



ERNIE FLETCHER
GOVERNOR

OFFICE OF THE SECRETARY
FINANCE AND ADMINISTRATION CABINET
383 CAPITOL ANNEX
FRANKFORT, KENTUCKY 40601
(502) 564-4240
(502) 564-6785 Fax

ROBBIE RUDOLPH
SECRETARY

In the matter of:

[REDACTED]

Contact:

[REDACTED]

FINAL RULING NO. 2006-36
April 26, 2006

Individual income tax assessments
for the periods ended
December 31, 1998

FINAL RULING

The Kentucky Department of Revenue (formerly known as the Kentucky Revenue Cabinet) has issued individual income tax assessments against you for the taxable year 1998 totaling \$ [REDACTED] including applicable interest, fees and penalties. The following table provides a breakdown of the amount of tax due as well as accrued interest, fees per KRS 131.440 and penalties per KRS 131.180 calculated through April 25, 2006; however interest will continue to accrue.

Tax Year	Notice Number	Tax Due	Interest	Fees	Penalties	Total
1998	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

At issue are adjustments made to your 1998 individual tax returns by the Department of Revenue that disallowed the deductions for certain employee business expenses for lodging taken on Federal Form 2106.

KRS 141.010(3) states:

“‘Internal Revenue Code’ means the Internal Revenue Code in effect on December 31, 1997, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 1998, that would otherwise terminate, and as modified by KRS 141.0101;”

KRS 141.010(9) and (10) define “gross income” and “adjusted gross income” to mean the following.

KRS 141.010(9) states:

“‘Gross income’ in the case of taxpayers other than corporations means ‘gross income’ as defined in Section 61 of the Internal Revenue Code;”

KRS 141.010(10) states in part:

“‘Adjusted gross income’ in the case of taxpayers other than corporations means gross income as defined in subsection (9) of this section minus the deductions allowed individuals by Section 62 of the Internal Revenue Code and as modified by KRS 141.0101...”

Internal Revenue Code Section 274 – In order to claim any deductions, a taxpayer must be able to prove that the expenses were in fact paid or incurred. Such expenses are deemed particularly susceptible to abuse, must generally be substantiated by adequate records or sufficient evidence corroborating the taxpayer’s own statement.

Generally, expenses must be substantiated as to (1) amount, (2) time and place, and (3) business purpose. A record of the elements of the expense at or near the time of the expenditure or use supported sufficient documentary evidence that has a high degree of credibility.

Internal Revenue Procedure 97-59, Section 6-02 states that receipts for lodging expenses are not required to substantiate the deduction. However, this procedure provides optional rules for deeming substantiated the amount of certain reimbursed traveling expenses and is stated in Section 1 as follows:

This revenue procedure updates Rev. Proc. 96-64 , 1996 2C.B. 427, by providing rules under which the amount of ordinary and necessary business expenses of an

employee for lodging, meal and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under 1.74-5T of the temporary Income Tax Regulations when a payor (the employer, its agent or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meals and incidental expenses paid incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

In addition, Section 3 of Revenue Procedure 97-59 provides the following definition of the term "per diem":

The term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in Internal Revenue Service regulation 1.62-2 (10) and that is paid with respect to ordinary and necessary business expenses incurred, by an employee for lodging, meals and incidental expenses or for meal incidental expenses for travel away from home in connection with the performance of services of the employer.....

The per diem method can be used to substantiate an employee's reimbursed expenses only if the arrangement is considered an accountable plan. A plan under which an employee is reimbursed for expenses or receives an allowance to cover expenses is an accountable plan only if the following three conditions are satisfied:

1. There must be a business connection for the expenses.
2. The employees must either substantiate or be deemed to have substantiated the expenses; and
3. The employee must return to the employer amounts in excess of the substantiated (or deemed substantiated) expenses.

Consistent with Internal Revenue Service Regulation 1.62-2(d)(2), an expense allowance or reimbursement arrangement that would be partly an accountable plan and partly a non-accountable plan if the two parts were separately considered will be treated as two separate arrangements, one accountable plan and the other a non-accountable plan.

Upon review of the facts, it has been determined that your client had an accountable plan for meals and incidental expenses and unaccountable with his employer for lodging

expense. As a result, the only lodging expenses allowable for the taxpayer are those substantiated by lodging receipts.

Upon review of your 1998 Kentucky individual income tax return, the Department of Revenue requested that you provide additional information regarding the amounts claimed as lodging expenses taken on Federal Form 2106. The Department of Revenue stated that the amount of lodging expenses taken on Federal Form 2106 was unsubstantiated because sufficient detailed information was not provided. Therefore, assessments were issued for calendar year ended 1998.

The Division of Protest Resolution requested additional information in letters dated [REDACTED], 2004 and [REDACTED], 2004, but no substantiated information was received.

After reviewing your protest, and the applicable statutes and regulations, it is the position of the Kentucky Department of Revenue that the individual income tax assessments issued against you for the tax year 1998 of \$ [REDACTED] including accrued interest, fees and penalties are legitimate liabilities due the Commonwealth of Kentucky. This is the final ruling of the Department of Revenue.

APPEAL

You may appeal this final ruling to the Kentucky Board of Tax Appeals pursuant to the provisions of KRS 131.110, KRS 131.340-131.365, 103 KAR 1:010 and 802 KAR 1:010. If you decide to appeal this final ruling, your petition of appeal must be filed at the principal office of the Kentucky Board of Tax Appeals, 128 Brighton Park Boulevard, Frankfort, Kentucky 40602-2120, within thirty (30) days from the date of this final ruling. The rules of the Kentucky Board of Tax Appeals, which are set forth in 802 KAR 1:010, require that the petition of appeal must:

1. Be filed in quintuplicate;
2. Contain a brief statement of the law and facts in issue;
3. Contain the petitioner's or appellant's position as to the law and facts; and
4. Include a copy of this final ruling with each copy of the petition of appeal.

The petition of appeal must be in writing and signed by the petitioner or appellant. Filings by facsimile or other electronic means shall not be accepted.

Proceedings before the Kentucky Board of Tax Appeals are conducted in accordance with 103 KAR 1:010, 802 KAR 1:010 and KRS 131.340-131.365 and KRS Chapter 13B. Formal hearings are held by the Board concerning the tax appeals before it, with all testimony and proceedings officially reported. Legal representation of parties to appeals before the Board is governed by the following rules set forth in Section 2 (3) of 802 KAR 1:010:

1. An individual may represent himself in hearings before the Board;

2. An individual who is not an attorney may not represent any other individual, corporation, trust, estate, or partnership before the Board; and
3. An attorney who is not licensed to practice in Kentucky may practice before the Board if he complies with Rule 3.030(2) of the Rules of the Kentucky Supreme Court.

You will be notified by the Clerk of the Board of the date and time set for any hearing.

Sincerely,
FINANCE AND ADMINISTRATION CABINET



THOMAS H. BROWN
Director
Division of Protest Resolution

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

