HOUSE RESEARCH

Bill Summary

FILE NUMBER: H.F. 2875 **DATE:** March 21, 2016
Version: As introduced

Authors: Rosenthal and others

Subject: Taxes; federal conformity

Analyst: Nina Manzi (651) 296-5204
Joel Michael (joel.michael@house.mn)

Overview

Retroactively conforms Minnesota's individual income tax and corporate franchise tax to most federal changes enacted since December 31, 2014.

Minnesota would not conform to the extension of federal bonus depreciation, but would follow the practice of allowing 20 percent of the federal amount in tax year 2015 and the rest to be deducted in equal amounts over the following five tax years.

Also establishes an administrative procedure to conform to future extensions of a list of federal tax provisions when Congress enacts the extension after the legislative session ends and it applies to a tax year that ends before the next regular legislative session reconvenes. $20 million is set aside in a dedicated account to offset the potential revenue loss from conforming to these federal extensions; this account is automatically refilled as it is drawn down to offset tax reductions under administrative conformity.

Section

1 **Update of administrative tax provisions.** Adopts federal tax administrative changes made between December 31, 2014, and December 31, 2015, that Minnesota references for state tax administration purposes under chapter 289A. None of the federal acts enacted changed federal provisions referenced in chapter 289A.

Effective date: Effective retroactive to tax year 2015.

Section

2 **Update to federal definition of taxable income.** Adopts all of the federal changes to taxable income, with the exception of the extension of bonus depreciation. The federal changes to taxable income are effective retroactively to when they became effective for federal purposes.

The four new federal laws and important changes are as follows.

The Slain Officer Family Support Act of 2015, Public Law 114-7, enacted April 1, 2015, allowed taxpayers to elect to treat contributions for supporting the families of New York Police Department detectives Wenjian Liu and Rafael Ramos made before April 15, 2015, as though they were made on December 31, 2014. The effect was to allow individual and corporate calendar-year taxpayers to deduct contributions for the families of the detectives on their 2014 federal income tax returns, rather than on their 2015 returns. This section would allow deductions made by Minnesota taxpayers to flow through to their 2014 state returns. Without this change, taxpayers deducting contributions for the families of the detectives on their 2014 federal returns would be required to add those contributions to Minnesota taxable income on their 2014 state returns and then deduct them from Minnesota taxable income on their 2015 state returns.

The Don't Tax Our Fallen Public Safety Heroes Act, Public Law 114-14, enacted May 22, 2015, clarifies that the exclusion of federal or state benefits paid to surviving dependents of a public safety officer killed in the line of duty also apply to state benefits that were payable without regard to whether the officer's death was in the line of duty.

The Bipartisan Budget Act of 2015, Public Law 114-74, enacted November 2, 2015, clarified the treatment of partnership interests created by gift.

The Protecting Americans from Tax Hikes Act of 2015 (PATH), and **The Consolidated Appropriations Act of 2016 (CAA)**, of which PATH was a division, Public Law 114-113, enacted December 18, 2015, contained new provisions, modified existing provisions, extended some expiring provisions, generally for two years (tax years 2015 and 2016) and made others permanent. The major changes included in PATH were:

New provisions

- Excludes from gross income compensation paid to individuals who were wrongfully incarcerated. This provision is effective retroactively for all tax years. PATH allowed affected individuals to file amended returns within one year of December 18, 2015 (the date of enactment).
- Allows rollovers from employer-sponsored retirement plans and traditional IRAs into SIMPLE (savings incentive match plan for employees) IRAs following the end of the two-year period that started when the employee first participated in the SIMPLE IRA.
- Allows contributions to agricultural research organizations to be claimed under the itemized deduction for charitable contributions.
- Clarifies valuation rules for charitable remainder unitrusts.
- Makes real estate investment trusts (REITs) ineligible to participate in tax-free spinoffs.

Section

- Allows non-corporate taxpayers to exclude from gross income clean coal power grants. The exclusion is already allowed for corporate taxpayers; in both cases the grant recipients must reduce the basis of any property acquired using the grant.
- Prohibits the transfer of losses from tax indifferent parties.

Modifications to existing provisions

- Expands the definition of qualified higher education expenses that can be paid for with distributions from section 529 college savings plans to include the purchase of computers and related equipment. Changes the manner of calculating the portion of a distribution that must be included in taxable income (in the case of amounts not used for qualifying expenses) to be made on a distribution-by-distribution basis, rather than aggregated over the taxable year. Enacts a new rule so that if a beneficiary receives a refund from a higher education institution of amounts paid with a distribution from a 529 plan, the refund is not subject to tax if it is recontributed to the 529 plan within 60 days.
- Extends the exclusion from gross income for qualified scholarships to apply to payments resulting from required participation in a comprehensive work-learning-service program at a work college. The exclusion does not generally apply to amounts paid to students for teaching, research, or other services.
- Allows the excise tax on high-cost employer-sponsored health coverage to be claimed as an itemized deduction. CAA also delayed the imposition of the excise tax to 2020.
- Extends the exclusion of reimbursements of medical expenses of a deceased employee's beneficiary who is not a surviving spouse or dependent under age 27 to apply to distributions from medical trusts. This exclusion is limited to certain governmental health plans.
- Allows ABLE (Achieving a Better Life Experience) accounts for a designated beneficiary to be opened in states other than the state of residency of the beneficiary.

Provisions extended to tax years 2015 and 2016, unless noted

- 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).
- Exclusion from gross income of discharges of indebtedness on principal residences.
- Itemized deduction for mortgage insurance premiums.
- Bonus depreciation, extended at 50 percent to tax years 2015 to 2017, 40 percent in tax year 2018, and 30 percent in tax year 2019 *(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 increased 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.)*

Section

- Various provisions related to depreciation and expensing, including more generous rules for certain racehorses (three-year property), motorsports entertainment complexes (seven-year recovery period), mine safety equipment, accelerated depreciation for business property on Indian reservations, qualified film and television production expenses, and second generation biofuel plant property.
- Increased Section 179D deduction for energy efficient commercial buildings.

Provisions made permanent

- Educator classroom expense deduction of up to $250. The deduction was also extended to expenses for professional development.
- Option for taxpayers to claim an itemized deduction for sales taxes rather than income taxes paid. *(Minnesota taxpayers are not affected 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.)*
- Increased 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 percent 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.
- 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.
- 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 ten percent of the taxpayer's net income from pass-through entities.
- 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 underlying law).
- Increased the section 179 expensing amount and phaseout threshold for tax year 2015 to $500,000 and $2 million; with the increased amounts indexed for inflation beginning in 2016.
- More generous depreciation rules for leasehold and restaurant improvements, including new restaurant property and improvements to retail property (15-year straight-line recovery)

Section

- 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, if a binding written contract between the organizations was in effect as of August 17, 2006.
- 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.
- Exception under subpart F, which allows U.S. shareholders with a ten percent or greater interest in a controlled foreign corporation that consists of banking, financing, and similar businesses to defer recognition of active income earned by the corporation but not distributed to the shareholders.
- The 100 percent exclusion for the gain on sale of qualified small business stock held for more than five years, which applies to stock acquired after September 27, 2010.
- 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.
- 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. *(Minnesota taxpayers are not affected by this, since Laws 2014, chapter 308, provided for the increased exclusion to be allowed at the state level regardless of the amount allowed at the federal level. Section 4 deletes the Minnesota-only subtraction since under this bill Minnesota would conform to the now-permanent federal provision.)*
- Extended the date for taxpayers to make rollovers to IRAs of payments in previous bankruptcy cases, including that of Delta Airlines, and to file claims for federal tax to 180 days after December 18, 2015 to accommodate the effects of Public Law 113-243, which amended the definition of "airline employee" thus expanding the pool of individuals eligible to make rollovers, and also expanded the definition of "airline payment amount".

3 **Additions to taxable income; individuals.** Conforms to increased section 179 expensing amounts enacted in PATH for tax year 2015 and following years. Effective retroactively to tax year 2015.

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.

4 **Subtractions from taxable income; individuals.** Replaces the section 179 expensing subtraction with a reference to the new subtraction and carryover provision in section 10. Also strikes the subtraction for qualified transportation fringe benefits; PATH made this

Section

subtraction permanent at the federal level and this bill would conform to the definition of federal taxable income that incorporates the transportation fringe benefit subtraction.

5 **Additions to taxable income; corporations.** Conforms to increased section 179 expensing amounts. Effective retroactively to tax year 2015.

6 **Subtractions from taxable income; corporations.** Replaces the section 179 expensing subtraction with a reference to the new subtraction and carryover provision in section 10.

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. Federal adjusted gross income also 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 **Tax extenders; one-year conformity by DOR action.** Establishes an ongoing method to conform to federal tax law changes by administrative action of the commissioner of revenue (DOR) when all of the following conditions are met:

- A listed expiring federal tax provision (see below for details) is extended
- Federal enactment occurs after the regular legislative session adjourned
- The extension affects a tax year that ends before the next regular legislative session convenes

The conformity applies only to the one tax year that ends before the regular legislative session convenes. That is, it does not permanently conform to the extension, if congress makes the extension permanent (or conform for two years, if congress extends the provisions for two tax years and so forth).

Federal tax conformity account. Conforming to future extensions of the listed provisions will reduce state tax collections (i.e., they are tax reductions). To offset the revenue loss, the provision sets aside $20 million from the general fund in a federal tax conformity account on July 1, 2016. As money in this account is used to offset revenue losses resulting from administrative conformity, the account is automatically "re-filled" to the $20 million level (i.e., DOR and the commissioner of Minnesota Management and Budget are directed to transfer general fund money to the account to maintain a $20 million balance when administrative conformity requires withdrawals).

Covered federal tax provisions. The following federal tax extender provisions, all of which expire under current federal law and all of which have been conformed to by prior legislatures, are "eligible federal tax preferences" for administrative conformity:

- Exclusion of discharge of qualified principal residence indebtedness
- Itemized deduction of mortgage insurance premiums
- Deduction of qualified tuition and related expenses
- Itemized deduction rules (7.5% adjusted gross income threshold) for medical care expenses by individuals aged 65 or older

Section

- Classification of certain race horses as 3-year property
- 7-year recovery period for motorsports entertainment complexes
- Accelerated depreciation for business property on an Indian reservation
- Election to expense mine safety equipment
- Special expensing rules for certain film and television productions
- Special allowance for second-generation biofuel plant property
- Energy efficient commercial buildings deduction
- 5-year recovery period for property qualifying for certain energy credits
- Additional section 179 allowance in an empowerment zone
- Bonus depreciation (under Minnesota's special rule allowing only 20 percent to be deducted in the tax year and the remainder recovered over the following five years)

Conformity rules and procedures (subdivision 4). When the conditions for administrative conformity are met (see above), DOR is directed to adopt the eligible federal tax provisions by administrative action for the designated tax year. Doing so is contingent upon the federal tax conformity account having sufficient money to offset the revenue loss. In determining whether there is sufficient money to cover a provision, the bill sets out a list of priorities – that is, the commissioner determines whether there are adequate funds to offset the first priority and if so, then makes a similar determination for the second priority, and so forth. The first item to be adopted is continuation of Minnesota's special rule for treatment of bonus depreciation; this item results in a small revenue gain in the first tax year and thus would not reduce the amount available in the account for subsequent items. This is the order of priorities:

- Computation of adjusted gross income used in Minnesota income tax, property tax refund, or homestead credit refund computations
- Computation of Minnesota tax credits
- "Timing" rules – i.e., rules that determine the period over which capital items are deducted (all of the bulleted items in the list except the first four and bonus depreciation)
- The first four bulleted items above

DOR is, then, directed to publish the qualifying items on its website and the federal provisions are in effect for Minnesota tax purposes for the designated tax year. DOR is directed to prepare forms that reflect the administrative conformity provisions, as well as to draft conformity legislation that can provide for permanent (ongoing) conformity to the covered and any other federal provisions that the commissioner of revenue determines appropriate.

9 **Working family credit; phaseout.** Reduces the marriage penalty in the working family credit phaseout by making the increased income level at which the credit begins to phase out for married joint filers a permanent feature of the credit. Previous federal law had increased the phaseout level through tax year 2017, and Minnesota is in conformity with that increase.

Section

PATH made the increase in the threshold permanent. For tax year 2018 and following years, the threshold would be increased by $5,000, with the $5,000 amount indexed for inflation from 2009. This section would match the income level for the working family credit phaseout to the income level for the federal earned income credit phaseout for 2018 and following tax years.

10 **Section 179 expensing allowance.** Allows subtractions related to section 179 expensing in excess of taxable income to be carried over for up to ten tax years, and also maintains the current law subtraction for amounts added to taxable income in previous years. For tax year 2015 and following years, such subtractions would relate to additions required prior to tax year 2015.

Effective date: Tax year 2015.

11 **Alternative minimum tax; individuals.** Strikes a cross-reference to the transportation fringe benefit subtraction, which is eliminated as a state-only subtraction in section 4 since this bill would conform to the federal law which made the subtraction a permanent feature of federal taxable income.

12 **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.

13 **Estate tax definitions.** Updates to changes in federal law made between December 31, 2014, and December 31, 2015. This change has no substantive effect on computation of the estate tax, but instead keeps the Internal Revenue Code date reference consistent with other sections of statute.

14 **Individual income tax collection action prohibited.** Prohibits the commissioner from increasing the amount due from individual income taxpayers for tax year 2015 as a result of changes enacted in this bill, provided that the taxpayer filed a 2015 return based on state law as it existed prior to enactment of this bill.

15 **Amended returns.** Extends the time for filing amended returns to September 1, 2016, if the 3½ year time limit on amending returns to make claims for refunds in statute has expired, for individuals who

- became eligible to make retroactive IRA rollovers under federal amendments to the Federal Aviation Administration Modernization and Reform Act of 2012.
- received compensation for wrongful incarceration.