consultant uses in fulfillment of the government contract.

[2] We note that it may be possible that Vendor obtained a direct prime contract with the government with the assistance of Consultant who was acting under the obligations of a separate prime contract with the government.

Consultants engage in providing
to the government through direct contracting with a government agency. Consultants may contract with the government for the products and services of individual or multiple Vendors, depending on the contract. Such Consultant-government contracts may be based on specific projects or for general purposes. Consultants may also contract with the government to assist the government in direct contracting with Vendors.

Transaction Structures: Resale vs. Referral

There are two basic transaction structures anticipated under the arrangement: (1) "resale" by Consultant of Vendor's Products; and (2) "referral" by Consultant of Vendor's Products to customers or to Vendor of sales opportunities.

Resale. This contracting relationship has two parts and forms a straight-line relationship: Vendor with Consultant, and Consultant with the end purchaser

Consultant then engages in sales and marketing of Vendor's Products, and retains a profit from any sales transactions of the excess of the final sales price over the discounted price under the reseller agreement. In some cases, Consultant may be paid a referral fee, rebate or
from the Vendor based on a percentage of the net price Consultant paid to Vendor. When the resale is to the government, Consultant is paid by the government for the full contract price of the Products, and receives any rebates, discounts, etc. from Vendor on the same transaction.

Referral. This contracting relationship has three parts and forms a triangle relationship: Vendor with Consultant, Vendor with end purchaser, and Consultant with end purchaser. If Consultant assists in referring customers to Vendor (i.e. for Vendor Products that Consultant is not authorized to market and sell directly), Vendor will pay a referral fee to Consultant. This referral fee arrangement may be incorporated into the reseller or agreement, or may be part of a separate referral agreement between the companies. Such fees may also be paid to Consultant where Consultant contracts Vendor to

When referral is made for a government contract and Consultant is not acting under the obligations of a government contract, Consultant is paid only by the Vendor on the transaction.

Resale Transactions

When Vendor receives a government subcontract through Consultant, Vendor bills Consultant the agreed upon discounted price, but ships the product directly to the government . In these transactions, Consultant enters into a procurement or other contract with a government agency or entity to provide products and services. These transactions may be referred to by the parties as .

In some cases, the government procurement contract may have specific Vendors identified as subcontractors from which the government may make purchases.

In other cases, the procurement contract may require Consultant to arrange directly the acquisition of products and services. Vendor's records may identify Consultant, the price paid by Consultant, and the government to whom the Product was provided.

Referral Transactions

When Vendor receives a government contract directly but with the assistance of a Consultant, Vendor bills and ships the product to the government customer.

As part of the agreement, in contracts, Consultant generally agrees to attempt to influence the customer to select Vendor's products, in part by incorporating Vendor's Products Consultant maintains joint communication with the customer, and Consultant's personnel may perform marketing, demonstration and sales activities. Consultant may also act as a liaison between Vendor and the customer.

Pursuant to the agreement in a case, Consultant generally must request a referral fee from Vendor through the use of some form of a referral request document.

Vendor's records may therefore include the government contract, the price paid by the government, the name of Consultant involved in the transaction, a copy of the referral request form, and the amount paid to Consultant.

Generally, resale transactions are and referral transactions are . But [redacted] that it is possible that a referral sale

may be considered if Consultant is sufficiently the "lead" in the transaction, and conversely, a resale may be considered if Vendor is the "lead" in the transaction. [redacted]

Reporting of Payments and Discounts

Vendors may have made payments to Consultants in the form of: (1) money; (2) free or discounted goods, services, and training; (3) salaries paid; (4) equities given or sold for consideration under their value; and/or (5) other items of value. These payments are referred to variously as "referral fees," [redacted]."

For income tax purposes, Vendors have treated discounted products provided to Consultants for resale as either costs of goods sold or have not included the full commercial price in gross receipts. Vendors have treated money paid for referral fees as business expenses deductible under I.R.C. § 162.

LEGAL ANALYSIS

As explained above, Vendors are providing two primary types of benefit to Consultants: (1) money payments for referrals; and (2) discounted goods, services and training. While these transactions result in a similar outcome in the form of financial benefit to Consultant, they are treated differently for income tax purposes. We therefore address each separately.

Payments for Referrals

I.R.C. § 162(c)(2) prohibits deductions "made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment" under any federal or generally enforced state law that "subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business."[3] A

[3] We are addressing here only the relevant federal law. There may be individual state laws that prohibit other forms of bribes and kickbacks. [redacted]

"kickback" includes a payment for the referral of a client, patient, or customer. I.R.C. § 162(c)(2). The burden of proof is on the Service to establish whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment to the same extent of its burden to demonstrate fraud, that is, by clear and convincing evidence. Id.; Zecchini v. Commissioner, T.C. Memo. 1992-8.

As relevant here, no deductions are allowed for payments that violate the federal Anti-Kickback Act.[4] As discussed in more detail below, only if a taxpayer claims a business expense deduction for amounts paid will it be necessary to determine whether the payments were illegal kickbacks under the Anti-Kickback Act. In order to do so, we look to the specific language of the statute.

The Anti-Kickback Act prohibits any person from: (1) providing or attempting to provide any kickback; (2) soliciting, accepting or attempting to accept any kickback; or (3) including, directly or indirectly, the amount of any prohibited kickback in the price charged to the government under a prime contract or subcontract. 41 U.S.C. § 53. Both criminal and civil penalties are imposed. 41 U.S.C. §§ 54-55. A "person" is defined as a "corporation, partnership, business association of any kind, trust, joint-stock company, or individual." 41 U.S.C. § 52(3). The Anti-Kickback Act applies only to contracts with the federal government. See 41 U.S.C. § 51(1), (4) and (5).

A "kickback" is defined as:

> any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

41 U.S.C. § 52(2). A "prime contract" is a contract or contractual action entered into by the government "for the purpose of obtaining supplies, materials, equipment, or services of any kind." 41 U.S.C. § 52(4). A "subcontract" is a contract or contractual action entered into by a prime contractor or subcontractor "for the purpose of obtaining supplies, materials, equipment, or service of any kind under a prime contract." 41 U.S.C. § 52(7). A "subcontractor":

> (A) means any person, other than the prime contractor, who offers to furnish or furnishes any supplies, materials, equipment, or services of any

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[4] We are not addressing here any other potential violations of federal law [redacted]

> kind under a prime contract entered into in connection with such primer contract; and
>
> (B) includes any person who offers to furnish or furnishes general supplies to the rime contractor or a higher tier subcontractor.

41 U.S.C. § 52(8). Typically, a kickback scheme will involve a subcontractor giving back to the prime contractor a percentage of the price charged to the prime for the subcontracts. A party cannot avoid liability by the use of an intermediary entity. Jensen v. United States, 326 F.2d 891, 895 (9th Cir. 1964) (concluding that the "clear intent and wording" of the Anti-Kickback Act "may not be evaded by the device of making payments through a partnership or corporation").

Initially, a prime contract held by the payee must be identified. See United States v. Kensington Hospital, 760 F. Supp. 1120, 1137-39 (E.D. Penn. 1991) (finding that no prime-subcontract arrangement existed and the defendants did not make kickbacks to a "party higher up in the relationship with the government[,]" so the Anti-Kickback Act could not apply); United States v. Merck-Medco Managed Care, LLC, 336 F. Supp.2d 430, 449-50 (E.D. Penn. 2004) (concluding that the Anti-Kickback Act applied where the defendant made payments to a health plan that held a prime contract with the government to induce health plan to rely exclusively on defendant's services). Accordingly, the complete contractual relationships between the government, the taxpayer, and the payee must be clear.

An illegal payment is any payment made to any prime contractor for the "purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract." 41 U.S.C. § 52(2). The term "favorable treatment" in connection with a prime contract may be read broadly: "Congress intended the language 'favorable treatment' be construed broadly to reach all conduct analogous to commercial bribery." Morse Diesel Int'l, Inc. v. United States, 66 Fed. Cl. 788, 800 (Fed. Cl. 2005). A kickback scheme involves obtaining or rewarding *any* favorable treatment, which is not defined, but could include diverse actions such as:

(1) a subcontract award itself;
(2) continued contractual relations when subcontractor fails to meet contractual obligations (i.e. waiving deadlines or accepting substandard or nonconforming goods);
(3) recovery of money through inflated bid prices or improper expenses;
(4) receiving confidential information on competitors' bids;
(5) placement on a bidder, manufacturer, or other contractor list without meeting the requisite qualifications;
(6) removal of other qualifying competitors from a bidder, manufacturer, or other contractor list; and/or
(7) other favorable treatment that can help lead to a contract award.

See, e.g., H.R. Rep. No. 99-964, at 11-12 (1986), as reprinted in 1986 U.S.C.C.A.N. 5960, 5968-69. This list is not exclusive. Id.

A payment must be for the "purpose of improperly obtaining or rewarding favorable treatment" in order to be considered a kickback. The test for "improperly obtaining or rewarding" in this context is not expressly stated in the statute or case law. In Morse Diesel, for example, the court concluded that a commission splitting arrangement was for an impermissible purpose based only on the facts that: (1) the government was the ultimate customer of the services being provided, but had no knowledge of and received no benefit from, the commission splitting arrangement; and (2) the arrangement resulted in higher prices for the services. 66 Fed. Cl. at 800-01. Additionally, a preexisting contingent fee arrangement with a subcontractor may constitute a kickback. See generally United States v. Acme Process Equipment Co., 385 U.S. 138 (1967) (concluding that contracts made in violation of the Anti-Kickback Act should be held unenforceable). [redacted]

Legislative history on the Anti-Kickback Act is limited, but the Congressional report indicates that the term "improperly" was included "to ensure that exchanges[s] made which are authorized by the contract itself, such as additional payments made under acceleration provisions, or for other permissible purposes, such as innocent or incidental favors, are not included." H.R. Rep. No. 99-964, at 12. This language suggests that payments for a "permissible purposes" are limited to those set forth in the government contract or to exchanges of nominal value. But we have found no controlling case law that clarifies the scope of this test.

Federal government contracts necessarily incorporate various federal laws and regulations. These include the False Claims Act, 31 U.S.C. §§ 3729-3733; the Truth in Negotiations Act, 10 U.S.C. § 2306a and 41 U.S.C. § 254b; organizational conflict of interest regulations, 48 C.F.R. §§ 9.500-508; and other federal acquisition regulations, i.e. 48 C.F.R.. § 3.400 (prohibitions against contingency fees), 48 C.F.R. § 3.502 (prohibitions against kickbacks); 48 C.F.R. § 15.400-408 (cost and price negotiation policies and procedures). Conduct which is in violation of (or is questionable in light of) federal laws requiring complete disclosure in government contraction is likely to be considered inherently "improper" conduct in the scope of government contracting, regardless of whether it was a common industry practice or under preexisting contractual obligations. [redacted]

No criminal conviction is necessary for a payment to be considered an illegal kickback. See Acme Process, 385 U.S. at 355-56. No specific intent to defraud the government is necessary, and it is not necessary that the offender be aware of government involvement. United States v. Purdy, 144 F.3d 241, 243-45 (2d Cir. 1998) ("[T]he purpose of the Anti-Kickback Act was to reach beyond frauds perpetrated directly on the government and to secure the subcontracting of government-related contracts from commercial bribery."). Nor is it necessary for the offender to be aware of the illegality of their conduct. See Morse Diesel, 66 Fed. Cl. at 800-01 (citing Purdy, 144 F.3d at 245), but see Merck-Medco Managed Care, 336 F. Supp.2d at 448 (suggesting that *scienter* is necessary in an illegal kickback claim). It is not necessary to demonstrate that the kickback was passed on to the government, as that is a presumption under the statute. Morse Diesel, 66 Fed. Cl. at 800-01 (citing 41 U.S.C. § 53). It is not necessary to prove that favorable treatment actually resulted, just that the payment was made with that intent. Howard v. United States, 345 F.2d 126, 128-29 (5th Cir. 1965). Finally, it is not necessary to show intent to "induce or influence the award of [any] particular subcontract[.]" Id. at 129.

The burden of proof is on the Service to establish whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment to the same extent of its burden to demonstrate fraud, that is, by clear and convincing evidence. It is not necessary to prove fraud or any badges of fraud in order for I.R.C. § 162(c)(2) to apply; this language specifies only that the Service has the burden to prove that a payment is an illegal bribe or kickback in order to disallow a deduction under the statute.

In all cases, a prime contract held by the payee must be identified and the complete contractual relationships between the payee, the payor, any distributor, and the government must be established. [redacted]

[redacted]

Discounted Goods, Services and Training

The prohibition of I.R.C. § 162(c)(2) against deduction of kickbacks applies only to business expense deductions, not to above-the-line adjustments to gross receipts. Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670, 672-74 (9th Cir. 1980), aff'g 69 T.C. 477 (1977); Rev. Rul. 82-149. A taxpayer providing free or discounted goods, even if provided in violation of law, need not include additional income in gross receipts, or may increase its costs of goods sold, to reflect the actual income or cost on the transaction, despite the illegal nature of the payment arrangement, if they would otherwise be eligible to do so. See id. The burden of proving the existence of a purchase price adjustment agreement is on the taxpayer. See, e.g., Mississippi Chemical Corp. v. Commissioner, 86 T.C. 627, 640 (1986). Therefore, a taxpayer has to demonstrate that the adjustment to gross receipts or costs of goods sold is proper and accurate in order to claim adjustment.

Purchase price adjustments and rebates are exceptions to the broad definition of gross income under I.R.C. § 61. See, e.g., Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707, 715-17 (1956); Eaton v. Commissioner, T.C. Memo. 1979-320, Max Sobel Wholesale Liquors, 630 F.2d at 672 (finding no difference between price adjustment for cash rebate and price adjustment for delivery of extra merchandise). Allowances, discounts or rebates that a seller pays to a buyer are generally considered an adjustment to purchase price, not an expense, if the purpose and intent of the parties is to reach an agreed upon net selling price. See Pittsburgh Milk, 26 T.C. at 715-17. However, not all discounts are properly considered purchase price adjustments; the test is generally based on what the intended purpose of the discount was. See id.; see also Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 490-91 (1980). As the Pittsburgh Milk court explained:

> Terminology, alone, is not controlling,[] and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration - as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied … is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where . . . the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes.

26 T.C. at 717.

Consistent with the Pittsburgh Milk holding, in Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467, the court allowed the taxpayer to exclude from gross income sales discounts and allowances in the form of warrants where the buyer could exercise the warrant only if it purchased a certain volume of product within a certain time. Similarly, Rev. Rul. 2008-26 concludes that a rebate a manufacturer pays in the Medicaid context to a state agency is an adjustment to sales price where the rebate is a factor used in setting the selling price, negotiated and agreed, before the final sale takes place.

In contrast, in United Draperies, Inc. v. Commissioner, 41 T.C. 457, 465 (1964), aff'd 340 F.2d 936 (7th Cir. 1964), the Tax Court held that a manufacturer could not exclude from gross income amounts paid as kickbacks to a purchasers' employees, where the payments were "independent of its agreements with its purchasers fixing the selling price of the products sold[.]" The court pointed out that the kickbacks were paid "for a consideration separate from the selling price of its products, namely [the] employees sending the business of their employers" to the taxpayer. Id. at 465. Similarly, in Mississippi Chemical, the court concluded that a taxpayer could not exclude a refund of purchase price where the taxpayer was required to pay a third party, not the purchaser. 86 T.C. 627, 640-41. The court stated that there was a "common thread" through the Pittsburgh Milk case and its progeny in that "in each case there was an agreement between the taxpayer and its customers, entered into prior to the sale of the product, providing for the refund of some part of the purchase price." Id. at 640. Therefore, above-the-line adjustments to purchase price are limited to buyer-seller agreements where the reduced price was a factor in the overall sales agreement. C.f. Rev. Rul. 82-149 (stating that illegal rebates are allowable adjustments to sales price where the rebate is "made by a seller directly to a purchaser").

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Please contact at if you have questions regarding this advice. Please contact your local Counsel office if you have questions regarding development of a specific case.

[redacted]
Associate Area Counsel

By: _____
[redacted]
Attorney (LMSB)