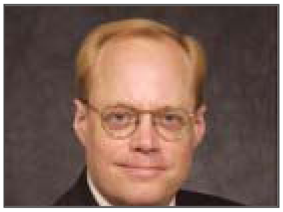

Robert W. Wood
THE TAX LAWYER

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Just Business Not Personal? IRS May Not Agree

When an employee makes a mistake and is sued, the employer will be sued too. If a delivery driver has an accident on his route, the company will be sued along with the driver. What if a supervisor sexually harasses an employee?

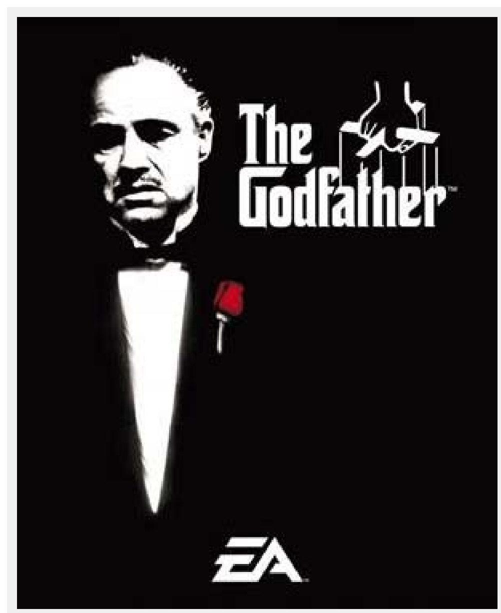

Photo credit: Wikipedia

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. In both cases, the company usually covers legal bills and settlements.

Sometimes 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 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. See Which Corporate Lawsuits Are Personal and Nondeductible? Why? The employees were on vacation, not Jani-King business, and were far from company property.

The 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.

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.

Here are some cases where 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).

You can reach me at [*Wood@WoodLLP.com*](mailto:Wood@WoodLLP.com)*. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*