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Fraudsters and the Form 1099 Technique

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Fraud is a major concern among companies, regulators, shareholders, and law enforcement agencies throughout the United States. Estimates of fraud in the U.S. range from $300 billion to $1 trillion annually.[1] There is about $220 million of fraud in U.S. healthcare expenditures alone (from 3 to 10 percent of expenditures). In 2009, the FBI estimated there was $14 billion in fraudulent mortgage loans. Asset misappropriation accounts for about four out of five offenses in an organization.[2] On average, employees steal more from companies than shoplifters.[3]

Fraud is not just a problem because of its size, but also because of the detrimental effects fraud has on its victims. Comer indicates that 30% of companies fail because of fraud.[4] In addition, Comer (2003) indicates that 85 percent of fraud victims never get their money or property back.[5] While a 2003 PriceWaterhouseCoopers fraud survey found that 76% of survey respondents were covered by insurance, fewer than ½ were able to recover from their insurers. Of those that did have insurance, two-thirds collected less than 20

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[1] 2010 Report to the Nations on Occupational Fraud and Abuse, p. 13. This report says U.S. organizations lose 5 percent of annual revenues to fraud ($712.8 billion) in 2010. The percentage was 7 percent in their 2008 report with a total of $994 billion. For further detail on fraud and abuse refer to Crumbley, D. L., L.E. Heitger, and G.S. Smith, *Forensic and Investigative Accounting*, Chicago: Commerce Clearing House, 2009.
[2] Ibid.
[3] Jack L. Hayes International, Inc. 2010. Theft Surveys. www.hayesinternational.com/thft_srvys.html.
[4] M.J. Comer, Investigating Corporate Fraud, Burlington, VT: Gower Publishing, 2003, p. 9.
[5] M.J. Comer, Investigating Corporate Fraud, Burlington, VT: Gower Publishing, 2003, p. 9.

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percent of the amount lost.[6] Frank W. Abagnale, a consultant who gives numerous speeches on security based on his experience he gathered from committing fraud during the 1960's, says that prevention is the only viable course of action since punishment for fraud and recoupment of stolen funds are so rare.[7]

There is no question that given the size and detrimental effects of fraud, the prevention of fraud should be a top priority for companies across the United States. However, the fact remains that prevention does not ensure that fraud will never occur. This article analyzes a technique that has been proposed, the Form 1099 technique, as a way companies could try to increase the recoupment of stolen money and property from the fraudster.[8] Under this technique the entity supposedly uses the threat of filing a Form 1099 with the IRS for the amount stolen, unless the fraudster signs an installment note agreeing to a payback. Using an example based upon the median loss incurred by an entity who is the victim of asset misappropriation as stated in the *Report to the Nations on Occupational Fraud and Abuse*, we analyze the desirability of the Form 1099 technique from the perspective of the company, the employee/fraudster, and the Internal Revenue Service (IRS). The combination of our results leads us to the conclusion that the Form 1099 technique may be a valuable option for companies to have when they have been victims of fraud. In addition, we show that the Form 1099 technique is desirable from a tax revenue standpoint,

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[6] J.D. Glater, "Survey Finds Fraud's Reach in Big Business," www.nytimes.com/2002/07/08/business/08CHIE.html

[7] www.abagnale.com/index2.asp. Abagnale is the fraudster depicted in the movie "Catch Me If You Can."

[8] Frank Abagnale proposes the use of the Form 1099 technique in his book *The Art of the Steal: How to Protect Yourself and Your Business from Fraud*, NY: Broadway Books, 2001. Specifically, on page 92, Abagnale states "It's always been my experience that the threat of a 1099 is far greater than the threat of a lawsuit or prosecution."

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and thus favored by the IRS under certain circumstances. The only party who never benefits from the Form 1099 technique is the employee/fraudster.

Unfortunately, a company's ability to use the Form 1099 technique is currently limited. In order for a company to use this technique, they have to meet specific criteria set forth in the second circuit decision for *Gilbert v. Comm* in 1977.[9] The IRS can challenge whether the situation qualifies under the criteria and circumstances set forth in the *Gilbert v. Comm* decision. Challenges from the IRS impose a risk of fines and penalties to the company. These potential fines and penalties effectively increase the total cost of the fraud to the company if the IRS rules that the situation does not meet the criteria set forth in the *Gilbert v. Comm* decision, and thus discourage companies from using the Form 1099 technique as a recoupment method once the company has discovered that it is the victim of fraud.[10]

The availability of the Form 1099 Technique has further been challenged by recent legislation that was enacted in the Patient Protection and Affordable Care Act, but was later repealed.[11] As we discuss, the expanded Form 1099 information reporting requirements mandated by the Patient Protection and Affordable Care Act had the unintended consequence of eliminating a company's ability to use the Form 1099 technique when the amount of fraud exceeded $600. While the expanded Form 1099 requirements were repealed, the possibility

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[9] *Gilbert v. Comm.*, 552 F. 2d 478 (CA-2, 1977).
[10] We spoke with an individual whose firm was a victim of fraud and had contemplated the use of the Form 1099 technique and they specifically noted their concern over recent IRS rulings as part of their decision process that ultimately led them to avoid using the Form 1099 technique in pursuing recovery.
[11] www.journalofaccountancy.com/Web/20114071.htm

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of future changes to Form 1099 reporting requirements remains a possibility. Indeed, as the United States currently struggles with mounting debt and insufficient tax revenues, congress is being charged with finding ways to increase tax revenue. If congress believes, similar to the reasoning that generated the original expanded Form 1099 reporting requirements in the Patient Protection and Affordable Care Act, that cash based businesses continue to evade taxes by underreporting revenues,[12] expanded Form 1099 reporting requirements could be seen as a way to eliminate substantial amounts of underreporting and generate additional tax revenues. Thus, the threat of legislative changes aimed at increasing tax revenues continues to threaten a company's ability to use the Form 1099 technique. Given the potential positive aspects of the Form 1099 technique, it may be prudent for Congress and the IRS to consider either enacting legislation which would provide all companies the option of using a Form 1099 technique, or at the very least, the effects legislative changes may have on prohibiting a company's ability to employ the Form 1099 technique in the hopes of improving recoupment of stolen money and property from a fraudster.

The remainder of the paper discusses each of these items in more detail, by first setting up an example and discussing the Form 1099 technique. The paper then discusses the desirability of the Form 1099 technique for the victim entity, the employee/fraudster, and the Internal Revenue Service. The article then provides a discussion of policy implications before concluding.

[12] http://money.cnn.com/2010/07/09/smallbusiness/irs_1099_flood/index.htm

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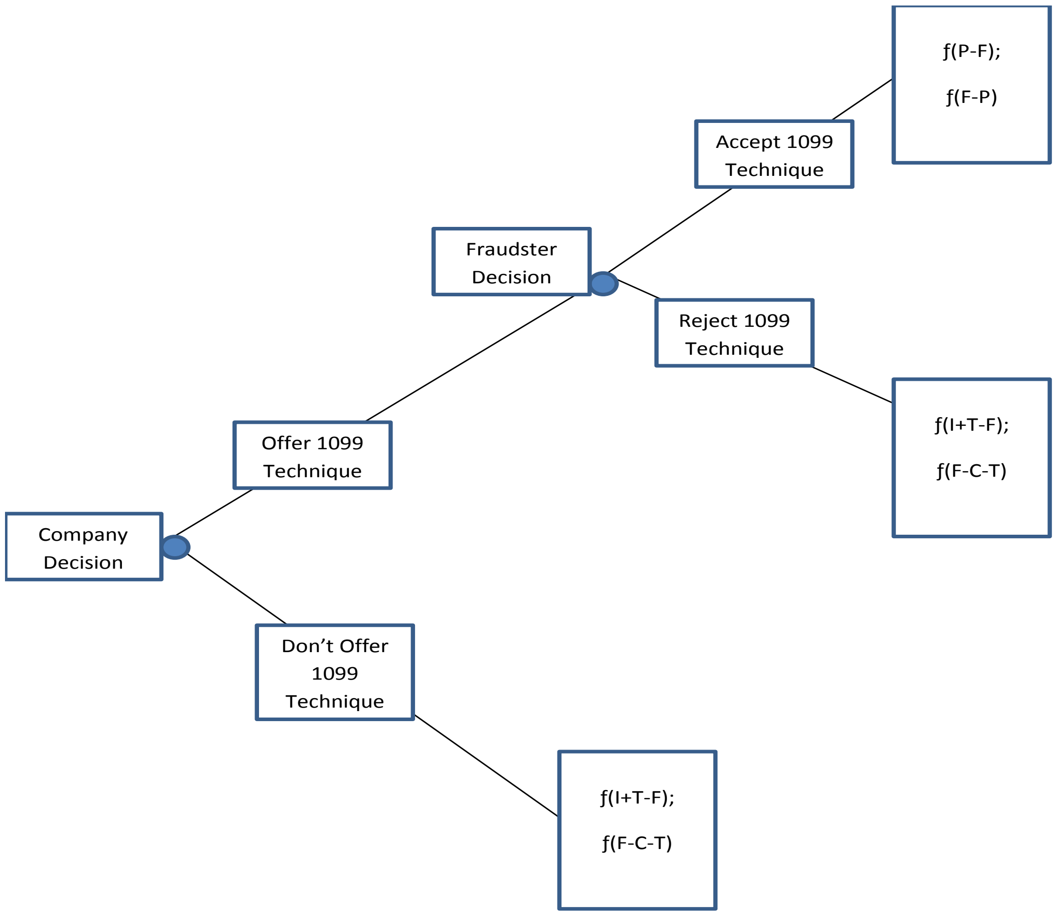
An Example of the Form 1099 Technique

Before we develop a specific example of the Form 1099 technique, it is useful to examine a flow chart of the decision options available to both the company and the fraudster after the fraud has been discovered. Figure 1 illustrates the decision options:

Figure 1: Post-fraud discovery options for the company and the fraudster.



This figure represents that post-fraud discovery decisions available to the company and to the fraudster. The company first makes the decision whether the company is going to offer the Form 1099 technique or not. If the company decides to offer the Form 1099 technique, then the fraudster may either accept the Form 1099 technique or reject the Form 1099 technique. Recovery amounts for the firm are denoted either f(I+T-F) representing the cases where the company recovers insurance, I, and taxes, T, less the amount of fraud, F, embezzled by the fraudster, and f(P-F) representing the case where the company recovers the payment, P, from the fraudster, less the amount of fraud, F, embezzled by the fraudster. In all cases the fraudster receives the amount embezzled, F, less the amounts paid, either civil, C, and tax, T, penalties, or to the company, P if the fraudster accepts the Form 1099 technique.

As we can see in Figure one, after discovering the fraud, F, the company has the first decision. The company will weigh the recovery options, and choose to offer the Form 1099 technique when the company expects that the payment, P, received from the fraudster will exceed the payments the company expects to receive from the company's insurance carrier, I, and from taxes, T. If the company chooses to offer the Form 1099 technique, then the fraudster has the decision of either accepting the Form 1099 technique or rejecting the Form 1099 technique. The fraudster will accept the Form 1099 technique whenever the payment, P, that the fraudster will have to make to the company is less than the expected civil, C, and tax, T, penalties faced by the fraudster.

In Figure one, the company has the advantage of knowing what amounts they expect to recover from insurance and taxes. However, the company is at an information disadvantage relative to the fraudster, since the fraudster knows the true amount of the funds embezzled, F, while the company only knows what fraud it has currently discovered. This information, combined with the fact that the company cannot ask for additional restitution may lead the fraudster to accept the Form 1099 technique when the fraudster fears that the IRS will discover more fraud, either from that company or from other sources, than was discovered by the company. The fraudster does not have the benefit of knowing what civil, C, and tax, T, penalties they face at the time they are making the decision to accept or reject the companies offer for the Form 1099 technique. Clearly, if the company refuses to offer the Form 1099 technique, then the fraudster has no choice but to face the civil and tax penalties.

Now that we have discussed a general case, it is useful to set up a numerical example. We rely on findings resulting from a survey conducted by the ACFE, which compiles information from 1,843 cases of occupational fraud as reported by the Certified Fraud

Examiners who examined them, as reported in the 2010 *Report to the Nations on Occupational Fraud and Abuse*. Occupational fraud is the "category of fraud… in which an employee abuses his or her position within the organization for personal gain."[13] We assume the employee commits asset misappropriation, namely, the embezzlement of cash, since this technique represented 90% of the fraud cases reported in the survey, which amounts to $135,000, the median loss incurred by an entity who is the victim of asset misappropriation.[14] In addition, we assume the employee's fraud is committed over 18 months, the median months reported by survey participants.[15]

Suppose an employee embezzled $135,000 from a corporation over 1½ years (starting in 2008). An officer explains to the employee that the company must file a Form 1099 unless the fraudster signs a secured installment note with 4 percent interest to be paid back in installments of $300 per month. The employee signs the secured note, hopefully with a confession of judgment in the note.[16] Any installment note should include a reasonable interest rate or the punitive imputed interest rule would apply.[17] The IRS would impute interest income to the employer.

Advisability of the Form 1099 Technique For Employers

If the company does not pursue the Form 1099 technique, the company has the authority under §165(a) to deduct any loss due to embezzlement in the year of discovery.

[13] 2010 *Report to the Nations on Occupational Fraud and Abuse*, p. 6.
[14] 2010 *Report to the Nations on Occupational Fraud and Abuse*, p. 4.
[15] Ibid.
[16] For the purpose of discussing the desirability of the Form 1099 technique, we assume that the Form 1099 technique is a legitimate option for the company. We will discuss, how current tax law restricts the availability of the Form 1099 technique when we discuss the IRS's position.
[17] IRC §7872(a)(1).

Under the facts in the example at the beginning of the article, if a company does not allow the fraudster to sign an installment note, the company can take a theft loss deduction in the year of discovery reduced by any insurance recoupment $108,000 ($135,000 - $27,000).[18] The company does not have to show a conviction for theft, but must prove the amount of the theft. Filing a police report could help substantiate the loss. In the case of stolen assets, the theft loss amount is the adjusted basis of the stolen property.[19]

However, where a reasonable prospect of recovery exists, no loss is available. "Reasonable prospect of recovery" is a question of facts to be determined upon examination of all of the facts and circumstances.[20] If in the year of discovery there exists a claim for reimbursement with a reasonable prospect of recovery, no loss is deductible until the taxable year in which it can be ascertained with reasonable certainty that the reimbursement will not be received.[21] Thus, if a company decides to implement the Form 1099 technique and obtains a signed installment note by the fraudster, the company would postpone a deduction until the taxable year in which it can be ascertained with reasonable certainty that the reimbursement will not be received.[22]

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[18] The 2003 PriceWaterhouseCoopers fraud survey suggested that for companies who had insurance against fraud, two-thirds of the companies collected less than 20% of the amount lost. Thus, 20% of $135,000 is $27,000.

[19] Reg. §1.165-7(b).

[20] I.R.C. §165(c)(2).

[21] Reg. §1.165-1(d)(3). In the year in which a firm ascertains with reasonable certainty that the reimbursement will not be received, the firm may have a choice between filing a loss deduction under §165 or filing a deduction for bad debt under §166.

[22] The signed installment note also raises an issue regarding the reporting of an uncertain tax position both to the Internal Revenue Service and in the firm's financial statements. As long as there is no uncertainty regarding the employee's ability to repay the installment note, then the company is not required to report a deferred tax asset and does not need to worry about reporting rules for uncertain tax positions. However, if it becomes more likely than not that the employee will not repay the installment note, but the employee has yet to default on the installment note, the company should record a temporary deferred tax asset on their financial statements as well as report the temporary deferred tax asset on Schedule M-3 if the company has $10 million or more in gross assets. The financial reporting requirements for this temporary deferred tax asset fall under FIN 48 regulations. As pointed out in Hennig, Raabe, and Everett's (2008) article, both FIN 48 regulations and Schedule M-3 were

Each of the $300 payments to the employer is not taxable, but the interest would be taxable. The fraudster could take a miscellaneous itemized deduction for the $300 repayments. In our example the monthly payment is not sufficient enough to even pay the amount of interest due and thus not enough to reduce the loan principal.[23] Here, the employee will never be able to pay off the loan. Even if the note is doubled to $600 per month, after 12 months the outstanding loan would still be approximately $133,167. Ideally, the company would seek either full restitution from the fraudster, or set the payment high enough that the company recovered more than just the interest off the installment note.

When thinking about the Form 1099 technique and the ability of this technique to promote payback of the amount that the company was defrauded, one must think about what incentives each party faces if the alternate route is taken. First, ask the question of what the company gets if they refuse to offer the Form 1099 technique to the employee who defrauded them, or the employee rejects the offer for the Form 1099 technique. In both of these cases the company reports the amount of fraud discovered to the IRS. The company is entitled to use the amount as a deduction against their net income. In our original example, the total fraud amount is $135,000, less insurance reimbursement.[24] If the company's marginal tax rate is 40 percent, then this deduction would result in a recoupment of $43,200 through taxes

designed to increase the financial transparency regarding the reporting of uncertain tax positions. Everett and Hennig (2010) indicate that IRS Announcement 2010-9 proposes additional disclosure requirements of uncertain tax positions for corporations that have at least $10 million in gross assets and file statements using GAAP. We defer discussion of the FIN 48, Schedule M-3, and IRS Announcement 2010-9, disclosure requirements, except to suggest that these additional disclosures may be needed by a firm that is considering the Form 1099 technique, especially when the consideration of whether to employ the Form 1099 technique evaluates the challenges involved in meeting FIN 48 and Schedule M-3 reporting requirements as discussed by Hennig, Raabe, and Everrett's (2008).

[23] In fact, the principal of the loan will be increased by $150 the first month.

[24] We are not discussing insurance subrogation, where the insurance company steps into the shoes of the victim and sues the fraudster.

($108,000 x .40). Combining the tax recoupment with the insurance recoupment of $27,000, the company's total recoupment by not filing the Form 1099 is $70,200.

The amount recovered through insurance and taxes is a mere 52 percent ($70,200/$135,000) of the amount that had been stolen. In addition, in order for a company to consider the tax recoupment in the present year, the company must have taxable income that exceeds the fraud amount and the embezzled funds must have been from revenue that was previously reported to the IRS.[25] However, as we stated when reviewing the company's options in Figure one, this result is desirable when the amount of recovery from insurance and taxes exceeds the amount of expected recovery from the fraudster. The company will have to weigh not only what assets the fraudster has which may be used to secure the note, in addition to whether the fraudster has a low probability of paying back the amount, in determining the amount of expected recovery from the fraudster. Time value of money considerations also would argue for an immediate deduction versus future payments.

If, however, the company offered the Form 1099 technique, the company expects the employee to make payments on the installment loan. The company has some protection against employee default as the company may once again threaten reporting to the IRS using Form 1099C to report the relief of debt, and take a deduction for bad debt in the year that the debt is written off. Under this scenario, even if the employee defaulted on the first loan payment, the company would still recover at least as much as it would have if the company had not offered the Form 1099 technique, the $43,200 in our example. The company would have to account for the time value of money impact of this scenario, since the tax deduction will be delayed until the loan is written off.

[25] The latter would not be the case if the fraudster had embezzled the funds through skimming.

The Form 1099 technique also has a non-tax benefit to the company. In the scenario that we have presented, the fraudster is given the option of signing a secured installment note. The secured installment note gives the company the right to place a lien against the property used to secure the note, ultimately improving the company's total recoupment, assuming the asset used to secure the note was valuable.[26] Frank Abagnale's statement that there is no restitution from criminal prosecution highlights the value of a secured installment note and the subsequent property lien rights it may hold for a company seeking to recoup as much money as possible following the incidence of fraud.[27] The company also has the option of reporting the default to credit rating agencies.

Advisability for the Employee/ Fraudster

Now we can consider the employee choices. Employees who commit fraud may do so because they lack the ability to financially support their needs. The employee may start with a small amount of fraud to meet a temporary need, probably with the intention of repaying the funds before anyone knows anything has happened. If the employee's actions are not caught, then they may become more confident and increase the amount of fraud. They also are likely to use the funds garnered through fraud to live beyond their means.

Ultimately, in our example, the employee's actions are discovered, and the company tabulates the total amount of fraud. How should the employee react? In the above scenario, the employee is smart enough to figure out how to defraud the company, but they are not smart enough to ultimately get away with their actions. If the employee is smart, then they

[26] We thank an anonymous reviewer for this insight.
[27] Frank Abagnale, *The Art of the Steal: How to Protect Yourself and Your Business from Fraud*, NY: Broadway Books, 2001, p. 92.

should equally weigh the penalties that would be enforced by taking the Form 1099 plea deal, or by refusing the deal and allowing the company to report the full amount of the fraud to the IRS.

If the employee takes the Form 1099 deal, then they are agreeing to pay back the full $135,000 plus interest at a rate of 4 percent. This approach hardly seems worthwhile when the penalty of having the Form 1099 reporting is going to be less than the full amount of the repayment. For example, assume that the employee is pushed into a higher tax bracket following the inclusion of the amount of fraud (e.g., say 35 percent). In addition to being pushed into the higher tax bracket, the employee also would owe self-employment taxes, which is currently 13.3 percent, but generates a tax effect closer to 9.2 percent. [28] The total tax owed by the employee would then be about 44.2 percent or $59,670. This scenario means that the employee's net proceeds from defrauding the company would be $75,330 ($135,000 - $59,670), which is more than the employee's net proceeds from repaying the full amount of funds stolen and paying the company 4 percent interest.

An astute follower of this argument might suggest that an important piece of information missing from the above calculation is the interest and penalties that could be assessed to the employee by the IRS for not reporting the income from fraud in a timely fashion. This assessment is true. However, the above discussion also assumes that the employee does not attempt to negotiate with the IRS for a lower settlement amount. When

[28] While the self-employment tax rate is 15.3 percent prior to 2011, the rate decreased to 13.3 percent in 2011. While the rate is 13.3 percent, the net amount of taxes paid due to self-employment tax paid by the fraudster in our example is decidedly less, since he only has to pay the 10.4 percent of Social Security on the first $106,800 of income. Using the $135,000, this equates to $15,022 of self-employment tax, or a tax rate of approximately 11.1 percent. However, the fraudster is also eligible to claim the Self-Employment Tax Deduction, equivalent to one-half of his self-employment tax, in figuring out his adjusted gross income, a deduction of $7,511 from his adjusted gross income. Assuming this yields a tax benefit at the marginal rate of 35 percent, this benefit would result in a $2,629 deduction. Using this deduction, the net self-employment tax rate is closer to 9.2 percent for this fraudster. Thus, we use 9.2% in our example.

faced with such a large tax bill, the employee is clearly motivated to at least attempt to negotiate. Since it is difficult to assess what the net impact of the interest and penalties and potential negotiation should be, we assume that $75,330 is clearly more than what the employee's net proceeds from defrauding the company would be if they took the Form 1099 plea deal.

Since it does not appear that the pending tax bill alone may motivate the fraudster to take the Form 1099 plea deal, the company also may use the incentive of allowing the fraudster the opportunity to avoid criminal prosecution if he signs an installment note. This approach may be an important consideration of a fraudster who does not want the details of their activities to be scrutinized by various media outlets. While it may seem as though criminal prosecution may be enough, Frank Abagnale notes that criminal prosecution often results in probation for the fraudster and that the company receives no restitution from criminal prosecution.[29] Abagnale states "(i)t's always been my experience that the threat of a 1099 is far greater than the threat of a lawsuit or prosecution."

While it seems unlikely that a fraudster will accept an offer to sign a secured installment note, there are several factors which improve the likelihood of the fraudster accepting the Form 1099 offer and thus raise the potential effectiveness of the Form 1099 technique. The first is that many people are terrified of the IRS, especially when the word "audit" is used in conjunction with the IRS. Theoretical and empirical research supports the notion that fear of the IRS may exceed the rational side of the individual who committed the fraud. Graetz and Wilde (1985) discussed early conservative estimates which indicated U.S. tax avoidance rates were between 10-15%. Much of the early empirical and theoretical

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[29] Frank Abagnale *The Art of the Steal: How to Protect Yourself and Your Business from Fraud*,NY: Broadway Books, 2001, p. 92.

research tried to examine why the compliance rates were so high, given that a rational assessment of the risk of audit and the penalties imposed for noncompliance would encourage less compliance. In order to explain the high compliance rates, theoretic models used risk aversion rates that were well above the levels deemed normal. Bernasconi (1998) was able to solve this puzzle by showing that consideration of differential risk aversion rates afforded theoretical results that allowed rational risk aversion rates and explained the high tax compliance rates. While not directly transferrable, Bernasconi's (1998) model also may explain why the Form 1099 technique is effective and employees opt to try a repayment plan, even though our above analysis would suggest that only irrational employees, or employees with additional unreported income would be the ones to accept the repayment plan.

In addition to an irrational fear of the IRS, there may be a rational reason for the fraudster to fear IRS involvement. As we pointed out when discussing Figure one, the company does not have the advantage of knowing the full amount of the funds embezzled by the employee. Thus, the fear an employee has from threatened IRS involvement could be rational if the extent of additional illegal tax activities that may be uncovered during audits exceed the amount of the repayment plus the added interest.

Another reason why an employee may accept the Form 1099 plea deal may be due to the fact that people who commit fraud are highly likely to have spent that money living a life that they could not otherwise afford. Thus, the repayment plan offered may seem more palatable than the large tax bill that may or may not be able to be repaid in installments.

IRS's Position

The IRS is not an impartial party to this possible technique. If a company has net income against which to offset the amount of fraud committed, then the IRS prefers the outcome where the fraud is not reported immediately. Here, the IRS loses the funds from the tax deduction of the company, which is likely to be greater than the tax revenue collected from the employee (particularly if the employee seeks a bargaining arrangement with the IRS).

If a company has no net income against which to offset the amount of fraud committed, then the IRS prefers the fraud to be reported immediately. Here, the IRS seeks to gain more tax revenue from the employee, even at a bargained amount, because they are delaying the offset to the company's revenue until some point in the future. This early reporting is a win for the IRS due to the time value of money effect.

Policy Implications

Current tax policy limits a company's ability to offer the Form 1099 technique. Under normal circumstances, receipts from embezzlement, fraud, extortion, bank robbery, and other illegal income are includible in gross income (unless the money is paid back in that year). The Supreme Court in *James v. U.S.*[30] overturned the prior *Wilcox*[31] decision and held that embezzled funds are taxable to a thief under §61(a) in the year the funds are stolen. Any stolen assets less any insurance recoupment are not deductible by the employer until the year the thefts are discovered.

[30] 366 U.S. 213 (1961). See Rev. Rul. 65-254, 1965-2 C.B. 50 and Rev. Rul. 61-185, 1961-2 C.B. 9.
[31] *Comm. v. Wilcox*, 327 U.S. 404 (1946). Wilcox held that embezzled funds were not taxable because the thief had no "claim of rights" over the funds.

The embezzler must report the assets embezzled or stolen in gross income for each year of the theft, which may require the filing of amended returns.[32] Essentially, income is taxable at the time the fraudster takes control of the funds, regardless of future restitution or signing a payback agreement.[33] The stolen funds are taxable even if the employer fails to provide a Form 1099. Stolen funds are taxable in the year taken even if the victim institutes proceedings to recover the full amount prior to the assessment of the tax by the IRS.[34] In other words, even in a debtor-creditor relationship, the fraudster still has taxable income. Further, the illegally acquired funds are taxable even if the victim is reimbursed by an indemnity bond. Also, a self-employed fraudster would report the amount on Schedule C and may be subject to self-employment taxes on any illegally acquired income. Further, the fraudster may be subject to interest and penalties by the I.R.S. for non-payment of taxes on the illegal income.[35]

Any included income can be reduced each year by the amount that is repaid to the employer in that particular year. If, as in our example, the repayment is made in a year after the theft, the fraudster may report the restitution amount as a miscellaneous itemized deduction, subject to the two-percent adjusted gross income limitation.[36] A deduction is not available unless the fraudster can show that the embezzled assets were previously recorded as taxable income. This tax information could be helpful to a forensic accountant in case of legal proceedings.

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[32] Rev. Rul. 61-185, 1961-2 C.B. 9.
[33] Blaine Fox, 61 T.C. 704 (1974).
[34] Richard M. Horn, TC Memo 1966-220.
[35] IRC, 165(c)(2); Rev. Rul. 82-74, 1982-1 C.B. 110; *Stephens v. Comm.*, 905 F.2d 667 (CA-2 1990)
[36] Rev. Rul. 65-254, 1965-2 C.B. 50; I.R.C. §165(c); *Stephens v. Comm.*, 905 F. 2d 671 (CA-2, 1990).

A limited exception may potentially provide authority under certain circumstances for companies to use the Form 1099 technique. A Second Circuit decision[37] in 1977 held that an employee does not have to include the illegally acquired funds in income if four criteria are met:

1. Taxpayer fully intended to repay the funds.
2. Taxpayer expects with reasonable certainty that he/she will be able to repay.
3. The person believes that the withdrawals will be approved by the corporation.
4. Employee makes a prompt assignment of assets sufficient to secure the amount owed.

The installment note option used in the Form 1099 technique could qualify under this Second Circuit decision, since the court specifically noted in the decision "…we do not interpret *James*[38] as requiring income realization in every case of unlawful withdrawals by a taxpayer."[39] The court expands upon this theory and further states, "(w)e conclude that where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals under the *James* test."[40] Thus, if the installment note option used in the Form 1099 technique qualifies under the Second Circuit decision, the embezzled funds change

[37] *Gilbert v. Comm.*, 552 F. 2d 478 (CA-2, 1977).
[38] Refers to *James v. U.S.* 366 U.S. 213 (1961).
[39] *Gilbert v. Comm*., 552 F. 2d 478 (CA-2, 1977).
[40] *Gilbert v. Comm*., 552 F. 2d 478 (CA-2, 1977).

from taxable income, to non-taxable income because they are now considered a loan. As long as the fraudster does not default, the funds are not taxable.[41]

While the *Gilbert v. Comm*. decision may provide some authority for the Form 1099 technique, the court also recognized that this dispute was a very unique case. Specifically, the president of the company made withdraws from the company funds, but immediately informed board members that he had withdrawn the funds and signed a secured installment note as quickly as possible. This scenario is unlikely to be the situation in the more common cases of fraud. Most employees who take funds from a company may have the intentions to repay the funds, but they do not notify anyone that they are taking funds or make an effort to sign an installment note until they have been caught. The IRS makes it clear that a company is required to report the stolen amount as an employee's taxable income to the IRS in each year the employee embezzles assets and may not offer to ignore the reporting in return for a signed installment note. Therefore, if a company uses this Second Circuit decision as authority for the Form 1099 technique, the company should be aware that the IRS can challenge the company's position, hold the company in violation of the requirement to report stolen property and funds, and assess fines and penalties which raise the cost of the fraud to the company.

Even if a company believes that it has the authority to use the Form 1099 technique, current legislative actions threaten the future of a company's ability to use this technique. In April 2011, the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act (CTPRESO) of 2011 repealed the expanded Form 1099

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[41] We discuss the authority of the *Gilbert v. Comm*., 552 F. 2d 478 (CA-2, 1977) decision when we discuss the current tax policy implications on a firm's ability to use a Form 1099 technique. For now, we assume that a company has the authority to use the Form 1099 technique.

information reporting requirements mandated by the Patient Protection and Affordable Care Act as well as the Small Business Jobs Act.[42] Prior to this repeal, legislation would have made it mandatory that a Form 1099 be filed by both parties to a transaction for all transactions which exceed $600 in value for payments made after December 31, 2011. If a Form 1099 was not issued, then the business that pays the amount of the transaction is required to withhold 28% of the payment and remit that amount directly to the IRS. Proponents of the CTPRESO argued that this change will aid in collecting additional tax revenue. Opponents of the CTPRESO argue that these new filing requirements will place unnecessary burden on small businesses due to recordkeeping requirements.

An unintended consequence of the now repealed legislation is that the current legislation and judicial rulings which provide firms with the limited flexibility to avoid filing a Form 1099 when fraud is detected, would not provide protection if the amount of fraud exceeded $600. If the amount of fraud exceeds $600, then the company would have been faced with the choice of either filing a Form 1099 or grossing-up the amount of the fraud to include the 28% required tax-withholding and submitting that amount to the IRS if the company wants to provide the employee with the opportunity to repay the fraud.

While the expanded Form 1099 requirements were repealed, the possibility of future changes to Form 1099 reporting requirements remains a possibility. Indeed, as the United States currently struggles with mounting debt and insufficient tax revenues, Congress is charged with finding ways to increase tax revenue. If future committees charged with tax reform believes, similar to the reasoning that generated the original expanded Form 1099 reporting requirements in the Patient Protection and Affordable Care Act, that cash based

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[42] www.journalofaccountancy.com/Web/20114071.htm

businesses continue to evade taxes by under reporting revenues,[43] expanded Form 1099 reporting requirements could be seen as a way to eliminate substantial amounts of underreporting and generate additional tax revenues. Thus, the threat of legislative changes aimed at increasing tax revenues continues to threaten a company's ability to use the Form 1099 technique.

Notwithstanding the current legislative changes, a company may be reluctant to report the embezzlement, particularly using a Form 1099. We spoke with an accountant who worked at a firm that had a client that was a victim of fraud regarding the advice they gave to their client.[44] Ultimately, the accounting firm advised the client against the use of the Form 1099 technique. Part of their decision process in not using the Form 1099 technique was that they were uncertain about both the total amount of the fraud and how to allocate the amount of theft among the various individuals involved in the fraud scheme. In addition, the company's officers were reluctant to use the Form 1099 because they had been advised by a "Big Four" accounting firm that the Form 1099 was not designed for theft reporting. The company's officers also were concerned that a defense lawyer in a criminal case might try to show that the company had authorized the amount paid to the employee since the amount embezzled had been reported on a Form 1099.

Finally, the individual also cited an example that they were made aware of when they were considering how to react to the discovery of fraud. Particularly, their "Big Four" accounting firm made them aware of a situation where a company had reported an embezzlement of funds to the IRS using a Form 1099. While the company was accurate in reporting the embezzlement of funds, the company exaggerated the amount of the fraud and

[43] http://money.cnn.com/2010/07/09/smallbusiness/irs_1099_flood/index.htm
[44] This individual wished to remain anonymous.

had to spend significant resources in consulting and legal fees to avoid penalties associated with filing a false tax report under Section 6721. So while the IRS mandates reporting of embezzlement, a company may be reluctant to do so because they may still face penalties and fines from the IRS.

Assuming a company finds itself in a position that they need to report the embezzlement to the IRS, the company's best choice is to report the income on Form 3949A, rather than Form W-2 or Form 1099-MISC. Form W-2 is used to report compensation for work performed, and Form 1099-MISC is used to report payments to non-employees (e.g., awards, commissions, prizes). Informational Referral (Form 3949A) is used to report possible violations of the tax laws, such as unreported income, kickbacks, and false and altered documents. An employer can provide the fraudster's name, address, social security number, and describe the alleged violation. By providing the amount of illegal income and the tax years, such information could help prove the amount of the theft loss. Ultimately, the individual that we spoke with suggested that they elected to file a Form 3949-A.

Given the potential positive aspects of the Form 1099 technique and regardless of the form an embezzlement would be reported on, it may be prudent for Congress and the IRS to consider changes to policies that would protect a company's right to pursue the Form 1099 technique in the hopes of improving recoupment of stolen money and property from the fraudster. Crumbley (1973) made an important observation, that behavioral implications, or tax incentives, should be considered in the formulation of tax law and policy before the laws are enacted. This observation came from the realization, that tax policies influence human and corporate behavior. Given the potential that Form 1099 reporting requirements may change in the future, we follow Crumbley's (1973) advice, and consider the behavioral implications that would result from a limitation of a company's ability to use the Form 1099 technique, using the expanded Form 1099 requirements as our example.

Under the current legislative environment, the company is more likely to report the fraud to the IRS. Thus, the current legislative environment shifts the equilibrium away from providing the employee the opportunity to pay back the amount of fraud plus interest to the company. This shift is detrimental to those companies who could have received more from allowing the employee the opportunity to payback the amount of fraud plus interest then the company could have received from insurance settlements and tax deductions. Ultimately, the shareholders will pay the price for this shift by bearing the full dead weight loss of the suboptimal solution where the fraud is immediately reported to the IRS.[45]

If the equilibrium is shifted away from companies offering employees the opportunity to repay the funds, this shift also will affect the employee's behavior, since the employees who commit the fraud will have no choice but to report the income to the IRS. Facing a large tax bill, the employee is likely to attempt to negotiate with the IRS to reduce their tax obligation. Through the process, the employee may realize that the commission of fraud was still a profitable venture for them, and may actually encourage similar behavior in the future when the opportunity arises.

[45] Shareholders who are forced to liquidate their positions in the firm following the discovery and announcement of the fraud may elect to treat any capital losses incurred on their investment as either a theft loss on their itemized deduction schedule or as a net capital loss as a deduction for AGI. As Cataldo (2004) points out, the theft loss is more aggressive, since the entire amount of the loss is able to be deducted at once, but the theft loss deduction is prohibitive for many taxpayers since the theft loss deduction requires itemization and is subject to a reduction of the loss by both $100 and a reduction equal to 10% of AGI. Given these restrictions, many shareholders who are forced to liquidate their positions following the fraud will not only suffer the loss, but they will also be penalized by time value of money effects, since they are limited to a $3,000 net capital loss per year. Regardless of whether these losses are taken as a theft loss or a net capital loss, the losses are only partially offset by the tax benefits received.

If the employee negotiates a settlement, and the company is able to claim a tax deduction for their loss, then the net tax revenue generated through this process can be negative. This result means that the taxpayers also lose money since that revenue will either have to be made up through other tax revenue or cuts to federally funded programs. When all of these factors are considered together, it appears that the only person who consistently benefits from legislation which prohibits a company's choice to use the Form 1099 technique is the employee who committed the fraud.

The behavior implications from this analysis serve as an issue that should be considered in any future rule changes Congress may consider that can affect a firm's ability to use the Form 1099 technique. In addition, the possible genesis for authority for the Form 1099 technique comes from the Second Circuit decision.[46] This Second Circuit decision is subject to challenge, has strict requirements, and can be overruled by future tax code changes. In light of the analysis presented in this paper, Congress should enact a tax code change that protects a company's right to pursue repayment from the employee through a process similar to the Form 1099 technique currently being used.

[46] *Gilbert v. Comm*. 552 F.2d 478 (CA-2, 1977)

Conclusion

Based upon the above discussions we have provided examples where recovery of funds embezzled by a fraudster using a Form 1099 technique may be greater for a company than the recovery of funds through other sources (i.e., insurance and taxes). An employer must use a cost/benefit analysis of a current deduction versus a present value of risky future payments to determine whether to go the Form 1099 route.

Unfortunately, a company's ability to employ the Form 1099 technique is restricted, and could become even more restricted by future legislative changes. As we discuss, the limitations on this technique hurt shareholders and taxpayers at large if there was a reasonable chance that the employee could and would have repaid the firm for the fraud. Thus, the only person who consistently benefits from legislation which prohibits a company's ability to use the Form 1099 technique is the employee who committed the fraud. We suggest that Congress consider a tax code change that protects a company's right to pursue repayment from the employee through a process similar to the Form 1099 technique currently available.

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