

REVENUE RULING 19-2012-02

AUGUST 30, 2012

APPLICATION OF 2012 HB 2117 TO CERTAIN INCOME RECEIVED BY INDIVIDUALS

Overview

This Revenue Ruling provides guidance on how the Department of Revenue will administer Section 12 of 2012 House Bill 2117 with regard to certain income (such as dividends, interest, capital gains, gain from sale of business assets, income from partnerships, S corporations, trusts and estates, and retirement benefits, such as IRA distributions, pensions and annuities) received by individuals.

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

Section 12 of House Bill 2117 added a new individual income tax subtraction modification to K.S.A. 79-32,117. This new subparagraph provides:

(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.

Certain requirements must be met for income to qualify for this subtraction modification, and therefore be exempt from Kansas income tax. These requirements are:

- (1) The income must be properly reported on Schedule C, Schedule E, or Schedule F of the individual's federal Form 1040, pursuant to the Internal Revenue Code and any instructions or regulations promulgated by the Internal Revenue Service.
- (2) The income must be properly reported on Line 12 (in the case of income reported on Schedule C), Line 17 (in the case of income reported on Schedule E), or Line 18 (in the case of income reported on Schedule F) of the individual's federal Form 1040, pursuant to the Internal Revenue Code and any instructions or regulations promulgated by the Internal Revenue Service.

Income which is properly reportable on any Schedule or any line of the individual's federal Form 1040 other than the Schedules and lines described above is outside the scope of the exemption provided in Section 12 of House Bill 2117.

Income from Partnerships, S Corporations, and LLC's

Federal Schedule K-1 is the form provided to a partner, S corporation or LLC shareholder, or beneficiary of an estate or trust. Schedule K-1 states the portion of the entity's income allocated to the partner, shareholder, or beneficiary, and specifically identifies the various items of entity income (interest, dividends, capital gains, etc.). These carry over to the partner, shareholder, or beneficiary for federal individual income tax purposes.

The IRS instructions for the Schedule K-1 provide specific directions as to how the partner, shareholder, or beneficiary should report the income on the individual federal income tax return of such partner, shareholder or beneficiary. Partners, shareholders, and beneficiaries should report dividend income on line 9 of federal Form 1040 and interest income on line 8 of federal Form 1040. Similarly, capital gain income is reported on Schedule D.

Income from Estates and Trusts

Simple Trusts

Under federal income tax law, income distributed or required to be distributed (whether actually distributed or not) to a beneficiary by a simple trust must be included in the gross income of the beneficiary. Such income in the hands of the beneficiary retains the same character as it had in the hands of the trust. See IRC Section 652; Treasury Regulation Section 1.652(a)-1; 1.652(b)-1. Therefore, the subtraction modification in new subparagraph K.S.A. 79-32,117(c)(xx), Section 12 of 2012 House Bill 2117, applies to the beneficiary as if the beneficiary had received the income directly from the source that produced it.

Estates and Complex Trusts

Under federal income tax law, income distributed or required to be distributed (whether actually distributed or not) to a beneficiary by an estate or complex trust must be included in the gross income of the beneficiary. Such income in the hands of the beneficiary retains the same character as it had in the hands of the estate or trust. See IRC Section 662; Treasury Regulation Section 1.662(a)-1; 1.662(b)-1. Therefore, the subtraction modification in new subparagraph K.S.A. 79-32,117(c)(xx), Section 12 of 2012 House Bill 2117, applies to the beneficiary as if the beneficiary had received the income directly from the source that produced it.

Grantor Trusts

Under federal income tax law, if the grantor or other person is treated as the owner of the trust corpus or income, or a portion thereof, such item of income is treated as if it had been received directly by the grantor or such other person. Such income is taken into account in computing the tax liability as if the trust had not been in existence during the period such person is treated as the owner. As a result, such income retains the same character as if directly received by the grantor or such other person and should be reported on the federal Form 1040 and Schedules accordingly. See IRC Section 671; Treasury Regulation Section 1.671-1; 1.671-2; 1.671-3; 1.671-4.

For example, if the grantor owns a sole proprietor business and places it in a will substitute revocable trust with the grantor as sole trustee, then assuming the grantor-trustee uses the federal reporting method provided at Treas. Reg. Section 1.671-4(b)(2)(A), the grantor would ignore the existence of the trust for federal income tax purposes and would properly report the income from operation of the business held in the trust on Schedule C and on Line 12 of the grantor's federal Form 1040 (thus qualifying for the new subparagraph K.S.A. 79-32,117 (c)(xx)(1) subtraction modification in Section 12), while interest, dividends, and capital gain income will be reported elsewhere on the return and will not qualify for the subtraction modification.

If the grantor-trustee uses the Treas. Reg. Section 1.671-4(a) reporting method, filing Form 1041 for the trust with a separate statement attached, the K-1 instructions for trust beneficiaries will apply to reporting the income on the grantor's federal Form 1040, with the income from operation of the business reported on Schedule E and Line 17 of the 1040 return (qualifying for the new subparagraph K.S.A. 79-32,117(c)(xx)(2) subtraction modification in Section 12), while interest, dividends, and capital gain income will not be reported on Schedule E or Line 17 of the 1040 (and will not qualify for the new subparagraph K.S.A. 79-32,117(c)(xx)(2) subtraction modification in Section 12).

Interest, Dividends, and Capital Gains Not Included

Income that is interest, dividends, or capital gains (including such income received from a grantor trust) properly reportable on any lines other than lines 12, 17, or 18 of federal Form 1040 will not meet the requirements imposed by new subparagraph K.S.A. 79-32,117(c)(xx) in Section 12, and cannot be claimed as part of that subtraction modification.

Line 8 of the federal Form 1040 is specifically provided for the reporting of interest. Line 9 is specifically provided for the reporting of dividends. Line 13 is specifically provided for the reporting of capital gain. Federal law contemplates, and federal forms and instructions clearly direct, the reporting of interest, dividends and capital gains from partnerships, S corporations, estates or trusts either directly on lines 8, 9, and/or 13 of federal Form 1040 or on federal Schedule D. According to federal income tax instructions these items of income are not to be reported on federal Schedule E, or on line 17 of federal Form 1040.

Gains from Sale of Certain Business Assets Not Included

Gain from the sale of certain business assets, involuntary conversions, or recapture (including such income received from a grantor trust) properly reportable on any lines other than lines 12, 17, or 18 of federal Form 1040 will not meet the requirements imposed by new subparagraph K.S.A. 79-32,117(c)(xx) in Section 12, and cannot be claimed as part of that subtraction modification. Form 1040 Line 14 is specifically provided for the reporting of certain types of gains or losses from sales of business property.

Federal Form 4797 is used to report sales of certain business assets, also involuntary conversions and recapture amounts. The IRS instructions for Form 4797 indicate income or loss, depending on its nature, is to be reported on federal Schedule A, federal Schedule D, line 14 of federal Form 1040, or federal Form 4684. Federal law contemplates, and federal forms and instructions clearly direct, the reporting of gains or losses from sales of business assets either directly on federal Form 1040, line 14, or on federal Schedule A, federal Schedule D, or federal Form 4684. Therefore, income from transactions reported on Form 4797 that according to federal income tax instructions is not properly reported on federal Schedules C, E, or F, and on lines 12, 17, or 18 of federal Form 1040, does not qualify for the new subparagraph K.S.A. 79-32,117(c)(xx) subtraction modification in Section 12.

Retirement Benefits Not Included

If an individual receives income in the form of retirement benefits, such as IRA, SEP or other qualified plan distributions, pensions or annuities, such income cannot be claimed as part of the subtraction modification provided by new subparagraph K.S.A. 79-32,117(c)(xx)(2) in Section 12.

Federal law contemplates, and federal forms and instructions clearly direct, the reporting of IRA distributions received by an individual on federal Form 1040, line 15. Federal law contemplates, and federal forms and instructions clearly direct, the reporting of pensions and annuities received by an individual on federal Form 1040, line 16.

According to applicable federal income tax law, regulations and instructions, generally, Form 1099-R is used to report all distributions from qualified retirement plans that are not otherwise reported on Form W-2 (Wage and Tax Statement), including pensions, annuities,

retirement or profit sharing plans, IRAs, or SEPs. Payments subject to withholding and employment taxes are reported on Form W-2.

If an individual receives income, or is responsible for the payment of tax on such income, from a trust or estate and such income consists of retirement benefits, such as IRA, SEP or other qualified plan distributions, pensions or annuities, such income retains its character as retirement benefits and cannot be claimed as part of the subtraction modification provided by new subparagraph K.S.A. 79-32,117(c)(xx)(2).

Nick Jordan

Secretary of Revenue