New Kansas Tax Legislation

July 9, 2012

On May 22nd, Kansas Governor Sam Brownback signed into law one of the largest tax cuts in Kansas history. The tax cuts go into effect beginning with the 2013 tax year. The purpose of this client alert is to explain how the new legislation affects business owners.

Elimination of Tax on Small Business Income and Farm Income

Beginning in 2013, the new legislation eliminates Kansas individual income tax on business income earned in sole proprietorships and pass through entities (*e.g.*, S corporations, partnerships and LLCs taxed as partnerships), as well as royalty and rental income and farming income.

All business income from a sole proprietorship reported on Schedule C of the business owner's Federal Form 1040 will be exempt from Kansas income tax. The law also exempts from income tax all non-wage income received from a partnership, S corporation, estate or trust or LLC taxed as a partnership or S corporation which is reported on Schedule E of the individual owner's Form 1040. (W-2 wages paid to an owner will not be exempt.) In addition, royalties and rental real estate income reported on Schedule E of the individual owner's Form 1040 are also exempt. Net farm income reported on Schedule F of the individual owner's Form 1040 is also exempt under the new law. Similarly, the law disallows an individual's use of any net operating loss allocated to the individual through a partnership, LLC or S corporation and also disallows a deduction for farm losses. A Kansas net operating loss of an individual from years prior to 2013 cannot be carried forward to 2013 and later years.

While the new legislation will either reduce or eliminate the Kansas income tax for a Kansas resident who owns certain types of businesses located in Kansas, it may not allow an individual who is not a resident of Kansas to avoid paying state-level taxes by simply relocating the business to Kansas. A resident of a state other than Kansas with Kansas business income will still be subject to income tax on that Kansas business income in the state of residence. (If the state of residence does not impose income tax, the Kansas business income should not be subject to state income tax.) Similarly, a Kansas resident with income earned in another state will still be subject to income tax in that other state. Therefore, the new legislation will be most beneficial to a Kansas resident having Kansas-sourced income from a sole proprietorship, S corporation, partnership, trust or estate.

Note that the legislation eliminates income tax only on net income reported on an individual's Schedule C (sole proprietorships), Schedule E (partnership, trust or S corporation net business income, including LLCs taxed as partnerships or S corporations royalties or rental real estate) or Schedule F (farm income). The legislation does not exempt from tax all other types of income from trusts, partnerships and S corporations which may be reported on another schedule of Form 1040. For example, a partnership, S corporation, or trust reports interest and dividend income on Schedule B and capital gains from investments or certain business assets on Schedule D of Form 1040. Therefore, investment income earned in a pass-through entity is not exempt from tax under the new legislation.

The legislation provides that an individual taxpayer's basis in his partnership or LLC interest or S corporation stock is equal to the basis on January 1, reduced by any distributions received by the taxpayer after that date. This has the net effect of deferring the taxation of a taxpayer's income received through a partnership, LLC or S corporation, which appears to be inconsistent with the legislative intent to exempt this income. We understand that efforts are underway to correct this issue at the Kansas legislature.

Individual Income Tax Rate Changes and Itemized Deductions

The new legislation reduces and compresses Kansas' three current income tax brackets of 3.5, 6.25, and 6.45 percent into two brackets of 3.0 and 4.9 percent. This amounts to a tax-rate reduction of approximately 14 to 24 percent for all Kansas taxpayers. The new law also increases the standard deduction for single head-of-household filers and married taxpayers filing jointly. Although the legislature apparently intended to allow individuals to claim itemized deductions (which include deductions for mortgage interest and charitable contributions), a drafting error has created some confusion as to whether these deductions are available. The legislature has indicated that it will fix the glitch sometime next year before the first tax returns are due under the new law. The Secretary of Revenue has also stated that the law will be administered the way that the legislature intended, *i.e.*, allowing taxpayers to reduce taxable income with itemized deductions.

Tax Planning Opportunities

There may be potential tax savings for new businesses or existing businesses contemplating relocation to Kansas. Please contact your Lathrop Gage attorney or a member of our tax department with questions or for more information on the new Kansas tax legislation.