HOUSE RESEARCH
Bill Summary

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Overview

Conforms Minnesota's individual income tax and corporate franchise tax to most federal changes enacted since April 14, 2011, on an ongoing basis beginning in tax year 2012.

Some of the principal federal changes Minnesota would conform to are:

- Increased standard deduction for married filers
- Increased section 179 expensing amounts
- Higher education tuition deduction
- Educator classroom expense deduction
- Mortgage insurance premiums deduction
- Extended phaseout for married working family credit claimants
- Increased income phaseout for the student loan interest deduction
- Increased eligible expense limit for the dependent care credit
- Authority for individuals age 70½ or older to transfer up to $100,000 from an IRA or Roth IRA directly to a qualified charity
- Extension of various provisions related to depreciation and expensing
- Discharge of indebtedness income on principal residents
- Allowing airline employees who received bankruptcy payments to retroactively roll over the payments into traditional individual retirement accounts (IRAs), in the year in which the payments were received.

Minnesota would not conform to the increase in bonus depreciation for tax year 2013. Minnesota would also not conform to the modified federal limitation on itemized deductions and phaseout of personal and dependent exemptions; instead

Minnesota would retain its more restrictive state level limitation on itemized deductions and phaseout of exemptions.

Section

1 **Update of administrative tax provisions.** Adopts federal tax administrative provisions made between April 14, 2011, and January 3, 2013, that Minnesota references for state tax administration purposes under chapter 289A. Neither of the federal acts enacted between April 14, 2011, and January 3, 2013, 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, for tax year 2012 and following years, with the exceptions of increased bonus depreciation and the reinstated and modified limitation on itemized deductions and phaseout of exemptions.

The two new federal laws and important changes are:

The Federal Aviation Administration Modernization and Reform Act of 2012, Public Law 112-95, enacted February 14, 2012, allows employees who received payments in airline bankruptcy cases filed after September 11, 2001, and before January 1, 2007, to roll over all or part of the payments to traditional individual retirement accounts (IRAs). A previous federal law allowed employees to roll over bankruptcy payments into Roth IRAs; this law allows amounts previously rolled over into Roth IRAs to be further rolled over into traditional IRAs. Taxpayers had 180 days, until August 12, 2012, to elect to make a rollover into a traditional IRA. The income limits on deductible IRA contributions do not apply to the rollovers. The rollovers are retroactive to the year in which the payments were received, and taxpayers are allowed to file amended returns to claim refunds of federal income taxes reflecting the reduction in taxable income resulting from the deduction of rolled-over amounts.

The American Taxpayer Relief Act of 2012 (ATRA), Public Law 112-240, enacted January 2, 2013, made the following major changes:

Provisions made permanent

- Increased the adjusted gross income (AGI) thresholds for the limitation on itemized deductions to $300,000 for married joint filers, $250,000 for single filers, and $275,000 for head of household filers, indexed after tax year 2013 for inflation. *(Minnesota would not conform to this provision, but instead would retain its limitation on itemized deduction, which in tax year 2013 begins when AGI reaches $178,150, adjusted annually for inflation, and allow a new subtraction from taxable income in section 4 for the amount limited at the federal level.)*
- Increased the adjusted gross income (AGI) thresholds for the phaseout of personal and dependent exemptions to $300,000 for married joint filers, $250,000 for single filers, and $275,000 for head of household filers, indexed after tax year

2013 for inflation. *(Minnesota would not conform to this provision, but instead would retain its phaseout of exemptions, which in tax year 2013 begins when AGI reaches $267,200 for married joint filers, $178,150 for single filers, and $222,700 for heads of household, adjusted annually for inflation, and allow a new subtraction from taxable income in section 4 for the amount phased out at the federal level.)*

- Increase in the standard deduction for married joint filers to be twice that for single filers (from $9,900 to $11,900 in tax year 2012), with a corresponding increase in the standard deduction for married separate filers to equal the amount allowed for single filers. *(Minnesota conforms to the extension of the increased standard deduction for married filers in section 3 by limiting the addition to taxable income of the difference between the "old" and "new" federal standard deduction amounts to tax years before 2012.)*
- Increased contribution limit for education savings accounts and allowing use of education savings accounts for elementary and secondary school expenses.
- Exclusion of up to $5,250 of employer-provided educational assistance.
- 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 $125,000 to $75,000 in tax year 2013, and for single filers income eligibility would decrease from $60,000 to $50,000.
- Exclusion of awards under the National Health Service Corps scholarship program and related awards for health-care professionals.
- Extends increased credit rates and maximum credit amounts for the federal dependent care credit, which affect calculation of the state dependent care credit.
- Increased maximum exclusion for employer-provided adoption assistance ($12,770 in tax year 2013), adjusted annually for inflation.

Provisions temporarily extended to tax years 2012 and 2013

- Increased the section 179 expensing amount and phase-out threshold for tax years 2012 and 2013 to $500,000 and $2 million. *(In section 3, Minnesota conforms to the extension of increased section 179 amounts for tax years 2012 and 2013 by limiting the addition to taxable income to tax years before 2012.)*
- Extends the educator classroom expense deduction of up to $250.
- Extends the higher education tuition expense deduction. 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 itemized deduction for mortgage insurance premiums.
- 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; 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. Permanent law limits deduction of contributions of appreciated 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 parity in qualified transportation fringe benefits, under which employers may exclude up to the same maximum amount per month per employee for vanpool and transit pass expenses as for parking.
- Extends the authority for individuals age 70½ 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, and allows taxpayers to recharacterize distributions made in January 2013 as having been made in 2012.
- Extends the enhanced deduction for charitable contributions of food inventory, which allows pass-through entities (S corporations, partnerships, and proprietors) to deduct contributions of food inventory under the same rules as C corporations. Instead of being limited to the basis in the food inventory, the enhanced deduction equals the lesser of basis plus one-half of the appreciation in the food inventory, or two times basis, but may not exceed 10 percent of the taxpayer's net income from pass-through entities.
- Extends the special rule limiting the amount of payments from controlled subsidiaries to parent exempt organizations that are subject to the unrelated business income tax to the amount in excess of allowable payments under the arm's-length transaction rules, providing that a binding written contract between the organizations was in effect as of August 17, 2006.
- Extends preferential treatment of dividends of regulated investment companies, under which dividends paid to foreign shareholders are exempt to the extent the dividends are derived from interest income that would be exempt if it had been earned directly by the foreign shareholder.
- Extends 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), mine safety equipment, accelerated depreciation for business property on Indian reservations, and qualified film and television productions expenses.
- Extends the exception under subpart F which allows U.S. shareholders with a 10 percent or greater interest in a controlled foreign corporation (banking, financing, and similar businesses) to defer recognition of active income earned by the

corporation but not distributed to the shareholders.

- Extends 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, 2012, to apply to stock acquired before January 1, 2014. The exclusion will revert to 50 percent for stock acquired on or after January 1, 2014.
- Extends the reduction in the minimum holding period to avoid the tax on built-in gains on sales of assets of S corporations that converted from C corporations from ten years to five years, allowing S corporations to sell assets held more than five years without being taxed on built-in gains.

Provisions temporarily extended to tax year 2013 only

- Extends 50 percent bonus depreciation to tax year 2013. *(Minnesota would not conform to the extension of bonus depreciation but would retain its current law requirement that taxpayers add 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).*
- Excludes from gross income discharges of indebtedness on principal residences.

3 **Additions to federal taxable income for individuals.** Conforms Minnesota's income tax to the increased federal standard deduction for married filers and to increased section 179 expensing amounts by restricting the additions to taxable income for these items to tax years before 2012. ATRA made the increased standard deduction for marred filers a permanent feature of the income tax, and extended increased section 179 expensing amounts to tax years 2012 and 2013 only.

Underlying federal law allows businesses to claim up to $25,000 of section 179 expensing annually. If a business places more than $200,000 of property in service, the amount allowed is reduced dollar for dollar by the amount over $200,000. ATRA increased the $25,000 amount and $200,000 phaseout threshold to $500,000 and $2 million for tax years 2012 and 2013 only.

Also modifies the current law addition for state income taxes deducted at the federal level to reflect the retention of Minnesota's limitation on itemized deductions.

Effective beginning in tax year 2012.

4 **Subtractions from federal taxable income for individuals.** Provides new subtractions for the federal limitation on itemized deductions and phaseout of personal and dependent exemptions. The federal limitation and phaseout resulted in additions to taxable income at the federal level; this section subtracts these amounts from state taxable income. Section 3

retains Minnesota's current law limitation on itemized deductions and phaseout of exemptions, which apply at lower income thresholds than the federal limitation and phaseout. The new subtractions in this section are necessary to avoid limiting deductions and phasing out exemptions twice.

Effective beginning in tax year 2013.

5 **Additions to federal taxable income for corporations.** Conforms Minnesota's income tax to increased section 179 expensing amounts by restricting the addition to taxable income to tax years before 2012. ATRA extended increased the section 179 expensing allowance to $500,000 and the phaseout threshold to $2 million for tax years 2012 and 2013.

6 **State itemized deduction; definition.** Provides a definition of "state itemized deduction," equal to federal itemized deductions before the federal limitation. This definition is referenced in the changes to the existing addition to taxable income of state income taxes in section 3.

7 **Internal revenue code.** Adopts federal changes to federal adjusted gross income (FAGI) made between March 18, 2010, and April 14, 2011. FAGI is used for computing individual alternative minimum tax and determining withholding, and is the starting point for calculating household income, which is used to compute the dependent care and K-12 education credit. The main changes to federal adjusted gross income are described in section 2.

8 **Working family credit; phaseout.** Reduces the marriage penalty in the working family credit phaseout by increasing the income level at which the credit begins to phase out for married joint filers by $5,000 in tax years 2012 to 2017, with the $5,000 amount indexed for inflation from 2009, so that the additional phaseout amount for tax year 2012 is estimated to be $5,210. Increases the income level at which the credit begins to phaseout for married joint filers by $3,000 in tax year 2018 and following years, with the $3,000 amount indexed for inflation from 2008. This would match the working family credit phaseout to the federal earned income credit phaseout for tax years 2012 and following years. *(In 2011 First Special Session Chapter 7, Minnesota matched the federal extension to the phaseout threshold for tax year 2011 only)*.

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.

10 **Estate tax.** Adopts federal changes in the Internal Revenue Code that affect the estate tax chapter. These changes made permanent many of the 2001 through 2010 federal changes (e.g., repeal of the state death tax credit and enactment of the deduction for state death taxes), which Minnesota has not conformed to, or affected the federal rates and exclusion amount, which do not directly affect computation of the Minnesota estate tax, because Minnesota decoupled from federal law in 2001.

11 **Amended returns.** Extends the time for filing amended returns for individuals who made retroactive IRA rollovers under the Federal Aviation Administration Modernization and

Reform Act to June 1, 2013, if the 3½ year time limit on amending returns to make claims for refunds in statute has expired.