Yerkie v. Commissioner, 67 T. C. 388 (1976)

Embezzled funds are not considered income received under a claim of right, thus repayments do not qualify for tax adjustments under section 1341 or net operating loss carrybacks under section 172.

Summary

Bernard Yerkie embezzled funds from his employer from 1966 to 1970 and later repaid them in 1971 and 1972. He sought to apply sections 1341 and 172 of the Internal Revenue Code for tax relief on the repayments. The Tax Court held that embezzled funds, despite being taxable as income, are not received under a claim of right, disqualifying them from section 1341 adjustments. Additionally, repayments were deemed nonbusiness losses under section 165(c)(2), ineligible for section 172's carryback provisions. This decision underscores the distinction between legal and illegal income in tax law and its implications for deductions and tax adjustments.

Facts

Bernard Yerkie, employed by A. & C. Carriers, Inc. and Laketon Equipment Co. , embezzled funds from 1966 to 1970, totaling $110,000. He did not report these funds as income on his tax returns for those years. In 1971, he was accused of embezzlement and repaid $20,900 in 1971 and $89,100 in 1972. Yerkie sought to apply sections 1341 and 172 of the Internal Revenue Code for tax relief on these repayments, arguing they were business losses connected to his employment.

Procedural History

The Commissioner of Internal Revenue issued deficiency notices for the years 1966 through 1970, including the embezzled funds as income. Yerkie filed petitions with the U. S. Tax Court in 1974 and 1975, contesting the deficiencies and seeking tax adjustments under sections 1341 and 172. The Tax Court consolidated the cases and ruled in favor of the Commissioner, denying the applicability of sections 1341 and 172 to Yerkie's repayments.

Issue(s)

1. Whether the repayment of embezzled funds qualifies for the tax computation adjustments under section 1341 of the Internal Revenue Code.
2. Whether the repayment of embezzled funds can be treated as a business loss eligible for the net operating loss carryback and carryover provisions under section 172 of the Internal Revenue Code.

Holding

1. No, because embezzled funds are not received under a claim of right as required by section 1341(a); the funds were illegally obtained and thus do not meet the

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section’s criteria.
2. No, because the repayment of embezzled funds is classified as a nonbusiness loss under section 165(c)(2), not connected to a trade or business, and thus ineligible for section 172’s carryback and carryover provisions.

Court’s Reasoning

The court distinguished between the inclusion of embezzled funds as gross income under section 61 and the concept of “claim of right” required for section 1341. The court cited *James v. United States*, which held that embezzled funds are taxable as income, but clarified that this does not equate to a claim of right. The court emphasized that embezzlement is not an aspect of employment, rejecting Yerkie’s argument that his repayments were business losses. It referenced *McKinney v. United States* and *Hankins v. United States* to support its conclusions, noting that these cases similarly denied section 1341 and 172 benefits for embezzlement repayments. The court’s decision was based on the legal rules of sections 1341 and 172, their application to the facts, and the policy of not treating embezzlers more favorably than honest taxpayers.

Practical Implications

This ruling clarifies that embezzled funds, while taxable as income, do not qualify for section 1341’s tax computation adjustments or section 172’s carryback provisions upon repayment. Legal practitioners must recognize that embezzlement repayments are treated as nonbusiness losses under section 165(c)(2), limiting the tax benefits available to the embezzler. This decision influences how similar cases involving illegal income are analyzed, emphasizing the distinction between legal and illegal income in tax law. Businesses and employers may find reinforcement in their efforts to recover embezzled funds, knowing that the tax code does not provide significant relief to the embezzler. Subsequent cases like *McKinney* and *Hankins* have followed this precedent, solidifying its impact on tax law regarding embezzlement.

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