HOUSE RESEARCH

Bill Summary

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Overview

This bill conforms to federal law definitions of federal taxable income, effective through December 17, 2010. That would adopt the federal tax changes enacted in the two 2010 health care acts, the Small Business Jobs Act of 2010, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA). Minnesota would conform to all federal changes, with the exceptions of:

- Increased section 179 expensing for tax years 2010 and 2011
- 50 percent bonus depreciation for tax years 2011 to 2013, with temporary 100 percent bonus depreciation for property placed in service after September 8, 2010, and before January 1, 2012
- The enhanced deduction for charitable contributions of computers for tax years 2010 and 2011

The bill also eliminates the foreign operating corporation (FOC) provisions of the corporate franchise tax and repeals the subtraction for foreign royalties. It reduces the corporate franchise tax rate from 9.8 percent to 7.6 (with a corresponding reduction in the alternative minimum tax or AMT rate), effective for tax year 2013.

1 **Update of administrative tax provisions.** Adopts federal tax administrative provisions made between March 18, 2010, and December 17, 2010, that Minnesota references for state tax administration purposes under chapter 289A. The new federal laws did not change federal provisions that Minnesota provisions refer to in chapter 289A.

Effective date: day following final enactment

2 **FOCs filing requirement.** Eliminates the exemption for FOCs from the corporate return filing requirement. The bill repeals FOCs.

3 **Update to federal definition of taxable income.** Adopts all of the federal changes to taxable income effective when the federal changes became effective, with the following exceptions:

- Increased section 179 expensing for tax years 2010 and 2011
- 50 percent bonus depreciation for tax years 2011 to 2013, with temporary 100 percent bonus depreciation for property placed in service after September 8, 2010, and before January 1, 2012
- The enhanced deduction for charitable contributions of computers for tax years 2010 and 2011

The four new federal laws and important changes were:

The Patient Protection and Affordable Care Act of 2010, Public Law 111-148, enacted March 23, 2010, and **The Health Care and Education Reconciliation Act of 2010,** Public Law 111-152, enacted March 30, 2010, made the following major changes:

- Extended the income exclusion for health insurance to benefits for adult children up to and including age 26, effective for plan years beginning on or after September 23, 2010. Under prior federal law, the exclusion was limited to coverage for dependents who were under age 19, students under age 24, or permanently and totally disabled.
- Disallowed reimbursement from health savings accounts and similar accounts for over-the-counter medicines, effective tax year 2011.
- Increased the maximum exclusion for employer-provided adoption assistance to $13,170 for tax year 2010, and extending the increased amount adjusted for inflation to tax year 2011.
- Allowed an income exclusion for state loan forgiveness programs for health care professionals intended to increase the availability of health professionals in underserved areas, retroactive to tax year 2009.
- Increased the floor on deductibility of medical expenses by itemizers from 7.5 percent to 10 percent of adjusted gross income, effective in tax year 2013.
- Codified the economic substance doctrine, requiring transactions to which the doctrine is relevant to change the taxpayer's economic position in a meaningful way, excepting the effects on federal income tax liability, and requiring the taxpayer to have a substantial purpose, excepting the corresponding change in federal income tax liability, from entering into the transaction.

The Small Business Jobs Act of 2010, Public Law 111-240, enacted September 27, 2010, made the following major changes:

- Increases the 75 percent exclusion for the gain on sale of qualified small business stock held for more than five years for stock acquired after February 18, 2009, and before January 1, 2011, to 100 percent for stock acquired after September 27, 2010, and before January 1, 2011. The exclusion will revert to 50 percent for stock acquired on or after January 1, 2011.
- Reduces the holding period for assets of S corporations that converted from C corporations from ten years to five years, for tax year 2011 only, allowing S corporations to sell assets held more than five years without being taxed on built-in gains. Effective for tax year 2011 only.
- Increases the section 179 expensing amount and phase-out threshold for tax years 2010 and

2011 to $500,000 and $2 million *(Minnesota would not conform retroactively to the extension of increased section 179 amounts for tax year 2010, but would conform prospectively for tax year 2011. For tax year 2010, Minnesota would retain its current law requirement that taxpayers add-back to taxable income 80 percent of the expensing amount in the first tax year, and then subtract one-fifth of the amount added back in each of the five following tax years)*.

- Extends 50 percent bonus depreciation amounts to tax year 2010 *(Minnesota would not conform to the extension of bonus depreciation but would retain its current law requirement that taxpayers add-back to taxable income 80 percent of the additional depreciation amount in the first tax year, and then subtract one-fifth of the amount added back in each of the five following tax years)*.
- Provides that the percentage completion method for long-term contracts, which requires that income be recognized when related costs are recognized, is calculated without regard to bonus depreciation amounts claimed. This prevents bonus depreciation, which shifts costs into the first year of a contract, from also shifting income into the first year of the contract. Effective for tax year 2010 only.
- Increases the amount of start-up expenditures that can be directly expensed in the first year of a start-up, from $5,000 to $10,000, with the threshold for the dollar-for-dollar phaseout of the allowance increased from $50,000 to $60,000, effective beginning in tax year 2010.
- Removes cell phones and similar devices from "listed property," so that the employer deduction for cell phone expenses is not reduced by personal use of the phone by the employee. Effective beginning in tax year 2010.
- Allows participants in government section 457(b) retirement plans to make nonexcludable contributions to associated Roth IRA accounts. Present law permits 401(k) and 403(b) plan participants to make these contributions. Also allows qualified distributions from deferral plans, such as 401(k), 403(b), or 457(b) plans, to be rolled over directly to associated Roth IRA accounts in 2010 to be recognized 50 percent in tax year 2011 and 50 percent in tax year 2012, rather than 100 percent in tax year 2010.
- Allows annuity holders to annuitize, or take payment of, a portion of the assets in an annuity while keeping the remaining assets in the contract; previously annuity holders wishing to take payments from only a portion of the annuity had to exchange the annuity for two separate annuities. Effective beginning in tax year 2011.
- Reduces the share of income on guarantees that can be sourced outside the United States, effective for guarantees issued after September 27, 2010.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-321, enacted December 17, 2010, made the following major changes:

- Extends provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) that were scheduled to sunset after tax year 2010 for two years, to tax years 2011 and 2012. The major EGTRRA provisions that affect Minnesota's income definition are:
    - § Increase in the standard deduction for married joint filers to be twice that for single filers (from $9,650 to $11,600 in tax year 2011)

§ Elimination of the phaseout of personal and dependent exemptions

§ Elimination of the limitation on itemized deductions

§ Increased income limits and unlimited time period for deduction of student loan interest - for married joint filers, income eligibility for the deduction would otherwise decrease from $120,000 to $70,000 in tax year 2011, and for single filers income eligibility would decrease from $60,000 to $45,000.

- Extends 50 percent bonus depreciation to tax years 2011 to 2013, with temporary 100 percent bonus depreciation for property placed in service after September 8, 2010, and before January 1, 2012. *(Minnesota would not conform to the extension of bonus depreciation but would retain its current law requirement that taxpayers add-back to taxable income 80 percent of the additional depreciation amount in the first tax year, and then subtract one-fifth of the amount added back in each of the five following tax years). The Small Business Jobs Act of 2010, P.L. 111-240, extended 50 percent bonus depreciation to tax year 2010.)*

- Increases the section 179 expensing amount and phase-out threshold for tax year 2012 to $125,000 and $500,000, indexed from 2007 to 2012, estimated at $137,000 and $540,000. *(Minnesota would not conform to the extension of section 179 but would retain its current law requirement that taxpayers add-back to taxable income 80 percent of the additional expensing amount in the first tax year, and then subtract one-fifth of the amount added back in each of the five following tax years).*

- Extends the teacher classroom expense deduction of up to $250 to tax years 2010 and 2011.

- Extends the option for taxpayers to claim an itemized deduction for sales taxes rather than income taxes paid to tax years 2010 and 2011. *Minnesota taxpayers will be unaffected by this, since present law requires any deducted sales tax to be added back in computing Minnesota tax; the same add-back is required for income taxes deducted at the federal level.*

- Extends the increase in the federal adjusted gross income limit on the amount of qualified conservation easements that may be claimed as a charitable deduction to tax years 2010 and 2011. General law limits deduction of contribution of capital property to 20 or 30 percent of adjusted gross income, depending on the type of recipient organization. Beginning in 2006, the limit was increased to 50 percent for donations of qualified conservation easements by most taxpayers, and to 100 percent for donations made by farmers and ranchers, defined as individuals with 50 percent of gross income from farming/ranching.

- Extends the higher education tuition expense deduction to tax years 2010 and 2011. The deduction applies to up to $4,000 of qualifying expenses for taxpayers with adjusted gross income up to $65,000 ($130,000 for married joint filers), and to up to $2,000 of qualifying expenses for taxpayers with adjusted gross income over $65,000 but less than $80,000 ($130,000 to $160,000 for married joint filers).

- Extends the authority for individuals age 701/2 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 to tax years 2010 and 2011, and provides that distributions made before after December 31, 2010, and before February 1, 2011, may be recognized in tax year 2010.

- Extends the maximum amount of benefit that an employer may exclude from gross income for employee transit and vanpool expenses to equal the amount allowed to be excluded for employee parking expenses, for tax year 2011 only.

- Extends to tax years 2010 and 2011 various provisions related to depreciation and expensing, including more generous rules for leasehold and restaurant improvements, including new restaurant property and improvements to retail property (15-year straight-line recovery), motorsports entertainment complexes (seven-year recovery period), advanced mine safety equipment, accelerated deprecation for business property on Indian reservations, brownfields environmental remediation costs, and qualified film and television productions expenses.

- Extends to tax years 2010 and 2011 the enhanced deductions for contributions of food inventory, book inventory, and computers. *Minnesota would not conform to this deduction with regard to computers; instead taxpayers would be required to add the amount deducted for contributions of computers at the federal level to state taxable income. Minnesota did not conform to this deduction in tax years 2007 through 2009.*

- Extends preferential treatment of dividends of regulated investment companies to tax years 2010 and 2011

- Extends to tax years 2010 and 2011 the limit on basis adjustments in S corporation stock when S corporations donate appreciated property to the tax basis of the property rather than the fair market value (this reduces capital gain on later sales of the S corporation stock, compared with prior law).

- Extends the 100 percent exclusion for the gain on sale of qualified small business stock held for more than five years for stock acquired after September 27, 2010, and before January 1, 2011, to apply to stock acquired before January 1, 2012. The exclusion will revert to 50 percent for stock acquired on or after January 1, 2012.

- Extends the itemized deduction for mortgage insurance premiums to tax year 2011.

- Extends increased credit rates and maximum credit amounts for the federal dependent care credit, which affect calculation of the state dependent care credit, to tax years 2011 and 2012.

4 **Additions to federal taxable income (FTI) for individuals.** Conforms Minnesota's income tax to federal deductions for teacher classroom expenses and higher education tuition deductions by restricting the addition to taxable income for these items to tax years before 2010. Also limits the addition for subsidies received by companies that provide retiree drug benefits to tax years before 2013; changes to federal law eliminated the federal exclusion for subsidies, making the state tax addition duplicative.

Effective date: tax year 2010

5 **Additions to FTI for corporations; FOC deemed dividends and subpart F income.** Repeals the corporate franchise tax additions to federal taxable income for foreign operating corporations' (FOCs) deemed dividends. Sections 10 and 13 repeal FOCs deemed dividend treatment. This provision eliminates the corresponding addition to income for the deemed dividend.

Also updates the federal law reference used in determining the addition for subpart F income of financial institutions. The December federal law continues deferred recognition of subpart F income; Minnesota does not currently allow the deferral and the reference update in this section would continue the current law treatment.

Effective date: tax year 2011

6 **Subtractions to FTI for corporations; royalties and subpart F income.** Repeals the subtraction from federal taxable income for foreign royalties.

Also updates the federal law reference relating to deferral of subpart F income of financial institutions to continue current law treatment of these deferrals. Section 5 requires addition at the state level of amounts allowed to be deferred federally under the December federal law. The change to this section ensures that the amounts deferred at the federal, but not the state level, may be subtracted from taxable income in the year in which they would have been recognized absent the federal deferral.

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 determining withholding on wages. FAGI also is the starting point for calculating household income which is used to compute the dependent care and K-12 education credit for tax year 2010 and following years. The main changes to federal adjusted gross income are described in section 3.

8 **Corporate franchise tax rate.** Reduces the corporate franchise tax rate from 9.8 percent to 7.6 percent, effective in tax year 2013.

9 **Corporate alternative minimum tax rate.** Reduces the AMT rate under corporate franchise tax from 5.8 percent to 4.5 percent, effective in tax year 2013.

10 **FOCs and unitary business.** Eliminates the authority to exclude the income and apportionment factors of FOCs from the combined report and eliminates the deemed dividend deduction for 80 percent of FOC income.

11 **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.

12 **Corrected form W-2 not required.** Provides that employers are not required to issue corrected 2010 W-2s to employees if they have already issued W-2s for 2010 that show the value of health insurance coverage provided to adult children under age 27 that was includible in state taxable income under prior law.
Effective date: day following enactment

13 **Repealer**. Repeals the definition of foreign operating corporations and the modification to alternative minimum tax for FOCs.