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Kansas: Veto override repeals pass-through measure, raises individual income tax rates

The Kansas legislature on June 6, 2017, overrode the governor's veto, and thus repealed a pass-through modification and raised the individual (personal) income tax rates.

The legislature overrode Governor Sam Brownback's veto of Senate Bill 30 (S.B. 30) that, in relevant part:

- Repeals the "subtraction modification" for individual taxpayers' income from partnerships, subchapter S corporations, and limited liability companies, retroactive to January 1, 2017
- Changes the current two-tier individual income tax bracket to a three-tier bracket with higher rates, to be phased-in between 2017 and 2018, and phases in certain itemized deductions through 2020 that were eliminated under legislation in 2012

Background

During the 2012 legislative session, the Kansas legislature passed and Governor Brownback signed into law H.B. 2117—thereby enacting some of the most significant tax reforms in the United States.

H.B. 2117 implemented the governor's "signature changes" including subtraction modifications for certain types of income from pass-through entities, reductions in individual income tax rates and deductions, and elimination of various income tax deductions.

Since 2012, Kansas has experienced substantial deficits because planned economic growth largely failed to make up for revenue losses from tax cuts. Over the past several months, bipartisan pressure mounted for a budget solution, with bills introduced in both the House and Senate to undo the governor's reforms.

The Kansas House and Senate both on June 5, 2017, passed S.B. 30 by a vote of 69 to 52 and 26 to 14, respectively. Gov. Brownback kept his promise to veto the bill. Support for S.B. 30 grew into a supermajority in a late session, and the Kansas House and Senate overrode the governor's veto by a vote of 88 to 31 and 27 to 13, respectively.

With S.B. 30's enactment, significant changes take effect retroactively to January 1, 2017. Other changes are phased-in beginning in tax years 2018 through 2020.

Pass-through modification repealed

Under H.B. 2117, non-wage business income was effectively exempted from Kansas individual income tax, the so-called "pass-through exemption." To be clear, the "exemption" was actually three separate subtraction modifications closely tied to items on individuals' federal income tax returns: (1) Schedule C net profits; (2) Schedule E net income; and (3) Schedule F net farm profits. The modifications were allowed on a taxpayer's Kansas individual income tax return, to the extent those items were included in the taxpayer's federal adjusted gross income.

S.B. 30 effectively removes this modification from K.S.A. 79-32,117(c)(xx) for tax years beginning on or after January 1, 2017, by limiting the time period when the subtraction applies:

> "*There shall be subtracted from federal adjusted gross income: [. . .]*
> ***For taxable years beginning after December 31, 2012, and <u>ending before January 1, 2017</u>,*** *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, not including guaranteed payment as defined in section 707(c) of the federal internal revenue code ad as reported to the taxpayer from federal schedule K-1, (form 1065-B), in box 9, code F or as reported to the taxpayer from federal schedule K-1, (form 1065) in box 4, 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…"*

S.B. 30 provides some transitional relief from penalties and interest for taxpayers emerging from the pass-through modification:

> *"No taxpayer shall be assessed penalties and interest from the underpayment of taxes due to changes to this section that became law on July 1, 2017, so long as such underpayment is rectified on or before April 17, 2018."*

This new language may alleviate the need for estimated payments for the 2017 tax year, simply requiring full payment for the 2017 tax year by the original April 17, 2018 due date for the Kansas personal income tax return.

Increased rates of individual income tax

Under H.B. 2117, Kansas law provided for two individual (personal) income tax brackets for individuals at reduced rates. Between 2013 and 2017:

- A tax rate of 3.0% (2013 tax year) to 2.7% (2014-2017 tax years) applied to individuals with annual income of $15,000 or less.
- A tax rate of 4.9% (2013 tax year) to 4.6% (2014-2017 tax years) was imposed on individuals with greater than $15,000 in annual income.

With S.B. 30, Kansas phases in a three-bracket personal income tax system. Kansas law now requires:

- Individuals with $15,000 or less in annual income will pay income tax at a rate of 2.9% (2017 tax year), increasing to 3.1% (2018 tax year).
- Individuals with greater than $15,000 but less than $30,000 in annual income will be subject to an income tax rate of 4.9% (2017 tax year), increasing to 5.25% (2018 tax year).
- Individuals with annual income of greater than $30,000, the tax rate will be 5.2% (2017 tax year), increasing to 5.7% (2018 tax year).

Thus, the highest marginal rate will be 5.2% for 2017 and 5.7% in 2018 and thereafter and these threshold income amounts are doubled for individuals that are married filing jointly.

Itemized deductions

S.B. 30 phases in an itemized deduction for medical care and increases deductible amounts for home mortgage interest and real and personal property taxes through 2020.

Medical expenses: Beginning with tax years starting on or after January 1, 2018, the itemized deduction for medical expenses permitted under IRC section 213 is reinstated. Kansas will allow an itemized deduction for 50% of these permitted medical expenses in tax year 2018, increasing to 75% in tax year 2019 and 100% in tax year 2020.

Mortgage interest deduction, real estate taxes: Both home mortgage interest deductible under IRC section 163(h) and taxes on real and personal property deductible under IRC section 164(a) increase from 50% of the federally deductible amounts in tax year 2018 to 75% of the federally deductible amounts in tax year 2019 and 100% of the federally deductible amount in tax year 2020.

KPMG observation

S.B. 30—like H.B. 2117 before it—fundamentally changes the Kansas taxation of individuals' income from pass-through entities. Businesses also need to consider how S.B. 30 may affect their tax obligations and those of their partners, shareholders or members, as well as their filing options.

After the enactment of H.B. 2117, the Kansas legislature supplemented the new tax cuts with S.B. 265 in 2014, which eliminated withholding by pass-through entities.

Effective July 1, 2014, K.S.A. § 79-32,100e was entirely repealed, which previously required pass-through entities to withhold tax from nonresidents' share of income. However, with the enactment of S.B. 30 and the repeal of the pass-through modification, withholding could become an issue again—though S.B. 30 does not re-enact Kansas' withholding requirements. Further legislative action would be required to re-institute withholding in Kansas. For the 2017 tax year, S.B. 30 provides transitional relief from penalties and interest, which would further alleviate the burden of withholding.

Kansas partnerships, S corporations, and limited liability companies may wish to re-consider filing composite returns on behalf of nonresident partners, shareholders, and members in tax year 2017. After H.B. 2117, absent some compelling administrative reason, filing Kansas composite returns made little financial sense. Individuals were required to claim the pass-through modification on individual income tax returns; the same subtraction modification was not available to composite return filers. Nonresidents joining the composite return lost the benefit of the pass-through modification.

Now under S.B. 30, with the pass-through subtraction eliminated, a Kansas composite return may become again an attractive option for nonresident partners, shareholders and members.

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