Which Corporate Lawsuits Are Personal and Nondeductible?

By Robert W. Wood


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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Most companies that are forced to defend legal claims do not consider the possibility that settlements and even defense costs could be nondeductible. Yet in the world of closely held companies, that possibility is real, as *Cavanaugh v. Commissioner* makes clear. Wood examines *Cavanaugh* and its reprise of the origin of the claim doctrine.

What is a legitimate business expense? Many clients claim business expense deductions aggressively and try not to ask too many questions of their tax advisers. It doesn't take a tax lawyer to know that a business expense must be ordinary and necessary. Most business people know that it cannot be frivolous and should be calculated to advance the interests of the business. But beyond those platitudes it can be hard to say.

What qualifies as a business expense may be a legal question, but in most respects it is a factual one. At its root, the business expense query asks about the expected benefits to the business. In the taxation of lawsuit settlements and related legal expenses (an area in which I've spent the bulk of my professional career), the origin of the claim test is meant to resolve the business expense question. However, it can be mercurial, with eye-of-the-beholder elements. But as *Cavanaugh v. Commissioner*[1] makes clear, some things are impossible to ignore.

Cleaning Up

Jani-King International is a successful janitorial services franchisor founded by James Cavanaugh. He remains its CEO and sole shareholder. Jani-King is an S corporation, and Cavanaugh reaps significant rewards from his company. In 2005 and 2006 (the years that ended up in the Tax Court), the company paid him at least $1 million in annual compensation. He also received profits of $7 million in 2005 and $16 million in 2006.

In 2002 Cavanaugh and three others went to the Caribbean for rest and relaxation over the Thanksgiving weekend. The only non-Jani-King employee on the trip was Cavanaugh's 27-year-old girlfriend, Colony Robinson. The two others were Cavanaugh's bodyguard, Ronald "Rock" Walker, and Erika Fortner. The trip was for pleasure and not to conduct or further Jani-King business. After ingesting large amounts of cocaine, Robinson went into cardiac arrest and died.

Robinson's mother sued Cavanaugh and Jani-King for wrongful negligence, assault and battery, conspiracy, and wrongful death. She claimed that Jani-King contributed to her daughter's death by the action of its employees. And she alleged that Cavanaugh, Walker, and Fortner were acting within the course and scope of their employment when they provided Robinson the cocaine.

Jani-King paid $2.3 million to settle the case and deducted it on its 2005 and 2006 tax returns. Cavanaugh contributed $250,000 to the settlement, which Jani-King reimbursed and deducted. The IRS denied the deductions, arguing that no part of the settlement was deductible as a business expense. The Tax Court agreed with the IRS.

Naming Names

Cautious business people probably would have noted the implicit allocation questions presented by these facts. Yet the company was actually named in the suit and had to defend itself. There were even facts to support the corporate response to this tragic situation.

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[1]T.C. Memo. 2012-324, *Doc 2012-24183*, *2012 TNT 228-9*.

Jani-King's board called a special meeting in September 2004. Cavanaugh insisted that the case was frivolous but also said that he was willing to contribute $250,000 to settle it. He even recused himself from the meeting to allow the rest of the board to discuss it. Of course, it is hard to ignore the fact that this is Cavanaugh's company.

Indeed, the Tax Court noted that Cavanaugh was one of only four directors, and as the company's sole shareholder, he had the power to remove any director for any reason.

The company's lawyers said Cavanaugh and Jani-King would probably prevail but warned that juries were unpredictable and that Jani-King's reputation could be soiled by protracted litigation and publicity. The board's minutes revealed that the directors were especially worried that Jani-King franchisees would sue if they thought the wrongful death suit would hurt their own businesses.

What Is Ordinary and Necessary?

Before considering the case law, the Tax Court noted that corporations and prominent individuals are commonly sued. Settling to avoid a potentially enormous payout is often justifiable to protect a business from scandal. Nevertheless, the IRS claimed that no amount of worry over business assets and reputation could convert payments for the death of the boss's girlfriend into a corporate business expense.

Section 162 is famously broad, allowing businesses to deduct ordinary and necessary business expenses. Here, the settlement costs and attorney fees were ''necessary'' because they were appropriate and helpful. Legal fees and settlement costs, even if sporadic, are ordinary. So far, so good.

But section 162 requires expenses to be business and not personal. With lawsuits, the question usually turns on the origin and character of the claim underlying the legal controversy.[2] Cavanaugh argued that *United States v. Gilmore* was inapplicable because Jani-King was a business corporation engaged solely in business activities. The correct analysis, he argued, was that in *Kopp's Co. v. United States*.[3]

In *Kopp's* the son of a lumber company president crashed a company car and seriously injured another driver. The injured driver sued the son, the company president, and the company. The company settled and deducted its share of the settlement and legal fees. The Fourth Circuit upheld the deductions because the company was named in the suit and bore direct exposure to the risk of a judgment.

Commentators have noted that the apparent focus in *Kopp's* on the consequences of the claim rather than its origin seems to conflict with *Gilmore*.[4] An appeal in Cavanaugh's case, however, would not be to the Fourth Circuit where *Kopp's* was decided. The Tax Court has cited *Kopp's* for the proposition that a corporation engaged exclusively in business activities is not bound by *Gilmore*.[5] In any event, the Tax Court said that naming a company as a defendant does not by itself make the company's legal fees or settlement costs deductible business expenses.

Origin of the Claim

In *Gilmore* a husband argued that legal fees from his divorce were ordinary and necessary business expenses because he had to shield his business from his former wife's community property claims. The Supreme Court held that deductibility depends on whether the claim arises in connection with the taxpayer's profit-seeking activities. The consequence to the taxpayer from a failure to defeat the claim was not enough.[6]

The same idea applies to capitalized costs, too. In *Woodward v. Commissioner*,[7] the taxpayer deducted appraisal fees he incurred during a shareholder dispute. He argued that his primary purpose was to protect his business. The Supreme Court held that the costs of acquiring or defending a capital asset are nondeductible capital expenditures.

It is often harder to apply these rules than it looks. Moreover, in several Tax Court cases, the court has tried to consider all facts and circumstances.[8] In *Cavanaugh* the Tax Court said it could consider all the facts, but under *Gilmore*, it said it could not consider the harm the suit might have caused Jani-King's reputation. Thus, the deductibility of Jani-King's portion of the settlement and its

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[2]*See United States v. Gilmore*, 372 U.S. 39, 49 (1963).

[3]636 F.2d 59 (4th Cir. 1980).

[4]*Id.* at 61-62 (Ervin, J., dissenting); note, ''Federal Taxation: The Deductibility of Legal Expenses in the Fourth Circuit — *Kopp's Co. v. United States*,'' 17 *Wake Forest L. Rev.* 1008, 1017 (1981); note, ''The Transaction Approach to the Origin of the Claim Doctrine: A Proposed Cure for Chronic Inconsistency,'' 55 *Brook. L. Rev.* 905, 940-941 (1990) (suggesting misapplication of the origin of the claim test).

[5]*See Synanon Church v. Commissioner*, T.C. Memo. 1989-270; *Nw. Ind. Tel. Co. v. Commissioner*, T.C. Memo. 1996-168, *Doc 96-10129*, *96 TNT 66-7*, *aff'd*, 127 F.3d 643 (7th Cir. 1997), *Doc 97-29532*, *97 TNT 208-15*.

[6]*Gilmore*, 372 U.S. at 48.

[7]397 U.S. 572 (1970).

[8]*See Boagni v. Commissioner*, 59 T.C. 708 (1973); *Guill v. Commissioner*, 112 T.C. 325, 329 (1999).

legal fees turned on identifying the claim and determining whether its origin lay in Jani-King's business.

What was the claim? The suit was against Jani-King and Cavanaugh. Cavanaugh argued that its origin was the contention of Robinson's mother that Jani-King killed her daughter by negligently allowing its employees to provide illegal drugs to her. The IRS argued that the origin of the claim was Robinson's death. The Tax Court had a third view of the origin of the claim, observing that Robinson's death alone could not make Jani-King liable.

Examining the allegations about Cavanaugh, Walker, and Fortner as employees of Jani-King, the Tax Court asked whether the three employees undertook business or personal activities during the trip. The suit alleged they gave Robinson the drugs that killed her. Finding that the origin of the mother's claim lay in the conduct of the Jani-King employees did not make the payments deductible.

The court said it also had to determine whether the conduct in question arose from Jani-King's profit-seeking activities. The parties had stipulated that the trip involved no business conduct, and the IRS claimed that should end the case. Yet Cavanaugh argued that tort claims against company employees are rampant in business today, making them proximately related to undertaking business operations.

The Tax Court went out of its way to note cases in which personal conduct gave rise to business expense deductions:

- *Kopp's* (costs of suit were deductible by the corporation because they involved negligently entrusted corporate property)[9];
- *Dolese v. United States* (divorce costs were deductible because the wife enjoined the business of her husband's paving company)[10];
- *Guill v. Commissioner* (costs of suit against affiliated insurance carrier were deductible because they entirely related to the plaintiff's insurance business)[11];
- *O'Malley v. Commissioner* (costs of defense against bribery charge were deductible because they related to attempts by the trucking business to influence trucking deregulation legislation)[12];
- *Hauge v. Commissioner* (costs of defending suit brought for conspiracy to defraud were deductible because the case implicated ongoing business operations)[13]; and
- *Naporano Iron & Metal Co. v. United States* (costs of suit resulting from fight on company property during business hours were deductible by the corporation).[14]

Each of these cases involved a company's profit-seeking business or the actual conduct of a profit-seeking business. 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, furthered, or used property directly employed in Jani-King's franchising business.

In *Northwestern Indiana Telephone Co. v. Commissioner*,[15] the taxpayer owned an independent telephone company. When the Federal Communications Commission banned him from offering cable television services, the taxpayer allowed his two sons to use his phone company's leased office space, equipment, and employees to operate a cable business they owned. He paid their utility bills and wrote off substantial debt the cable business owed his telephone company. After a competitor complained, the FCC intervened, resulting in lengthy and expensive litigation and a payment by the telephone company to the competitor.

The Seventh Circuit denied the telephone company a deduction for its costs because none of the company's actions involved its profit-making activities. Far from being profit-driven, it was a subsidy to the son of the telephone company president. Similarly, the Jani-King employees were not engaged in profit-seeking activities and were far from any company property. The legal fees and settlement payments therefore could not be deductible business expenses.

The Rock

For Walker, the court said that it was conceivable that Jani-King determined his security duties furthered its business objectives. However, there was no evidence that having the bodyguard on every personal trip made *everything* business. If the Jani-King employees had been attending a conference or if they had given Robinson drugs at Jani-King's offices during business hours, the analysis might be different.

The bodyguard acted as Cavanaugh's personal valet, chef, confidant, and enabler. Intimating that it might be possible for Cavanaugh to prove that the

[9]636 F.2d at 61.
[10]605 F.2d at 1146, 1151-1152 (10th Cir. 1979).
[11]112 T.C. at 329-330.
[12]91 T.C. at 362-364.
[13]T.C. Memo. 2005-276, *Doc 2005-24120*, *2005 TNT 229-11*, at 18.
[14]6 Cl. Ct. 422, 431-432 (1984).
[15]127 F.3d at 645.

bodyguard was carrying out his work duties when he gave Robinson the drugs, the Tax Court simply said that there was nothing to show that the bodyguard's conduct arose from or furthered Jani-King's profit-seeking activities.

Indemnity Payment

Could the indemnity payment to Cavanaugh still be deductible? He personally contributed $250,000 to the settlement, which Jani-King reimbursed and then deducted. It would be deductible if Jani-King was legally obliged to reimburse Cavanaugh or if it was a voluntary payment with a sufficient business purpose. Jani-King claimed that its bylaws required it to reimburse Cavanaugh.

Noting first that indemnification is not necessarily deductible even when contractually required,[16] the Tax Court read Jani-King's bylaws not to require it. Indemnity was required only when the person became involved in the controversy by reason of being a director, officer, or employee. In that event, he would be entitled to indemnity if he was "wholly successful" in his defense. Partial success in the controversy would make indemnification discretionary. Cavanaugh proved neither element here, making the indemnity authorities simply irrelevant.

Voluntary payments can sometimes be deductible when made to protect or promote a business. In *Lohrke v. Commissioner*,[17] a corporation was liable for a defective product. An individual taxpayer voluntarily agreed to be personally liable to protect the business and the corporation's reputation. He paid customers from his personal accounts and deducted the payments under section 162. The Tax Court allowed the deductions as furthering the trade or business.

Of course, Cavanaugh's situation was the reverse, because his company was paying for him. In that situation, the Tax Court said, it would be necessary for the company to show that the person for whom it was paying was unable to pay. Here, Cavanaugh was quite able to pay and had paid all the litigation costs and expenses. Thus, even the reimbursed $250,000 was not deductible.

Conclusion

Legal claims are often made against a company and its employees. If a company's delivery driver has a traffic accident, the company will be sued even if the driver was an independent contractor. The origin of the claim may be a bad driving record, but whatever the facts, there can be little doubt that the basic activity is related to the business and the conduct of business activity.

The same is true in sexual harassment litigation. If a supervisor harasses another employee, it is almost certain that the conduct is personal. It is surely outside the scope of the supervisor's employment, too. Yet it arises out of a working relationship and usually involves company property, business trips, and business activities.

Those situations are unlikely to give rise to many tax questions even when there are technical bases for arguing they are nondeductible. But *Cavanaugh* is a warning that when the facts are egregious and there is little or no business connection, the fact that the company is named as a defendant is simply not enough to import deductibility.

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[16]*See HIE Holdings Inc. v. Commissioner*, T.C. Memo. 2009-130, *Doc 2009-12974, 2009 TNT 108-25*, at 296-297 (citing *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 359 (1971)).

[17]48 T.C. 679, 684-685 (1967).