HOUSE RESEARCH
Bill Summary

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Subject: Income tax federal conformity, including section 179 expensing and retiree prescription drug benefits

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Overview

Conforms Minnesota's income tax to federal changes enacted since May 18, 2006, and also to the extension of increased section 179 expensing limits enacted in 2004 and extended in 2006, and to the subtraction for federal subsidies paid to employers who provide prescription drug benefits to retirees enacted in 2003.

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1 **Update of tax administration provisions.** Adopts federal tax administrative provisions made between May 18, 2006, and December 31, 2006, that Minnesota references for state tax administration purposes under chapter 289A. None of the three federal acts enacted since May 18, 2006, changed federal provisions that Minnesota provisions refer to in chapter 289A.

Effective the day following final enactment.

2 **Update to federal definition of taxable income.** Adopts all of the federal changes to taxable income effective when the federal changes became effective. Laws 2007, chapter 1 (HF 8), adopted these same changes but 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

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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

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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.

3 **Additions to taxable income; individuals.** Conforms to increased section 179 expensing amounts enacted in the Working Families Tax Relief Act of 2004 for tax years 2006 and 2007 and extended to tax years 2008 and 2009 in the Tax Increase Prevention and Reconciliation Act of 2006, and also to the subtraction for federal subsidies for employers who provide prescription drug benefits to retirees enacted in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. Conformity to section 179 expensing is effective retroactively to tax year 2006, and conformity to the prescription drug benefit subtraction is effective in tax year 2007.

Present law requires taxpayers to add to taxable income 80 percent of the increased section 179 expensing allowed at the federal level, and then subtract one-fifth of the amount added-back in each of the five following tax years, so that the full amount is subtracted over a six year period, rather than in one year as at the federal level. For tax year 2006, the comparable allowances are $108,000 under federal law (the allowance is phased-out for total amounts of property purchased over $430,000), as compared with $25,000 (phased-out for amounts over $100,000) under Minnesota law.

4 **Subtractions from taxable income; individuals.** Strikes the subtraction for additional federal section 179 expensing amounts added to taxable income in previous years. Since section 0conforms retroactively to the increased federal expensing amounts, the subtraction is no longer necessary.

5 **Additions to taxable income; corporations.** Conforms to increased section 179 expensing amounts and also to the subtraction for federal subsidies for employers who provide prescription drug benefits to retirees as in section 0. Conformity to section 179 expensing is effective retroactively to tax year 2006, and conformity to the prescription drug benefit subtraction is effective in tax year 2007.

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6 **Subtractions from taxable income; corporations.** Strikes the subtraction for additional federal section 179 expensing amounts added to taxable income in previous years. Since section 0conforms retroactively to the increased federal expensing amounts, the subtraction is no longer necessary.

7 **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. Laws 2007, chapter 1 (HF 8), adopted these same changes but for tax year 2006 only. The main changes to federal adjusted gross income are described in section 0.

8 **Alternative minimum tax; cross references.** Updates references in the definition of alternative minimum taxable income to conform to the elimination of additions and subtractions in sections 0and 0.

9 **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. Laws 2007, chapter 1 (HF 8), adopted these same changes but for tax year 2006 only.

10 **Federal update; estate tax.** Changes the date through which Minnesota incorporates the federal estate tax from May 18, 2006, to December 31, 2006. Since there have not been any federal changes to the estate tax since the last update, this change does not have any substantive effect.