

Commonwealth of Kentucky
Court of Appeals

NO. 2006-CA-002512-MR

PAUL J. PERCONTI AND
LESLIE PERCONTI

APPELLANTS

APPEAL FROM JEFFERSON CIRCUIT COURT
v. HONORABLE ROGER L. CRITTENDEN, SENIOR JUDGE
ACTION NO. 05-CI-010450

COMMONWEALTH OF KENTUCKY,
FINANCE AND ADMINISTRATION CABINET

APPELLEE

OPINION
AFFIRMING

** ** *

BEFORE: HOWARD,¹ NICKELL, AND TAYLOR, JUDGES.

TAYLOR, JUDGE: Paul J. Perconti and Leslie Perconti (collectively referred to as the Percontis) bring this appeal from a November 2, 2006, order of the Jefferson Circuit Court that affirmed a decision of the Kentucky Board of Tax Appeals (KBTA)

¹ Judge Howard concurred in this opinion prior to Judge Michael Caperton being sworn in on December 7, 2007 as Judge of the Third Appellate District, Division 1. Release of this opinion was delayed by administrative handling.

disallowing a deduction of \$1,850,000.00 as a business expense on their Kentucky income tax returns for the 2003 tax year. We affirm.

Paul was formerly the president and chief executive officer of Thornton Oil Company (Thornton Oil), where he served as an executive for approximately sixteen years. Paul and other executives of Thornton Oil established Tegra Investment Group, LLC (Tegra), as a personal investment. Tegra invested in the futures market in a strategy known as “hedging.” Thornton Oil also engaged in hedging activities in the course of its day to day activities. However, Paul improperly converted assets of Thornton Oil to cover losses incurred by Tegra. Eventually, this improper activity was discovered, and Paul was terminated from employment by Thornton Oil.

As a result, Thornton Oil instituted a civil action against Paul for conversion, and Paul brought various claims against Thornton Oil. Thornton Oil ultimately secured a judgment in the amount of \$1,196,830.00 against Paul upon its conversion claim and a separate judgment in the amount of \$1,000,000.00 for a promissory note indebtedness. In July 2002, Paul sought relief under Chapter 11 of the United States Bankruptcy Code. Paul also secured a judgment against Thornton Oil for various ERISA claims. Eventually, Thornton Oil and Paul reached a settlement agreement in the bankruptcy court. In this agreement, Paul agreed to pay Thornton Oil \$1,850,000.00, as a secured claim in settlement of the conversion judgment.²

On the Percontis' 2003 Kentucky Individual Tax Return, they claimed the \$1,850,000.00 settlement payment as a business loss or expense and claimed the payment

² Thornton Oil Company was also paid \$50,000.00 in the bankruptcy as an unsecured claim.

as a deduction from gross income. This deduction would have resulted in a refund of \$111,522.00 to the Percontis. The Commonwealth of Kentucky, Finance and Administration Cabinet, (Cabinet) disallowed this deduction and assessed income tax liability of \$2,066.96 on the Percontis. The assessment was affirmed by a final ruling of the Cabinet. The Percontis appealed to the KBTA. Kentucky Revised Statutes (KRS) 131.340. The KBTA concluded that the \$1,850,000.00 settlement payment was made in settlement of a conversion judgment obtained by Thornton Oil against Paul. As such, the KBTA viewed the \$1,850,000.00 settlement payment in 2003 as a personal loss and, thus, not deductible as a business loss/expense.³ The Percontis then appealed the KBTA's ruling to the Jefferson Circuit Court. KRS 131.370. In a November 2, 2006, order, the circuit court affirmed the decision of the KBTA. This appeal follows.

The Percontis argue that the KBTA erroneously disallowed the \$1,850,000.00 settlement payment as a deduction for business loss/expense on their 2003 Kentucky Individual Tax Return. Upon review of the relevant facts and law, we disagree.

In reviewing an administrative agency's decision, we step into the shoes of the circuit court and review the agency's decision for arbitrariness. *Kentucky Unemployment Ins. Com'n v. Landmark Cmty. Newspapers of Kentucky, Inc.*, 91 S.W.3d 575 (Ky. 2002) and *Com. v. Weinberg*, 150 S.W.3d 75 (Ky.App. 2004). Our review of

³ The actual losses were incurred by Tegra Investment Group, LLC in 1998. As an LLC, Tegra could elect to be taxed similar to a partnership whereby the actual losses could be passed through to the LLC members. However, Tegra did not file a tax return in 1998, nor did the Percontis assert the loss on their personal 1998 returns.

administrative agency's interpretation or application of law is *de novo*. *Camera Ctr., Inc. v. Revenue Cabinet*, 34 S.W.3d 39 (Ky. 2000). In this appeal, the material facts are undisputed, and our review is limited to the question of whether the KBTA erred as a matter of law by concluding that the \$1,850,000.00 settlement payment may not be claimed as a deduction for a business loss/expense on the Percontis' 2003 Kentucky Individual Tax Return.

KRS 141.020 requires every individual resident of this Commonwealth to pay an income tax upon “his entire net income.” For our purposes, an individual's net income is generally derived by taking his gross income, as defined by 26 U.S.C. § 61, minus deductions allowed individuals under 26 U.S.C. § 62. KRS 141.010(9); KRS 141.010(10); KRS 141.010(11). 26 U.S.C. § 62 permits individuals to claim “[t]rade business deductions” as “allowed by this chapter . . .” And, contained in “this chapter” are 26 U.S.C. § 162 and 26 U.S.C. § 165.

26 U.S.C. § 162 allows an individual to claim as a deduction from gross income “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” And, 26 U.S.C. § 165 allows an individual to claim as a deduction from gross income “losses incurred in a trade or business” and “losses incurred in any transaction entered into for profit, though not connected with a trade or business” However, an individual is not generally entitled to claim as a deduction from gross income personal expenses or losses. 26 U.S.C. § 262.

The Percontis believe that the \$1,850,000.00 settlement payment constituted an allowable deduction under 26 U.S.C. § 162 and 26 U.S.C. § 165. Specifically, they argue that the \$1,850,000.00 settlement payment was made to settle a “business debt.” Moreover, the Percontis point out:

The settlement agreed upon by [Paul] Perconti and Thornton Oil arose out of losses sustained by Tegra, a group set up by Perconti and other executives for the purpose of conducting hedging activities. When Tegra sustained losses, it paid for them out of Thornton Oil's corporate funds. The conversion verdict against Perconti and subsequent settlement between Perconti and Thornton Oil served to restore the losses suffered by Thornton Oil caused by Tegra's hedging activities. Thornton Oil may have obtained an individual verdict against Perconti for these activities, but at no time did the litigation involve the “personal” matters of Perconti. All matters relating to the dispute were of a business nature.

Percontis' Brief at 5-6. Essentially, the Percontis maintain that the \$1,850,000.00 settlement payment “was a business cost, having arisen in connection with . . . [Paul's] profit-seeking hedging activities.”

The KBTA viewed the \$1,850,000.00 settlement payment as a nondeductible “personal liability” rather than a business expense. In so concluding, the KBTA reasoned:

[A]lso as part of the settlement agreement, Mr. Perconti agreed to pay Thornton Oil \$1,850,000 in settlement of the conversion judgment Thornton had obtained against him, also a personal liability.

Mr. Perconti has characterized this payment as a “business” expense on his 2003 Kentucky return and has attempted to support this contention by the claim that the

payment was for losses suffered by him as part of his investment losses.

Unfortunately the payment was not for such losses but by his own admission paid as a result of a judgment obtained against him personally for conversion. As such his appeal must fail.

In determining whether a claimed loss or expense is business or personal under the tax code, it is well-settled that “the origin and character of the claim with respect to which an expense was incurred . . . is the controlling basic test” *United States v. Gilmore*, 372 U.S. 39, 49, 83 S.Ct. 683, 9 L.Ed.2d 570 (1963). In our case, the \$1,850,000.00 settlement payment was made by the Percontis to settle claims in connection with judgments obtained by Thornton Oil. In particular, the \$1,850,000.00 settlement payment effectively extinguished Paul's personal liability upon the conversion judgment obtained by Thornton Oil and was part of a settlement in Paul's personal Chapter 11 bankruptcy. This conversion judgment in turn operated to reimburse Thornton Oil for assets Paul obtained from Thornton Oil and directed toward Tegra. Thus, the conversion judgment did not reimburse Thornton Oil for a business debt or loss; rather, the conversion judgment reimbursed Thornton Oil for Paul's personal improper conduct. Stated differently, the origin of the \$1,850,000.00 settlement payment was based upon and arose out of Paul's personal improper conduct that directly led to the conversion judgment. Accordingly, we are of the opinion that the \$1,850,000.00 settlement payment is properly characterized as a nondeductible personal loss or expense. *See id.*

In sum, we hold that the KBTA's decision was not arbitrary. *See Am. Beauty Homes Corp. v. Louisville and Jefferson County Planning and Zoning Comm'n*, 379 S.W.2d 450 (Ky. 1964).

We view the Percontis' remaining arguments as moot or without merit.

For the foregoing reasons, the order of the Jefferson Circuit Court is affirmed.

ALL CONCUR.

BRIEFS AND ORAL ARGUMENT
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BRIEF AND ORAL ARGUMENT FOR
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