TAX RELEASES

("Tax Releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. However, the answer may not apply to all questions of a similar nature. In situations where the facts vary from those given herein, it is recommended that advice be sought from the Department. Unless otherwise indicated, Tax Releases apply for all periods open to adjustment. All references to section numbers are to the Wisconsin Statutes unless otherwise noted.)

Income and Franchise Taxes

INCOME AND FRANCHISE TAXES

1. Imputed Interest

Background: Section 71.04(15)(h), Wis. Stats. (created by Chapter 20, Laws of 1981), provides a deduction from gross income to corporations for any portion of the purchase price of property which is treated as interest under Section 483 of the federal Internal Revenue Code. Section 71.04(15)(h) is effective for purchases made in taxable year 1981 and thereafter. This Tax Release explains the provisions of Section 483 of the Internal Revenue Code as they relate to Wisconsin corporate purchasers of property as well as Wisconsin individuals, estates and trusts who compute their Wisconsin taxable incomes under the provisions of the Internal Revenue Code.

Unstated interest is the amount of interest that the law imputes as included in the contract price when property is sold under a deferred payment or installment arrangement that fails to specify any interest, or that specifies interest at a rate less than the amount prescribed in the federal regulations under Section 483 of the Internal Revenue Code.

A payment under a contract for the sale or exchange of property, which constitutes part or all of the selling price and which is due more than 6 months after the date of such sale or exchange, is deemed to include unstated interest for all purposes of the Internal Revenue Code if none of the exceptions provided in the Code are met and if all of the following facts exist:

A. Property is sold under a deferred payment contract where the selling price exceeds $3,000. For purposes of determining the selling price, the downpayment and amount of any unstated interest are included but the amount of any stated interest is excluded.

B. Some or all of the payments are due more than one year after the date of the sale or exchange.

C. There is total unstated interest under the contract (see below).

Any payment under a contract for the sale or exchange of property is *not* subject to imputed interest if one of the following facts exists:

A. The selling price of the property is $3,000 or less.

B. The payment is made pursuant to the sale or exchange of a patent.

C. The payment is made under an annuity, endowment, or life insurance contract.

D. In the case of the purchaser, the tax treatment of the amount paid is determined under Section 163(b) of the Internal Revenue Code. This section provides for the tax treatment of personal property and educational services purchased under a contract which provides that a part or all of the purchase price is to be made in installments, and in which carrying charges are separately stated but the interest charge cannot be determined.

E. In the case of the seller, all of the gain, if any, on the sale or exchange of the property would be considered ordinary income.

Total unstated interest means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of:

a. The sum of the payments constituting the selling price which are due more than 6 months after the date of the sale or exchange under the contract, over

b. The sum of the present values of such payments and the present values of any stated interest payments due under the contract.

To determine whether there is total unstated interest, the present values of the payments due under the contract are determined as of the date of the sale or exchange by discounting the payments at the interest rates prescribed in federal regulation 1.483-1(d)(1)(ii). For payments on account of a sale or exchange of property entered into on or after July 1, 1981, the test rate is 9 percent per annum simple interest. Tables are available in federal regulation 1.483-1(g)(2) to compute the present value of a deferred payment.

Once it is determined that there is total unstated interest (regardless of amount) with respect to a contract in the above computation, the actual unstated interest must be computed. The present values of the payments due under the contract must be recomputed by discounting the payments at an interest rate that is one percentage point higher than the rate used for testing whether unstated interest exists. These interest rates are prescribed in federal regulation 1.483-1(c)(2)(ii). For payments on account of a sale or exchange of property entered into on or after July 1, 1981, the imputed interest rate is 10 percent per annum, compounded semiannually.

Example 1: On January 1, 1983, A sells property to B under a contract that provides that B is to make payments of $2,500 ($2,200 sales price plus $300 interest), $2,600 ($2,200 sales price plus $400 interest), and $2,700 ($2,200 sales price plus $500 interest), such payments being due, respectively, 1, 2 and 3 years from the date of sale.

Since the property is sold under a deferred payment contract where the selling price exceeds $3,000, some or all of the payments are due more than one year after the date of the sale or exchange, and none of the exceptions to imputing interest are met, it is necessary to determine whether there is total unstated interest under this contract.

Sum of payments to which imputed interest rules apply		$6,600.00
Less:		
Present value of $2,500 due January 1, 1984 ($2,500 × .91743 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	$2,293.58	
Present value of $2,600 due January 1, 1985 ($2,600 × .84746 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	2,203.40	
Present value of $2,700 due January 1, 1986 ($2,700 × .78740 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	2,125.98	6,622.96
Test for unstated interest		$ 0

Since the sum of the payments constituting the selling price under the contract ($6,600) are less than the sum of the present values of such payments and the present values of the stated interest payments ($6,622.96), there is no unstated interest under this contract.

Example 2: On August 25, 1983, C sells property to D under a contract that provides that D is to make three payments of $1,500 each, such payments being due on August 25, 1983 (downpayment), March 1, 1984 and September 1, 1984. No interest is provided for in the contract.

Unstated interest exists in this contract because there is no specified rate or amount of interest. Since the property is sold under a deferred payment contract where the selling price exceeds $3,000, some or all of the payments are due more than one year after the date of the sale or exchange, and none of the exceptions to imputing interest are met, it is necessary to compute the actual unstated interest.

Sum of payments to which imputed interest rules apply		$3,000.00
Less:		
Present value of $1,500 due March 1, 1984 ($1,500 × .95238 factor from Table VII, Col. (b) in federal regulation 1.483-1(g)(2))	$1,428.57	
Present value of $1,500 due September 1, 1984 ($1,500 × .90703 factor from Table VII, Col. (b) in federal regulation 1.483-1(g)(2))	1,360.55	2,789.12
Total unstated interest		$ 210.88

Only those payments which are due more than 6 months after the date of sale under the contract are considered in this computation.

Example 3: On December 31, 1982, E sells his personal residence to F under a contract that provides that F is to make a downpayment of $40,000 and additional payments as follows:

January 1, 1984	$ 5,000
January 1, 1985	$ 5,000
January 1, 1986	$10,000

Simple interest at 10 percent per annum is to be charged on the final 2 payments. In order to sell the residence, E agreed to charge no interest on the payment due on January 1, 1984.

Since the property is sold under a deferred payment contract where the selling price exceeds $3,000, some or all of the payments are due more than one year after the date of the sale or exchange, and none of the exceptions to imputing interest are met, it is necessary to determine whether unstated interest exists.

In a contract which provides for interest of an amount equal to or in excess of the test rate specified in federal regulation 1.483-1(d)(1) (simple interest of 9 percent per annum on a sale or exchange of property entered into on or after July 1, 1981), unstated interest cannot exist if the stated interest is payable on *each* installment of principal when due. This example does not provide for interest of an amount equal to or in excess of 9 percent simple interest on *each* installment, and therefore, it is necessary to determine whether unstated interest exists.

Sum of payments to which imputed interest rules apply		$20,000.00
Less:		
Present value of $5,000 due January 1, 1984 ($5,000 × .91743 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	$ 4,587.15	
Present value of $6,000 ($5,000 principal + $1,000 stated interest) due January 1, 1985 ($6,000 × .84746 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	5,084.76	
Present value of $13,000 ($10,000 principal + $3,000 stated interest) due January 1, 1986 ($13,000 × .78740 factor from Table VII, Col. (a) in federal regulation 1.483-1(g)(2))	10,236.20	19,908.11
Test for unstated interest		$ 91.89

Since the above computation indicates that unstated interest exists, it is necessary to compute the actual unstated interest.

Sum of payments to which imputed interest rules apply		$20,000.00
Less:		
Present value of $5,000 due January 1, 1984 ($5,000 × .90703 factor from Table VII, Col. (b) in federal regulation 1.483-1(g)(2))	$4,535.15	
Present value of $6,000 due January 1, 1985 ($6,000 × .82270 factor from Table VII, Col. (b) in federal regulation 1.483-1(g)(2))	4,936.20	
Present value of $13,000 due January 1, 1986 ($13,000 × .74622 factor from Table VII, Col. (b) in federal regulation 1.483-1(g)(2))	9,700.86	19,172.21
Total unstated interest		$ 827.79

Allocation of Payments: To compute the amount of interest included in each payment which constitutes part or all of the selling price and which is due more than 6 months after the date of sale or exchange of the property, the payment must be multiplied by a fraction, the numerator of which is the total unstated interest under the contract, and the denominator of which is the sum of all payments subject to the imputed interest rules which are due under the contract.

In Example 2, the imputed interest included in each payment on March 1, 1984 and September 1, 1984 is computed as follows:

$$\$1{,}500 \times \frac{\$\ 210.88}{\$3{,}000.00} = \$105.44$$

In Example 3, the imputed interest included in each payment on January 1, 1984 and January 1, 1985 is computed as follows:

$$\$5{,}000 \times \frac{\$\ 827.79}{\$20{,}000.00} = \$206.95$$

The imputed interest included in the payment on January 1, 1986 is computed as follows:

$$\$10{,}000 \times \frac{\$\ 827.79}{\$20{,}000.00} = \$413.90$$

Transfers of Land Between Related Parties: In the case of a sale of land by an individual to a member of such individual's family (brothers and sisters, spouse, ancestors and lineal descendants), the maximum imputed interest rate is 7 percent, compounded semiannually, on payments made after June 30, 1981 on sales or exchanges after such date. This interest rate does not apply to any qualified sale between these individuals made during any calendar year to the extent that the aggregate sales prices of such sales between such individuals exceeds $500,000.

2. Installment Sales - Accounting for Difference between Wisconsin and Federal Basis of Property Acquired by Inheritance

Facts and Question: A and B own real estate as joint tenants. In 1983 A dies and B inherits this property. For federal estate tax purposes the entire value of the property is includable in A's estate. Thus, B acquires a federal basis equal to the full fair market value of the property. In other words, B acquires a "stepped-up" basis for the entire property.

On the Wisconsin inheritance tax return only one-half of the property is determined to be includable for inheritance tax purposes. Thus, B's basis for Wisconsin purposes under the provisions of s. 71.05(1)(g), Wis. Stats., is one-half of the original cost plus one-half of the fair market value on the date of A's death. B acquires a stepped-up basis for only one-half of the property for Wisconsin purposes.

Section 71.05(1)(g) of the Wisconsin Statutes provides that the resulting difference between the Wisconsin and federal basis must be treated as an addition or subtraction to federal income, as appropriate.

Example: A and B acquire real estate in their joint names at a cost of $80,000. When A dies the property has a fair market value of $190,000. For federal income tax purposes, B acquires a basis of $190,000 in this property (the full value of the property was includable in the federal estate tax return filed for A). For Wisconsin inheritance tax purposes, one-half ($95,000) of the value of the property was reportable. Thus, under s. 71.05(1)(g), Wis. Stats., B has a Wisconsin basis of $135,000 ($40,000 original cost plus $95,000 included in Wisconsin inheritance tax return). The difference between the Wisconsin and federal basis is $55,000 ($190,000 minus $135,000).

In the same year the property is inherited, B sells it in an installment sale for $195,000. Payments of principal received in the year of sale total $10,000.

What is the amount of the addition modification to be reported, if this installment sale is B's only capital gains transaction?

Answer: The $55,000 difference in basis may be reported based on the installment sales proceeds actually collected each year. Since $10,000 was received in 1983, $2,821 of the difference in basis would be allocated to 1983. This adjustment is computed:

$$\frac{\$\ 10{,}000 \text{ Proceeds received}}{\$195{,}000 \text{ Selling price}} \times \$55{,}000 \text{ Basis difference}$$
$$= \$2{,}821 \text{ Basis adjustment for 1983}$$

Additional basis adjustments would be required in subsequent years as the balance of the installment sale contract price is received.

Section 71.05(5), Wis. Stats., provides that effective for the 1983 tax year and thereafter, the difference in the basis of assets must be combined with other long-term or short-term capital gains and losses to determine the amount of capital gain exclusion or capital loss deduction. Although the basis adjustment for 1983 is $2,821, the addition modification required is $1,692. Since only 60% of a long-term capital gain is taxable in 1983, the modification is 60% of $2,821, or $1,692.

Note: If B has other capital gain or loss transactions, a revised federal Schedule D should be prepared on which the $2,821 basis adjustment is combined with other capital gains or losses to determine the amount of gain or loss reportable.

3. Wisconsin Foreign Earned Income Exclusion

Background and Law: For the 1983 taxable year, Wisconsin taxable income is computed under the provisions of the federal Internal Revenue Code (IRC) in effect as of December 31, 1982 with the exceptions specified in s. 71.02(2)(b)9, Wis. Stats. One of these exceptions is the taxation of foreign earned income. Wisconsin follows IRC s. 911(c) in effect as of December 31, 1977 in taxing foreign earned income and Wisconsin does not follow the foreign earned income exclusion and foreign housing cost exclusion or deduction provided in IRC ss. 911 and 119(c) as amended and added by ss. 111 and 113 of P.L. 97-34 (Economic Recovery Tax Act), effective for taxable years beginning after December 31, 1981 for federal tax purposes.

For the 1978 through 1982 taxable years, Wisconsin followed IRC s. 911(c) in effect on December 31, 1977 on the taxation of foreign earned income. Wisconsin did not recognize amendments made to this section of the IRC after December 31, 1977 by P.L. 95-615 (foreign earned income exclusion for employees who resided in hardship area camps) and P.L. 97-34 (foreign earned income exclusion limits and housing cost exclusion or deduction). Wisconsin also did not recognize IRC s. 913 which was created by P.L. 95-615 and provided for a deduction for excess living costs.

A United States citizen who is a Wisconsin resident and receives compensation for personal services performed in a foreign country is liable for Wisconsin taxes. However, for the 1978 through 1983 taxable years, a Wisconsin foreign earned income exclusion of up to $15,000 ($20,000 for employees of qualified U.S. charitable organizations) is allowed for an individual who is a bona fide resident of a foreign country or who is present in a foreign country for a specified period of time.

Definition of a Foreign Country: For purposes of claiming the foreign earned income exclusion, a foreign country is an area outside of the United States, its possessions, Guam, Puerto Rico, the Virgin Islands, the Northern Marianas Islands and the Antarctic region (Fed. Publication 54, "Tax Guide for U.S. Citizens Abroad").

Definition of a Qualified U.S. Charitable Organization: A qualified United States charitable organization is a nonprofit group organized in the United States, or under the laws of the United States, any State or the District of Columbia, for charitable, religious, educational or other certain purposes (IRC ss. 911(c) (1)(D) and 501(c)(3), 12-31-77).

Qualifications for Wisconsin Foreign Earned Income Exclusion: A United States citizen who is a bona fide resident of a foreign country or who is present in a foreign country for a specified period of time may exclude from gross income a limited portion of the earned income attributable to services performed in the foreign country (IRC ss. 911(a)(1) and (2) and 911(c)(6), 12-31-77; Fed. Reg. 1.911-2(a) and (b), 12-31-77).

A. *Bona Fide Resident of Foreign Country.* An individual who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year is eligible for a foreign earned income exclusion. Bona fide residence is determined according to each individual case, taking into account such factors as intention or the purpose of the trip, and the nature and length of the stay abroad. Bona fide residence is not necessarily the same thing as domicile. An individual's domicile is his or her permanent home, the place to which the individual always returns or intends to return.

Example: A Wisconsin domiciliary who travels to London for vacation or on a business trip has not established bona fide residence in London. But a Wisconsin domiciliary who goes to London to work for an indefinite or extended period and who sets up permanent quarters for himself and his family may establish a bona fide residence in London, even though he intends to return ultimately to his Wisconsin domicile.

An individual is not a bona fide resident of a foreign country if he or she makes a statement to the authorities of that country that he or she is not a resident and, therefore, the individual is not subject to the income tax of that country. An individual does not automatically acquire bona fide resident status merely by living in a foreign country, or countries, for one year. During the period of bona fide residence in a foreign country, an individual may leave the country for brief or temporary trips back to the United States or elsewhere for vacation or business as long as the individual returns to the foreign residence from such trips.

B. *Physical Presence in Foreign Country.* An individual who is physically present in a foreign country for at least 510 full days during any 18 consecutive months is eligible for a foreign earned income exclusion. The type of residence established, the intentions about returning from the foreign country and the nature and purpose of the trip abroad are disregarded in this case. Presence in the foreign country does not have to be exclusively for employment purposes. Some of the qualifying foreign-presence time may consist of vacation time in foreign countries. However, the requirement of at least 510 days on foreign soil within the 18-month period is unconditional.

The following principles must be considered in computing the 18-month period:

1. Any period of 18 consecutive months may be used, provided that the 510 qualifying days on foreign soil fall within that period. A qualifying day means a period of 24 consecutive hours beginning at midnight.
2. The 18-month period does not have to begin with the first qualifying day in a foreign country and the period does not have to end on the day of departure.
3. In determining the qualifying 18-month periods falling within an extended period of absence from the United States, any 18-month period may overlap another 18-month period.

Example: A construction worker arrived in Ecuador on January 15, 1982 and returned to the United States on June 10, 1983. He was physically present in Ecuador for 510 full days and therefore met the physical presence test. If the construction worker filed his 1982 Wisconsin income tax return before he qualified for the foreign earned income exclusion, he could file a 1982 amended tax return (Wisconsin Form 1X) claiming the allowable exclusion on the date he met the physical presence requirement.

Income Qualifying for Exclusion: An exclusion of up to $15,000 per year ($20,000 for employees of qualified U.S. charitable organizations) of earned income from foreign services may be excluded from Wisconsin gross income by qualified individuals (IRC s. 911(b), 12-31-77; Fed. Reg. 1.911-2(c) and (d), 12-31-77).

Foreign earned income is income that is

A. For services performed in a foreign country during the part of the tax year that an individual meets either the bona fide residence or physical presence tests, regardless of the place or manner of payment,

B. Not paid by the U.S. government or any of its agencies including the U.S. Armed Forces,

C. Not pension or annuity income, and

D. Not received after the close of the tax year following the tax year in which it is earned.

Wages, salaries, professional fees and other amounts received for personal services actually rendered in a foreign country (and paid by sources other than the U.S. government) qualify for the exclusion. Earned income does not include income from a business unless personal services produce the entire business income. However, if services and capital are income producing factors, a reasonable allowance for personal services (up to a maximum of 30% of net business profit) can be considered as earned income. Earned income includes allowances or reimbursements received for the cost of living, overseas differential and living quarters. It also includes the fair market value of noncash remuneration furnished by an employer such as a home or automobile.

Unearned income (for example, interest, dividends, capital gains, rent and royalties, annuities, etc.) does not qualify for the earned income exclusion.

Limitations on Amounts Excludable: The allowable foreign earned income exclusion is computed on a daily basis at an annual rate of $15,000 ($20,000 for employees of qualified U.S. charitable organizations). For married taxpayers, each spouse may claim an exclusion if both qualify (IRC s. 911(c)(1), (2) and (4), 12-31-77; Fed. Reg. 1.911-2(a), (b) and (d), 12-31-77).

If an individual meets either the bona residence or physical presence requirement and the individual qualifies for an exclusion for only part of a particular tax year, the maximum $15,000 (or $20,000) exclusion must be prorated based on the number of days in the qualifying period.

Example 1: A wage earner was physically present in Germany from January 1, 1982 through July 31, 1983. She received foreign earned income of $35,000 in 1982 and $25,000 for the first seven months in 1983. The amounts excludable from Wisconsin income in 1982 and 1983 are computed as follows:

Year		Limitation on Exclusion
1982	365 days ÷ 365 days × 15,000	$15,000
1983	212 days ÷ 365 days × 15,000	$ 8,712

An individual may not claim an exclusion for an amount in excess of the foreign income actually earned during the qualifying period.

For purposes of determining the foreign earned income excludable, compensation is allocated to the year in which the services are performed even though non-excludable compensation is reported in the year received by a cash basis taxpayer. To exclude income earned abroad, the income must be received no later than the tax year after the tax year it is earned.

Example 2: An employee of a qualified U.S. charitable organization qualified for the bona fide residence exclusion for the years 1982 and 1983. During 1982 the excludable earned income was $18,000. During 1983, the employee received earned income of $19,000 for services rendered in 1983 and a bonus of $5,000 for services rendered in 1982.

1982

Exclusion allowable	$20,000
Amount actually excluded	18,000
Remainder of available exclusion	$ 2,000

1983

Income earned in 1983 and excluded	$19,000
Amount of bonus earned in 1982 that may be excluded in 1983	2,000
Total amount to be excluded in 1983	$21,000

Example 3: An executive of a private Wisconsin corporation is assigned to the corporation's Canadian subsidiary. The executive established residence abroad as of December 31, 1979 and returned to the United States on January 1, 1983. The executive received an annual salary of $12,000 and, in addition, received a bonus of $6,000 on January 15, 1983, shortly after returning to the United States. The executive qualified for a Wisconsin foreign earned income exclusion for the entire 3-year period and could exclude the salary earned each year.

The $6,000 bonus must be allocated equally over the years 1980, 1981 and 1982 when the bonus was earned for purposes of determining the foreign earned income excludable. The amount of bonus excludable is limited to the $2,000 allocable to 1982. The remaining $4,000 ($2,000 allocable to each of the years 1980 and 1981) does not qualify for exclusion, since it was received later than the close of the tax year after the tax year in which the services were performed.

Claiming Exclusion on Wisconsin Tax Return: Wisconsin Form 1 must be filed by any individual claiming a Wisconsin foreign earned income exclusion. Complete copies of the individual's federal income tax return and supporting schedules, a computation of the Wisconsin foreign earned income exclusion and a Wisconsin Schedule I must be attached to the Wisconsin Form 1.

Schedule I is used to convert the federal adjusted gross income from an individual's federal tax return to the amount that is reportable for Wisconsin tax purposes. Once the Wisconsin foreign earned income exclusion is computed, the excludable amount is entered on line 5, Col. II of the 1983 Wisconsin Schedule I. The federal foreign earned income exclusion and any foreign housing cost exclusion or deduction that was claimed on the federal tax return is entered on line 5, Col. I of the 1983 Wisconsin Schedule I. The difference in the amounts entered on line 5, Col. I and Col. II, is entered on line 5, Col. III. This differ-