HOUSE RESEARCH

Bill Summary =

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Subject: Conforming to federal income tax changes

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Overview

Updates references to Internal Revenue Code for purposes of the income and franchise taxes, property tax refund, and general tax administration to adopt federal changes made in the Military Family Tax Relief Act of 2003 and the health savings accounts provisions of the Medicare Prescription Drug, Improvement and Modernization Act of 2003. These changes were enacted since the last update to June 15, 2003, which occurred in chapter 21 of the 2003 special session.

Changes to the Internal Revenue Code that affect Minnesota are:

- various exclusions for benefits to members of the military and their survivors; and
- exclusion of contributions to health savings accounts (HSAs) and also of HSA distributions used for medical expenses

Provides an addition to taxable income and alternative minimum taxable income for both individuals and corporations for federal subsidies paid to employers who provide medical coverage for retirees. These subsidies are excluded at the federal level under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are first scheduled to be paid beginning in 2006.

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1 **Federal update**; administrative. Updates the administrative chapter Internal Revenue Code reference to federal changes through December 31, 2003.

2 **Net income.** Conforms to federal changes to the definition of net income. Two federal laws enacted since the 2003 legislative session affected the definition of net income.

The Military Family Tax Relief Act of 2003:

- Increases the exclusion from taxable income of the death gratuity benefit paid to survivors of member of the military who is killed in the line of duty that is excluded from \$3,000 to \$12,000 (also increased the benefit from \$6,000 to \$12,000). Effective for deaths after September 10, 2001.
- Excludes from taxable income the cost of dependent care assistance provided by the military to a service member. Effective beginning in tax year 2003.
- Excludes from taxable income payments from the Department of Defense Homeowner Assistance program to members of the military to offset the adverse effects of military base closings on housing values. Effective for payments made after November 11, 2003.
- Suspends the running of the five-year period for purposes of meeting the two out of five year "use of house as principal residence" test used to qualify for the exclusion of the gain on sale of the residence for up to 10 years for members of the military on official extended duty. Effective for sales after May 6, 1997.
- Provides a deduction for unreimbursed travel, meal, and lodging expenses of members of the national guard and reserves when they travel at least 100 miles and must stay overnight to attend a guard or reserve meeting. Effective beginning in tax year 2003.
- Exempts astronauts who lose their life on a space mission from income tax. Effective for deaths after December 31, 2002.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003:

Allows the deduction of contributions to a health savings account for individuals with high-deductible medical health plan coverage. The maximum deduction is \$2,250 for individuals with self-only coverage and \$4,500 for individuals with family coverage. The maximum deduction is \$500 higher for individuals age 55 or older, and is increased by an additional \$100 per year until tax year 2009, when it will be \$1,000 higher than the maximum deduction for individuals under age 55. "High-deductible" plan is defined as having an annual deductible of at least \$1,000 for self-only coverage and \$2,000 for family coverage, and having a maximum combined deductible and out-of-pocket expense requirement of at most \$5,000 for self-only coverage and \$10,000 for family coverage. Earnings on amounts contributed to HSAs H.F. 3058
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are tax-exempt. Distributions from HSAs are tax-exempt if used for medical expenses. Effective beginning in tax year 2004.

- Exempts federal subsidies paid to employers who provide medical coverage for retirees. Provides for federal subsidies to be paid beginning in 2006.
- Additions to taxable income; individuals. Provides an individual income tax addition for federal subsidies paid to employers who provide medical coverage for retirees. These subsidies are excluded at the federal level under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are first scheduled to be paid beginning in 2006.
- Subtractions from taxable income. Allows a subtraction for military pay received by members of the military stationed in Minnesota but domiciled in another state. Current law provides for these individuals to calculate their tax based on total taxable income and then apportion the result based on the ratio of Minnesota source income to taxable income. Public Law 108-189 revised the Soldiers' and Sailors' Civil Relief Act of 1940 to require states to allow a subtraction for nonresident active service members of the military rather than apportioning tax. The Department of Revenue is complying with this change to federal law.
- Additions to taxable income; corporations. Provides a corporate franchise tax addition for federal subsidies paid to employers who provide medical coverage for retirees. These subsidies are excluded at the federal level under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are first scheduled to be paid beginning in 2006.
- Income tax definitions. Updates the income tax chapter Internal Revenue Code reference to federal changes made through December 31, 2003. The effect of this would be to allow the exclusion of all the Military Family Tax Relief Act items and HSA contributions as well as distributions used for medical expenses from Minnesota's alternative minimum tax, and to allow the deduction of national guard and reserve travel expenses and HSA contributions from household income used to determine eligibility for the dependent care credit, and K-12 education credit. The remaining Military Family Tax Relief Act items and distributions from HSAs would be included in household income.
- Alternative minimum taxable income; individuals. Includes in individual alternative minimum taxable income federal subsidies paid to employers who provide medical coverage for retirees. These subsidies are excluded at the federal level under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are first scheduled to be paid beginning in 2006.
- Alternative minimum taxable income; corporations. Includes in corporate alternative minimum taxable income federal subsidies paid to employers who provide medical coverage for retirees. These subsidies are excluded at the federal level under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are first scheduled to be paid beginning in 2006.
- Federal update; property tax refund. Updates the property tax refund chapter Internal Revenue Code reference to federal changes through December 31, 2003. This conforms the property tax refund to changes in the definition of net income. The effect is to exclude national guard and reserve travel expenses and HSA contributions from household income

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used to determine eligibility for the property tax refund for homeowners and renters. The remaining Military Family Tax Relief Act items and distributions from HSAs would be included in household income.

Federal update; estate tax. Conforms Minnesota's estate tax to a federal change exempting the estate of astronauts who die on a space mission. Effective for deaths after January 31, 2003.