

January 31, 2013

House Taxation Committee

Testimony in Support of House Bill 2059

by Richard Cram

Chairman Richard Carlson and Members of the Committee:

House Bill 2059 is a “trailer” bill to address technical and implementation concerns raised in 2012 House Bill 2117. An explanation for each section is provided.

Federal 1040NR line references

Section 1 adds language to K.S.A. 79-32,109(a) to provide that any references in the Kansas individual income statutes to specific line numbers on federal income tax return forms for residents should be deemed to refer as well to the corresponding line numbers on the same federal income tax return forms for non-residents. Amendments in Section 12 of 2012 House Bill 2117 amended K.S.A. 79-32,117 to create new addition and subtraction modifications (part of the “business income exemption” provisions) for income or loss reported on Schedules C, E or F and on lines 12, 17 or 18 of the individual income taxpayer’s federal form 1040 return. Those particular lines have different line numbers on the federal form 1040NR, which is the return that a non-resident of the U.S. must file. The amendment makes clear that new addition and subtraction modifications in the “business income exemption” created under 2012 House Bill 2117 based on income or loss reported on specific line numbers of the federal 1040 form apply as well to income or loss reported on the corresponding line numbers of the federal 1040NR form.

Itemized Deduction

Section 2 adds language to K.S.A. 2012 Supp. 79-32,118 (which same language was stricken in 2012 House Bill 2117) to clarify that the Kansas itemized deduction was not repealed.

Correct subparagraph reference

Section 3 amends K.S.A. 2012 Supp. 79-32,266(c) to change an incorrect reference to “(c)(xxi)” of K.S.A. 2012 Supp. 79-32,117 to the correct reference to “(c)(xx)”.

Food sales tax rebate provisions

Section 4 strikes language from K.S.A. 2012 Supp. 79-3620 referencing K.S.A. 79-3635, one of the food sales tax rebate statutes. 2012 House Bill 2117 repealed the food sales tax rebate

program effective in Tax Year 2013. The language in K.S.A. 2012 Supp. 79-3620 referencing K.S.A. 79-3635 is therefore inoperable and needs to be stricken. This bill (see Section 6) also repeals two food sales tax rebate statutes (K.S.A. 79-3632 and 79-3639a) that are now inoperable, with the repeal of the food sales tax rebate program effective Tax Year 2013.

“New pool” exemption from severance tax

Section 5 adds language to the oil severance tax “new pool exemption” provisions in K.S.A. 2012 Supp. 79-4217(b)(5) needed to implement the changes that were made to the “new pool” exemption in 2012 House Bill 2117. In last year’s legislation, effective July 1, 2012, the “new pool” exemption from severance tax was narrowed to apply only to oil production and wells in a “new pool” that are producing 50 barrels-a-day or less. However, the legislation did not specify how the “50 barrels-a-day or less” limitation was to be determined. After the legislation became effective and following discussions with the Kansas Independent Oil and Gas Association, the Department published revised Notice 12-02 (attached), stating that the determination of the “50 barrels-a-day” production limitation would be based on the initial six months of production of the well in a certified “new pool” and on the average oil production per day from the well during that period. The language added by Section 5 would codify the Department’s interpretation implementing the “50 barrels-a-day” production limitation enacted in 2012 House Bill 2117.

Partnership interest and S corporation stock basis

Section 6 repeals K.S.A. 2012 Supp. 79-32,117n, which was enacted as Section 37 of 2012 House Bill 2117. Section 37 of 2012 House bill 2117 requires taxpayers who are partners or S corporation shareholders to compute a different adjusted basis for their partnership interest or S corporation stock for Kansas income tax purposes than for federal income tax purposes. Without Section 37, the same basis adjustment rules for federal income tax would also apply for state income tax purposes.

Section 37 (K.S.A. 2012 Supp. 79-32,117n) provides:

(a) For Kansas income tax purposes: (1) The basis of a partner’s interest in a partnership formed prior to January 1, 2013, shall be determined by computing the basis as of January 1, 2013, in accordance with section 705 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the partner’s interest as provided in section 733 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

(2) The basis of a partner’s interest in a partnership formed on or after January 1, 2013, shall be determined by computing the basis as of the date of formation of the partnership in accordance with section 705 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the partners’ interest as provided in section 733 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

(b) (1) The basis of each shareholder’s stock and indebtedness in an S corporation formed prior to January 1, 2013, shall be determined by computing the basis as of January 1, 2013, in accordance with section 1367 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the shareholder’s stock and indebtedness as provided in section 1367(a)(2)(A)

of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

(2) The basis of each shareholder's stock and indebtedness in an S corporation formed on or after January 1, 2013 shall be determined by computing the basis as of the date of formation of the S corporation in accordance with section 1367 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the shareholders stock and indebtedness as provided in section 1367(a)(2)(A) of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

(c) The provisions of this section shall be effective for tax year 2013, and all tax years thereafter.

Basis is the taxpayer's cost for a particular asset. When a taxpayer sells an asset, gain income from the sale is determined by subtracting from the sale proceeds the selling taxpayer's basis in that asset. Several sections of the Internal Revenue Code state the federal income tax basis rules for partnership interests and S corporation stock. The same principles apply in determining partnership interest and S corporation stock basis.

Under the Internal Revenue Code (IRC), a partner's basis in the partnership interest starts out as the partner's initial investment in the partnership. Example: partner invests \$1000 in a partnership, so his basis in his partnership interest is \$1000. If the partner were to later sell his partnership interest for \$1500, the partner would have "gain" income of \$500 ($\$1500 - \1000).

If the partnership makes money during the tax year and has a net profit, that income is taxable to the partners at the federal income tax level, whether it is distributed or not. The partner's share of net income, which is taxable to that partner, then becomes an addition to the partner's basis in his partnership interest. IRC Section 705 provides for this. Example: partner has undistributed net income of \$100 from the partnership and reports that income as part of his federal adjusted gross income. Partner's original basis of \$1000 increases to \$1100 as a result.

Additions to basis have the effect of helping to reduce the amount of gain income realized when the asset is sold.

If the partnership distributes money to the partners during the tax year, that distribution reduces the partner's basis in his partnership interest, pursuant to IRC Section 733. In the above example, if the partner's share of partnership income was \$100 and that amount was distributed to the partner, then there is no change to the partner's basis. If the \$100 income had not been distributed, it would have increased the partner's basis by \$100. Distribution of \$100 income decreases the basis by that \$100, so the net effect on basis is a "wash."

Other IRC provisions cover additional situations where a partner's basis in his partnership interest may change under the federal rules:

1. If the partner invests additional capital in the partnership, that additional capital increases basis. Example: Partner's initial investment in the partnership is \$1000 but later he invests another \$500 in the partnership. His new basis is \$1500.

2. If the partner assumes additional liability for the partnership, that additional liability is also treated as an addition to basis. Example: Partner signs a note for partnership debt for \$1000. Partner's basis then increases by that \$1000.
3. If the partner receives distributions from the partnership that exceed the partner's basis, then those excess distributions are considered "gain" income and are taxable.
4. If the partner is released from liability of the partnership for a certain amount, that is treated like a distribution and reduces partnership basis.

Section 37 of HB 2117 provides that as of January 1, 2013, the basis for a partner's interest (S corp stockholder's interest in S corporation stock) is frozen, and thereafter, the only adjustments that can be made to partnership basis (S corporation stock basis) are to decrease basis for any distributions received from the partnership, pursuant to IRC Section 733. Basis would not be increased by the partner's share of undistributed partnership income. The rationale behind this provision was that if undistributed partnership net profit income is going to be exempt from Kansas income tax for the partners, then that income should not increase the partner's basis for Kansas income tax purposes (in contrast, for federal income tax purposes, the partner will pay federal income tax on his share of undistributed partnership income, so that undistributed income will increase the partner's basis in his partnership interest). This requires partners to keep separate basis records for their partnership interests for federal income tax purposes vs. for Kansas income tax purposes.

The Department has received feedback from practitioners on Section 37, raising the following questions:

1. In view of Section 37, isn't the "business income exemption" merely a deferral of Kansas income tax on that income, not an exemption? When the partner sells or liquidates his partnership interest, his basis will have been reduced by all income distributions (which will include net profit income intended to be exempted from Kansas income tax), Kansas income tax on the gain income (which is taxable and outside the scope of the Kansas business income exemption) on that transaction will then be due. Also, any distributions in excess of basis will be treated as taxable "gain income" and outside the scope of the "business income exemption." For businesses that distribute most, if not all, income each year, such distributions become taxable once basis has reached zero.
2. There are many situations when partnership basis must change under the Internal Revenue Code (partner makes additional investment in partnership, partner assumes more partnership debt, partner is released from liability on partnership debt, etc.), yet the only circumstance that Section 37 appears to allow is to reduce basis when the partner receives a distribution from the partnership.

The Department recommends that Section 37 (K.S.A. 2012 Supp. 79-32,117n) be repealed. The IRC basis rules would then apply in determining partnership interest and S corporation stock basis. No separate basis calculations would be needed for Kansas income tax purposes.

The Department estimates that this change will have a negative fiscal impact of \$8 million/fiscal year.