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GOVERNOR

OFFICE OF THE SECRETARY
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ROBBIE RUDOLPH
SECRETARY

In the matter of:

[REDACTED]

Contact:

[REDACTED]

FINAL RULING NO. 2006-49
June 8, 2006

Individual income tax assessments
for the periods ended
December 31, 1999
December 31, 2000
December 31, 2001
December 31, 2002

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 years 1999 through 2002 totaling \$ [REDACTED], plus 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 May 23, 2006; however interest will continue to accrue.

Tax Year	Notice Number	Tax Due	Interest	Fees	Penalties	Total
1999	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
2000	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
2001	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
2002	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

At issue are adjustments made to your tax years ended 1999, 2000, 2001 and 2002 Kentucky Individual Income tax returns by the Kentucky Department of Revenue that adjusted federal income to include additional wages taxable to Kentucky, interest and dividends, capital gains, and unemployment benefits. The Kentucky Department of Revenue disallowed the deductions on Schedule M for pre-taxed insurance premiums and deductions on Schedule A for medical expenses claimed, local taxes, personal property taxes, charitable contributions, and job expenses. The Schedule C–Business Income was adjusted for car expenses, depreciation, legal/professional fees, supplies, meals/entertainment, utilities, cell phone/pager expenses, cost of goods sold and union dues. In lieu of the disallowance of the aforementioned expenses the Kentucky Department of Revenue allowed the individual standard deduction to decrease the amount of Kentucky income subject to tax.

Chapter 141 of the Kentucky Revised Statutes pertains to income taxes. The definitions for the chapter are found in KRS 141.010.

KRS 141.010(3) states:

“Internal Revenue Code’ means the Internal Revenue Code in effect on December 31, 1997, for tax year end 1999, December 31, 1999 for tax year end 2000 and 2001, December 31, 2001 for tax year end 2002 for exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 2002, 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 231 - A medical expense deduction is allowed for premiums paid for medical care insurance subject to 7.5% limitation.

Generally, the pre-taxed health insurance are not a deduction from Federal Form 1040, line 28 and is not a subtraction to Federal adjusted gross income on schedule M of the Kentucky Income tax return.

Due to limitations on deductible medical and miscellaneous expenses, the amount that could be verified was less than the 7.5% medical limitation. Therefore, no deduction was allowed on the Kentucky Individual Income tax return for medical expenses. Also, there was not a way to verify other medical expenses claimed.

Internal Revenue Code Section 164 allows a taxpayer to deduct substantiated local taxes paid by the individual.

Generally, taxes not directly connected with a trade or business or property held for production of rents or royalties may be deducted only as itemized deduction on Schedule A of the Federal Form 1040. State, local or foreign income taxes, war profits or excess profits tax are deductible under Internal Revenue Code Section 164.

Internal Revenue Code Section 164 allows a taxpayer to deduct substantiated personal property taxes paid by the individual.

Generally, taxes not directly connected with a trade or business or property held for production of rents or royalties may be deducted only as itemized deduction on Schedule A of the Form 1040. State or local personal property taxes and state, local or foreign real property tax are deductible.

Internal Revenue Code Section 170 allows a taxpayer to deduct charitable contributions under Code Section 170(a)(1).

Generally, there shall be allowed as a deduction any charitable contribution (as defined subsection (c) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

Internal Revenue Code Section 162 and 274 allows a taxpayer to deduct substantiated business mileage expenses and auto expenses.

Generally, the standard mileage rate method is a simplified method available to both employees and self-employed persons in computing deductions for car expenses in lieu of calculation the operating and fixed costs allocable to business purposes (Rev. Proc. 99-38).

Generally, a taxpayer can substantiate car expenses by keeping an exact record of the amount paid for gasoline, insurance and other costs. However, the standard mileage rate method is a simplified method available to both expenses and self-employed persons in

computing deductions for car expenses in lieu of calculating the operating and fixed costs allocable to business purposes (Rev. Proc. 99-38).

Internal Revenue Code Section 167 and 179 allows a taxpayer to deduct a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business, or of property held for the production of income. Depreciation is not allowed for property used for personal purposes, such as a residence or car used solely for pleasure.

IRC Section 179- Election to Expense Certain Depreciable Business Assets - is an expense deduction provided for taxpayers who elect to treat the cost of qualifying property, as an expense rather than a capital expenditure.

Generally, the total cost of property that may be expensed for any tax year cannot exceed the total amount of taxable income derived from the active conduct of any trade or business during the tax year, including salaries and wages. To qualify as IRC Section 179 property must be tangible Code Section 1245 property, depreciable under IRC Section 168 and acquired by purchase for use in the active conduct of a trade or business.

Internal Revenue Code Section 162, Code Sec 262(a) and Code Sec 263 allow attorney fees, court costs and other legal expenses to qualify as deductible business expenses. Legal expenses are not deductible if they are either capital expenditures or a personal expense of the taxpayer.

Generally, fees for bookkeeping and accounting work incurred in the operation of the taxpayer's business are deductible.

Internal Revenue Code Regulation 1.162 allows expenses for operating a car used in making professional calls, dues to professional organizations, rent paid for office space and other ordinary and necessary business expenses are deductible by a professional person. Amounts for books and equipment may be deducted if the useful life of the item is not more than one year.

Generally, supplies, utilities, telephone and cell phone/pagers are deductible if they are considered ordinary and necessary to conduct the business of the taxpayer.

Internal Revenue Code 274 has special limits imposed on the deduction of business-related entertainment, meal and gift expenses.

Generally, the deduction for entertainment expenses may not exceed the portion that is related to the business. If there are both business and non-business expenses at the same event, an allocation must be made and only the business portion may be deducted.

Generally, only 50% of otherwise allowable meal and entertainment expenses are deductible.

Internal Revenue Code Section 61 – the definition of gross income includes gross income derived from business. Gross profit is the total receipts from sales minus the cost of the goods sold.

Generally, cost of goods sold includes the purchase price of the article sold plus delivery costs, warehousing, etc. Costs of goods sold should be distinguished from deductions allowed by law. Thus, salaries, rent etc. are deductions and not cost of goods sold.

Internal Revenue Code Section 162 – a deduction is allowed for ordinary and necessary traveling expenses incurred by a taxpayer while away from home in the conduct of a trade or business.

Generally, deductible travel expenses that are paid or incurred while traveling away from home ordinarily are deductible: travel, meals, lodging and transportation.

Internal Revenue Code Section 67(a) – an individual is allowed itemized deductions, only to the extent that the aggregate of such deductions exceeds two percent of the individual's adjusted gross income for the tax year.

Generally, union dues, initiation fees and out-of-work benefit assessments are deductible as an itemized deduction on Schedule A of the Form 1040, subject to the 2% floor.

Internal Review 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.

Upon review of your 1999, 2000, 2001 and 2002 Kentucky individual income tax returns, the Department of Revenue requested that you provide additional information. The Department of Revenue stated that the amount of the aforementioned deductions taken on Schedule A and Schedule C were incomplete because unsubstantiated information was provided. Therefore, assessments were issued for tax years 1999, 2000, 2001 and 2002.

In addition, the Division of Protest Resolution requested additional information in letters dated [REDACTED], 2004 and [REDACTED], 2005 but no response 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 years 1999, 2000, 2001 and 2002 totaling \$ [REDACTED] plus accrued interest,

fees per KRS 131.440 and penalties per KRS 131.180 are legitimate liabilities due the Commonwealth of Kentucky. This is a final ruling of the Kentucky 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

