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 May 18, 2006. The principal federal changes that Minnesota would conform to are:

- allowance of IRA contributions by members of the military with income primarily from nontaxable combat pay
- allowance of direct transfers to charities from traditional IRAs and Roth IRAs
- exclusion of $3,000 of distributions from governmental pension plans to pay qualified health insurance premiums for public safety retirees
- various limits on charitable contributions
- making permanent the increases in contribution limits to various retirement plans (IRAs, 401(k)s, and so forth) that were increased on a temporary basis in earlier federal laws
- provides a new itemized deduction for mortgage insurance premiums

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- allows a one-time rollover to a health savings account, and reduces limitations on contributions to health savings accounts

- excludes from gross income discharges of indebtedness on principal residences

- annually excludes from gross income up to $360 of payments to volunteer firefighters and emergency medical technicians

Federal changes that Minnesota would not conform to are:

- deduction for higher education tuition expenses

- deduction for teacher classroom expenses

- increase in section 179 expensing for tax years 2007 and 2008

- allowance of 50 percent bonus depreciation for tax year 2008

Eliminates the exclusion from taxable income for wages that were earned when the taxpayer was a Minnesota resident and received when the taxpayer was not a Minnesota resident.

Requires construction contractors to withhold 2 percent of payments to independent contractors who are individuals.

Directs the commissioner to adjust the individual income tax brackets downward in tax year 2009, and upward in tax year 2010, in order for the overall impact of this bill to be revenue-neutral and both the 2008-2009 and 2010-2011 biennia.

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1 **Update of tax administration provisions.** Adopts federal tax administrative provisions made between May 18, 2006 , and February 13, 2008 , that Minnesota references for state tax administration purposes under chapter 289A. None of the seven 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 **Information reporting.** Requires payers who federal law requires to file Form 1099 information for contractor payments with the IRS to also file a copy of the return with DOR. This applies if the payments either were made to a Minnesota resident or if the services were performed in the Minnesota . The commissioner may require the information to be filed electronically.

Present law gives the commissioner of revenue authority to require this information to be

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filed by notice and demand to the payer.

Effective beginning with tax year 2010.

3 **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 2007 and following years. The seven 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 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 Keogh plans, and included a number of provisions relating to charitable contributions. Provisions include:

- authorizes 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

- 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 percent (but coordinates this with the percentage limits on other charitable contributions) from the old 20 percent or 30 percent limit. The 50 percent limit is raised to 100 percent for farmers and ranchers (individuals with 50 percent of gross income from farming/ranching)

- tightens the restrictions on claiming a charitable deduction for façade

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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)

- allows an annual exclusion of $3,000 of distributions from governmental pension plans to pay qualified health insurance premiums for eligible public safety retirees

- makes various increases in the permitted annual contributions to retirement plans, such as IRAs, 401(k)s, 403(b), and 457 plans, and makes increases provided under earlier federal legislation permanent

- makes permanent various changes to section 529 qualified tuition plans made in earlier federal legislation, including the exclusion of earnings held in 529 accounts from taxable income if used for qualified higher education expenses

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 premiums. Provisions include:

- extends the higher education tuition expense deduction of up to $4,000 (Minnesota would not conform to this deduction; instead an addition to taxable income would be required under section 0)

- extends the teacher classroom expense deduction of up to $250 (Minnesota would not conform to this deduction; instead an addition to taxable income would be required under section 0)

- 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 and accelerate depreciation for business property on Indian reservations

- extends the deduction for amounts contributed to Archer medical savings accounts

- extends expensing for brownfield cleanups

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- allows advanced mine safety equipment purchased after December 20, 2006, and before December 31, 2008, to be expensed at up to 50 percent of its cost, with the remainder depreciated

- extends the enhanced deduction for donations of computers

- extends the election to include combat pay in earned income for purposes of claiming the federal earned income tax credit

- conforms on changes to health savings accounts that allow a one-time rollover of health reimbursement and flexible spending accounts to health savings accounts, and eliminates contributions limits corresponding to plan deductibles

- provides a new itemized deduction for mortgage insurance premiums (tax year 2007 only)

The Small Business and Work Opportunity Tax Act of 2007 , Public Law 110-28, enacted May 25, 2007 , increased and extended section 179 expensing, and as a revenue offset increased the age through which the unearned income of children is taxed at the parents' marginal rate from 14 to 18. Minnesota has not conformed to higher section 179 limits in past federal laws and 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.

The Energy Independence and Security Act of 2007 , Public Law 110-140, enacted December 19, 2007 , increased the amortization period for geological and geophysical expenditures from five to seven years.

The Mortgage Forgiveness and Debt Relief Act of 2007 , Public Law 110-142, enacted December 20, 2007 , provided and extended several provisions related to home mortgages:

- excludes from gross income discharges of indebtedness on principal residences

- extends the itemized deduction for mortgage insurance premiums for two years, through tax year 2010

- increases the amount of capital gain on a principal residence that a surviving spouse may exclude from gross income from $250,000 to $500,000, if the sale occurs within two years of the spouse's death

The act also provides a new income tax exclusion for up to $360 per year in payments to members of volunteer emergency medical services and firefighting organizations, for tax years 2008, 2009, and 2010.

The Economic Stimulus Act of 2008 , Public Law 110-185, enacted February 13, 2008 ,

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increased section 179 expensing and provided 50 percent bonus depreciation, both for tax year 2008 only. Minnesota would not conform to either provision but would retain its current law requirement that taxpayers add-back to taxable income 80 percent of the additional expensing or 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.

4 **Additions to taxable income; individuals.** Requires the federal deduction for up to $4,000 of higher education tuition expenses and up to $250 of teacher classroom expenses to be added to taxable income by individuals. These two deductions currently expire following tax year 2007.

5 **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 for tax year 2007 and following years. The main changes to federal adjusted gross income are described in section 0.

6 **Nonresident and part-year resident ratio.** Amends the calculation of the ratio used by nonresidents and part-year residents to apportion liability to Minnesota to include the federal higher education tuition and classroom expense deductions required to be added to Minnesota taxable income in section 0.

7 **Wage income of Minnesota residents.** Eliminates the exclusion from taxable income for wages that were earned when the taxpayer was a Minnesota resident and received when the taxpayer was not a Minnesota resident. Under present law, an individual is not subject to Minnesota income tax on wages for work performed while a Minnesota resident that are not received until the individual is a resident of another state. Examples include:

- individuals on contract whose contracts provide for them to continue to be paid for some time period after they complete the work required under the contract,
- individuals who receive nonqualified deferred compensation, and
- individuals who receive stock options while performing work as a Minnesota resident, but do not exercise the options until they have moved to another state.

This section would not apply to individuals participating in qualified plans (such as a regular defined benefit pension, 401(k), 403(b), IRAs, and 457 plans) while Minnesota residents and making withdrawals once they are nonresidents, since federal law prohibits state taxation of withdrawals from these plans by nonresidents.

Effective beginning in tax year 2008.

8 **Withholding; construction contractors.** Requires construction contractors to withhold 2 percent of payments to individuals (other than employees) who perform contract work for them as Minnesota withholding tax, if total payments to the individual during the year exceed $600. This requirement applies (based on North American Industry Classification System codes) to the following types of businesses engaged in the:

- Construction of buildings

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- Heavy and civil engineering construction
- Specialty trade contractors

The requirement applies to payments that are subject to federal information reporting (IRS Form 1099). In applying the withholding tax, the individual is treated as an employee. Recipients must furnish the contractor with the names, addresses, and social security numbers. (Federal law imposes a similar requirement to permit 1099 information reporting.) Withholding would not apply to payments made to entities (corporations, partnerships, LLCs, and so forth).

Effective for payments made after December 31, 2008 .

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 **Federal update; estate tax.** Changes the date through which Minnesota incorporates the federal estate tax from May 18, 2006 , to February 13, 2008 . Since there have not been any federal changes to the estate tax since the last update, this change does not have any substantive effect.

11 **Audit and report; construction contractor withholding.** Requires the commissioner to conduct a random sample audit of construction contracting withholding returns under section 0and to report to the legislature by February 1, 2011 , on the audit. The report must also include the total number and amount of withholding payments received under section 0, and the types of contractors making payments, grouped by specialty skills categories under the North American Industry Classification System codes.

12 **Indexing for tax brackets, tax years 2009 and 2010.** Directs the commissioner of revenue to adjust the individual income tax brackets downward in tax year 2009 and upward in 2010 in order for this bill to have no net impact on income and corporate tax revenues in both the fiscal year 2008-2009 and fiscal year 2010-2011 biennia. It is anticipated that the scheduled increase in the brackets for tax year 2009 would be reduced by 55 percent, and that the scheduled increase in the brackets for tax year 2010 would be increased by 40 percent; the commissioner would determine the final adjustment percentages, and the 2009 brackets could not be reduced to less than the brackets provided in 2008. Current law indexing of the brackets would resume in tax year 2011.