***Est. of Stein v. Comm'r*, 25 T.C. 940 (1956)**

A corporation cannot claim a deduction for embezzlement losses if the actions constituting the embezzlement were consented to or condoned by the corporation's controlling officers or shareholders, as their knowledge and intent are imputed to the corporation.

Summary

The Tax Court considered whether a corporation could deduct alleged embezzlement losses when its president and secretary-treasurer, with the knowledge and agreement of the third stockholder (who was also an officer), intentionally omitted a portion of the corporation's income from its books and tax returns to evade taxes. The court held that the corporation could not claim the deduction because the officers' actions were imputed to the corporation. The officers effectively held the unreported funds for the corporation's benefit and with the consent of all three stockholders, so there was no embezzlement. The court distinguished this case from embezzlement, where an individual acts against the corporation's interest, and emphasized the corporation's fraudulent intent, imputed from its officers' actions, to evade tax liability.

Facts

A corporation had three officer-stockholders who were also directors. In 1942, the officers agreed to conceal a portion of the company's sales to avoid taxes, with the unreported income divided equally among them. This scheme continued into 1943. The corporation did not report these incomes. Later, when the IRS investigated, the corporation claimed embezzlement losses. However, evidence showed the officers and stockholders knew about and consented to the concealment and the scheme to evade taxes. One stockholder later claimed to have been cheated out of his full share.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the corporation's tax returns for 1942 and 1943, based on the unreported income. The corporation contested these deficiencies, arguing that it was entitled to loss deductions for the amounts allegedly embezzled by its president. The case was heard by the Tax Court.

Issue(s)

1. Whether the corporation sustained losses from alleged embezzlement in 1942 and 1943.

2. Whether a minority stockholder's claim that he was cheated out of his share changes the outcome of the embezzlement claim.

Holding

1. No, because the withholding of the income was with the consent of the controlling stockholders, and thus, not embezzlement.

2. No, because the alleged cheating occurred after the scheme was in operation and was a personal grievance, not material to the corporation's tax liability.

Court's Reasoning

The court focused on whether there was consent to the appropriation of funds. The court reasoned that for embezzlement to occur, there must be no consent to or condoning of the appropriation, and the embezzler must be liable to return the full amount to the corporation. In this case, the three stockholders were in complete control, they agreed to omit income, and they shared in the concealed profits. The court cited *Commissioner v. Wilcox* to emphasize the requirement of no consent for embezzlement. The court distinguished the situation from embezzlement, where the officers' actions were considered part of a scheme to evade taxes. As the court stated: "The intent of the president is to be imputed to the corporation." The Court also noted that the fact that the third shareholder may have been "cheated" later was not material because he had been part of the original scheme to conceal the income from taxation.

Practical Implications

This case highlights the importance of imputing the knowledge and intent of corporate officers and shareholders to the corporation, particularly in tax matters. Attorneys should consider this imputation principle when assessing whether a corporation can claim a loss deduction. Corporate actions, even if nominally criminal, are viewed through the lens of the controlling individuals' intentions. If the controlling individuals condoned or were complicit in the actions that led to a purported loss, a deduction may be denied. It's vital for legal professionals to: (1) carefully examine the roles and actions of all key corporate actors; (2) ascertain whether the actions constituting the alleged loss were authorized, consented to, or knowingly disregarded by those in control; and (3) analyze the potential tax implications of actions taken by a corporation's key people. This case has implications for tax law, corporate law, and fraud claims. Later cases may cite this case to distinguish between situations where the individual acts against the corporate interest (embezzlement) and situations where the individual's actions are considered the actions of the corporation because the controlling individuals consented to the action.

