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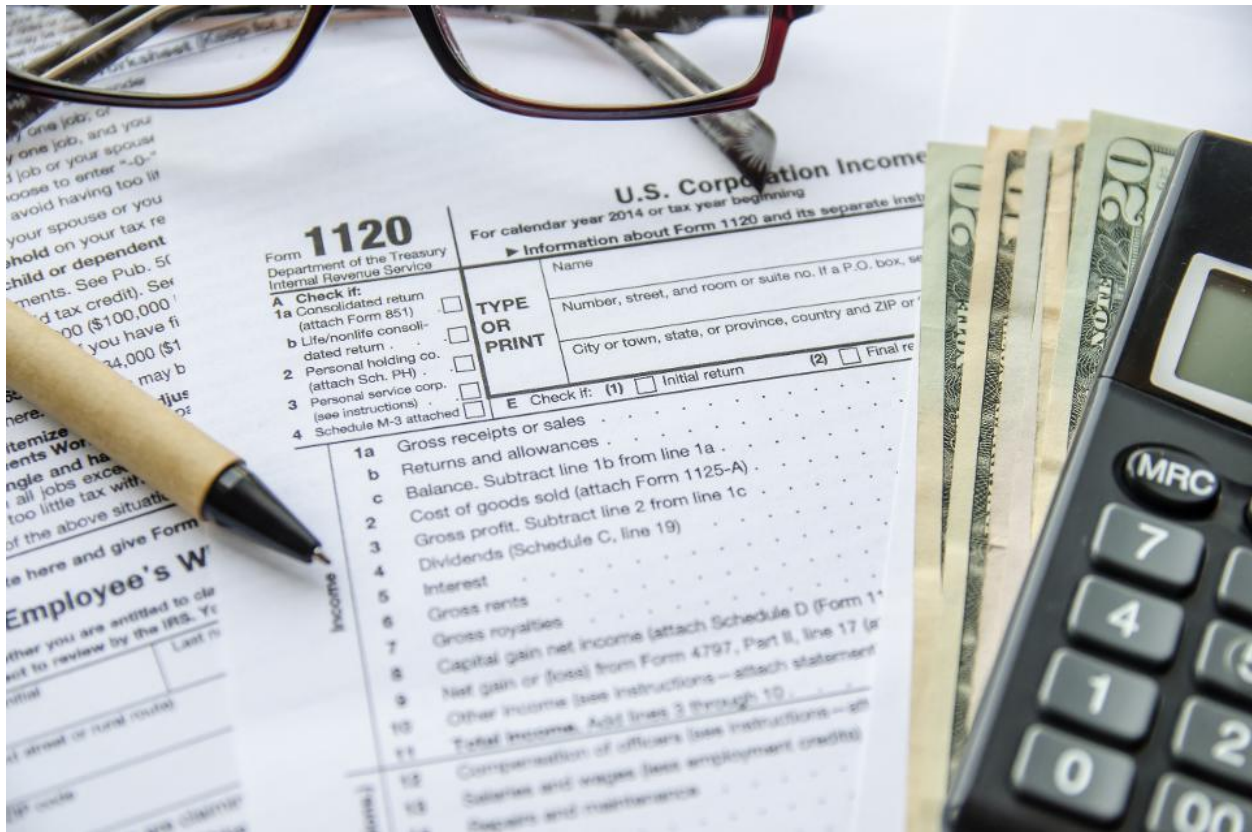
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## IRS Says Some Business Expenses Are Personal

Which expenses are business and which are personal? You might think it's obvious, but your view and the IRS view may differ. These days business and personal can often seem mixed up, such as when you do entertaining, try to motivate employees, go on combined business and work trips, and more. Even lawsuits can seem to be jumbled up. What if a supervisor sexually harasses an employee? This conduct may be personal and outside the scope of the supervisor's employment. Yet it arises out of a working relationship, and often involves company property, business trips, etc. The company usually covers legal bills and settlements, but there are new [tax rules about confidential sexual harassment settlements and legal fees](#) are taxed.

Even outside the sexual harassment context, the IRS sometimes points an accusing finger at corporate conduct and denies tax deductions. In fact, 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](#). The events go back to 2002, but a [2019 Fifth Circuit tax decision](#) gives it renewed interest. James Cavanaugh was 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, Ms. 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 Jani-King settled for \$2.3 million. Cavanaugh contributed \$250,000, which Jani-King reimbursed. Jani-King deducted all of it as a business expense.

The IRS challenged the deductions, [but the Tax Court agreed with the IRS](#). Why? The employees were on vacation, not Jani-King business, and were far from company property. Still, other courts have allowed business deductions where the claims are at least part business, as in [Kopp's Co. v. United States](#). There, 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, the IRS and Tax Court said. Only the *consequences* of the suit, not its origin, were business-related. In fact, even naming Jani-King as a defendant didn't automatically make legal fees or the settlement 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.

Here are some cases where tax deductions were allowed despite personal conduct:

- [\*Kopp's Co. v. United States\*](#) (deductible by corporation because claims involved negligently entrusted corporate property);
- [\*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).

Notably, each case involved a company's profit-seeking business or the actual conduct of a profit-seeking business. Fatally, Cavanaugh had stipulated that no business was done on the trip. Even if Jani-King employees gave Robinson the drugs that killed her, Cavanaugh did not show how those actions arose from or furthered the business.

The analysis might be different if Jani-King employees had been attending a conference or had given Robinson drugs at JaniKing's offices during business hours. But here, the employees were not engaged in profit-seeking activities and were far from company property. The courts found the legal fees and settlement payments were not deductible business expenses. The Tax Court had found that the origin of the claim was that Robinson was allegedly provided cocaine by Jani-King employees, and that providing cocaine does not arise from, further, or use property directly employed in Jani-King's franchising business.

Cavanaugh argued that Jani-King engaged only in profit-seeking activities, so its employees' actions (alleged to have been within the course and scope of their employment) must have arisen from profit-seeking activities. Of course, Cavanaugh did *not* argue that providing cocaine to Robinson was done with a profit-seeking motive. He also did not argue that the alleged actions arose from or were related to any Jani-King business activity. Thus, the Tax Court found that the JaniKing employees' alleged actions were not profit seeking, and the [Fifth Circuit](#) said the lower court's finding was not clearly erroneous.

Cavanaugh argued that the suit was founded on a theory of *respondeat superior*. That legal doctrine means that a company is liable for the acts of its

employees. He said the connection with the business was the allegation that the employees were acting within the course and scope of their employment. However, the Fifth Circuit said the *origin* of the claim was the employees' providing cocaine, not their employment by Jani-King. The settlement payment and related legal fees could not be deducted.

*This is not legal advice. For tax alerts or tax advice, email me at [Wood@WoodLLP.com](mailto:Wood@WoodLLP.com).*