

## SALES/USE TAXES

### Specialty Associates, Inc. vs. Wisconsin Department of Revenue

(Wisconsin Tax Appeals Commission, July 31, 1984). During the period under review, the taxpayer, a Wisconsin corporation with its principal place of business in West Allis, Wisconsin, was a roofing contractor doing real estate improvements. The issue for the Commission to determine is whether or not the taxpayer used construction materials to make real estate improvements for certain tax-exempt entities, and is thus liable for the use tax under s. 77.53(1), Wis. Stats. The department contends that the taxpayer cannot meet its burden to show that it purchased and sold building materials to specific tax-exempt entities. It is the department's position that the taxpayer used these building materials to make real estate improvements, and that the user of these materials is responsible for the sales and use tax on the materials.

Specialty Associates, Inc. contends that it was acting simply and solely as an agent for SAI Wholesale Distributors, Inc., which is a separate Wisconsin corporation formed solely for the purpose of selling wholesale roofing materials. In any contract with a tax-exempt entity, Specialty Associates was performing two separate contracts: one by Specialty Associates for the purpose of installing materials, and two as an agent for SAI as a retailer selling and delivering the materials directly to the tax-exempt entity.

The taxpayer entered into contracts with tax-exempt and non-tax-exempt entities for installing roofing materi-

als to real property. The contract may or may not have included specifications. If the contract was with a tax-exempt entity, Specialty Associates would request its tax number. The roofing materials were purchased from SAI, Inc. and other suppliers without payment of the sales and use tax by the taxpayer's use of the tax-exempt entity's number for jobs involving the tax-exempt entity. If the materials were purchased for a non-tax-exempt entity, the tax was paid in most cases. The taxpayer billed the entity for the entire job. Specialty Associates received 100% of the funds for the construction work. The taxpayer then paid its suppliers.

Specialty Associates used its name and credit to purchase the roofing materials. The taxpayer installed the materials with its employees. The taxpayer was not selling tangible personal property but rather real estate improvements using tangible personal property.

The Commission held that under s. 77.51(18), Wis. Stats., Specialty Associates was a contractor who purchased and was the consumer of tangible personal property used by it in real property construction activities and the use tax applies to the sale of materials used by it. Under s. 77.51(18), Wis. Stats., the taxpayer did not issue proper exemption certificates because it had such reason to believe it would sell the materials to customers for whom it would perform real property construction activities involving the use of the materials. The taxpayer is liable for the use tax under s. 77.53(1), Wis. Stats., on the purchase of the materials

which it sold to and installed for real estate improvements to tax-exempt entities.

The taxpayer has not appealed this decision.

## CIGARETTE TAX

### George R. Elliott vs. Wisconsin Department of Revenue

(Circuit Court of Dane County, September 6, 1984). In response to a newspaper ad, George Elliott ordered 63 cartons of cigarettes from Tobacco Land, USA. Because Tobacco Land does not maintain an office in Wisconsin, it did not collect Wisconsin excise taxes from Mr. Elliott on his purchase. Instead, Tobacco Land reported the sale of tax-free cigarettes to the Wisconsin Department of Revenue as required by 15 U.S.C. ss. 375-376. Based on this report, the department advised Mr. Elliott that he owed \$100.80 in Wisconsin excise taxes. Mr. Elliott promptly paid the amount due. The department then notified him that a penalty of \$25 per carton had been assessed under s. 139.33(3), Wis. Stats., for his failure to pay the excise taxes within 15 days of his receiving the cigarettes. Mr. Elliott challenged the penalty assessment before the Wisconsin Tax Appeals Commission, which affirmed the assessment. (See WTB #37 for a summary of the Tax Appeals Commission's decision.)

The Circuit Court affirmed the decision of the Wisconsin Tax Appeals Commission.

The taxpayer has not appealed this decision.

## 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.)*

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## INDIVIDUAL INCOME TAXES

### 1. The Determination of "Federal Adjusted Gross Income" for Computing Taxable Unemployment Compensation, the Earned Income Credit, and the Child and Dependent Care Credit for Wisconsin

**Facts:** The computation of taxable unemployment compensation, the earned income credit, and the child and dependent care credit for Wisconsin is based on federal adjusted gross income.

Taxable unemployment compensation is computed by adding federal adjusted gross income (other than the married couples' deduction) and the unemployment benefits received. This sum is compared with a base amount (\$18,000 for a joint return, \$12,000 for a single person, and zero for a married person filing separately). If this sum exceeds the base amount, either one-half of the excess or the amount of the unemployment benefits, whichever is lower, is included in gross income.

The Wisconsin earned income credit is 30% of the federal credit. The federal credit is 10% of earned income (e.g., wages, salaries, tips) up to \$6,000, or \$500, whichever is lower. When federal adjusted gross income exceeds \$6,000, the maximum available credit (\$500) decreases by 12.5% of the amount of federal adjusted gross income over \$6,000. If federal adjusted gross income is \$10,000 or more, no credit is available.

The Wisconsin child and dependent care credit is 30% of the federal credit. The federal credit is based on employment related expenses of up to \$2,400 for one dependent and \$4,800 for two or more dependents. The credit is a varying percentage of qualifying expenses, depending on federal adjusted gross income. If total federal adjusted gross income is \$10,000 or less, the credit is 30% of the expenses. As a person's income increases, the percentage of credit available decreases. For federal adjusted gross income above \$28,000, the credit is 20% of eligible expenses.

For Wisconsin purposes, federal adjusted gross income is not always the same as the amount reported on the federal return. There are several reasons why differences may occur.

A. For Wisconsin, federal adjusted gross income does not include state tax refunds which were reported as income on the federal return. Since taxes are not allowed as itemized deductions for Wisconsin, a refund of state income taxes which is taxable income for federal purposes is not includable in Wisconsin income.

B. For Wisconsin for the taxable year 1984, income is determined based on the Internal Revenue Code in effect on December 31, 1983. Therefore, federal laws enacted during 1984, including the Tax Reform Act of 1984, do not apply for Wisconsin.

C. Two provisions of the Internal Revenue Code in effect on December 31, 1983 also do not apply for Wisconsin for the 1984 taxable year. These provisions are (1) the foreign earned income exclusion and foreign housing cost exclu-

sion, and (2) the incentive stock option provisions of Section 422A of the Internal Revenue Code.

Federal law permits the exclusion of up to \$80,000 of foreign earned income and the exclusion of foreign housing costs for United States citizens working abroad. Wisconsin law provides a foreign earned income exclusion of \$15,000 (\$20,000 for employees of United States charitable organizations) for United States citizens who are bona fide residents of foreign countries or who are present in foreign countries for a specified period of time.

Federal law provides that there is no tax consequence when an incentive stock option is granted or exercised. The employee is taxed at the capital gains rates when the stock is sold. For Wisconsin, income is generally recognized either when the option is granted or when it is exercised, depending on the circumstances.

**Question:** Since the federal adjusted gross income reportable for Wisconsin may differ from the amount reportable for federal purposes, must the taxpayer recompute federal adjusted gross income before computing taxable unemployment compensation, or the allowable earned income credit or child and dependent care credit for Wisconsin?

**Answer:** The taxpayer may recompute federal adjusted gross income before computing the taxable unemployment compensation for Wisconsin, or the allowable Wisconsin earned income credit or child and dependent care credit. However, in many cases the recomputation of federal adjusted gross income will not alter the amount of taxable unemployment compensation. Likewise, the change in the amount of earned income credit or child and dependent care credit may be zero or minimal. Following are several examples which show how to recompute federal adjusted gross income and the result.

#### A. Unemployment Compensation

**Example 1:** A husband and wife file a joint federal return for 1984 and report total income of \$26,000, which includes a state tax refund of \$800 but does not include the husband's unemployment compensation of \$5,000. They claim a \$450 deduction for a married couple when both work, but have no other adjustments to income.

**Federal Return** — The total amount of the husband's unemployment compensation is taxable, based on the following computation (references are to lines on the federal unemployment compensation worksheet):

( 3) Unemployment compensation received	\$ 5,000
( 4) Add: Federal income other than unemployment compensation	<u>26,000</u>
( 5) Total income and unemployment compensation	\$ 31,000
( 6) Subtract: Adjustments to income except married couples' deduction	<u>-0-</u>
( 7) Adjusted federal income and unemployment compensation	\$ 31,000
( 8) Subtract: Base amount for married filing a joint return	<u>(18,000)</u>
( 9) Excess over base amount	\$ 13,000
(10) One-half of excess over base amount	\$ 6,500
(11) Taxable unemployment compensation (lesser of line 3 or line 10)	<u>\$ 5,000</u>

**Wisconsin Return** — The total amount of the husband's unemployment compensation is taxable, based on the following computation:

( 1) Amount from line 7 of federal unemployment compensation worksheet	\$ 31,000
( 2) Subtract: State tax refund	<u>(800)</u>
( 3) Adjusted income and unemployment compensation	\$ 30,200
( 4) Subtract: Base amount for married filing a joint return	<u>(18,000)</u>
( 5) Excess over base amount	<u>\$ 12,200</u>
( 6) One-half of excess over base amount	\$ 6,100
( 7) Amount from line 3 of federal unemployment compensation worksheet	\$ 5,000
( 8) Taxable unemployment compensation (lesser of line 6 or line 7)	<u>\$ 5,000</u>

As a result of recomputing federal adjusted gross income, there is no change in the amount of taxable unemployment compensation.

**Example 2:** A single person receives wages of \$12,400, a state tax refund of \$600 and unemployment compensation of \$1,000 during 1984.

**Federal Return** — The entire \$1,000 of unemployment compensation is taxable, based on the following computation:

( 3) Unemployment compensation received	\$ 1,000
( 4) Add: Federal income other than unemployment compensation	<u>13,000</u>
( 5) Total income and unemployment compensation	\$ 14,000
( 6) Subtract: Adjustments to income	<u>-0-</u>
( 7) Adjusted federal income and unemployment compensation	\$ 14,000
( 8) Subtract: Base amount for a single person	<u>(12,000)</u>
( 9) Excess over base amount	<u>\$ 2,000</u>
(10) One-half of excess over base amount	\$ 1,000
(11) Taxable unemployment compensation (lesser of line 3 or line 10)	<u>\$ 1,000</u>

**Wisconsin Return** — Only \$700 of the person's unemployment compensation is taxable, based on the following computation:

( 1) Amount from line 7 of federal unemployment compensation worksheet	\$ 14,000
( 2) Subtract: State tax refund	<u>(600)</u>
( 3) Adjusted income and unemployment compensation	\$ 13,400
( 4) Subtract: Base amount for a single person	<u>(12,000)</u>
( 5) Excess over base amount	<u>\$ 1,400</u>
( 6) One-half of excess over base amount	\$ 700
( 7) Amount from line 3 of federal unemployment compensation worksheet	\$ 1,000
( 8) Taxable unemployment compensation (lesser of line 6 or line 7)	<u>\$ 700</u>

As a result of recomputing federal adjusted gross income there is a \$300 decrease in the amount of taxable unemployment compensation. Assuming the person claims the standard deduction for Wisconsin, the tax savings as a result of recomputing federal adjusted gross income is \$25.

#### B. Earned Income Credit

**Example 1:** A single person having one dependent and qualifying for federal head of household status has 1984

federal adjusted gross income of \$5,925, which consists of wages of \$5,800 and a state tax refund of \$125. The federal earned income credit is \$500. Based on this amount, the Wisconsin earned income credit is \$150 ( $\$500 \times 30\%$ ).

If the person recomputes federal adjusted gross income by subtracting the state tax refund, federal adjusted gross income is \$5,800 and the federal earned income credit is \$500. Based on this amount, the Wisconsin earned income credit is \$150 ( $\$500 \times 30\%$ ). As a result of recomputing federal adjusted gross income, there is no change in the Wisconsin earned income credit.

**Example 2:** A husband and wife with two dependents report joint federal adjusted gross income for 1984 of \$10,010 which includes a \$160 state tax refund. Because their federal adjusted gross income exceeds \$10,000, they are not eligible for a federal earned income credit.

If they recompute their federal adjusted gross income by subtracting the state tax refund, their federal adjusted gross income is \$9,850 and their federal earned income credit is \$22. Based on this amount, their Wisconsin earned income credit is \$6.60 ( $\$22 \times 30\%$ ). As a result of recomputing federal adjusted gross income, a Wisconsin earned income credit of \$6.60 is allowable. No amount of credit was allowable before the recomputation.

#### C. Child and Dependent Care Credit

**Example 1:** A single person who paid \$2,000 for the care of one dependent reports 1984 federal adjusted gross income of \$14,050, which consists of wages of \$13,830, interest of \$45, and a state tax refund of \$175. Based on federal adjusted gross income of \$14,050, the person is entitled to a federal child and dependent care credit of \$540 ( $\$2,000 \times 27\%$ ). The person's Wisconsin child and dependent care credit is \$162 ( $\$540 \times 30\%$ ).

If the person recomputes federal adjusted gross income by removing the state tax refund, federal adjusted gross income is \$13,875. The federal child and dependent credit is \$560 ( $\$2,000 \times 28\%$ ). The Wisconsin child and dependent care credit is \$168 ( $\$560 \times 30\%$ ). As a result of recomputing federal adjusted gross income, an additional \$6 of Wisconsin child and dependent care credit is allowable.

**Example 2:** A husband and wife paid \$6,000 during 1984 for the care of their two children. They file a joint federal return for 1984 and report the husband's wages of \$40,000, the wife's wages of \$20,000, a state tax refund of \$800, and a rental loss of \$7,000. During 1984 the husband exercised incentive stock options, which resulted in the recognition of \$5,000 of taxable income for Wisconsin purposes. Based on federal adjusted gross income of \$53,800, the couple's federal child and dependent care credit is \$960 ( $\$4,800 \times 20\%$ ). Their Wisconsin child and dependent care credit is \$288 ( $\$960 \times 30\%$ ).

If they recompute their federal adjusted gross income by adding the income from exercising incentive stock options and subtracting the state tax refund, their federal adjusted gross income is \$58,000. Their federal child and dependent care credit is \$960 ( $\$4,800 \times 20\%$ ). Their Wisconsin child and dependent care credit is \$288 ( $\$960 \times 30\%$ ). As a result of recomputing federal adjusted gross income, there is no change in the Wisconsin child and dependent care credit.

**2. Minimum Tax Limited By Tax Benefit Rule**

**Facts:** Section 71.60(2), Wis. Stats., imposes a minimum tax on individuals, trusts and estates on the amount by which the sum of their tax preference items exceeds \$10,000. Tax preference items are adjusted itemized deductions, the capital gain deduction and the following other tax preference items defined in the Internal Revenue Code: accelerated depreciation on real property, accelerated depreciation on leased personal property, circulation and research experimental expenditures, depletion, intangible drilling costs and accelerated cost recovery deductions.

There are situations in which a person derives no tax benefit from a tax preference item. For example, if an individual has no adjusted gross income after deducting accelerated depreciation on real property, and has itemized deductions which are not used, no tax benefit has been derived from the accelerated depreciation to the extent of the unused itemized deductions. As a second example, if an individual has both adjusted itemized deductions and a capital gain deduction, one dollar of capital gain preference will generate more than one dollar of total preferences and hence, may create a situation where claiming a preference deduction may actually result in an increase in the person's tax liability. This is because the determination of adjusted itemized deductions is based in part on adjusted gross income which has been reduced by the capital gain deduction. (To illustrate, assume a person has gross income of \$100,000, a capital gain deduction of \$60,000, adjusted gross income of \$40,000 and itemized deductions of \$40,000. The \$60,000 capital gain deduction will generate total tax preferences of \$76,000, the \$60,000 capital gain deduction plus adjusted itemized deductions of \$16,000.)

**Question:** Does the tax benefit rule limit the application of minimum tax to preference deductions that provide a tax benefit to the taxpayer?

**Answer:** Yes, the minimum tax may be reduced or eliminated if a tax benefit has not been derived from the tax preference items.

A taxpayer must figure his or her "recomputed income" to determine the extent to which the tax preference items reduce taxable income and thereby provide a tax benefit. "Recomputed income" is gross income less all nonpreference deductions, other than those itemized deductions that exceed 100% of adjusted gross income computed without regard to preference deductions. Specifically, recomputed income is the following:

Gross Income	
Less: Nonpreference deductions for Wisconsin adjusted gross income (including the nonpreference net operating loss carryforward)	
Less: Medical, casualty and community development finance authority (CDFA) itemized deductions	
Less: Other itemized deductions (interest, charitable and political contributions and misc. deductions) to the extent of 60% of Wisconsin adjusted gross income computed without regard to preference deductions	
Equals: Recomputed income	

Recomputed income represents the maximum limit on the tax benefit provided by the tax preference items. Minimum tax is computed on the lesser of the recomputed income or the sum of the tax preferences, less the \$10,000 base.

For a husband and wife determining recomputed income, itemized deductions are prorated in the same manner that they are prorated in determining adjusted itemized deductions (see the instructions to Schedule MT, line 1).

**Example:** Assume an individual has the following gross income and deductions:

Gross income	\$ 260,000
Capital gain deduction	(30,000)
Business deductions (all nonpreference)	<u>(130,000)</u>
Adjusted gross income	\$ 100,000
Medical deduction	(10,000)
Other itemized deductions	<u>(150,000)</u>
Net taxable income (loss)	<u>\$ (60,000)</u>

The individual's tax preferences total \$70,000 (the capital gain deduction of \$30,000 plus adjusted itemized deductions of \$40,000).

The individual's first step is to calculate his or her recomputed income to determine whether a tax benefit was derived from the tax preference items:

Gross income	\$ 260,000
Nonpreference deductions for AGI	(130,000)
Medical, casualty and CDFAs deductions	(10,000)
Other itemized deductions to the extent of 60% of WI AGI computed without regard to preference deductions (60% × (AGI of \$100,000 + preference deductions of \$30,000 added back))	<u>(78,000)</u>
Recomputed income	<u>\$ 42,000</u>

The individual's second step is to compare recomputed income with the total tax preferences (these were \$70,000). In this example the recomputed income is less, therefore, \$42,000 is the maximum amount of tax preference items that should be reported on Schedule MT (the individual should attach a schedule to his or her tax return showing how the \$42,000 is computed, and report the amount on 1984 Schedule MT, line 8).

The individual's last step is to compute the minimum tax as follows:

Total tax preference items	\$ 42,000
Less: \$10,000	<u>(10,000)</u>
Subtotal	\$ 32,000
1984 rate	× 5%
Minimum tax	<u>\$ 1,600</u>

**3. Minimum Tax When Taxpayer Has a Net Operating Loss**

**Facts:** Section 71.60(2), Wis. Stats., imposes a minimum tax on individuals, trusts and estates on the amount by which the sum of their tax preference items exceeds \$10,000. Tax preference items include adjusted itemized deductions, the capital gain deduction and the following other tax preference items defined in the Internal Revenue Code: accelerated depreciation on real property, accelerated depreciation on leased personal property, circulation and research experimental expenditures, depletion, intangible drilling costs, and accelerated cost recovery deductions.

When tax preference deductions are claimed, they may result in a Wisconsin net operating loss as defined in s. 71.02(2)(m), Wis. Stats. In a net operating loss situation the Wisconsin minimum tax may be limited in the loss year to tax on the tax preference items that yield a tax benefit (see Tax Release #2 "Minimum Tax Limited by Tax Benefit Rule").

Under s. 71.05(1)(d), Wis. Stats., a net operating loss may be carried forward for up to 5 years. The net operating loss carryforward may be composed of both tax preference and nonpreference deductions. When the net operating loss carryforward is used, any tax preferences included in the carryforward may provide a tax benefit in the year the carryforward is deducted.

**Question 1:** Can the Wisconsin minimum tax be imposed in the year of a net operating loss, and if so, how is it computed?

**Question 2:** When a net operating loss carryforward includes tax preference items, can it result in minimum tax in the year it is deducted? If so, how is the minimum tax computed?

**Answer to Question 1:** Yes, Wisconsin minimum tax can be imposed in the year of a net operating loss. However, minimum tax is limited by the tax benefit rule to tax on preference deductions used to reduce taxable income to zero, and not below zero. See Tax Release #2 "Minimum Tax Limited by Tax Benefit Rule".

**Example:** Assume an individual has the following gross income and deductions:

Gross income (including \$5,000 of non-business income)	\$ 120,000
Accelerated depreciation on real estate (business)	(80,000)
Other business deductions (all nonpreference)	(70,000)
Adjusted gross income	\$ (30,000)
Itemized deductions (all interest)	(10,000)
Net taxable income (loss)	<u>\$ (40,000)</u>

The individual's tax preferences total \$80,000 (accelerated depreciation on real estate). The individual's net operating loss is \$35,000 (loss of \$40,000 plus nonbusiness deductions in excess of nonbusiness income of \$5,000).

The individual will calculate his or her minimum tax as follows:

Gross income	\$ 120,000
Nonpreference deductions for AGI	(70,000)
Itemized deductions to 60% of WI AGI computed without regard to preference deductions (60% × (-30,000 + 80,000) = 30,000, limited to actual deductions)	(10,000)
Recomputed income	<u>\$ 40,000</u>
Lesser of total tax preferences or recomputed income	\$ 40,000
Less: \$10,000	(10,000)
Subtotal	\$ 30,000
1984 rate	× 5%
Minimum tax	<u>\$ 1,500</u>

**Answer to Question 2:** Yes, if a net operating loss carryforward deduction includes tax preference items it can result in a Wisconsin minimum tax in the year the deduction is claimed. This will happen when the tax preference items do not produce a tax benefit in the year of the loss but do produce a tax benefit in the carryforward year.

In the loss year the taxpayer must determine what portion of his or her net operating loss consists of tax preferences. The portion of the net operating loss that consists of tax preferences is calculated as follows:

Total tax preferences for loss year	
Less: \$10,000 base	
Less: Tax preferences included in total above which were subject to the minimum tax in previous years (tax preferences in excess of the \$10,000 base)	
Less: Capital gain deduction included in total above	
Less: Nonbusiness tax preferences and adjusted itemized deductions included in the total above, if the preferences did not become part of the net operating loss	
Equals: Portion of net operating loss deduction that consists of tax preferences (limited to actual net operating loss)	

When the portion of the net operating loss that consists of tax preferences is deducted in the carryforward years, the amount used should be added to other tax preferences for the carryforward year on Schedule MT (for 1984, enter on line 11 of Schedule MT).

Note that the earliest net operating loss carryforwards must be used first. Also, the portion of the net operating loss carryforwards *not* due to tax preferences may be used first.

**Example:** Assume an individual has the following gross income, deductions, and net operating loss:

	Year 1	Year 2
Gross income (including \$20,000 of nonbusiness income)	\$ 100,000	\$ 100,000
Accelerated depreciation on real estate	(20,000)	(10,000)
Depletion	(30,000)	
Capital gain deduction	(20,000)	
Other business deductions	(50,000)	(40,000)
Net operating loss deduction	-0-	(20,000)
Adjusted gross income	\$ (20,000)	\$ 30,000
Medical deduction	(10,000)	
Other itemized deductions	(30,000)	(20,000)
Net taxable income (loss)	<u>\$ (60,000)</u>	<u>\$ 10,000</u>
Net taxable income (loss)	\$ (60,000)	
Add back capital gain deduction	20,000	
Add back nonbusiness deductions in excess of nonbusiness income	20,000	
Net operating loss	<u>\$ (20,000)</u>	