HOUSE RESEARCH
Bill Summary

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Subject: Income tax federal conformity for tax year 2006

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Overview

Conforms Minnesota's income tax to federal changes enacted since May 18, 2006 that affect tax year 2006 returns. Principal items are:

- deduction for higher education tuition expenses
- deduction for teacher classroom expenses
- allowance of IRA contributions by members of the military with income primarily from nontaxable combat pay
- allowance of direct transfers to charities from traditional IRAs and Roth IRAs
- various limits on charitable contributions

<u>**Section**</u>

1 **Update to federal definition of taxable income.** Adopts all of the federal changes to taxable income effective when the federal changes became effective, for tax year 2006 only. The three new federal laws and important changes were:

The Heroes Earned Retirement Opportunities Act, Public Law 109-227, enacted May 29, 2006, which allows military personnel to count tax-exempt combat pay as earned income for the purpose of qualifying to make tax deductible contributions to individual retirement accounts, effective retroactively to tax year 2004.

The Pension Protection Act of 2006, Public Law 109-280, enacted August 17, 2006, which made a large number of changes to federal provisions relating to employer-provided defined benefit or contribution plans, IRAs, and Koegh plans, and included a number of provisions relating to charitable contributions. Most of the changes effective in tax year 2006 relate to charitable contributions and not to pensions. Chief among these are:

- Authorizes individuals age 70 1/2 or older to transfer up to $100,000 from a traditional IRA or Roth IRA directly to a qualified charity, while excluding that amount from adjusted gross income

- Limits the charitable deduction of used household items and clothing to items in good used condition, and requires an appraisal for donations of items valued over $500

- Limits the deduction for charitable donations of taxidermy items to the cost of stuffing or mounting the animal

- Disallows the deduction of fractional interests in personal property if the donor and receiving charity do not own the total interest in the property after the gift

- Extends the ability of individuals to deduct cost plus 50 percent of market value over cost of the donation of food held as inventory

- Extends the enhanced charitable contribution deduction for donations of books and computers to schools

- Modifies the federal adjusted gross income limitation on charitable deductions for donations of qualified conservation easements to 50% (but coordinates this with the percentage limits on other charitable contributions) from the old 20% or 30% limit. The 50% limit is raised to 100% for farmers and ranchers (individuals with 50% of gross income from farming/ranching)

- Tightens the restrictions on claiming a charitable deduction for façade easements on historic buildings

- Limits the basis adjustment in S corporation stock when S corporations donate appreciated property to the tax basis of the property rather than the fair market value (This will reduce capital gain on later sales of the S corporation stock, compared with prior law.)

The Tax Relief and Health Care Act of 2006 , Public Law 109-432, enacted December 20, 2006, extended several expiring deductions, implemented new provisions related to health savings accounts, and provided a new itemized deduction for mortgage insurance premiums. Only the extensions of expiring deductions are effective in tax year 2006. These are:

- Extends the higher education tuition expense deduction of up to $4,000

- Extends the teacher classroom expense deduction of up to $250

- Extends the option for taxpayers to claim an itemized deduction for sales taxes rather than income taxes paid (Minnesota taxpayers will be unaffected by this, since present law requires any deducted sales tax to be added back in computing Minnesota tax.)

- Extends allowance of 15 year depreciation of restaurant buildings and leasehold improvements

- Extends the deduction for amounts contributed to Archer medical savings accounts

- Extends expensing for brownfield cleanups

- Allows advanced mine safety equipment purchased after December 20, 2006, and before December 31, 2008, to be expensed at up to 50% of its cost, with the remainder depreciated

2 **Subtractions from taxable income.** Modifies the charitable contribution subtraction for non-itemizers so that individuals who make direct transfers to charities from IRAs may not claim the subtraction. The transfers directly reduce federal adjusted gross income and consequently Minnesota taxable income, so that allowing the nonitemizer subtraction would allow taxpayers to both exclude the amount transferred from taxable income and to deduct the amount transferred.

3 **Update to other references to the Internal Revenue Code in chapter 290.** Adopts federal changes to federal adjusted gross income used for computing individual alternative minimum tax and household income which is used to compute the dependent care and K-12 education credit for tax year 2006 only. The main changes to federal adjusted gross income are described in section 0.

4 **Update of references to Internal Revenue Code in the property tax refund chapter.** Adopts the federal changes that affect household income, which uses the definition of federal adjusted gross income as a starting point, for tax year 2006 only.