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NOTICE 12-11

KANSAS INCOME TAX

CHANGES TO ADDITION AND SUBTRACTION MODIFICATIONS

INCOME EXEMPT FROM KANSAS TAX

Generally

The calculation of an individual's Kansas income tax starts with federal adjusted gross income. Certain modifications, either additions or subtractions, required by K.S.A. 79-32,117 are then made to arrive at Kansas adjusted gross income.

During the 2012 Legislative Session House Bill 2117 was passed and signed into law. Provisions in Section 12 of the Bill add five new addition modifications and one new subtraction modification to K.S.A. 79-32,117. The overall effect of these new provisions is to exempt certain categories of income from Kansas income tax.

Changes In The Law

Addition Modifications

K.S.A. 79-32,117(b) lists the items that are to be added in determining Kansas adjusted gross income. Section 12 of the Bill provides 5 new addition modification in subsection (b)(xix), (xx), (xxi), (xxii), and (xxiii). These new sections read as follows:

(b) There shall be added to federal adjusted gross income:

(xix) For all taxable years beginning after December 31, 2012, the amount of any: (1) Loss from business as determined under the federal internal revenue code and reported from schedule C and on line 12 of the taxpayer's form 1040 federal individual income tax return; (2) loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, residual interest in real estate mortgage investment conduits and net farm rental as determined under the federal internal revenue code and reported from schedule E and on line 17 of the taxpayer's form 1040 federal individual income tax return; and (3) farm loss as determined under the federal internal revenue code and reported from schedule F and on line 18 of the taxpayer's form 1040 federal income tax return; all to the extent deducted or subtracted in determining the taxpayer's federal adjusted gross income. For purposes of this

subsection, references to the federal form 1040 and federal schedule C, schedule E, and schedule F, shall be to such form and schedules as they existed for tax year 2011, and as revised thereafter by the internal revenue service.

(xx) For all taxable years beginning after December 31, 2012, the amount of any deduction for self-employment taxes under section 164(f) of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

(xxi) For all taxable years beginning after December 31, 2012, the amount of any deduction for pension, profit sharing, and annuity plans of self-employed individuals under section 62(a)(6) of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

(xxii) For all taxable years beginning after December 31, 2012, the amount of any deduction for health insurance under section 162(l) of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

(xxiii) For all taxable years beginning after December 31, 2012, the amount of any deduction for domestic production activities under section 199 of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

Subtraction Modification

K.S.A. 79-32,117(c) lists the items that are to be subtracted in determining Kansas adjusted gross income. Section 12 of the Bill provides a new subtraction modification in subsection (c)(xx), which reads as follows:

(c) There shall be subtracted from federal adjusted gross income:

(xx) For all taxable years beginning after December 31, 2012, the amount of any: (1) Net profit from business as determined under the federal internal revenue code and reported from schedule C and on line 12 of the taxpayer's form 1040 federal individual income tax return; (2) net income from rental real estate, royalties, partnerships, S corporations, estates, trusts, residual interest in real estate mortgage investment conduits and net farm rental as determined under the federal internal revenue code and reported from schedule E and on line 17 of the taxpayer's form 1040 federal individual income tax return; and (3) net farm profit as determined under the federal internal revenue code and reported from schedule F and on line 18 of the taxpayer's form 1040 federal income tax return; all to the extent included in the taxpayer's federal adjusted gross income. For purposes of this subsection, references to the federal form 1040 and federal schedule C, schedule E, and schedule F, shall be to such form and schedules as they existed for tax year 2011 and as revised thereafter by the internal revenue service.

Subtraction Modification - Exempt Income

New subparagraph (c)(xx) provides a subtraction modification for three categories of income. By allowing these three categories of income to be subtracted from federal adjusted gross income to calculate Kansas adjusted gross income, this income is made exempt from Kansas income tax. It should be noted the three categories of exempt income are cumulative, not exclusive, so a taxpayer can take advantage of multiple subtraction modifications simultaneously. These three categories are: (1) income that is net profit from a business; (2) income from certain entities or of certain types; and (3) farm income.

(1) Income that is Net Profit From a Business

New subsection (c)(xx) provides a subtraction modification for income that is net profit from a business. Specifically, the new language states:

(c) There shall be subtracted from federal adjusted gross income:

(xx) For all taxable years beginning after December 31, 2012, the amount of any: (1) Net profit from business as determined under the federal internal revenue code and reported from schedule C and on line 12 of the taxpayer's form 1040 federal individual income tax return;

In order to qualify for the exemption, income must meet two requirements. First, the income must be properly reported on Schedule C of federal Form 1040. Second, the income must be properly reported on Line 12 of federal Form 1040. Income not properly reported in accordance with federal income tax law and instructions on Schedule C and line 12 of the federal Form 1040 is outside the scope of the subtraction modification language in paragraph (c)(xx).

Under federal law, Schedule C is available only to sole proprietors, to single member limited liability companies not treated as separate entities for federal income tax purposes, and to individuals considered statutory employees for federal income tax purposes. Statutory employees include full-time life insurance agents, certain agent or commission drivers and traveling sales persons, and certain homeworkers. A statutory employee receives a Form W-2 with the "statutory employee" designation box checked on the form. Schedule C is not available to employees. Therefore, employees who receive wages reported on federal form W-2 (other than statutory employees) will not qualify for the business income exemption.

(2) Income from Certain Entities and Certain Income

New subsection (c)(xx) provides a subtraction modification for income from certain entities and for certain types of income. Specifically, the new language states:

(c) There shall be subtracted from federal adjusted gross income:

(xx) For all taxable years beginning after December 31, 2012, the amount of any: (2) net income from rental real estate, royalties, partnerships, S corporations,

estates, trusts, residual interest in real estate mortgage investment conduits and net farm rental as determined under the federal internal revenue code and reported from schedule E and on line 17 of the taxpayer's form 1040 federal individual income tax return;

Entities

Certain income from any of the following entities may qualify under new subsection (c)(xx) and be exempt from Kansas income tax:

Partnerships
S Corporations
Estates
Trusts

In order to qualify for the exemption, income must meet three requirements. First, the income must be allocated to an individual as pass-through income from a partnership, S corporation, or conduit income from an estate or trust. Second, the income must be properly reported on Schedule E of federal Form 1040. Third, the income must be properly reported on line 17 of federal Form 1040. Income not properly reported in accordance with federal income tax law and instructions on Schedule E and on line 17 of the federal Form 1040 is outside the scope of the subtraction modification language of paragraph (c)(xx). See Revenue Ruling 19-2012-02 regarding certain income that does or does not qualify for exemption.

Taxpayers with ownership interests in partnerships or S corporations, and beneficiaries of trusts and estates should receive a Form K-1. The Form K-1 instructions should designate the line, schedule, and/or form on which income from the partnership, S corporation, trust or estate should be reported. That information is needed to determine whether such income is includable in the exemption provided by new subsection (c)(xx).

Income from limited liability companies is not specifically included in the new subtraction modification language. However, K.S.A. 17-76,138, which is part of the statutes dealing with limited liability companies, provides that for all purposes of Kansas taxes, a limited liability company "shall be classified as a partnership unless classified otherwise for federal income tax purposes." As a result, certain pass-through income from a limited liability company that is treated as a partnership for federal income tax purposes will qualify for the exemption provided by new subparagraph (c)(xx).

A professional corporation may be formed in accordance with K.S.A. 17-2706 *et seq.* A professional corporation formed under these provisions will not qualify for the exemption provided by new subparagraph (c)(xx) unless an S corporation election is made for federal income tax purposes.

In order to qualify a partnership, limited liability company, or S corporation must be a pass-through entity for federal income tax purposes under the federal "check the box" provisions.

Types of Income

The following types of income qualify under new subsection (c)(xx) and are therefore exempt from Kansas income tax:

Rental real estate
Royalties
Residual interests in real estate mortgage investment conduits
Net farm rental

In order to qualify for the exemption, income must meet two requirements. First, the income must be properly reported on Schedule E of federal Form 1040. Second, the income must be properly reported on Line 17 of federal Form 1040. Income not properly reported in accordance with federal income tax law and instructions on Schedule E and on line 17 of the federal Form 1040 is outside the scope of the subtraction modification language of paragraph (c)(xx).

(3) Farm Income

New subsection (c)(xx) provides a subtraction modification for farm income. Specifically, the new language states:

> (c) There shall be subtracted from federal adjusted gross income:
>
> *(xx) For all taxable years beginning after December 31, 2012, the amount of any: (3)net farm profit as determined under the federal internal revenue code and reported from schedule F and on line 18 of the taxpayer's form 1040 federal income tax return;*

In order to qualify for the exemption, income must meet two requirements. First, the income must be properly reported on Schedule F of federal Form 1040. Second, the income must be properly reported on Line 18 of federal Form 1040. Pursuant to Schedule F instructions, a farmer who is a single member limited liability company not treated as a separate entity for federal income tax purposes may use Schedule F. Income not properly reported in accordance with federal income tax law and instructions on Schedule F and on line 18 of the federal Form 1040 is outside the scope of the subtraction modification language of paragraph (c)(xx)(3).

It should also be noted that "farm rental" income qualifies for exemption under (c)(xx)(2), mentioned above.

Addition Modifications - Inclusion of Losses and Deductions

Because the categories of income explained above will no longer be subject to tax, the Act includes provisions in new subsection (b)(xix) which prohibit individuals from deducting losses or claiming certain deductions associated with these categories of income.

(1) Loss from Business

New subsection (b)(xix) provides an addition modification for loss from business. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xix) For all taxable years beginning after December 31, 2012, the amount of any: (1) Loss from business as determined under the federal internal revenue code and reported from schedule C and on line 12 of the taxpayer's form 1040 federal individual income tax return;

In order to be included as an add-back, the loss must meet two requirements. First, the loss must be properly reported on Schedule C of federal Form 1040. Second, the loss must be properly reported on Line 12 of federal Form 1040. Loss not properly reported in accordance with federal income tax law and instructions on Schedule C and line 12 of the federal Form 1040 is outside the scope of the addition modification language in paragraph (b)(xix)(1).

(2) Loss from Certain Entities and Certain Types of Losses

New subsection (b)(xix) provides an addition modification for loss certain entities and certain types of losses. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xix) For all taxable years beginning after December 31, 2012, the amount of any: (2) loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, residual interest in real estate mortgage investment conduits and net farm rental as determined under the federal internal revenue code and reported from schedule E and on line 17 of the taxpayer's form 1040 federal individual income tax return;

Entities

Certain losses from any of the following entities may be included as an add-back under new subsection (b)(xix):

Partnerships
S Corporations
Estates
Trusts

In order to be included as an add-back, the loss must meet three requirements. First, the loss must be received by an individual as pass-through loss from a partnership, S corporation, estate or trust. Second, the loss must be properly reported on Schedule E of federal Form 1040.

Third, the loss must be properly reported on Line 17 of federal Form 1040. Loss not properly reported in accordance with federal income tax law and instructions on Schedule E and line 17 of the federal Form 1040 is outside the scope of the addition modification language in paragraph (b)(xix).

Loss from limited liability companies is not specifically included in the new addition modification language. However, K.S.A. 17-76,138, which is part of the statutes dealing with limited liability companies, provides that for all purposes of Kansas taxes, a limited liability company "shall be classified as a partnership unless classified otherwise for federal income tax purposes." As a result, certain pass-through loss from a limited liability company that is treated as a partnership for federal income tax purposes will be considered an add-back under the addition modification provided by new subparagraph (b)(xix).

A professional corporation may be formed in accordance with K.S.A. 17-2706 *et seq.* A professional corporation formed under these provisions will not be subject to the add-back requirement provided by new subparagraph (b)(xix) unless an S corporation election is made for federal income tax purposes.

In order to be subject to the add-back requirement a partnership, limited liability company, or S corporation must be a pass-through entity for federal income tax purposes under the federal "check the box" provisions.

Losses

The following losses are subject to the add-back requirement of new subsection (b)(xix) and therefore may be subject to Kansas income tax:

Loss from rental real estate
Loss from royalties
Loss from residual interests in real estate mortgage investment conduits
Loss from farm rental

In order to be included as an add-back, the loss must meet two requirements. First, the loss must be properly reported on Schedule E of federal Form 1040. Second, the loss must be properly reported on Line 17 of federal Form 1040. Loss not properly reported in accordance with federal income tax law and instructions on Schedule E and line 17 of the federal Form 1040 is outside the scope of the addition modification language in paragraph (b)(xix)(2).

Farm Loss

New subsection (b)(xix) provides an addition modification for farm loss. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xix) For all taxable years beginning after December 31, 2012, the amount of any: (3) farm loss as determined under the federal internal revenue code and reported from schedule F and on line 18 of the taxpayer's form 1040 federal income tax return; all to the extent deducted or subtracted in determining the taxpayer's federal adjusted gross income.

In order to be included as an add-back, the loss must meet two requirements. First, the loss must be properly reported on Schedule F of federal Form 1040. Second, the loss must be properly reported on Line 18 of federal Form 1040. Loss not properly reported in accordance with federal income tax law and instructions on Schedule f and line 18 of the federal Form 1040 is outside the scope of the addition modification language in paragraph (b)(xix)(3).

Deductions

Certain federal deductions must be added to federal adjusted gross income to calculate Kansas adjusted gross income. These deductions are not shown on federal Schedule C, E, or F, but are instead shown separately on a line of the federal Form 1040. These include:

A. One-half of self-employment taxes. Line 27, IRC §164(f)

B. Contributions to retirement plans by self-employed. Line 28, IRC §62(a)(6)

C. Purchases of health insurance by self-employed. Line 29, IRC §162(l)

D. Deduction for domestic production activities. Line 35, IRC §199

New subsection (b)(xx) provides an addition modification for one-half of self-employment taxes. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xx) For all taxable years beginning after December 31, 2012, the amount of any deduction for self-employment taxes under section 164(f) of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

New subparagraph (b)(xxi) provides an addition modification for contributions to retirement plans by self-employed. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xxi) For all taxable years beginning after December 31, 2012, the amount of any deduction for pension, profit sharing, and annuity plans of self-employed individuals under section 62(a)(6) of the federal internal revenue code as in effect on

January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

New subparagraph (b)(xxii) provides an addition modification for purchases of health insurance by self-employed. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xxii) For all taxable years beginning after December 31, 2012, the amount of any deduction for health insurance under section 162(l) of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

New subparagraph (b)(xxiii) provides an addition modification for any deduction for domestic production activities. Specifically, the new language states:

(b) There shall be added to federal adjusted gross income:

(xxiii) For all taxable years beginning after December 31, 2012, the amount of any deduction for domestic production activities under section 199 of the federal internal revenue code as in effect on January 1, 2012, and amendments thereto, in determining the federal adjusted gross income of an individual taxpayer.

Overall Effect of Changes

The changes made by Section 12 of HB2117 to K.S.A. 79-32,117 allow certain categories of income to be subtracted from federal adjusted gross income in calculating Kansas adjusted gross income, while at the same time requiring certain losses and deductions to be added. The overall effect is to exempt certain categories of income from tax, without allowing related losses and deductions to be offset against other taxable income.

Taxpayer Assistance

Additional copies of this notice, forms or publications are available from our web site, **www.ksrevenue.org**. If you have questions about income tax, please contact:

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