Instructions for 2011 Form 4R: Federal Taxable Income Reconciliation for Wisconsin Combined Groups

Purpose of Form 4R

Combined groups must use Form 4R to reconcile federal taxable income from the federal consolidated return (or federal separate returns, as appropriate) to the amount on line 1 of the combined return (Form 4).

Combined groups also use Form 4R to make the controlled group election and to make certain adjustments relating to intercompany transactions and limitations that apply at the combined group level.

The combined group files only one Form 4R with its combined return. Every combined return must include a Form 4R. Form 4R is not considered complete unless all of the required attachments are submitted, as explained throughout these instructions.

Line-by-Line Instructions

CAUTION: You must complete Form 4R before you complete line 1 of the combined Form 4.

These instructions are presented in the order the lines appear on Form 4R:

Part I: General Information and Consolidated Returns

■ **Line 1. Controlled Group Election** – Check the box if the group wishes to make the controlled group election. If you check "Yes," you must attach a statement which provides all of the following:

- A list of every corporation in the commonly controlled group.
- A statement that each corporation has agreed to be bound by the election.
- A statement that the election shall apply to any member that subsequently enters the group.

Following is an explanation of what the controlled group election does and the requirements for the election:

What the Controlled Group Election Does. If a group makes the controlled group election, the entire commonly controlled group is deemed to be engaged in a single unitary business, regardless of whether the companies are actually engaged in a unitary business. Additionally, all income of the commonly controlled group is considered to be apportionable income of that unitary business.

The controlled group election is binding for the taxable year it is elected and for the next nine taxable years.

NOTE: The controlled group election may simplify combined return filing because it eliminates the need to determine which corporations are engaged in the unitary business (Test 2). The controlled group election does not have any effect on the commonly controlled group (Test 1) or on water's edge (Test 3). The election applies for a ten-year period.

Requirements for Controlled Group Election. Any commonly controlled group is eligible to make the controlled group election, provided it is timely made. To be effective for the taxable year 2011, the election must be made on a timely filed 2011 Form 4R. A return filed under extension is considered timely filed.

In order for the election to be effective, the return must include an attached statement as described in the instructions for line 1.

Section Tax 2.63, Wisconsin Administrative Code, provides more information about the continuity of the controlled group election, including rules that apply in cases of corporate reorganizations.

■ **Line 2. Commonly Controlled Corporations Not in Combined or Consolidated Group –** Check the appropriate box to indicate whether there are companies in the commonly controlled group that are in neither the combined return nor the federal consolidated return.

■ **Line 3. Commonly Controlled Corporations Not in Combined or Consolidated Group –** If you checked "yes" for line 2, submit a supporting schedule to identify the name and identification number of each applicable company that is in neither the combined return nor the federal consolidated return.

■ **Line 4. Federal Net Income of Companies Described on Line 2 –** Enter the total net income, as reported for federal income tax purposes, of all com-

panies identified in the supporting schedule you prepared for line 3.

■ **Line 5. Gross Sales of Companies Described on Line 2 –** Enter the total gross sales that correspond to the income amount on line 4. Don't include sales that were not includable in federal gross income.

■ **Lines 6a through 6d. Net Income from Federal Consolidated Return –** Special instructions may apply in cases where there is more than one federal consolidated group in the combined group:

Differing Taxable Years. In general, the combined return will use the same taxable year as the federal consolidated return. However, if there is more than one federal consolidated return and the consolidated returns use differing taxable years, the information you enter on lines 6a through 6c should be for the taxable year that is included in this combined return. Generally, this is the taxable year that ended during the combined group's taxable year.

If a federal consolidated group uses a different taxable year than the rest of the combined group and you chose to include those members' income in this return by preparing a separate income statement for the months included in the combined group's taxable year, then prepare a separate income statements for all members of that federal consolidated group and include the total from those separate income statements on line 6.

More Than Three Federal Consolidated Groups. If there are more than three federal consolidated groups in the combined group, enter the information for the two largest federal consolidated groups on lines 6a and 6b, respectively. Then prepare a separate schedule to identify the remaining federal consolidated groups and their amounts from Form 1120, line 28. On line 6c, enter the sum of the Form 1120, line 28 amounts from the separate schedule and enter "See attached" on the line for Parent Company Name.

Part II: Corporations in Combined Group Which Are Not in Federal Consolidated Return

■ **Line 7. Corporations with Less Than 80% Common Ownership –** Identify any companies that are in the combined group but are not included in a federal consolidated return because they do not meet the 80% ownership test required to file a federal consolidated return. Ignore foreign corporations since those are accounted for on line 8. On a separate schedule, list each of the companies you identified, its federal employer identification number (FEIN), and federal taxable income from Form 1120, line 28 or from whichever federal form applies to the corporation. Enter the total federal taxable income of these companies on line 4.

■ **Line 8. Foreign Corporations –** Identify any companies that are in the combined group but are not included in a federal consolidated return because they are foreign corporations. On a separate schedule, list each of those companies, its federal employer identification number (FEIN), and federal taxable income.

Include all income that is effectively connected with the conduct of a trade or business in the United States, plus any other U.S. source income. For federal purposes, these amounts may have been reported on Form 1120-F or they may have been amounts for which federal income tax was withheld by the payer. Enter the total of these federal taxable income amounts on line 8.

NOTE: If federal income was reduced by provisions of a federal treaty, enter the amount after applying the provisions of the federal treaty. If a federal treaty reduced the federal tax rate, include the entire amount of federal income, including the income to which the reduced rate applied.

■ **Line 9. Other Corporations Not in Consolidated Group –** Identify any companies not included on lines 7 or 8 that are in the combined group but are not included in a federal consolidated return. On a separate schedule, list each of those companies, its federal employer identification number (FEIN), and federal taxable income, and explain why the company is not includable in a federal consolidated return. Enter the total federal taxable income of these companies on line 9.

Part III: Subtotal

Part III reverses out amounts included in the federal taxable incomes in Parts I and II that must be accounted for by treating the entire combined group as a single corporation. For the items you reverse out in Part III, you will recompute them later in Part V by treating the combined group as a single corporation.

For lines 12 and 14, you do not need to separately identify the companies to which the amounts relate.

■ **Line 12. Net Capital Gain –** Enter the total of the net capital gains reported on the consolidated return(s) shown on line 6 and on the separate federal returns for any companies included on lines 7, 8, and

9. Generally, these amounts are on line 8 of Form 1120 or 1120-F.

■ **Line 14. Charitable Contributions, Net Section 1231 Losses, Involuntary Conversions –** Enter the sum of the charitable contributions deduction, net section 1231 losses, and losses from involuntary conversions reported on the consolidated return(s) shown on line 6 and on the separate federal returns for any companies included on lines 7, 8, and 9. Charitable contributions are generally on line 19 of Form 1120 or 1120-F. Section 1231 losses and losses from involuntary conversions are generally accounted for on federal Form 4797.

Part IV: Corporations in Federal Consolidated Return Which Are Not Combined Group Members

To complete Part IV, identify all companies included in the federal consolidated return(s) on line 6 that aren't includable in the combined group.

For each company you identify, determine its "separate taxable income" as computed for federal income tax purposes under Treas. Reg. §1.1502-12. That is, determine its federal taxable income without regard to any items that had to be accounted for at the consolidated group level, such as capital gains and losses, section 1231 gains and losses, involuntary conversions, and charitable contributions. The separate taxable income amounts are what you will enter on lines 16, 18, and 19, as applicable.

■ **Line 16. Corporations Not Engaged in the Combined Group's Unitary Business –** On a separate schedule, list each of those companies, its federal employer identification number (FEIN), and federal separate taxable income. Enter the total of the federal separate taxable incomes on line 16.

> **CAUTION:** If the group made the controlled group election, do not enter any amounts on line 16 and skip line 17. Under the controlled group election, all corporations in the commonly controlled group are considered to be engaged in the same unitary business.

■ **Line 17. Indicator for Unitary in Another State –** Are any of the companies that have an amount on line 16 included in a combined ("unitary") return in another state because the corporation is part of the unitary business under that state's law? Do not count states where you made an election similar to the controlled group election where all companies in a commonly owned or controlled group elect to file a combined return regardless of whether they are in a common unitary business.

Check the appropriate box. If you checked "Yes," explain on an attached statement why the corporation was included in that other state's combined return but not in this combined return.

■ **Line 18. Corporations Not in the Combined Group Under Water's Edge Rules –** Identify any companies included in the federal consolidated return(s) that are *completely* excluded from the combined group under the water's edge rules, but do not include companies already accounted for on line 16. On a separate schedule, list each company excluded under the water's edge rules, its federal employer identification number (FEIN), and federal separate taxable income. Enter the total of the federal separate taxable incomes on line 18.

Following is an explanation of the water's edge rules as they apply to line 18:

Water's Edge Rules in General. The water's edge rules are explained in s. Tax 2.61(4), Wisconsin Administrative Code. In part, these rules provide that if a foreign (non-U.S.) or domestic (U.S.) corporation is an "80/20 corporation," it may be excluded from a combined group even if it is otherwise part of the group's unitary business.

The water's edge rules also provide that for some corporations, only part of their income from the unitary business is includable in the combined unitary income, with the remainder accounted for on a separate entity basis. The instructions for Form 4N, *Wisconsin Nonapportionable and Separately Apportioned Income*, describe these aspects of the water's edge rules in more detail.

> **NOTE:** If a combined group member has some income that is includable in combined unitary income and some that is excluded under the water's edge rules, do not report the excluded amount on Form 4R, line 18. Instead, report the excluded amount on Form 4N, line 7.

Qualifying as an "80/20 Corporation." A corporation is considered to be an "80/20 corporation" if 80 percent or more of its worldwide gross income during the taxable year that would otherwise be includable in the combined return is "active foreign business income" as defined in section 861(c)(1)(B) of the Internal Revenue Code. An 80/20 corporation may be either a foreign corporation or a domestic corporation, as long as it meets the active foreign business income test.

Under section 861(c)(1)(B) of the Internal Revenue Code, "active foreign business income" means gross income which is both:

1. Derived from sources outside the United States, as determined under subchapter N of the Internal Revenue Code, and
2. Attributable to the corporation's active conduct of a trade or business in a foreign country or possession of the United States.

For special rules regarding the 80/20 test as it relates to parent-subsidiary chains, disregarded entities, and part-year group members, see s. Tax 2.61(4)(b), Wisconsin Administrative Code.

Line 18 for Foreign 80/20 Corporations. If an 80/20 corporation is a foreign corporation, then it is not a member of the combined group unless it elected to be included in a consolidated return for federal purposes. If a foreign 80/20 corporation was not included in a federal consolidated return, you do not have to account for it on line 18.

CAUTION: If a foreign 80/20 corporation is not a member of the combined group, do not enter its income on line 18 since it was not included in a federal consolidated return to begin with.

If a foreign 80/20 corporation elected to be included in a consolidated return for federal purposes, it is treated in the same way as a domestic 80/20 corporation, described next.

Line 18 for Domestic 80/20 Corporations. If a domestic corporation is an 80/20 corporation, then its income includable in the combined unitary income is limited to only U.S. source income as provided in sections 861 through 865 of the Internal Revenue Code. Further, that U.S. source income must be of one of the following types to be included in combined unitary income:

1. Interest income or income generated from intangible property, regardless of who the payer is.
2. Income derived from interest or intangible expenses of other combined group members, to the extent not already included in 1. above.
3. Dividends from a real estate investment trust (REIT) that is not a "qualified REIT" under sec. 71.22(9ad), Wis. Stats.
4. Gains or losses derived from the sale or lease of real or personal property located in the United States.

The expenses attributable to these types of income, including an allocated share of indirect expenses, are also includable in combined unitary income.

The water's edge rules for domestic 80/20 corporations, summarized above, are specifically provided in sec. 71.255(2)(d), Wis. Stats., and s. Tax 2.61(4)(d)2., Wisconsin Administrative Code. In the statute, the term "consolidated foreign operating corporation" is used to describe a domestic 80/20 corporation. The terms "domestic 80/20 corporation" and "consolidated foreign operating corporation" have the same meaning.

If a domestic 80/20 corporation (or a foreign 80/20 corporation that elects to be included in a federal consolidated return) does not have U.S. source income of the types described in 1. through 4. above, it is not a combined group member. Include its federal separate taxable income on line 18.

■ **Line 19. Other Corporations Not in the Combined Group –** Identify any companies you didn't account for on lines 16 or 18 that are in a federal consolidated group but not the combined group. On a separate schedule, list each of those companies, its federal employer identification number (FEIN), and federal separate taxable income, and explain why the company is not includable in the combined group. Enter the total federal separate taxable income of these companies on line 19.

Part V: Adjustments Based on Limitations in Federal Law

The amount on line 21 represents the total federal taxable income of the combined group, before capital gains and losses, section 1231 gains and losses, involuntary conversions, and charitable contributions. This amount may also include adjustments for deferred intercompany transactions under Treas. Reg. §1.1502-13.

In Part V, you will adjust this amount so that certain federal limitations apply to the combined group as a whole, in the same way they would apply to a federal consolidated group.

■ **Line 22. Adjustment for Intercompany Deferrals –** On line 22 you will apply the provisions of Treas. Reg. §1.1502-13 so that intercompany transactions between members of the combined group are treated the same way as between members of a consolidated group for federal purposes.

Compute the amount on line 22 as follows:

1. For companies included in **both** the combined group and a federal consolidated group, reverse out the effect of adjustments you've already computed under Treas. Reg. §1.1502-13 for purposes of the federal return.
2. For all companies in the combined group, compute adjustments under Treas. Reg. §1.1502-13 as if the combined group is a federal consolidated group.
3. Compute the sum of the amounts derived from 1. and the ordinary income/loss items from 2., and enter the result on line 22.

Following are specific instructions for computing the amounts in these steps:

Step 1: Reverse Intercompany Adjustments for Federal Consolidated Group. If you had to compute intercompany adjustments under Treas. Reg. §1.1502-13 for purposes of the federal consolidated return and those adjustments are included in the amount on line 21, then include on line 22 an amount to offset those adjustments. This amount may be either positive or negative.

CAUTION: You may have already reversed out intercompany transactions in Part III if they consisted of capital gains, net section 1231 losses, or losses from involuntary conversions, or in Part IV if they were for companies that aren't combined group members. Do not double-count these items when you compute line 22.

Step 2: Compute Intercompany Adjustments for Combined Group. Identify any transactions that took place between members of the combined group and compute adjustments to defer income, gain, or loss between those members in the same manner as prescribed for members of consolidated groups under Treas. Reg. §1.1502-13.

In general, Treas. Reg. §1.1502-13 provides that income, deduction, gain, or loss on transactions between members of a consolidated group is deferred so that these transactions do not affect the combined group's income as a whole. As an example, assume Corporations S and B are in a federal consolidated group. In Year 1, S sells land with a basis of $50,000 to B for $80,000. Under Treas. Reg. §1.1502-13, in Year 1, you would make an adjustment to exclude S's $30,000 gain from the group's income.

However, any gain that you defer you must recognize when a triggering event occurs. For Wisconsin purposes, all of the following are triggering events:

- The buyer resells the object of the deferred intercompany transaction to an entity that is not a member of the combined group,
- The object of the deferred intercompany transaction is used outside the combined group's unitary business as a result of the buyer's resale, conversion, or transfer of the asset, or
- The buyer and seller are no longer members of the same combined group.

Continuing the previous example, assume in Year 3, B sells the land to P, an unrelated party, for $90,000. In Year 3, you would make an adjustment to recognize S's $30,000 deferred gain from Year 1 in addition to the $10,000 of gain that B recognized on the sale to P.

However, since Wisconsin did not recognize Treas. Reg. §1.1502-13 for taxable years beginning before January 1, 2009, do not make adjustments to recognize gains or losses deferred under Treas. Reg. §1.1502-13 that were incurred in taxable years beginning before January 1, 2009.

NOTE: Do not make adjustments to recognize amounts under Treas. Reg. §1.1502-13 if the deferred gain or loss was incurred in a taxable year beginning before January 1, 2009.

See Treas. Reg. §1.1502-13 for more details and examples of how to compute adjustments for various types of intercompany transactions.

Step 3: Completing Line 22. For the intercompany adjustments you computed in Step 2, separate the amounts into ordinary income/loss items and capital gain/loss items (including section 1231 gains and losses and gains and losses from involuntary conversions).

Combine the amount you computed in Step 1 with the ordinary income/loss items you computed in Step 2. If the net effect is a reduction in the combined group's income, enter the amount on line 22 as a negative number. If the net effect is an increase in the combined group's income, enter the amount on line 22 as a positive number.

For the capital gain/loss items, you will include those in the computation of line 23 and report them on line 23 or 24, as applicable.

■ **Line 23. Recomputed Net Capital Gain –** Line 23 is generally computed by applying the capital loss limitation to the group as a whole in the same manner it would apply to a federal consolidated group under Treas. Regs. §1.1502-22 and 1.1502-23.

To compute the amount on line 23, complete a separate federal Schedule D, *Capital Gains and Losses*, and the federal schedules referenced in Schedule D, including Form 4797, *Sales of Business Property*, and Form 4684, *Casualties and Thefts*, where applicable, as if the Wisconsin combined group is a federal consolidated group, but with two important exceptions:

1. Do not include any net capital loss carryovers that are non-sharable losses.
2. Do not include any gain or loss amounts that aren't includable in combined unitary income.

Each of these exceptions is described in detail below. If the computation on the federal Schedule D for the combined group results in a net capital gain, enter that net capital gain as a positive amount on line 23. Submit a copy of your recomputed federal Schedule D, Form 4797, and Form 4684, as applicable, with your return.

Non-sharable Losses. Non-sharable capital losses that cannot be included in the computation of line 23 are those that originated:

- In a taxable year beginning before January 1, 2009, or
- In the combined unitary income of another combined group, or
- In transactions that were reportable on a separate entity basis.

The rules which characterize a net capital loss as sharable or non-sharable are the same as those that characterize a net business loss as sharable or non-sharable. For special rules that apply in cases of subgroups and a corporation's options regarding sharable losses, see s. Tax 2.61(9), Wisconsin Administrative Code.

CAUTION: Do not include net capital loss carryovers from taxable years beginning before 2009 in the computation of the group's net capital gain on line 23.

Combined group members that have non-sharable capital loss carryovers may still use those carryovers to offset their share of the combined group's net capital gain. Those members should use Wisconsin Form 4CL, *Net Capital Loss Adjustments for Combined Group Members*, to claim their non-sharable capital loss carryovers. See the Form 4CL instructions for details.

Alternatively, a combined group member may choose to carry back a non-sharable capital loss carryover to a taxable year beginning before 2009 to the extent allowed under section 1212 of the Internal Revenue Code.

Gain or Loss Amounts Not Includable in Combined Unitary Income. A combined group member's capital gains and losses, section 1231 gains and losses, or gains and losses from involuntary conversions may not be includable in combined unitary income because they are attributable to a separate unitary business or because they are excluded under the water's edge rules.

In either case, instead of including these items in the computation of the group's net capital gain on line 23, report them separately for that member when you complete Part II of that member's Form 4N, *Wisconsin Nonapportionable and Separately Apportioned Income*. See the Form 4N instructions for details.

NOTE: If a combined group member's capital gains and losses, section 1231 gains and losses, or gains and losses from involuntary conversions are not includable in combined unitary income, report them on Part II of Form 4N, not on Form 4R.

■ **Line 24. Sum of Recomputed Charitable Contributions, Net Section 1231 Losses, Losses from Involuntary Conversions –** Enter the sum of the charitable contributions deduction and deductions for net section 1231 losses and involuntary conversions, as applicable, applying limitations at the combined group level. Enter as a negative amount. Further details are shown below:

Charitable Contributions. Determine the charitable contributions deduction under Treas. Reg. §1.1502-24 as if the combined group is a federal consolidated group. Unlike net capital loss carryovers, unused charitable contribution deduction carryovers may be applied at the group level even if they were incurred in a taxable year beginning before 2009, as long as the carryover period has not expired.

Net Section 1231 Losses and Losses from Involuntary Conversions. If the computations on the federal Forms 4797 and 4684 prepared as described in the instructions for line 23 result in a net section 1231 loss, a loss from involuntary conversions, or both, include those losses on line 24.

■ **Line 25. Other Adjustments Based on Federal Law –** Use line 25 to report any other adjustments that are necessary to reconcile the federal taxable income computed through line 24 and the federal taxable income reportable on Form 4, line 1.

CAUTION: On line 25, do not include Wisconsin modifications that should be reported on Schedule V or Schedule W, or separately reportable items that should be reported on Form 4N.

If there are adjustments reported on line 25, on a separate schedule list the name and federal employer identification number (FEIN) of each company with an amount included on line 25, the amount of adjustment for that company, and explain why the adjustment is necessary.

Additional Information and Assistance

Web Resources. The Department of Revenue has a web page dedicated to combined reporting issues, including:

- Frequently asked questions
- Training materials
- Links to Administrative Code sections that relate to combined reporting
- Articles on combined reporting

Access the combined reporting web page at: http://www.revenue.wi.gov/combrept/index.html

For questions that do not relate to combined reporting, the web page also has a library of frequently asked questions on general business tax topics, available at: http://www.revenue.wi.gov/faqs/index.html

Contact Information. If you cannot find the answer to your question in the resources available on the Department of Revenue's web page, contact the Department using any of the following methods:

- E-mail your question to corp@revenue.wi.gov
- Call (608) 266-2772
  (Telephone help is also available using TTY equipment. Call the Wisconsin Telecommunications Relay System at 711 or, if no answer, (800) 947-3529. These numbers are to be used only when calling with TTY equipment.)
- Send a fax to (608) 267-0834
- Write to the Audit Bureau, Wisconsin Department of Revenue, Mail Stop 5-144, PO Box 8906, Madison, WI 53708-8906