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TAXATION-FEDERAL INCOME TAX-PERIOD FOR DEDUCTION OF EMBEZZLEMENT LOSSES

Thomas P. Segerson S.Ed.
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—PERIOD FOR DEDUCTION OF EMBEZZLEMENT LOSSES—This action was brought against the United States for a refund of income taxes paid. Plaintiff taxpayer claimed she was entitled to a deduction in 1941 for losses resulting from the embezzlement of funds by a trustee which were discovered in that year. The Commissioner of Internal Revenue disallowed the claimed deduction because the acts constituting the embezzlement had taken place during prior years. *Held,* judgment for defendant. Embezzlement losses are deductible in the years in which the defalcations take place, not in the years such defalcations are discovered. *Alison v. United States,* (D.C. Pa. 1951) 97 F. Supp. 959.

The law pertaining to the period in which embezzlement losses are deductible is ambiguous in statement and uncertain in application. In accord with the principal case, the general rule is that such losses are deductible only in the year in which the wrongful taking occurred, even though such taking was not discovered until a later year.[1] Strict application of this rule may cause extreme hardship to the taxpayer in cases where the wrongful appropriations are dis-

[1] Borden v. Commissioner, (2d Cir. 1939) 101 F. (2d) 44; First National Bank of Sharon, Pa. v. Heiner, (3d Cir. 1933) 66 F. (2d) 925; Rahr-Malting Co. v. United States, (D.C. Wis. 1944) 54 F. Supp. 282; Maria G. Miglietta, 1 T.C.M. 499 (1943); Piggly Wiggly Corporation, 28 B.T.A. 412 (1933); Alabama Mineral Land Co., 28 B.T.A. 586 (1933); Gottlieb Realty Co., 28 B.T.A. 418 (1933); National Sash & Door Co., 5 B.T.A. 930 (1926); and Appeal of J. A. Bentley, 5 B.T.A. 314 (1926). See also I.T. 1470, I-2

covered after the period for filing an amended return has passed.[2] Similar hardship results from its application in cases where it is impossible, or at least extremely difficult, to determine the year of loss, or, in cases where the defalcations took place over a number of years, to allocate the specific amount of loss per year.[3] This possibility of oppressive consequences has prompted a few decisions in which a deduction has been allowed in the year of discovery; however, there has been little harmony with respect to the circumstances under which a deviation from the general rule is justified and the theory upon which such deviation is based.[4] This lack of harmony and the resultant uncertainty in the law can be traced to Congress, the Treasury Department, and the Supreme Court of the United States. Congress made the initial contribution when it stated that losses by individuals are deductible in the year in which "sustained" without defining what was meant by "sustained."[5] The word is susceptible to more than one meaning and in the case of unknown losses, as embezzlement losses usually are, it could be argued that they are not sustained until discovered, regardless of when they actually occur. The Treasury Department's regulation concerning the problem not only fails to furnish the needed definition, but in addition serves only to add to the ambiguity of the language by providing that embezzlement losses are *ordinarily* deductible for the year in which sustained.[6] It would seem from this language that the government contemplates certain situations wherein the deduction would be allowable in a year other than the year in which the loss is sustained; what these special situations might be, however, is not expressed. The picture of confusion was completed with the *Wilcox* decision

Cum. Bul. 118 (1922); A.R.R. 2503, II-2 Cum. Bul. 131 (1923); A.R.M. 144, 5 Cum. Bul. 139 (1921); and O. 845, 1 Cum. Bul. 118 (1919).

[2] Ordinarily the claim must be filed within three years or the benefit of a deduction will be lost. I.R.C., §§332(b)-1 to 332(b)-6.

[3] Treas. Reg. 111, §29.23(e)-1 provides: "In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed."

[4] One decision may talk of "extraordinary circumstances" warranting different treatment while another proceeds on the theory that the embezzlement creates a debt. Boston Consol. Gas Co. v. Commissioner, (1st Cir. 1942) 128 F. (2d) 473; Gwinn Bros. & Co., 7 T.C. 320 (1946); Samuel M. Felton, 5 T.C. 256 (1945). Cf., however, First National Bank of Sharon, Pa. v. Heiner, supra note 1, wherein the court refused a deduction even though the statute of limitations had already run. Often a deduction is sought to be taken subsequent to the year of discovery. In cases where the money embezzled is not the taxpayer's but is instead money for which he is responsible, this has generally been allowed. Although the taxpayer becomes liable at the time of taking, it is felt that there is no loss until restitution is made. Burnet v. Huff, 288 U.S. 156, 53 S.Ct. 330 (1933); John H. Farish & Co. v. Commissioner, (8th Cir. 1929) 31 F. (2d) 79; Leedy-Glover Realty & Ins. Co., 13 T.C. 95 (1949); Alvin C. Cass, 16 B.T.A. 1341 (1929); Peter Frees, Jr., 12 B.T.A. 737 (1928); Israel T. Deyo, 9 B.T.A. 900 (1927). Without this feature, however, the decisions are confused. See Douglas County Light & Water Co. v. Commissioner, (9th Cir. 1930) 43 F. (2d) 904; Ralph Murphy, 7 T.C.M. 35 (1948); Lucy D. Gilpin, 6 T.C.M. 370 (1947); and Southern School-Book Depository, Inc., 10 B.T.A. 931 (1928).

[5] I.R.C., §23(e).

[6] Treas. Reg. 111, §29.43-2.

rendered in 1946.[7] In that case the Supreme Court held that the proceeds of embezzlement do not constitute taxable gain because the embezzler does not obtain title to the money and remains under a duty to make repayment. Conversely, if consistency is sought, it would seem to follow that there is no taxable loss to the victim since he retains title and a correlative right to be repaid. Accepting this analysis, the courts might be forced to recognize that embezzlement losses are not losses under sections 23(e) and (f) of the Internal Revenue Code. Instead, they would be treated as bad debts which could be deducted not in the year of discovery, but rather in the year in which recovery from the embezzler is determined to be impossible.[8] As a result, clarification of the law obviously is necessary.[9] To follow the philosophy of the *Wilcox* case, however, would serve only to add to the unreality of the situation created by that decision.[10] Failure on the part of Congress and the Treasury Department to take any steps to rectify the unfortunate state of the law as it has existed for these past years would seem to indicate that legislative or regulatory clarification is unlikely. However, clarification by judicial action could be justified under the wording of the regulation, for if the Treasury Department impliedly contemplates that certain situations might warrant different treatment, but fails to specify those situations, it would seem that the door is open for the courts to do so. The running of the statutory time limit for claiming a refund or the inability to determine the date or the extent of loss in prior years should be considered a special case calling for allowance of the deduction in the year of bona fide discovery. The time for taking a deduction presents a practical, not theoretical, problem and it should be resolved by a practical, not theoretical, approach.

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[7] Commisisoner v. Wilcox, 327 U.S. 404, 66 S.Ct. 546 (1946), noted in 44 MICH. L. REV. 885 (1946).

[8] Geller and Rogers, "Embezzlement Has Its Tax Problems, Too," 26 TAXES 1097, 1101 (1948); see also the concurring opinion of Judge Magruder in Boston Consol. Gas Co. v. Commissioner, supra note 4, at 477.

[9] Brown, "The Time for Taking Deductions for Losses and Bad Debts for Income Tax Purposes," 84 UNIV. PA. L. REV. 41 (1935) and Stuetzer, "Embezzlement Losses: Time for Deduction," 4 TAX L. REV. 195 (1949), both stress the need for change in the law and suggest that the deductible period be made the year of discovery. On this same subject, see Krekstein, "When are Embezzlement Losses Deductible," N.Y. UNIV. 7TH ANNUAL INSTITUTE ON FEDERAL TAXATION 51 (1949).

[10] The reasoning of the Court has been criticized for various reasons: see 44 MICH. L. REV. 885 (1946) and 20 So. CALIF. L. REV. 113 (1946). Compare Akers v. Scofield, (5th Cir. 1948) 167 F. (2d) 718, where the court distinguished between gain from swindling and gain from embezzlement, holding the former to be taxable because title to the money had passed.