

ence must be added to federal adjusted gross income per the instructions on line 6 of Schedule I.

Deductions Related to Excludable Foreign Earned Income: Expenses directly attributable to foreign earned income must be allocated when part of the income is excludable and part is taxable in a particular tax year. An individual may not deduct expenses, losses, and other items that went into producing the *excludable* income. Only those expenses that are attributable to *taxable* income are deductible. This limitation only applies to expenses directly connected with excludable earned income. It does not apply to other deductions, such as those for medical expenses, interest or alimony (IRC s. 265, 12-31-82 and Fed. Reg. 1.911-2(d)(6), 12-31-77).

Example 1: A Wisconsin resident employed in a foreign country qualifies for the physical presence exclusion for the entire 1983 tax year. Foreign earned income for the year is \$30,000 of which \$15,000 is excluded from gross income. Included in allowable itemized deductions are employee business expenses for safety equipment of \$224 and union dues of \$450. These expenses are directly attributable to foreign earned income and, therefore, the part of the expenses allocable to the excluded income is not deductible. Since 50% of the foreign earned income is excludable, 50% of the employee business expenses, or \$337 is not deductible.

Example 2: A management consultant was self-employed in a foreign country and personal services produced the business income. The consultant is a U.S. citizen and meets the physical presence test for the entire 1983 taxable year. Gross business income was \$75,000, business expenses were \$50,000 and net profit was \$25,000. Since the first \$15,000 of gross income is excluded, only \$60,000 or 80% of the gross income is reported on the 1983 Wisconsin tax return. The consultant can deduct only 80% of the expenses attributable to gross income, or \$40,000.

Nondeductible expenses, losses and other items attributable to the excludable Wisconsin earned income must also be accounted for on line 5 of the 1983 Wisconsin Schedule I.

4. Wisconsin Tax Treatment of Safe Harbor Leases

Background: The Economic Recovery Tax Act of 1981 (ERTA) enacted by the United States Congress provided "safe harbor" lease rules (Section 168(f)(8) of the Internal Revenue Code) under which certain transactions, applicable to property placed into service on or after January 1, 1981, were treated as leases for federal income tax purposes whether or not the transactions otherwise would qualify as leases under pre-ERTA federal guidelines.

The Wisconsin Statutes—ss. 71.01(4)(g)5, 6 & 7, 71.02(1)(a)6, 7 & 8, and 71.04(15)(b)—were modified to deny corporations use of these special federal safe harbor lease rules, effective for taxable year 1981 and thereafter. (A brief summary of the effect of these federal rules on individuals, estates and trusts for Wisconsin income tax purposes is found near the end of this Tax Release.)

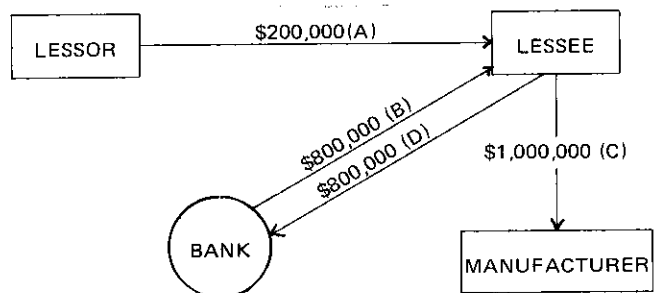
There are two general types of leases covered by the federal safe harbor lease rules—namely, "straight leases" and "sale-leasebacks". Only the latter type is discussed in this Tax Release.

Facts and Question: In taxable year 1981 Seller/Lessee Corporation purchased equipment from a manufacturer

for \$1,000,000 and then "sold" (but did not transfer title to) the equipment to Purchaser/Lessor Corporation for \$200,000 in cash plus an \$800,000 nonrecourse note receivable from Purchaser/Lessor bearing interest at the market rate and payable over nine years in equal annual principal and interest payments of \$168,000. The \$200,000 was the agreed upon price of the Seller/Lessee's tax benefits consisting of its depreciation deductions and investment tax credit on the equipment. Purchaser/Lessor Corporation simultaneously "leased" the equipment back to the Seller/Lessee for nine years (90% of its useful life) for annual rental payments of \$168,000 which are due on the same date and exactly offset the principal and interest payments Purchaser/Lessor must make to Seller/Lessee under the note. The only money changing hands between Seller/Lessee and Purchaser/Lessor was the \$200,000 payment in 1981 for the tax benefits. Seller/Lessee used the \$200,000 as a down payment to the equipment manufacturer and financed the remaining \$800,000 with a financial institution.

The following diagram illustrates the flow of the various payments in the above example:

SALE-LEASEBACK AGREEMENT



- (A) Represents the \$200,000 payment made by the lessor to the lessee under the safe harbor lease agreement for some of the lessee's tax benefits.
- (B) Represents the \$800,000 the lessee borrowed from the bank for the purchase of the equipment.
- (C) Represents the \$1,000,000 payment made by the lessee to the manufacturer for the purchase of the equipment.
- (D) Represents the repayment by the lessee of the \$800,000 loan over a period of years.

What is the Wisconsin franchise/income and sales/use tax treatment of the various components of this transaction?

Answer: The following summarizes the Wisconsin tax treatment of each aspect of the transaction. This treatment applies to corporations engaged in business solely in Wisconsin as well as to multi-state corporations reporting to Wisconsin on the apportionment or separate accounting methods.

- A. *Sale of Equipment by Seller/Lessee.* Sale is not recognized.
- B. *Initial \$200,000 Payment by Purchaser/Lessor to Seller/Lessee.*

- (1) The transfer of federal tax benefits for \$200,000 is considered to be the sale of such benefits.

The Seller/Lessee Corporation must recognize income of \$200,000 in taxable year 1981. (It is allowed the entire \$1,000,000 cost of the equipment as basis for depreciation purposes. This payment, accordingly, does not constitute a reduction of the underlying asset account for Wisconsin tax purposes.)

- (2) The Purchaser/Lessor Corporation may not deduct the \$200,000 cost of these benefits since the law contains no provision for such deduction.

- C. *Depreciation of Equipment.* Seller/Lessee corporation deducts depreciation using a basis of \$1,000,000.
- D. *Rental Expense/Income.* Neither Seller/Lessee nor Purchaser/Lessor recognizes rental expense or income.
- E. *Interest Expense/Income.* Seller/Lessee may deduct interest it pays to the financial institution on the \$800,000 loan. However, neither Seller/Lessee nor Purchaser/Lessor recognizes interest income or expense on the \$800,000 nonrecourse note the two parties executed.
- F. *Apportionment Basis Taxpayers - Effect upon Property and Sales Factors.* Seller/Lessee includes the equipment in the property factor at its \$1,000,000 cost. Rental payments under the safe harbor agreement are not considered rental payments for purposes of the property factor.

The Purchaser/Lessor may not include the property in its property factor.

The manufacturer includes \$1,000,000 in its sales factor; the Seller/Lessee, however, may not include the \$1,000,000 in its sales factor.

- G. *Wisconsin Sales/Use Tax.* The sale of equipment by the manufacturer to Seller/Lessee Corporation is a taxable sale unless a specific exemption applies to the transaction, such as the farming or manufacturing exemptions in ss. 77.54(3), (3m) or (6)(a). The Seller/Lessee Corporation may not give the manufacturer a resale certificate, since there is not an actual resale to the Purchaser/Lessor Corporation.

The \$200,000 received by Seller/Lessee is not taxable for sales tax purposes because it represents proceeds from the sale of intangible tax benefits.

Other offsetting principal, interest and rental amounts recognized for federal income tax purposes have no Wisconsin sales or use tax consequences.

- H. *Nexus Issues.* The Purchaser/Lessor Corporation will not have nexus with Wisconsin for franchise or income tax purposes if its only "activity" in Wisconsin is the safe harbor "rental" property located in Wisconsin.

The presence of this property in Wisconsin, however, will cause the Seller/Lessee to have Wisconsin nexus for franchise/income and sales/use tax purposes (if it does not already have such nexus).

To summarize, for Wisconsin corporation franchise/income tax purposes the sale-leaseback transaction is treated as the purchase of equipment by the Seller/Lessee and the taxable sale of some of its federal income tax benefits. The cost of such benefits is not deductible by the Purchaser/Lessor. The federal income tax treatment of the equipment "sale" and "leaseback" aspects of the transaction have no application for Wisconsin corporation franchise/income or sales/use tax purposes.

Individuals, Estates and Trusts: For federal income tax purposes, individuals, estates and trusts may qualify as *lessees* under the safe-harbor lease rules; lessors, however, must always be corporations.

For 1981, individuals, estates and trusts did not qualify for safe harbor treatment for Wisconsin income tax purposes because they computed their income and deductions under the December 31, 1980 Internal Revenue Code. For 1982, they were subject to the Internal Revenue Code in effect on December 31, 1981. Therefore, individuals, estates and trusts on their 1982 Wisconsin income tax returns could receive full benefits of the safe harbor leasing provisions that became effective for federal income tax purposes in 1981. For 1983, however, they must follow the provisions of TEFRA enacted in 1982 since Wisconsin individual income tax law, as applied to these leases, is the Internal Revenue Code in effect on December 31, 1982.

Finance Leases Replace Safe Harbor Leases: The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) enacted by the U.S. Congress effectively ends safe harbor leasing for property placed in service after December 31, 1983, and imposed many limitations and restrictions on the benefits from safe harbor lease agreements entered into between July 1, 1982 and December 31, 1983. TEFRA also created an entirely new category of lease rules known as "finance lease" rules that apply to leases entered into after December 31, 1983 and to leases of up to \$150,000 of farm equipment entered into from July 1, 1982 through December 31, 1983.

These new federal "finance lease" rules are also contained in Section 168(f)(8) of the Internal Revenue Code. Therefore, under the Wisconsin corporation franchise/income tax law as of December 31, 1983—ss. 71.01(4)(g)5, 6 & 7, 71.02(1)(a)6, 7 & 8, and 71.04(15)(b), Stats.—the new federal treatment of finance leases, including the lease of farm equipment from July 1, 1982 through December 31, 1983, does not apply to corporations.

Information: Questions relating to Wisconsin treatment of safe harbor leases should be addressed to:

Wisconsin Department of Revenue
P.O. Box 8906
Madison, WI 53708
Attn: Jerry Hendrickson

Example of Tax Return Adjustments on Federal Schedule M-1 and Wisconsin Schedule L

The following federal Schedule M-1 (with required Wisconsin adjustments thereto) and Wisconsin Schedule L illustrate the adjustments that should appear on the tax returns of a taxpayer who had entered into a sale-leaseback transaction with the facts set forth in the foregoing example.

FEDERAL SCHEDULE M-1 AND WISCONSIN SCHEDULE L ADJUSTMENTS FOR A SALE-LEASEBACK TRANSACTION (FIRST YEAR)

	Seller/Lessee		Purchaser/Lessor	
	Initial Payment Booked to Income	Initial Payment Not Booked to Income	Initial Payment Booked to Expense	Initial Payment Not Booked to Expense
Federal Schedule M-1 (with required Wisconsin adjustments thereto)				
Book Income (Loss)	\$(4,800,000)	\$(5,000,000)	\$9,800,000	\$10,000,000
Schedule M-1 Adjustments:				
Rental Expense	(168,000)	(168,000)		
Rental Income			168,000	168,000
*Interest Income	120,000	120,000		
Interest Expense			(120,000)	(120,000)
**Depreciation Expense	150,000	150,000	(150,000)	(150,000)
Initial Payment	<u>(200,000)</u>	<u> </u>	<u>200,000</u>	<u>-0-</u>
Federal Taxable Income	\$(4,898,000)	\$(4,898,000)	\$9,898,000	\$ 9,898,000
Required Wisconsin Adjustments:				
Rental Expense	168,000	168,000		
Rental Income			(168,000)	(168,000)
*Interest Income	(120,000)	(120,000)		
Interest Expense			120,000	120,000
**Depreciation Expense	(150,000)	(150,000)	150,000	150,000
Initial Payment	<u>200,000</u>	<u>200,000</u>	<u>*** -0-</u>	<u>-0-</u>
Wisconsin Net Income	<u>\$(4,800,000)</u>	<u>\$(4,800,000)</u>	<u>\$10,000,000</u>	<u>\$10,000,000</u>
Wisconsin Schedule L				
Book Income (Loss)	\$(4,800,000)	\$(5,000,000)	\$ 9,800,000	\$10,000,000
Schedule L Adjustment:				
Initial Payment	<u> </u>	<u>200,000</u>	<u>200,000</u>	<u> </u>
Wisconsin Net Income	<u>\$(4,800,000)</u>	<u>\$(4,800,000)</u>	<u>\$10,000,000</u>	<u>\$10,000,000</u>

Contract Date - January 1, 1981

*Interest rate of 15% × \$800,000 note = \$120,000 first year interest

**Depreciation Expense at 15% for first year of contract (\$1,000,000 × 15% = \$150,000)

(This assumes ACRS depreciation was booked; if a different method of booking depreciation was used, then the Schedule M-1, Required Wisconsin and Schedule L depreciation adjustments would be different from those above.)

***Federal adjustment not reversed because initial payment is not deductible for either federal or Wisconsin tax purposes.

The above chart illustrates the point that every adjustment made for federal tax purposes is reversed for Wisconsin tax purposes with the exception of the initial payment made by the lessor to the lessee for the tax benefits.