

To: **VP of Tax, Client**
From: _____, KPMG U.S. LLP
Date: Today's Date
Subject: Federal and State Tax Implications of Fulfillment Project

Issues:

1. What is the impact on federal taxable income from the proposed project?
2. How is the state incentive of \$2,000,000 treated for federal income tax purposes?
3. Which state has the lowest incremental tax burden, Ohio, or Virginia?

Research:

For federal income tax purposes, the property placed in service in the proposed fulfillment center will be classified under the MACRS depreciation system. The Modified Accelerated Cost Recovery System (MACRS) is used to recover the basis of most business and investment property placed in service after 1986. Furthermore, an incentive grant from the state in which the fulfillment center is located may qualify for section 118 non-shareholder contribution to capital treatment. This may allow the incentive not to be recognized in federal taxable income but rather reduce the basis of the qualified property acquired by the incentive.

For state income taxes, assume state taxable income of \$5 million per year. The two proposed locations, Ohio and Virginia, have different state income tax regimes. Ohio has a corporate activities tax (CAT) which is a gross basis tax while Virginia has their traditional state income tax system. The calculations below show the tax impact expected from the fulfillment center's activities.

Analysis:

Federal Issues:

According to IRS Publication 946, property that is owned by the taxpayer and using a trade or business is generally subject to an allowance for depreciation. According to the publication, land and land improvements as well as inventory are not subject to the allowance for depreciation. Therefore, the following parts of the project will be subject to allowance for depreciation:

New building shell	\$10,000,000
Building improvements and other building fixtures	\$5,000,000
Movable equipment such as forklifts, material handling, machines	\$20,000,000

According to appendix B of the IRS publication, the asset class lives are indicated along with the appropriate MACRS recovery period. Since this type of fulfillment center is not specifically listed in any class life, the recovery period assigned for personal property with no class life is seven years under the MACRS system. Therefore, the movable equipment, forklifts, material handling, etc., will fall under the seven-year recovery period for MACRS.

In Chapter 4, nonresidential real property (such as a warehouse) is considered section 1250 property and, since it is not residential rental property, will have a class life of 27.5 years, including the building improvements. Since the property will be placed in service in January 2022, the following will be the impact to federal taxable income:

Building and improvement adjusted basis: \$15,000,000

MACRS depreciation allowance, table A-7: 3.042%

Depreciation: \$456,300

Equipment adjusted basis: \$20,000,000

MACRS depreciation, 7 yr. property,
half-year convention, first-year recovery
(From table A-1): 14.29%

Depreciation allowance: \$2,858,000

Regarding the state grant of \$2,000,000, certain contributions to capital will not be taxable income if they meet certain requirements. See Internal Revenue Code, Section 118. However, according to IRC Section 118(b)(2), the grant from a government entity would not qualify for Section 118 treatment, therefore the grant is taxable.

State Issues:

Ohio's CAT tax is based on gross receipts not taxable income.

Ohio sales: \$25,000,000

Ohio CAT rate: \$2,600 plus $(25,000,000 \times .26\%) = 67,600$

Virginia's taxable income: \$5,000,000

Virginia tax rate: $\$5,000,000 * 6\% = 300,000$

At a high level, the Ohio tax burden is less than Virginia.

Conclusions:

The impact of the project for federal tax purposes will be:

Additional depreciation deductions in 2022 for the building and equipment totaling \$3,311,300, which is offset by additional taxable income from the state grant of \$2,000,000.

The more favorable state from an income tax standpoint is Ohio, which has a lower tax liability of \$67,600, vs. Virginia's corporate income tax of \$300,000.