STEVEN L. BESHEAR
Governor

FINANCE AND ADMINISTRATION CABINET
DEPARTMENT OF REVENUE

501 HIGH STREET
FRANKFORT, KENTUCKY 40620
Phone (502) 564-3226
Fax (502) 564-3875
www.kentucky.gov

JONATHAN MILLER
Secretary

WILLIAM M. COX, SR.
Commissioner

In the matter of:

[redacted]

Contact: [redacted]

[redacted]

FINAL RULING NO. 2007-56
December 27, 2007

Individual income tax assessments
for the tax periods ended December 31, 2002
through December 31, 2004

FINAL RULING

The Kentucky Finance and Administration Cabinet, Department of Revenue (successor to the Kentucky Revenue Cabinet; the "Department") has issued individual income tax assessments against [redacted] for the taxable years 2002, 2003 and 2004, totaling $[redacted], plus applicable interest, fees and penalty. The following table provides a breakdown of the amount of tax due and the accrued interest as of the date of this final ruling.

Tax Period	Tax	Interest	Fees	Penalty	Total
December 31, 2002	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
December 31, 2003	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
December 31, 2004	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Totals	$[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]

The Kentucky Department of Revenue, Division of Field Operations, conducted an examination of [redacted]'s records and Kentucky Individual Income Tax Returns filed for the years in question. [redacted] was a resident of [redacted], Kentucky for all tax years audited. In addition,

the Federal Individual Income Tax Returns were also examined pursuant to KRS 141.050, which interprets Kentucky income tax law to be "as nearly as practicable identical" with the "computations of gross income and deductions therefrom, accounting methods, and accounting procedures" required for federal income tax purposes. Because KRS 141.010(9) defines "gross income" as meaning the same as gross income defined in Section 61 of the Internal Revenue Code and KRS 141.010(10) defines "adjusted gross income" as gross income minus the deductions allowed by Section 62 of the Internal Revenue Code as modified and adjusted by Kentucky statutes, it is necessary to begin the Kentucky audit with an examination of the federal returns.

The taxpayer claimed a large amount of unreimbursed employee expenses on Schedule A of her Federal Form 1040 for all tax years in question. During that time, she was under contract with and considered employed by [redacted]. [redacted] is a [redacted], Kentucky-based company that provides staffing services for companies seeking individuals with information technology expertise for short-term projects. During the audit period, [redacted] signed a Standard Hourly Employment Contract with [redacted] on [redacted], 2002, to perform duties as a [redacted] Manager for [redacted] in [redacted], Kentucky for an unspecified period of time, which lasted for less than one year. On [redacted], 2003, [redacted] signed another Standard Hourly Employment Contract with [redacted] to perform work for [redacted] in the capacity of [redacted] Manager. Although [redacted] was considered an employee of [redacted], there is no indication that she maintained an office at the company's location in [redacted]. The work was generally performed at the offices of [redacted]' client. The Employment Contract [redacted] entered into with [redacted], Inc. was "for services with [redacted client] for a temporary period, to perform such duties and for such hours of work as may be assigned to you during the term of service."

[redacted]'s protest was timely filed by her representative, [redacted], E.A., of [redacted], Kentucky. In the protest, [redacted] raised a number of issues from the Agent's Narrative Report that involve any or all of the years in question.

Mileage and Auto Expense Records: The protest claims that [redacted] provided detailed mileage and auto expense records for her [redacted] through [redacted] 2002 commute from [redacted] to her temporary work location in [redacted], as well as miles driven for the purpose of securing a job. [redacted] believed those records substantiated the total allowable actual expenses of [redacted]'s personal vehicle based on 87.6% business use. However, there were no records to substantiate personal mileage during 2002. Because [redacted] used the actual expense method rather than the standard mileage method in arriving at her deduction for automobile expenses, she was required to document both her personal miles as well as her business miles driven. As a result of the lack of substantiation, the auditor decreased business use for actual auto expenses from 87.6% to 80% for the tax period ended December 31, 2002. The auditor gave [redacted] credit for [redacted] months of auto lease payments, as this was the time frame when she was under contract with [redacted]. The lease payments for [redacted] months totaled $[redacted], less $[redacted] for the inclusion deduction on leased vehicles, which made the total deductible lease payments $[redacted]. The auditor was able to verify expenses of $[redacted] for gasoline, oil, insurance premiums, repairs, and other auto-related expenses. Applying the 80% business use percentage

to the applicable expenses rendered a total deduction for actual auto expenses of $[redacted]. The taxpayer had deducted $[redacted] as actual vehicle expenses on her 2002 Form 2106. The auditor disallowed $[redacted] of vehicle expenses claimed in 2002.

IRC 274(d)(4) states that no deduction shall be allowed with respect to any listed property unless the taxpayer can substantiate by adequate records or by sufficient evidence corroborating the amount of such expense or other item or the time and place of the travel. Adequate records of personal miles versus business miles driven generally include an odometer reading at the beginning and end of the year. A listing on a daily basis of the total miles driven can suffice for total mileage with a notation of roundtrip miles driven that day for business purposes will suffice as proof of business miles driven. Section 1.274-5T(a), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985), provides that a taxpayer shall not be allowed a deduction based on approximately or the taxpayer's unsupported testimony.

A large portion of auto expenses were disallowed by the auditor in 2003 and 2004 because the auditor was able to determine from mileage logs that [redacted] worked in [redacted], Kentucky for well over one year and [redacted] became her tax home for part of 2003 and 2004. The only deductible actual auto expenses in 2003 were for the first few months, which gave the auditor cause to reduce the business mileage percentage from 100% as claimed by the taxpayer to 36.1% for 2003. As a result, the deductible vehicle expense amount for gasoline, oil, insurance, and repairs went from $[redacted] to $[redacted].

In 2004, the taxpayer purchased a new car and began using the mileage method. Business mileage of [redacted] was allowed and after applying the mileage rate of .375, $[redacted] was allowed as a deductible expense. This created an adjustment disallowing $[redacted] of the taxpayer's claimed deductible business mileage.

Revenue Ruling 94-47 amplified and clarified portions of Internal Revenue Code Section 162 regarding traveling expenses in connection with a trade or business. Daily transportation expenses for commuting between a personal residence and a temporary work location can be deducted only if the temporary work location is defined as being reasonably expected to last less than one year or if it does in fact last less than one year. Revenue Ruling 94-47 also states that the work must not only be temporary, but it must be outside the metropolitan area where the taxpayer normally works. Generally, an individual's tax home is the entire city or general area where the taxpayer's main place of business or work is located, regardless of where the family home is located.

The IRS has clearly made commuting expenses deductible only if a two-prong test is met. The first prong of the definition provides that a work location is temporary if employment at that location is realistically expected to last, and does in fact last, for one year or less. The U.S. Tax Court case of Daniela Aldea, TC Memo 2000-136, indicates that the IRS is now focusing on the second prong of the test – the work must not only be temporary, but it must be outside the metropolitan area where the taxpayer resides and normally works in order for the commuting mileage to be deductible. In the Aledea case, the taxpayer was not entitled to deduct transportation expenses because she did not have a single metropolitan area where she normally worked. In the

case at hand, [redacted] must not only prove that the temporary work lasted for less than one year, but she must also prove that [redacted] was the metropolitan area where she normally worked.

Business Use of Home: IRC, 2004 Code Sec. 280A sets forth that the following two tax law requirements must be met in order to qualify for the home office deduction: (1) Part of the home must be regularly used exclusively for trade or business; and (2) the home must be used as the principal place of business. If [redacted] used a part of her home for business and also for personal purposes, she would not meet the exclusive use test. In order for her home to qualify as her principal place of business, [redacted] had to have conducted administrative or management activities of her business solely from her residence, and was provided no other fixed location from which to conduct those activities. [redacted] provided no proof that she satisfied the requirements of home office usage.

Cell Phone Deduction: Pursuant to IRC Section 280F(d)(4)(A)(v), a cell phone is considered listed property for tax purposes. The IRS imposes detailed record keeping requirements on listed property in IRC 274(d)(4). To meet the adequate records requirements of section 274, a taxpayer must maintain some form of records and documentary evidence that in combination are sufficient to establish each element of an expenditure or use. To secure a business deduction for a cell phone, it is recommended that the taxpayer notes business calls on a detailed list of outgoing calls from the cell phone's monthly bill. It is also recommended that the taxpayer keep a log of incoming calls and indicate on the list the ones that are for business. [redacted] did not provide substantiated business use of her cell phone and this office maintains that the auditor's disallowance of the deduction was correct.

Home Phone and Long Distance Calls Deductions. Regarding the home phone deduction, IRC Section 262(b) provides that an individual is denied a business deduction for basic local telephone service charges on the first line in the residence. [redacted] did not provide documentation to substantiate a second line that was used strictly for business purposes. She did not provide adequate documentation to allow a deduction for long distance phone calls that would include detailed telephone bills and a list of long distance phone calls which include the name of the business or person called and the nature of the call.

Clothing and Dry Cleaning Expenses: Clothing expenses are not deductible unless the taxpayer is required to wear safety equipment, protective clothing and gear, uniforms or other clothing that is not suitable for everyday wear. Dry cleaning expenses for regular clothing are deductible only if the taxpayer is away from home overnight on business. See Dunkelberger v. Commissioner, T.C. Memo, 1992-723, 64 TCM 1567; Hynes v. Commissioner, 74 T.C. 1266, 1290 (1980) and Yeomans v. Commissioner, 30 T.C. 757, 767 (1958). [redacted] provided no proof that she was required to wear uniforms or that the dry cleaning expenses were incurred during overnight business travel.

Travel Expenses: [redacted]'s representative contended that [redacted] provided sufficient documentation regarding business travel, including the nature of the travel incurred, a guide and tally sheet, and credit card statements detailing travel-related expenses. There is no evidence

other than credit card statements to substantiate business travel expenses. IRC section 162(a)(2) allows a deduction for traveling expenses, including meals and lodging while away from home in pursuit of a trade or business. IRC section 274(d) disallows this deduction unless the taxpayer complies with stringent substantiation requirements with respect to the amount, time and place, and business purpose of the expense. [redacted] failed to provide documentation that would satisfy the substantiation requirements and thus the travel expenses must be disallowed. Specifically, the information that must be provided for substantiation of travel expenses includes receipts that show the cost of each separate expense for travel, lodging, meals and incidental expenses, dates the taxpayer left and returned for each trip and number of days spent on business, destination of travel, and business purpose for the expense or the business benefit gained or expected to be gained. A cancelled check or credit card statement, together with a bill from the payee, ordinarily establishes the cost. However, the IRS goes on to state in its recordkeeping requirements that a canceled check (or a credit card statement) does not prove a business expense without other evidence to show that it was for a business purpose.

Attorney and Accountant Fees: Attorney's fees and other litigation costs are deductible to the extent they are incurred to produce income that is includable in the taxpayer's gross income. 2004FED ¶8520.315. An accountant's fees may be tax deductible to the extent their work involved obtaining spousal support such as work involved in determining the parties' actual cash flow. Fees are also deductible to the extent they are paid for tax planning advice or for the production of income. [redacted] was asked to provide statements from attorneys and/or accountants that showed the nature of the services provided to her in support of her deduction. The statements were not produced.

Meals: [redacted] provided no substantiation to prove the business nature of any meals that were deducted. The IRS allows a deduction for travel expenses, including meals, which are paid or incurred in connection with a temporary work assignment. However, travel expenses paid in connection with an indefinite work assignment are not deductible. See IRS Tax Topic 511. In the Standard Hourly Employment Contract that [redacted] signed with [redacted], it states that "[y]ou acknowledge and understand that your employment with [redacted] is 'at will', with no certain term being offered or promised, and that you or [redacted] may terminate your employment, with or without cause, at any time." [redacted] signed a contract with [redacted] to work for an unspecified period of time. As such, the meals were not deductible.

Business Gifts: IRS Code Section 274 limits deductions for business gifts to $25 per recipient per year. Additionally, IRS rules disallow a deduction for gifts given as business expenses unless the taxpayer maintains adequate records to substantiate the expense amount, time and place the expense was incurred, business purpose of the expense, a description of the item given, and the business relationship with the person receiving the gift. [redacted] failed to provide the requisite documentation for business gifts.

In summary, tax deductions are a matter of legislative grace with a taxpayer bearing the burden of proving entitlement to the deductions claimed. Rule 142(a)(1); INDOPCO, Inc. v.

Commissioner, 502 U.S. 79, 84 (1992). Taxpayers bear the burden of substantiating the amount and purpose of any claimed deduction. See Hradesky v. Commissioner, 65 T.C. 87 (1975), affd. per curiam 540 F.2d 821 (5th Cir. 1976). See also sec. 1.274-5T(b)(2), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985).

IRC Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. O'Malley v. Commissioner, 91 T.C. 352, 363-365 (1988); sec 1.162-17(a), Income Tax Regs. The employee must show the relationship between the expenditures and the employment. See, 91 T.C. 352, 363-365 (1988); sec 1.162-17(a), Income Tax Regs. See also Joseph v. Commissioner, T.C. Memo, 2005-169. Section 6001 and the regulations promulgated thereunder require taxpayers to maintain records sufficient to permit verification of income and expenses. Higbee v. Commissioner, 116 T.C. 438, 440 (2001); sec. 1.6001-1(a), Income Tax Regs.

After reviewing the protest, and the applicable statutes, regulations and cases, it is the position of the Kentucky Department of Revenue that the individual income tax assessments issued against you for the tax years 2002, 2003 and 2004 totaling $[redacted] plus accrued interest and fees per KRS 131.440 and penalties per KRS 131.180 are legitimate liabilities due the Commonwealth of Kentucky.

This letter 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

Douglas M. Dowell

Douglas M. Dowell
Attorney Manager
Office of Legal Services for Revenue

FIRST CLASS MAIL TO BOTH ADDRESSES

CERTIFIED MAIL
RETURN RECEIPT REQUESTED TO [redacted] ADDRESS