Overview

Minnesota income and franchise tax is based on “federal taxable income” (“FTI”) for regular Minnesota tax purposes; “federal alternative minimum taxable income” (“AMTI”) for Minnesota alternative minimum taxable income; “federal adjusted gross income” (“FAGI”) for household income used for the Minnesota dependent care credit, education credit, and property tax refund; and “earned income” for the working family credit.

Minnesota law formerly referenced these federal items as amended through December 31, 2014. All reference dates to the Internal Revenue Code (“Code”) were changed to December 16, 2016.

The significant substantive changes made to the Code were adopted in the Protecting Americans from Tax Hikes Act of 2015, which was part of the Consolidated Appropriations Act of 2016 (P.L. 114-113), signed into law by President Obama on December 18, 2015. Other changes were contained in the Bipartisan Budget Act of 2015 (P.L. 114-74), signed into law on November 2, 2015; the Slain Officer Family Support Act (P.L. 114-7), signed into law on April 1, 2015; the Don’t Tax Our Fallen Public Safety Heroes Act (P.L. 114-14), signed into law on May 22, 2015; the United States Appreciation for Olympians and Paralympians Act of 2016 (P.L. 114-239), signed into law on October 7, 2016; 21st Century Cures Act (P.L. 114-255), signed into law on December 13, 2016; and the Combat-Injured Veterans Tax Fairness Act of 2016 (P.L. 114-292), signed into law on December 16, 2016.

Federal update to Minnesota administrative provisions. Minn. Stat. § 289A.02, subd. 7, was amended to adopt references to the federal administrative provisions found in chapter 289A as defined in the Code as amended through December 16, 2016. Since there were no changes to the Code provisions used in chapter 289A, this change has no substantive effect. All changes are effective for Minnesota purposes at the same time as they are effective for federal purposes.

Federal update to Minnesota net income. Minn. Stat. §§ 290.01, subd. 19; 290.0131, subd. 10; and 290.0133, subd. 12; were amended to adopt a number of changes made to federal taxable income between December 31, 2014 and December 16, 2016. Some of the federal changes were extensions of items that were previously in effect but had been allowed to sunset. Minnesota had previously adopted most of the provisions of the same years that they were effective for federal purposes.
Permanent extensions. The changes that are now permanently in effect include:

- The deduction in the computation of adjusted gross income of up to $250 of classroom expenses paid by a K-12 grade educator.
- The increase in the maximum exclusion for employer provided commuter vehicle or transit pass fringe benefits from $130 per month to $250 per month to obtain parity with the exclusion of fringe benefits parking benefits.
- The option to claim an itemized deduction for State and local general sales and use taxes in place of an itemized deduction for state and local income taxes. Minnesota has an addition for sales and use taxes paid in Minn. Stat. § 290.0131, subd. 3.
- The special rules to encourage charitable contributions of real property for conservation purposes, including the enhanced deduction for certain individual and corporate farmers and ranchers.
- The ability of taxpayers age 70 ½ or older to exclude from gross income up to $100,000 of their distributions from an Individual Retirement Account that are made directly to a charitable organization. The amount excluded is not allowed as a charitable deduction.
- The ability of entities other than C-Corporations to take a deduction for contributions to a charity equal to the lesser of the cost-basis plus one-half the normal price mark-up of food inventory or twice their basis in the food inventory.
- Changes to the rule that a shareholder’s basis in the stock of an S-Corporation is reduced by the shareholder’s pro rata share of the adjusted basis of the property contributed by the S-Corporation for charitable purposes, rather than by the pro rata share of the fair market value of the property.
- The ability to depreciate leasehold improvements and qualified restaurant property, including new restaurant property and improvements to retail property over 15 years (rather than 39 years) was extended to property placed in service after December 31, 2014.
- The following changes were made to Code section 179 expensing election:
  - The $500,000 expensing limitation and $2 million phase-out amounts are now permanent and, beginning after tax year 2015, are indexed for inflation.
  - Special rules that allow expensing for computer software and qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) also are now permanent.
  - Modification of the expensing limitation with respect to qualified real property by eliminating the $250,000 cap beginning in tax year 2016.
  - Beginning in tax year 2016, air conditioning and heating units are included in the definition of qualifying property.
  - While Minnesota conforms to these provisions, the treatment of the new amount is still subject to the 80% add back, meaning an addition of 80% of the 179 expensing in the first year and a subtraction of 20% of the addition in each of the next five years.
- The ability of regulated investment companies to designate certain dividends to be considered exempt.
- The ability to exclude all of the gain on the disposition of qualified small business stock acquired after September 27, 2010 and going forward if the stock was held for at least 5 years. Also permanently extends the rule that eliminates these gains as an AMT preference item.
• The permanent extension of a temporary exception that excludes certain income from the determination of what constitutes active financing income for purposes of subpart F.
• Special rule limiting payments from controlled subsidiaries of exempt organizations that are subject to the unrelated business income tax to the amount in excess of allowable payments under arm’s length transactions rules. This applies only if there is a binding written contract between the entities that was in effect on August 17, 2006.

Extensions through 2019. The changes that are extended through 2019 include:

• Extension of bonus depreciation (additional first-year depreciation) under a phase-down schedule through 2019:
  o 50% for property placed in service in 2015-2017.
  o 40% property placed in service in 2018.
  o 30% property placed in service in 2019.
Minnesota treatment will be the same as previous rounds of federal bonus depreciation, meaning an addition of 80% of the bonus in the first year and a subtraction of 20% of the addition in each of the next five years.

• Extension of the special rule that provides that payments of dividends, interest, rents, and royalties received by a controlled foreign corporation from a related CFC is not treated as foreign personal holding company income to the extent that the money is attributable to the related corporation that is not subpart F of income from business operations in the United States.

Extensions for 2015 and 2016. The changes that are extended through 2016 include:

• The exclusion for discharge of principal residence acquisition indebtedness income.
• The ability to claim an itemized deduction for mortgage insurance premiums on a principal residence.
• The deduction in the computation of adjusted gross income of up to $4,000 of qualified tuition for higher education.
• Race horses placed in service during 2015 or 2016 that are younger than three years old can be depreciated over 3 years rather than 7 years.
• The ability to depreciate certain motor sports entertainment complex property over 7 years rather than 15 or 39 years was extended to property placed in service during 2015 or in 2016.
• The ability to use accelerated depreciation of qualified Indian reservation property was extended to property placed in service during 2015 or in 2016. The extension provision also permits taxpayers to elect out of the accelerated depreciation rules.
• The ability to expense 50% of the cost of advanced mine safety equipment was extended to equipment placed in service during 2015 or in 2016.
• The ability to expense the first $15 million of production costs of films and television shows was extended to productions beginning before January 1, 2017.
• Extension of 50% bonus depreciation through 2016 for cellulosic biofuel facilities.
• An energy efficient commercial building deduction equal to 100% of the cost of property placed in service through 2016 as part of a plan to reduce by 50% or more the cost of
lighting, heating, cooling, ventilation, and hot water systems, up to a maximum of $1.80 per square foot of the building.

- The ability for vertically integrated electric utilities to defer recognition of gain from qualifying electric transmission transactions over 8 years rather than within the year of the sale.

Other provisions impacting Minnesota. Other provisions in the Consolidated Appropriations Act of 2016, the Bipartisan Budget Act of 2015, the United States Appreciation for Olympians and Paralympians Act of 2016, the 21st Century Cures Act, and the Combat-Injured Veterans Tax Fairness Act of 2016 that are adopted by Minnesota include:

- The exclusion from gross income of any payments from certain work-learning-service programs that are operated by a work college as defined in section 448(e) of the Higher Education Act of 1965.
- Starting in tax year 2015, the purchase of computer equipment and technology with a distribution from a 529 College Savings Plan is considered a qualified higher education expense. The 529-account rules were also modified to provide that any distribution from a 529 account made after December 31, 2014 is considered to have come only from that account even if the individual making the distribution owns more than one account.
- Changes that eliminated the residency requirement for qualified ABLE programs. Earnings of, and distributions from, these tax preferred savings accounts for disabled individuals (ABLE accounts) are exempt from tax if properly used by the disabled individual. The Minnesota ABLE account program is administered by the Department of Human Services. Contributions to ABLE accounts are managed by the State Board of Investment. Previously, ABLE accounts were only allowed to be opened in the State where the beneficiary resided. This change eliminates that requirement.
- The exclusion from gross income for civil damages, restitution, or other monetary awards that a taxpayer received as compensation for a wrongful incarceration. This provision applies to all tax years. A separate uncodified provision extends the time for filing an amended individual income tax return to claim a refund for taxes paid on civil damages restitution, or other monetary awards that a taxpayer received for wrongful incarceration. The period to claim a refund is until September 1, 2017 if the general statute of limitations has expired.
- For contributions made after December 18, 2015, taxpayers are allowed to roll over amounts from an employer-sponsored retirement plan, such as a 401(k), to a SIMPLE IRA, if the plan has existed for at least two years.
- Clarification of a special rule that expands the exception for reimbursements of certain benefits paid by accident or health plans of a public retirement system to also apply to benefits paid by plans established by or on behalf of a state or political subdivision. The provision expands the exception to apply to plans funded by medical trusts in addition to those under current law.
- Clarification of effective dates in P.L. 113-243, the FAA Modernization and Reform Act of 2012, to allow certain airline employees to contribute amounts received in certain airline bankruptcies to an IRA without being subject to the annual contribution limit. A separate uncodified provision extends the time for filing amended returns for an individual who made retroactive IRA rollovers from payments received from an airline in bankruptcy. The period to claim a refund is September 1, 2017 if the general statute of limitations to claim a refund has expired.
• For contributions made after December 18, 2015, charitable contributions by individuals to an agricultural research organization are subject to the higher individual limits (generally up to 50% of the taxpayer’s contribution base) if the organization commits to the use of the contribution for research before January 1 of the fifth year beginning after the date of contributions.

• An exclusion from gross income of certain clean coal power grants received under the Energy Policy Act of 2005 by eligible taxpayers that are not corporations. This provision applies retroactively to grants received after December 31, 2011.

• Amending rules relating to aggregation of certain church plans. Specifically amending rules relating to controlled group rules, contribution and benefit limits 403(b) defined benefit plans, automatic enrollment, plan mergers, and investments in group trust.

• Clarification of the valuation method for the early termination of certain charitable remainder unitrusts.

• Modification of the related-party loss rules, which generally disallow a deduction for a loss on the sale or exchange of property to certain related parties or controlled partnerships, to prevent losses from being shifted from someone who wouldn’t be subject to tax to another party in whose hands a gain or loss would be subject to United States tax.

• Delay in the ability to deduct the excise tax on high cost employer-sponsored health coverage until 2020 because imposition of excise tax delayed.

• Clarification of family partnership rules to provide that a family member who receives a capital interest in a partnership as a gift should be treated as a partner in the partnership and should be taxed on the income from that partnership.

• Exclusion from gross income of any prizes or awards won in competition in the Olympic or Paralympic games.

Provisions modifying and clarifying tax rules for Real Estate Investment Trusts (REITs).

By conforming to the federal code, Minnesota also conformed to provisions within the Consolidated Appropriations Act that modified and clarified tax rules for REITs. Many of these provisions are meant to limit the aggressive use of REIT rules in corporate tax-reduction strategies by making the following changes:

• Limiting tax-free spin-offs involving REITs and restricting distributing and controlled corporations from electing to be treated as a REIT for 10 years after the tax-free spin-off.

• Reducing the percentage limitation on assets of a REIT’s ownership of a taxable REIT subsidiary, which is taxed as a corporation.

• Limiting the aggregate amount of dividends that can be designated by a REIT as qualified dividends or capital gains dividends and repealing the preferential dividend rule for publicly offered REITs.

• Providing that current REIT earnings and profits for any tax year are not reduced by any amount that is not allowable in computing taxable income for the tax year.

• Permitting a taxable REIT subsidiary to operate foreclosed real property without causing income from the property to fail a qualifying test.

• Treating debt instruments of publicly offered REITs and mortgages as real estate assets.

• Provides an alternative safe-harbor for determining the percentage of assets that a REIT may sell annually.

• Increases the rate of withholding on dispositions of United States Real Property Interest.
• Clarifies the rules that apply to dispositions of interests in a corporation that is not a qualified investment entity.
• Expands the treatment of REIT hedging to include a third category of excluded hedging income.
• Clarifications of the asset and income tests for certain ancillary personal property.

Federal update to individual alternative taxable income, wages, built in gains for S corporations and credits. Minn. Stat. § 290.01, subd. 31, was amended to incorporate federal changes that impact Minnesota tax provisions that are not part of the computation of regular tax. For alternative minimum tax the new changes to federal adjusted gross income incorporated into the definition of net income will apply to the computation of Minnesota alternative taxable income. Similarly, the definition of “income” for purposes of the Minnesota dependent care credit and the education credit have adopted the same federal changes.

The definition of “wages” for purposes of Minnesota wage withholding changes to make employer provided commuter transit fringe benefits exempt from withholding to the same extent they are exempt from federal withholding.

Prospectively changing a taxpayer’s ability to file an amended return (or file an original return if the taxpayer failed to file) where the taxpayer retroactively claims the earned income tax credit for any prior year in which the taxpayer did not have a valid social security number.

Finally, the rule reducing the period for which an S-Corporation must hold its assets following a conversion from a C-Corporation to avoid the tax on built-in gains from 10 years to 5 years.

Federal update to Minnesota Working Family Credit. Minn. Stat. § 290.0671, subd. 1, was amended to permanently extend the higher phase-out thresholds for married couples filing joint returns for the federal earned income tax credit which was set to sunset after 2018.

Federal update to property tax refund. Minn. Stat. § 290A.03, subd. 15, was amended to adopt all federal changes that affect household income, which uses the definition of federal adjusted gross income as a starting point. Effective retroactively for refunds based on property taxes payable after December 31, 2016 and rent paid after December 31, 2015.

Federal update to estate tax. Minn. Stat. § 291.005, subd. 1, was amended to adopt references to the federal estate tax provisions found in chapter 291 as defined in the Code as amended through December 16, 2016. All changes are effective for Minnesota purposes at the same time as they are effective for federal purposes. This change has no substantive effect.

Recoupment of improper withholding on military severance payments. A separate uncodified provision that extends the statute of limitations for certain veterans to file amended returns to recoup amounts that were improperly withheld by the Department of Defense on certain severance pay. Impacted taxpayers will be contacted by the Department of Defense and are allowed to make a claim for refund until December 15, 2018.

Individual income tax assessment prohibited. A separate uncodified provision prohibits the commissioner from increasing the amount due or decreasing a refund for a taxable year beginning after December 31, 2014 and before January 1, 2016, to the extent the amount in issue
was overstated or understated because calculated under the Code as amended through December 31, 2014.