Creating an Environment for Entrepreneurial Success in Kansas

A Technical Primer on Expensing Provisions in House Substitute for Senate Bill 196 (revised 10/2/12)

Senate Bill 196 provides a new expense deduction to all Kansas businesses for certain qualifying machinery and equipment, as well as canned computer software, placed into service starting in tax year 2012. Further, by repealing or limiting certain tax credits and exemptions now available only to a limited number of businesses, the bill moves the state toward a more streamlined approach to economic incentives.

Note: Effective Tax Year 2013 and after, as a result of the enactment of 2012 House Bill 2117, Section 18 amending K.S.A. 2011 Supp. 79-32,143a, the expensing deduction will only be available to corporate income taxpayers for application against corporate income tax liability.

Expense Deduction

SB 196 creates an expense deduction against Kansas taxable income for businesses that invest in machinery and equipment depreciable under the Modified Accelerated Cost Recovery System (MACRS) in section 168 of the Internal Revenue Code, or canned software as defined in section 197 of the Internal Revenue Code. The property must be located in Kansas.

The Kansas expense deduction, when added to the present value of the depreciation deductions provided under federal income tax law, ***equals the full value of the cost*** *of the machinery and equipment placed into service.*

Present value is the current worth of a future sum of money or stream of cash flows given a specified rate of return. One dollar in your wallet now has a value of one dollar, and it is worth more to you than a dollar received a year from now. If you could earn 5% interest on an investment and you invested one dollar today, it would be worth $1.05 a year from now. Thus, the "present value" of $1.05 received a year from now is only $1.

The federal depreciation rules provide a stream of depreciation deductions, depending on the applicable recovery period for the type of property and the applicable depreciation method. For example, a computer is considered "five-year property" and is normally subject to the 200% declining balance method of depreciation under IRC Section 168. For a computer placed into service in the business in Tax Year 2012 with a cost of $10,000 and five-year applicable recovery period, the MACRS IRC section 168 depreciation rules would provide federal income tax depreciation deductions as follows:

Tax Year 2012 $2,000
Tax Year 2013 $3,200
Tax Year 2014 $1,920
Tax Year 2015 $1,152
Tax Year 2016 $1,152
Tax Year 2017 $576
Total Cost Recovered $10,000

If we assumed a discount rate (same as interest rate) of 5%, the present value of this stream of depreciation deductions would equal $8,840.

The expense deduction is computed by multiplying the depreciable cost of the item placed into service times the factor shown in the table in subparagraph (f) of Section 2 of SB 196, based on the recovery period (differs by type of property) and method of depreciation (200% declining balance, 150% declining balance, straight-line) determined under IRC section 168, **minus any IRC section 168(k) bonus depreciation claimed** for the same item on the federal return. In determining the Kansas expense deduction, the business does not need to subtract from the depreciable cost any IRC section 179 expense deduction claimed on the federal return for the item.

The table in subparagraph (f) of Section 2 provides the factor, which when multiplied times the depreciable cost, determines the Kansas expense deduction (assuming no bonus depreciation is claimed at the federal level). This represents the difference between the present value of the stream of depreciation deductions permitted under the MACRS IRC section 168 rules and the depreciable cost of the property, using a discount rate of 5%. For businesses taking the IRC section 179 federal expense deduction, the Kansas expense deduction gives them the full value of the investment ─ plus the federal section 179 expense deduction ─ essentially “double counting” the investment for Kansas income tax purposes.

The expensing provisions in SB 196 do not “decouple” from the federal bonus depreciation or expensing provisions. SB 196 provides a Kansas expense deduction claimed on the Kansas income tax return after any available federal depreciation deductions are already taken on the federal return. This means there is no requirement to “add back” to the Kansas return any federal depreciation deductions taken in future tax years after the SB 196 expense deduction is taken in the year the capital asset is placed into service.

Table B-1 from IRS Publication 946 identifies the class life, recovery period and depreciation method applicable to certain types of depreciable property. Asset class 00.12, information systems, includes computers, assigned a recovery period of five years under the general depreciation system (GDS), which means the 200% declining balance depreciation method applies. The table in subparagraph (f) of Section 2 in SB 196 shows a factor of .116 (second column) for property with a recovery period of five years (first column), where the 200% declining balance method of depreciation (second column) applies. If the business is not taking any IRC section 168(k) bonus depreciation on the property, the Kansas expense deduction for a $10,000 computer placed into service in Tax Year 2012 would be .116 times $10,000 = $1,160.

If the business is claiming IRC Section 168(k) 50% bonus depreciation in Tax Year 2012, that amount must be subtracted from the depreciable cost of the computer before the Kansas expensing deduction is calculated: $10,000 -$5,000 = $5,000. The amount of the Kansas expense deduction in this situation is: $5,000 times .116 = $580.

If the business is claiming IRC Section 179 expensing for this computer, then no subtraction is made from the depreciable cost before multiplying that times the applicable factor to compute the Kansas expense deduction: $10,000 times .116 = $1,160.

The Kansas expense deduction is a post-apportionment deduction. For a multi-state business, this means the deduction is applied after the income has been apportioned to Kansas.
For example, if a corporation does business in both Missouri and Kansas and has property, payroll and sales in both states, the corporation's total multi-state business income (i.e., its federal taxable income after any applicable Kansas modifications) will be apportioned to Kansas for Kansas income tax purposes, based on the application of the three-factor formula, which takes the average of three fractions: Kansas payroll divided by the corporation's payroll everywhere; Kansas property divided by property everywhere; and Kansas sales divided by sales everywhere. The average of those three fractions determines the corporation's Kansas apportionment factor, which is multiplied by the corporation's federal taxable income after Kansas modifications to compute the corporation's Kansas taxable income.

For example, assume the multi-state corporation has Tax Year 2012 federal taxable income after Kansas modifications of $200,000 and has placed in service a computer with a cost of $10,000. In computing federal taxable income, the corporation would already have subtracted any applicable federal depreciation or expensing deductions. If the corporation were claiming IRC Section 179 expensing, it would have already taken a federal expensing deduction of $10,000. If the corporation were claiming 50% bonus depreciation, it would have already taken the normal MACRS deduction of $2,000 plus the 50% bonus depreciation deduction of $5,000.

Unused expense deduction is treated as a Kansas net operating loss that may be carried forward.
Note: Effective Tax Year 2013 and after, as a result of the enactment of 2012 House Bill 2117, Section 17 amending K.S.A. 2011 Supp. 79-32,143, the net operating loss deduction will only be available to corporate income taxpayers for application against corporate income tax liability.

Part of the deduction is recaptured if the property is later sold or moved outside of Kansas during its applicable recovery period. For example, if a computer with a cost of $10,000 were placed in service in Tax Year 2012 and a Kansas expense deduction of $1,160 were claimed

in Tax Year 2012, then, if the computer were moved outside of Kansas during Tax Year 2013, part of the Kansas expense deduction of $1,160 claimed in Tax Year 2012 would need to be recaptured and claimed as Kansas apportioned income in Tax Year 2013. Since the computer has a recovery period of five years and it was moved out of state with four years still remaining in the recovery period, then 4/5 of the expense deduction would need to be recaptured and reported as Kansas income in Tax Year 2013: .8 x $1,160 = $928.

For a unitary business group, the deduction earned by one member may be claimed by another member that can use it.

If the business claims the expense deduction, it will not be eligible for the following investment-related tax credits or other incentives: high performance incentive program credit; research and development credit; alternative fuel vehicle credit; swine facility improvement credit; historic preservation credit; refinery credit or accelerated depreciation; oil or gas pipeline or accelerated depreciation; integrated coal or coke gasification nitrogen fertilizer plant credit or accelerated depreciation; biomass-to-energy plant credit or accelerated depreciation; integrated coal gasification power plant credit; renewable electric cogeneration facility credit or accelerated depreciation; biofuel storage and blending equipment credit or accelerated depreciation; carbon dioxide capture equipment credit; or film production credit.

Other Provisions

SB 196 limits certain credits and exemptions.

No further business and job development credits may be earned starting in Tax Year 2012.

Starting in Tax Year 2012, HPIP credits earned for qualified business facility investment located in the counties of Douglas, Johnson, Sedgwick, Shawnee and Wyandotte will be subject to a new increased minimum investment threshold of $1 million, and the credit applies to qualifying investment in excess of $1 million. The secretaries of Commerce and Revenue are authorized to address transition situations during 2012. For example, in Tax Year 2011, an HPIP-certified business places into service $10 million of qualified business facility investment located in Shawnee County and earns an HPIP credit equal to $10 million - $50,000 = $9,950,000 x 10% = $995,000. Were that same amount of investment to be placed into service in Tax Year 2012, the HPIP credit earned would be $10 million - $1 million = $9 million x 10% = $900,000.

The refundable business machinery and equipment tax credit for property taxes paid will no longer apply starting in Tax Year 2012. Business machinery and equipment placed into service on or after July 1, 2006, is exempt from personal property tax. Equipment placed into service prior to that date would still be subject to personal property tax, and K.S.A. 79-32,206 provides a refundable tax credit for 25% of the personal property tax paid on business machinery and equipment.

The enterprise zone sales tax exemption (K.S.A. 79-3606(cc)) exempts from sales tax purchases of materials, machinery, equipment, and labor for the construction, reconstruction, enlargement or remodeling of a business facility when the requirements of the business and job development credit or the HPIP credit are met. Under SB 196, this sales tax exemption ends effective January 1, 2012, for projects qualifying for the business and job development credit, which will end after Tax Year 2011. The enterprise zone sales tax exemption will continue to apply for HPIP-qualified projects.

Example Computation of Expensing Deduction Using Two Depreciation Methods

A farmer purchases a used tractor for $100,000 in 2012. Assume it is not eligible for Sec. 168(k) bonus depreciation. The tractor has a 7-year GDS recovery period. It is depreciated using the 150% MACRS depreciation method for federal income tax purposes.
The farmer elects to expense $40,000 of the tractor's cost under IRC Sec. 179 and depreciate the remaining $60,000 cost for federal income tax purposes using 150% MACRS depreciation under IRC Sec. 168(b)(2).

The Kansas expense deduction on the farmer's individual income tax return for the tractor is ($40,000 x .151) + ($60,000 x .173) = $16,420.

If the IRC Sec. 179 expense election is made on the federal income tax return for only a portion of the cost of an asset, the Kansas expense deduction for that portion of the cost of the asset will be computed by multiplying that portion of the cost times the factor in the table in subparagraph(f) of K.S.A. 79-32,143a under the Sec. 168(b)(1) column and the applicable GDS recovery period for that asset. The Kansas expense deduction for the portion of the cost of the asset that is being depreciated for federal income tax purposes under IRC Section 168(b)(2) (i.e., 150% MACRS) is computed by multiplying that portion of the cost times the factor under the Sec. 168(b)(2) column and the applicable 150% MACRS recovery period for that asset.