Mannette v. Commissioner, 69 T. C. 990 (1978)

Embezzlement repayments do not qualify as net operating losses eligible for carryback to offset income from the years in which the funds were embezzled.

Summary

Russell L. Mannette, Jr. , embezzled funds from his employer between 1969 and 1971 and used them to invest in securities. In 1972, he made partial restitution of these funds. He sought to carry back the 1972 loss resulting from this restitution to offset the income from the embezzlement years. The U. S. Tax Court held that such a loss did not qualify as a net operating loss under section 172 of the Internal Revenue Code because embezzlement is not a trade or business, and the loss was not deductible as a theft loss under section 165(c)(3). The court also rejected Mannette's Fifth Amendment due process argument.

Facts

Russell L. Mannette, Jr. , worked at Skokie Trust and Savings Bank from 1959 to 1972. During 1969, 1970, and 1971, he embezzled over $248,000 from the bank and its customers. Mannette did not report these embezzled funds as income on his tax returns for those years. He used the majority of these funds to purchase and sell securities for his own account. In 1972, Mannette made a partial restitution of $200,650. 21 to the bank.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Mannette's federal income taxes for 1969, 1970, and 1971 due to unreported embezzlement income. Mannette filed a petition with the U. S. Tax Court, seeking to carry back a 1972 loss from his partial restitution to offset the tax deficiencies for the earlier years. The Tax Court ruled against Mannette, affirming the Commissioner's determination.

Issue(s)

1. Whether Mannette's 1972 loss from restitution of embezzled funds qualifies as a net operating loss under section 172 of the Internal Revenue Code, allowing it to be carried back to offset income from the years in which the funds were embezzled.
2. Whether Mannette's 1972 loss qualifies as a theft loss under section 165(c)(3) of the Internal Revenue Code.
3. Whether taxing Mannette's embezzlement income without accounting for the 1972 restitution violates his Fifth Amendment right to due process.

Holding

1. No, because the 1972 loss was not incurred in a trade or business as required by

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section 172(d)(4).
2. No, because Mannette was not a victim of theft and thus cannot claim a theft loss under section 165(c)(3).
3. No, because taxing embezzlement income on an annual basis without accounting for future restitution does not violate the Fifth Amendment.

Court’s Reasoning

The court reasoned that embezzlement is not a trade or business, and thus, repayments of embezzled funds cannot be treated as business losses for net operating loss purposes. The court cited previous cases like Yerkie v. Commissioner, which established that embezzlement is not an aspect of any legitimate trade or business. The court rejected Mannette’s argument that his embezzlement was part of a securities trading business, noting that allowing such a claim would subvert public policy by reducing the financial risks of embezzlement. The court also dismissed Mannette’s claim for a theft loss deduction, stating that only victims of theft can claim such a deduction. Finally, the court upheld the annual accounting method of taxation as a practical necessity, citing Burnet v. Sanford & Brooks Co. , and found no violation of Mannette’s due process rights.

Practical Implications

This decision clarifies that embezzlement repayments cannot be used to create net operating losses for carryback purposes. Tax practitioners should advise clients that embezzlement income must be reported in the year it is received, and any subsequent restitution does not offset prior tax liabilities. This ruling reinforces the principle that embezzlement is not a trade or business, impacting how embezzlement-related losses are treated under the tax code. It also upholds the annual accounting method as a constitutional approach to taxation, which has broad implications for tax planning and compliance.

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