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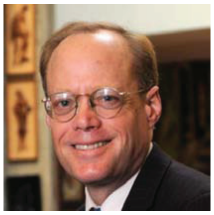

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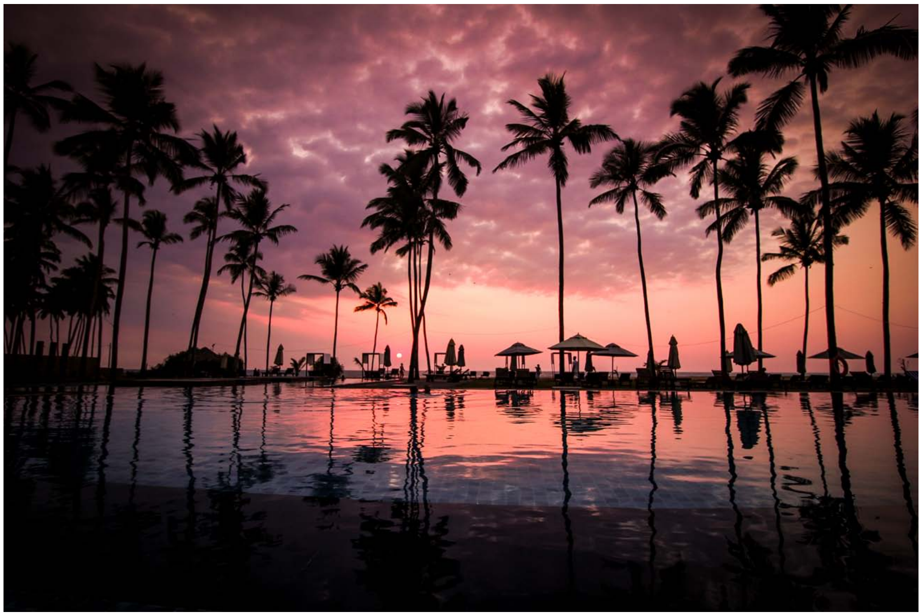
TAXES 3/30/2016

IRS Allows Some Personal Items Deducted As 'Business Expenses' On Your Taxes

Trying to morph personal expenses into business ones can be asking for trouble. For example, don't try to deduct the cost of your divorce because your business is at risk. A divorce is still personal, even if it is expensive. Likewise, try to avoid claiming that your hobby activity is really engaged in for profit. Don't try to write off the expenses against other income.

Of course, the tax code doesn't entirely rule out costs that do double duty. There are many provisions in the tax law that recognize dual purposes. However, try to avoid such dual-purpose goals, and do your best to categorize things appropriately. In some cases, personal conduct can morph into business expenses. For example, what if a supervisor sexually harasses an employee?

This conduct may be personal, but it arises out of a working relationship, and may involve company property and business trips. In both cases, the company usually covers legal bills and settlements. Sometimes, though, the IRS points an accusing finger at corporate conduct and denies tax deductions. Even if the company is a named defendant, it may not be enough to make a settlement payment–or even legal fees–tax deductible.



That's what happened in *Cavanaugh v. Commissioner*. James Cavanaugh was the CEO and sole shareholder of Jani-King, a successful janitorial-services franchisor. He vacationed in St. Maarten one Thanksgiving with his girlfriend, Jani-King employee, Claire Robinson. It wasn't a business trip, but they were accompanied by Cavanaugh's bodyguard, and another Jani-King employee.

While on the trip, Robinson suffered fatal cardiac arrest after ingesting a large amount of cocaine. Her mother sued Cavanaugh and Jani-King. Jani-King's board worried that losing the case would trigger a backlash from franchisees so settled for $2.3 million. Cavanaugh contributed $250,000, which Jani-King reimbursed. Jani-King deducted it all as a business expense.

The IRS challenged the deductions, but the Tax Court agreed with the IRS. The court found that some corporate lawsuits are personal and nondeductible. After all, the employees were on vacation, not on Jani-King business, and they were far from company property. Some other courts have been more forgiving, allowing business expense deductions where the claims are at least *part* business.

For example, in *Kopp's Co. v. United States*, a company deducted a settlement after the CEO killed a child in a company car on the way to the office. But Cavanaugh's case was different. For Cavanaugh, only the *consequences* of the suit–not its origin–were business-related. Even naming Jani-King as a defendant didn't automatically make legal fees or settlement costs deductible.

The deductibility of Jani-King's payment turned on the claim (that Jani-King employees negligently provided illegal drugs resulting in Robinson's death) and whether its origin lay in Jani-King's business. However, here are some cases where deductions were allowed despite personal conduct:

- *Dolese v. United States* (divorce costs deductible because wife enjoined husband's business);
- *O'Malley v. Commissioner* (costs of defending bribery charge deductible because they related to attempts by the business to influence trucking deregulation legislation);
- *Hauge v. Commissioner* (costs of defending fraud suit were deductible because the case implicated ongoing business operations); and
- *Naporano Iron & Metal Co. v. United States* (costs relating to fight on company property during business hours were deductible).

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.