Dear Client:

You recently inquired about employee fraud and embezzlement issues, and how the tax law can help you if your business has suffered losses from employee-related thefts. There are a number of ways that employees may steal from a company. Four common types of fraud include embezzlement, theft of inventory, creating fictitious vendors, and padding expense accounts. In fact, according to the Association of Certified Fraud Examiners (ACFE), the current economic climate has led to an increase in employee fraud. Moreover, ACFE found that the fraud most expected to increase in the workplace over the next 12 months is embezzlement.

This letter is intended to provide you with a basic understanding of how the tax law can help your business recover from losses incurred as the result of employee fraud or embezzlement. This is a very complex area of tax law; please do not hesitate to contact us if you have any questions.

Section 165 of the Tax Code provides a deduction for a loss due to theft, such as the above mentioned types of fraud, and which has not been compensated for by insurance or otherwise reimbursed. For tax purposes, "theft" involves the unlawful taking and removing of money or property with the intent to deprive the owner of it, and includes embezzlement by employees. Therefore, an employer is allowed a deduction of in calculating their taxable income for the year in which the money was embezzled by the employee in that year.

A deduction for theft loss, such as from embezzlement or fraud, can only be taken in the year that you discover the loss. Thus, a loss arising from theft is not deductible in the tax year in which the theft actually occurred, unless that is also the year in which the taxpayer discovers the loss.

A loss is not deductible if you have a claim for reimbursement with a reasonable prospect of recovery. The loss cannot be deducted until it can be determined with reasonable certainty whether or not reimbursement will be received - for instance, on settlement, adjudication, or abandonment of the claim. This may affect all or part of your loss deduction.

Theft losses, such as from employee embezzlement, are generally reported on Form 4684, Casualties and Thefts, in the year that you have discovered the theft losses. A loss due to an employee's embezzlement will be deducted as a theft loss and generally listed in the "Other Expenses" category on the tax return.

A special rule applies for losses of inventory. In general, there are two ways you can deduct theft losses of inventory. You can either:

1. Deduct the inventory-related loss through the increase in the cost of goods sold by adding the amount of your loss to the "cost of goods sold" that you normally report on Schedule C, Profit or Loss From Business (Sole Proprietorship), when you figure your business losses and profits. If you use this method, you cannot also claim casualty or theft loss. Moreover, if you receive any reimbursement for the loss, you have to include that amount in your gross income; or

2. Deduct the loss separately by removing the damaged inventory from the Schedule C "cost of goods sold" by making a downward adjustment to opening inventory or purchases. Reduce the loss by any reimbursement you received, and so you do not include the reimbursement in gross income.
It is imperative that you maintain records that will prove your deduction for the theft. To prove a theft loss, it is important to have documents showing:

* When you discovered that property was missing;
* That your property was in fact stolen;
* That you are the owner of the stolen property; and
* Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

If you receive insurance or another type of reimbursement, you need to subtract the reimbursement when computing your loss. You do not have a casualty or theft loss to the extent you are reimbursed. As mentioned above, you cannot deduct any amount for losses where a reasonable prospect of recovery exists. You must wait until it can be established with reasonable certainty whether you will receive reimbursement. If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if payment is not received until a later tax year.

If you have any questions about the tax implications of business losses due to employee fraud, embezzlement or theft, and whether certain expenses qualify, please contact our office at your convenience.

Sincerely yours,

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