

To: **VP of Tax, Client**

From: Ananya, KPMG U.S. LLP

Date: September 2, 2024

Subject: Federal and State Tax Implications of Fulfillment Project

ISSUES:

1. **MACRS Depreciation:** Calculate the MACRS tax depreciation expense for the building, building shell, and equipment.
2. **Federal Tax Incentives:** Determine if the \$2 million state grant qualifies for IRC Section 118 exclusion.
3. **State Tax Implications:** Recommend a state location (Ohio vs. Virginia) based on CAT (Ohio) and corporate net income tax (Virginia).

RESEARCH:

Federal Tax Rules:

- **MACRS Depreciation:** The Modified Accelerated Cost Recovery System (MACRS) is the tax depreciation system used in the United States. Under MACRS, the building, building improvements, and equipment have specific recovery periods and methods (straight-line or declining balance).
- **IRC Section 118:** IRC Section 118 allows certain contributions to a corporation's capital, including state and local government grants, to be excluded from gross income.

State Tax Rules:

- **Ohio Commercial Activities Tax (CAT):** A gross receipts tax imposed on businesses with taxable gross receipts exceeding \$150,000. The first \$1M in gross receipts is excluded, and receipts over this threshold are taxed at a rate of 0.26%.
- **Virginia Corporate Net Income Tax:** Imposed on a corporation's state taxable income at a rate of 6%, based on federal taxable income with state-specific modifications.

ANALYSIS:

Federal Issues:

1. MACRS Tax Depreciation Calculation

- **Building Shell (\$10,000,000):**

- Depreciated over 39 years using the straight-line method under MACRS.
- For the first year, with the half-year convention, the depreciation expense would be:

$$\text{Depreciation (Year 1)} = (\text{Cost} / \text{Useful Life}) * 0.5$$

$$\text{Depreciation (Year 1)} = (10,000,000 / 39) * 0.5 = \$128,205.13$$

- **Building Improvements (\$5,000,000):**

- Also depreciated over 39 years using the straight-line method with a half-year convention:

$$\text{Depreciation (Year 1)} = (\text{Cost} / \text{Useful Life}) * 0.5$$

$$\text{Depreciation (Year 1)} = (5,000,000 / 39) * 0.5 = \$64,102.56$$

- **Movable Equipment (\$20,000,000):**

- Depreciated over 7 years using the double-declining balance method with the half-year convention:

$$\text{Depreciation (Year 1)} = (\text{Cost} * 2 / \text{Useful Life}) * 0.5$$

$$\text{Depreciation (Year 1)} = (20,000,000 * 2 / 7) * 0.5 = \$2,857,142.86$$

- **Total First-Year Depreciation:**

$$\text{Total Depreciation (Year 1)} = \$128,205.13 + \$64,102.56 + \$2,857,142.86 = \$3,049,450.55$$

2. IRC Section 118 Analysis:

The \$2M state grant is intended to build new infrastructure (e.g., a road) and could qualify for exclusion under IRC Section 118 as a capital contribution. To qualify, the grant must be used for specific capital expenditures and should not be considered compensation for services rendered or products provided by the corporation. Based on these facts, the grant appears to meet the criteria for exclusion under IRC Section 118.

State Issues:

1. Ohio vs. Virginia Taxation:

- **Ohio CAT Calculation:**
 - **Gross Receipts:** \$25,000,000
 - **Exclusion:** \$1,000,000

- **Taxable Gross Receipts:** \$24,000,000

- **CAT Rate:** 0.26%

- **CAT Due:**

- Exclusion:

Net Taxable Gross Receipts = Gross Receipts - Exclusion

Net Taxable Gross Receipts = 25,000,000 - 1,000,000 = 24,000,000

- Tax Liability:

CAT Tax Liability = Net Taxable Gross Receipts * CAT Rate

CAT Tax Liability = 24,000,000 * 0.0026 = \$62,400

Therefore, the Ohio Commercial Activities Tax (CAT) liability for a company with \$25,000,000 in gross receipts is \$62,400.

- **Virginia Corporate Net Income Tax Calculation:**

- **Net Taxable Income:** \$5,000,000

- **Tax Rate:** 6%

- **Tax Due:**

Corporate Tax Liability = Net Taxable Income * Corporate Tax Rate

Corporate Tax Liability = 5,000,000 * 0.06 = \$300,000

Therefore, the Virginia Corporate Net Income Tax liability for a company with \$5,000,000 in net taxable income is \$300,000.

Additional Considerations:

1. **Ohio CAT - Annual Minimum Tax (AMT):**

- Ohio imposes an AMT, which is based on total taxable gross receipts. For gross receipts over \$1M but less than \$2M, the AMT is \$800, and for receipts over \$2M up to \$4M, the AMT is \$2,100.
- For receipts over \$4M (which applies here), the AMT is \$2,600. However, the AMT is part of the total CAT calculation and not an additional tax.

2. **Ohio CAT - Progressive Rate Structure:**

- Although the rate of 0.26% applies to gross receipts over \$1M, the AMT must be factored into the tax calculation. Given the gross receipts of \$24M, the correct total liability includes both the calculated tax and the AMT. Since the total tax

(\$62,400) exceeds the AMT (\$2,600), the AMT doesn't increase the total tax owed but serves as a minimum threshold.

Comparison:

- Ohio's CAT results in a lower tax liability (\$62,400) compared to Virginia's corporate net income tax (\$300,000). However, Ohio's CAT is based on gross receipts and does not account for profitability, which may be less favorable if the project's profitability fluctuates.

CONCLUSIONS:

Federal Issues:

1. The total MACRS tax depreciation expense for the first year is approximately \$3,049,450.55.
2. The \$2M state grant qualifies for exclusion from taxable income under IRC Section 118 as it is a capital contribution intended for infrastructure development.

State Issues:

3. From a purely tax liability perspective, Ohio's CAT would result in a lower tax payment than Virginia's corporate net income tax. However, Ohio's CAT is based on gross receipts, which could be less favorable in years with lower profitability. Therefore, Ohio may be the preferable location based on the current project's anticipated revenue and profitability.