7 T.C. 320 (1946)

An embezzlement loss may be deducted in the year the loss is discovered and its extent determined, particularly when the years of misappropriation are unknown, making it impossible to amend prior tax returns.

Summary

Gwinn Bros. & Company discovered in 1935 that an employee had embezzled approximately $65,000 between 1932 and 1935, and for an unknown period before 1932. The Commissioner allowed deductions for the amounts embezzled from 1932-1935. In 1935, the company established an account receivable for the entire embezzled amount, credited amounts recovered from the employee, and wrote off $54,077.47 as a bad debt. The Tax Court held that the $54,077.47 was properly deducted in 1935, following the principle that extraordinary losses, especially those with indeterminable timing, can be deducted in the year of discovery and determination.

Facts

In mid-1935, Gwinn Bros. discovered that their employee, W.R. Sweney, had embezzled $64,730.79 of customer payments. Sweney admitted to the misappropriation, spanning from 1935 back through an unknown number of prior years. The company recorded the embezzled amount as an account receivable. Sweney transferred assets, including notes, insurance policies, and real property (less liens), totaling $8,232.64, to the company as partial repayment. The Commissioner allowed deductions for the misappropriated funds applicable to 1932-1935, but disallowed the deduction for $44,475.35 misappropriated before 1932.

Procedural History

Gwinn Bros. filed its 1935 income tax return and paid the assessed tax. Subsequently, the company filed a timely claim for refund, seeking to deduct the $54,077.47 loss in 1935. The Commissioner disallowed the deduction, leading to the Tax Court case.

Issue(s)

Whether the petitioner is entitled to a deduction of $44,475.35 in the taxable year 1935 as a bad debt or as a loss due to embezzlement losses prior to 1932.

Holding

Yes, because the years of misappropriation of the $44,475.35 were unknown, and the petitioner could not prove the loss of any particular amount in any specific year. The situation was considered extraordinary, permitting the deduction in the year the

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loss was discovered and determined.

Court's Reasoning

The court relied on the *Boston Consolidated Gas Co. v. Commissioner* precedent, emphasizing that strict application of the rule requiring deduction in the year of embezzlement would result in unjust consequences. The court acknowledged the general rule that embezzlement losses are deducted in the year suffered but emphasized the unusual circumstances where the years of embezzlement were unknown. This made it impossible for Gwinn Bros. to file amended returns for prior years. The court also cited *Commissioner v. Wilcox, 327 U.S. 404*, indicating that embezzlement creates a debtor-creditor relationship, thus permitting a bad debt deduction when the debt was determined worthless and charged off in 1935. Judge Magruder's concurring opinion in *Boston Consolidated Gas* noted that if an embezzler makes no gain due to the offsetting obligation, the victim doesn't sustain a loss until it's clear the funds can't be recovered. The court found the Commissioner's determination resulted in

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