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Taxation - Federal Income Tax - Deductibility by an Employee of Sum Paid in Settlement of Claim Arising from His Operation of Automobile Used in Company's Business

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TAXATION — FEDERAL INCOME TAX — DEDUCTIBILITY BY AN EMPLOYEE OF SUM PAID IN SETTLEMENT OF CLAIM ARISING FROM HIS OPERATION OF AUTOMOBILE USED IN COMPANY'S BUSINESS—Petitioner and one Elkins were employed by a corporation which they had organized to engage in the electrical contracting business. They furnished their own automobiles to transport

men and material from job to job, and were reimbursed by the corporation for operating expenses. The corporation also paid for insurance and repairs of the automobiles. While Elkins was using petitioner's car to drive two employees to a job in progress, a collision occurred causing personal injuries to the two employees, who recovered a judgment against petitioner which he finally settled by payment of \$4,000 in excess of the amount of the insurance coverage. The corporation was not made a party to the suit, nor was any demand ever made against it for reimbursement of the amount paid by petitioner. He sought to deduct the \$4,000 on his personal income tax return as a trade or business expense. Upon hearing, the Tax Court *held* that, at the time of the accident, the automobile was being used in the business of the corporation, not that of petitioner, and the deduction was disallowed. *Emanuel O. Diamond*, 19 T.C. 737 (1953).

Implicit in the provision of the Internal Revenue Code permitting deduction of trade or business expenses¹ is the limitation that such expenses must be incurred in relation to the taxpayer's own business and not that of someone else.² This limitation is illustrated by the case of *Deputy v. DuPont*.³ The DuPont Company wanted a new group of executives to have a financial interest in the company, but since stock could not legally be sold to them directly an arrangement was worked out whereby it was furnished by a large shareholder. In order to carry out the plan it was necessary for the shareholder to borrow some stock, and in doing so he incurred expenses which he sought to deduct as trade or business expenses. The deduction was disallowed since the expenses resulted not from the taxpayer's business but from business of the DuPont Company—its effort to increase the efficiency of its management.⁴ The same

¹ "SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) EXPENSES.—

(1) TRADE OR BUSINESS EXPENSES.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." 26 U.S.C. (1946) §23(a)(1).

²To be deductible the taxpayer's expense must be one which is "directly connected with, or as otherwise stated, proximately resulted from his business. . . ." *Kornhauser v. United States*, 276 U.S. 145, 48 S.Ct. 219 (1928).

³308 U.S. 488, 60 S.Ct. 363 (1940).

⁴*Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 63 S.Ct. 1279 (1943), indicates the strictness with which this limitation has sometimes been applied. The Interstate Transit Lines in order to comply with a California law formed a wholly owned subsidiary to carry on its intra-state business there. It contracted with the subsidiary to receive all profits from operation of the intrastate business and to reimburse it for any operating deficits. The Interstate Company paid such a deficit and sought to deduct it as a trade or business expense, but the court held that the businesses of the two companies were distinct, and the mere agreement of the taxpayer to assume the deficit was not sufficient to make it an expense. In *Aldo R. Balsam*, 1944 P-H TCM ¶44,368, the court disallowed a deduction by a trust for expenses that it paid to officers of a corporation in which the trust was one of the principal stockholders. The court stated at pp. 1318-1344: "The statute contemplates the deduction of only such ordinary and necessary non-trade or non-business expenses as are personal to the taxpayer. . . . It does not embrace expenses of a separate and distinct taxpayer." See also *Word Specialty Mfg. Corp.*, 34 B.T.A. 974 (1936); *Coosa Land Co.*, 29 B.T.A. 389 (1933).

principle may come into play in connection with expenses paid or incurred by an officer or employee of a corporation for which he is not reimbursed. If the court determines that the expenses are primarily related to the business of the corporation rather than that of the employee, neither will be able to benefit from an otherwise valid deduction. The courts have recognized that an individual who is an officer of a corporation may have trade or business expenses which are deductible, though such cases are probably infrequent. Thus, an officer of a corporation whose primary work was sales promotion was allowed to deduct amounts paid for operation of his car and entertainment on frequent trips which were necessary in connection with his work.⁵ In that case the employee was not reimbursed by the corporation, nor was there any express agreement that part of his salary was intended as compensation for these expenditures. In somewhat similar cases, non-reimbursed expenditures were held not deductible by the officer-employee. Where the taxpayer paid for telephone calls, travel, and entertainment in connection with the management of a family-owned real estate holding company, the court refused to permit him the deduction, reasoning that the company's business was not that of the officer and that the expenses were incurred in the company's business.⁶ The same result was reached when a corporation officer tried to deduct the expenses of renting a club room which was used by the corporation for conferences and other business purposes.⁷ It may often be difficult to distinguish in such cases whether the expenses are related primarily to the business of the corporation or that of the officer-employee, since in many cases the business interests of the two will be substantially the same. To prevent the loss of such deductions one of two courses may be followed: (1) the corporation may agree to reimburse the officer or employee for such expenditures and take the deduction itself;⁸ or (2) the resolution authorizing the salary of the officer or the contract with the employee may stipulate that he is to pay any designated expenses out of such salary, in which case the employee will claim the deduction. Thus, where part of the employment agreement between the employee and the corporation provided that the employee was to bear certain entertainment expenses he incurred on behalf of the corporation, it was held that such expenses were deductible.⁹ Since the company in the principal case was paying the operating

⁵ Arthur A. Byerlein, 13 T.C. 1085 (1949). The president of a corporation was permitted to deduct expenses in connection with the use of his personal car to travel about from one plant to another in a metropolitan area. Ralph D. Hubbart, 4 T.C. 121 (1944).

⁶ *Low v. Nunan*, (2d Cir. 1946) 154 F. (2d) 261. If the travel expenses which the taxpayer seeks to deduct are merely those incurred in traveling to work they are not deductible because they are personal expenditures and not ordinary and necessary business expenditures. *W. S. Dickason*, 20 B.T.A. 496 (1930).

⁷ *Franklin M. Magill*, 4 B.T.A. 272 (1926). See also *Arthur B. Chivers*, 4 B.T.A. 1083 (1926).

⁸ "If the sums paid had been paid or incurred by the Corporation, they would, no doubt, have been deductible under section 23(a)(1)(A) by the Corporation. . . . It might well be that the Corporation was liable for reimbursement of such sums to petitioner and, after reimbursement, could have claimed a deduction under that section; but that question also is not before us." Principal case at 742.

⁹ *Grover Tyler*, 13 T.C. 186 (1949).

expenses, the insurance, and the repair bills on the car, and since the car was undoubtedly being used in connection with company business at the time of the accident, it would appear that petitioner should have been reimbursed by the corporation for the amount he paid to the injured employees.¹⁰ However, where there is difficulty in drawing any real distinction between the trade or business of the company and that of its officer, the courts might well be a little more lenient in permitting a deduction by the party actually paying the expenses, because in most instances the expenses are incurred in the trade or business of one or the other.

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¹⁰ See note 8 *supra*.