

Don't Get Caught Holding the Bag: Embezzlement Repayments and NOL Limitations

Tax Section



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The net operating loss ("NOL") rules in Section 172 are complex. A revisit every few years is beneficial, particularly given the 2017 Tax Act modified these rules to disallow NOL carrybacks and allow NOL carryforwards indefinitely, with a new limit of 80% of taxable income.

While the rules seem simple at first glance, how they work with various types of losses is surprising. For example, one who embezzles from an employer is rightfully assessed tax on the income from his or her illegal activities pursuant to the landmark ruling of *James v. United States*, 366 U.S. 213 (1961). That decision, while answering the question of whether illegally obtained income is taxable, created a new question of how the repayment of embezzled funds is treated for income tax purposes. Although both the IRS and the taxpayers agreed a deduction should be allowed where embezzled funds are repaid, they differed on which Code section provides the deduction. The IRS maintained the deduction is allowed under Section 165(c)(2), which addresses "losses incurred in any transaction entered into for profit, though not connected with a trade or business." In contrast, the taxpayers in a number of cases argued the embezzlement itself was a trade or business, the embezzled funds were invested in a trade or business, or the embezzlement from their employer was inextricably linked to their trade or business of being an employee with such employer.

The motivation for these arguments by the Commissioner and the taxpayers, although not always clearly spelled out in the cases, stems from the operation of the net operating loss rules. Section 172(d)(4)

provides deductions not attributable to a taxpayer's trade or business are allowed only to the extent of the amount of gross income not derived from a trade or business in that year. Section 165(c)(2) is an example of one such non-business deduction. Unlike the treatment of excess business deductions, Section 172 does not allow excess non-business deductions to be included in the NOL calculation. Therefore, it is crucial to the taxpayer that the repayment of embezzled funds is treated as a business deduction so the deduction can be used to offset income in years other than the year in which repayment is made. It seems equitable for even an embezzler to be entitled to offset illegal income with a deduction when the repayment is made. However, embezzler taxpayers rarely have enough non-business income in the year of repayment to use fully the non-business deduction. This is where the NOL cases come into play.

Mannette v. Commissioner, 69 T.C. 990 (1978), is a good example of a typical embezzler NOL case. In that case, the taxpayer was an employee of a bank from which he embezzled funds. He was assessed tax from illegal income in 1969, 1970, and 1971. In 1972, he repaid the bank and asked the court to treat the repayment as a Section 162 deduction, giving rise to an NOL carryback that could offset the illegal income in 1969 through 1971. The court instead ruled the deduction was allowable only under Section 165(c)(2) and thus could be used only to offset non-business income of the taxpayer in 1972. Because the taxpayer did not have any non-business income that year, the deduction was wasted.

This result seems inequitable. The court's explanation was Section 172 is intended to allow carryforwards only for businesses to assist businesses with fluctuating annual incomes and losses. The section is not intended to give the same treatment to taxpayers who are not operating businesses. Taxpayers who realize large non-business deductions in a given year should consider the tax consequences. Triggering equivalent amounts of non-business income in that year is key to prevent the deduction from being wasted as in *Mannette*.

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