Changing or Revoking Election: A corporation electing to report the profit on a sale on the accrual method will not be permitted to change to the installment method at a later date.

M. PERCENTAGE OF COMPLETION METHOD OF ACCOUNTING - Corporations

Description: Most incorporated contractors are required to report their taxable incomes on the accrual basis. A variation of this method is allowed in computing income from contracts on which work is performed in two or more taxable years. This method is called the percentage of completion method and may be used by contractors if such method clearly reflects income pursuant to s. 71.11(8), 1985 Wis. Stats., and Wis. Adm. Code section Tax 2.21.

Under this method, a portion of the total contract price is treated as sales for the current period, based upon the percentage of completion which is usually determined by an engineer's or architect's estimate. Actual costs, adjusted for inventories of materials on hand at the end of the years, are deducted from the sales to compute taxable income.

When and How Election Made: The election to report on the percentage of completion method is generally made on the first franchise/income tax return filed by the contractor. However, if the contractor has previously reported under another accounting method, a change to the percentage of completion method represents a change in method of accounting which requires prior approval (see "Changing or Revoking Election").

Changing or Revoking Election: A method of accounting may not be changed without written approval of the department. For example, a change from the percentage of completion method to the completed contract method, or vice versa, requires departmental approval prior to the change (Wis. Adm. Code section Tax 2.16).

NOTE: The "completed contract" method is another method of accounting used by incorporated contractors. Although not authorized by rule, the same provisions for making, changing or revoking the election apply to the completed contract method as stated above for the percentage of completion method.

N. DEFERRED PROFIT METHOD OF ACCOUNTING - Corporations

Description: Acceptance corporations and dealers in commercial paper may elect to report their taxable incomes on the deferred profit basis, provided the books are kept on this basis and that both income and attributable expenses are deferred, pursuant to Wis. Adm. Code section Tax 2.20(3) and s. 71.11(8), 1985 Wis. Stats.

Under the deferred profit method, the discount on purchase of commercial paper is credited initially to a deferred profit account, and is transferred from this account to earned income ratably over the life of the paper.

When and How Election Made: Acceptance corporations and dealers in commercial paper reporting on the accrual method do not have to obtain authorization from the Department of Revenue to change to the deferred profit method. To effect the change, the taxpayer must notify the department in writing, before the close of the year in which the change is to be made, of the taxpayer's intent to report on the deferred profit method.

Schedules must be attached to the franchise/income tax return clearly setting forth the unrealized profit accounts and reconciling the income and retained earnings per books with taxable income.

Changing or Revoking Election: The deferred profit method, once elected, must be adhered to consistently thereafter.

O. VALUATION OF INVENTORIES - Corporations

Description: Section 71.11(9), 1985 Wis. Stats., provides that inventories shall be taken whenever, in the opinion of the Department of Revenue, their use is necessary to clearly determine income.

Wis. Adm. Code section Tax 2.25 authorizes the use of (1) the cost method and (2) the lower of cost or market method. Wis. Adm. Code section Tax 2.24 authorizes the retail method of inventory valuation for retail merchants. Wis. Adm. Code section Tax 2.26 authorizes the LIFO (last-in, first-out) method of identifying the particular goods in inventory.

A corporation may elect a method of inventory valuation which conforms to the best accounting practice in the particular trade or business and which clearly reflects income, pursuant to the above law and rules.

When and How Election Made: A new corporation selects the inventory valuation method which it will use when it files its first franchise/income tax return.

An election to use the LIFO method of identifying inventories can be made by filing an application with the Department of Revenue in substantially the same form as required by the Internal Revenue Service. It must be filed with the return for the taxable year as of the close of which the method is first to be used.

Treas. Reg. section 1.472-3 provides that the required statement be made on Form 970 pursuant to the instructions thereon and the requirements of the regulation, or in such manner as may be acceptable to the Internal Revenue Service commissioner. An analysis of beginning and ending inventories is also required by regulation. All provisions of the federal regulation apply for Wisconsin tax purposes.

Changing or Revoking Election: A method of inventory valuation, once chosen, must be adhered to consistently thereafter. Except for corporations reporting on the LIFO method, no change from one method to another can be made without written permission from the Department of Revenue.

Corporations reporting on the LIFO method of valuing inventories, which have been authorized or directed by the Internal Revenue Service to change their method of inventory valuation, shall also do so for Wisconsin tax purposes. Notice of the change in method must be filed with the franchise/income tax return on which it is effective. A copy of the federal authorization or order to change must also be attached to the return (Wis. Adm. Code section Tax 2.26(6)).

P. DECLARATION OF INACTIVITY - Corporations

Description: Section 71.10(1)(b), 1985 Wis. Stats., permits a corporation which has been completely inactive (both within and without Wisconsin) for an entire taxable year to file a Declaration of Inactivity (Form 4H) in lieu of filing a regular franchise/income tax return (Form 4, Form 5, Form 5A). Thereafter, the corporation need not file a franchise/income tax return or Form 4H for any subsequent year unless requested to do so by the Department of Revenue or unless in a subsequent year the corporation has been activated or reactivated.

When and How Election Made: The election is made by filing Form 4H with the Department of Revenue on or before the 15th day of the third month following the close of the taxable year. If not filed by the due date, a $10 late filing fee is due. If Form 4H is due on or after July 20, 1985 and is filed 60 or more days late, a $20 late filing fee is due.

Form 4H should be mailed to the Wisconsin Department of Revenue, Post Office Box 8908, Madison, Wisconsin 53708.

Section 71.10(1)(b), 1985 Wis. Stats., provides a civil penalty of $25 against the corporate officers, jointly and severally, for filing a false declaration, or for each failure to file a franchise/income tax return or to file required information returns, upon activation or reactivation.

Changing or Revoking Election: If the corporation is activated or reactivated, the corporation is required to file regular franchise/income tax returns thereafter, pursuant to s. 71.10(1), 1985 Wis. Stats.

Q. DISTRIBUTIONS OF STOCK AND STOCK RIGHTS - Corporations and Individuals

Description: Section 71.305(1), 1985 Wis. Stats., provides, under a general rule, that a distribution to shareholders by a corporation of its stock or rights to acquire stock, is not taxable. However, a distribution in lieu of money is taxable under s. 71.305 (2), 1985 Wis. Stats., if:

(1) In discharge of preference dividends, or
(2) The shareholder elects to receive stock (or stock rights), or property.

Section 71.307(1), 1985 Wis. Stats., provides that if the distribution of stock (or rights) is not taxable, the basis of the new stock is determined by allocating the basis of the old stock between the old and new stock.

Section 71.307(2), 1985 Wis. Stats., provides that if the fair market value of the stock rights is less than 15% of the fair market value of the old stock, the above allocation is not made and the basis of the rights will be zero. However, a shareholder may elect to allocate the basis between the old stock and the new rights.

When and How Election Made: The election to allocate part of the basis of the old stock to the rights is made by attaching a statement to the shareholder's franchise/income tax return filed by the due date (including extensions) for the years in which the rights are received.

Pursuant to Wis. Adm. Code section Tax 2.53, the statement must contain the following information:

(1) The number of old shares owned on the distribution date,
(2) The basis of the old shares, and
(3) The fair market value of the old shares, and of the rights, on the distribution date.

The election is made with respect to all rights received in a particular distribution in respect of all stock of the same class owned in the issuing corporation at the time of such distribution.

Changing or Revoking the Election: The election, once made, is irrevocable.

R. GAIN ON CORPORATE LIQUIDATION - Corporations and Individuals

Description: Section 71.333, 1985 Wis. Stats., provides that qualified electing shareholders (corporate or non-corporate) may avail themselves of partial non-recognition of gains on property distributed within one calendar month in complete liquidation of a corporation.

A corporate shareholder qualifies if corporate shareholders owning 80% of the combined voting power owned by corporate shareholders (other than excluded corporations) have filed written notices of election. If the owners of 80% or more have elected, then all which have elected qualify. An excluded corporation is one which, at any time between January 1, 1955 and the date of adoption of a plan of liquidation, owned 50% or more of the combined voting power of all classes of stock of the liquidating corporation.

A non-corporate shareholder qualifies if notices of election have been filed by such shareholders owning 80% or more of the total combined voting power owned by all non-corporate shareholders.

Qualified electing shareholders are taxed on their gain only to the extent of the greater of the following:

(1) The portion of the assets received which consists of money, or of stock or securities acquired by the liquidating corporation after January 1, 1955, or
(2) The shareholder's ratable share of the earnings and profits of the liquidating corporation accumulated after January 1, 1911, determined as of the close of the month in which liquidation occurs, without reduction for any distributions made during the month.

When and How Election Made: Wis. Adm. Code section Tax 2.83 provides that, to qualify for the benefits of s. 71.333, 1985 Wis. Stats., a qualified electing shareholder must file with the Wisconsin Department of Revenue within 30 days of the adoption of the plan of liquidation, a copy of federal Form 964 "Election of Shareholder Under Section 333 Liquidation" in accordance with the instructions thereon.

Another copy of the federal Form 964 must be attached to the shareholder's Wisconsin income or franchise tax return for the taxable year in which the transfer of all the property under the liquidation occurs.

The completed Forms 964 should be mailed to the Wisconsin Department of Revenue, Post Office Box 8908, Madison, Wisconsin 53708.

Changing or Revoking the Election: The election, once made, is irrevocable.

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2. Limitations on Travel, Entertainment and Gift Expenses

Statutes: Sections 71.01(4)(a)6m, 71.04(2)(b) and 71.05(1)(a)27, 1985 Wis. Stats .

Note: This Tax Release applies only with respect to taxable years 1986 and thereafter.

Background: Sections 71.01(4)(a)6m., 71.04(2)(b) and 71.05(1)(a)27., 1985 Wis. Stats., were created by 1985 Wisconsin Act 29. These statutes provide the following:

A. Deductions are not allowed for entertainment expenses other than admissions to organized athletic events or other public events or performances that take place in Wisconsin.

B. Deductions for business meals are limited to those meals which occur in a clear business setting. The amount deductible is limited to $25 plus half the meal expense over $25 per meal per person.

C. Deductions are not allowed for travel expenses of trips lasting one year or more in one city.

D. Deductions are limited for travel by luxury water transportation.

E. Deductions are not allowed for travel expenses in regard to conventions, meetings or seminars held on cruise ships unless such expenses are paid by an employer and the payment is treated as wages paid to an employe.

F. Deductions are not allowed for travel as a form of education.

G. Deductions for business gifts are not allowed other than for gifts of Wisconsin agricultural commodities not to exceed $15 per gift per recipient.

The limitations in A through F above apply to individuals (employes and self-employed persons), partnerships, tax-option (S) corporations, estates, trusts and corporations. Item G above applies only to corporations, including tax-option (S) corporations.

This tax release is divided into eight parts. The first part illustrates how the limitations apply in reimbursement situations. The remaining parts explain each of the above limitations (A-G) individually.

Part I

GENERAL When a reimbursement situation exists between an employe and an employer or between an independent contractor and customers or clients, the limitations on entertainment, business meals, travel or gift expenses apply as explained below. A chart at the end of this tax release summarizes the various reimbursement situations between an employer and employe.

Question 1: Will the travel, entertainment, business meal and gift expense limitations apply to an employe, employer, or both when an employe is being fully reimbursed by his or her employer for expenses which are fully or partially nondeductible for Wisconsin tax purposes?

Answer 1: The limitations apply only to the employer except as described below. It makes no difference whether the employe "accounts" or "does not account," per federal definitions, to his or her employer.

Exception: If the employer treats the expenditure as compensation and wages paid to the employe, the limitations apply to the employe, not the employer.

Example 1: An employe incurs expenses for entertainment that are deductible for federal tax purposes but not deductible for Wisconsin tax purposes. The employer reimburses the employe for the entire entertainment expense but does not treat the reimbursement as wages. The limitations on the entertainment will apply to the employer.

Example 2: Assume the same facts as in Example 1 except that the employer includes the reimbursement as wages on the employe's W-2 form. The Wisconsin limitation will apply to the employe, not to the employer.

Question 2: Will the limitations apply to an employe, an employer or both when an employe is partially reimbursed by his or her employer for an expense which is completely nondeductible for Wisconsin tax purposes?

Answer 2: The limitations apply to both the employe and employer except as described below. The employer may not deduct the portion of the expense reimbursed. The employe may not deduct the portion of the expense for which he or she did not receive reimbursement.

Exception: If the reimbursement is treated as compensation and wages paid to the employe, the limitations apply to the employe, not the employer.

Example 1: An employe incurs $1,000 of entertainment expenses that are not deductible for Wisconsin tax purposes. His or her employer reimbursed $600 of the expenses and did not treat the reimbursement as compensation and wages. Neither the employe nor the employer is allowed to deduct the entertainment expenses. The employer may not deduct the $600 reimbursement paid to the employe. The employe may not deduct the $400 ($1,000 – $600) of net expense he or she incurred.

Example 2: Assume the same facts as in Example 1 except the employer includes the reimbursement as wages on the employe's W-2 form. The employer deducts $1,000 as wage expense. The employe reports the $1,000 as wages but may not claim any deduction for the entertainment expenses.

Question 3: Will the limitations apply to an employe, employer or both when an employe is partially reimbursed by his or her employer and only a portion of the expense incurred by the employe is not deductible for Wisconsin tax purposes?

Answer 3a: If the expense relates solely to the employe (e.g., meal expenses incurred by an employe in travel status who eats alone), and

a) Reimbursement exceeds the portion of total expense allowable as a deduction - the limitations apply to both the employer and employe. The employer may not deduct the portion of the reimbursement that exceeds the deductible expense. The employe may not deduct the portion of the expense for which he or she did not receive reimbursement.

Exception: If the employer treats the expense as compensation and wages paid to the employe, the limitations apply to the employe, not the employer.

b) Reimbursement does not exceed the portion of total expense allowable as an expense - the limitations apply only to the employe.

Example 1: An employe in travel status incurs a meal expense of $50 and was reimbursed $40 by his or her employer. The employe dined alone. The deductible meal expense is $37.50 ($12.50, which is one-half of the $50 expense exceeding $25, is not deductible). The employer's deduction for the meal reimbursement is limited to $37.50. Therefore, the employer is not allowed to deduct $2.50 ($40 – $37.50) of the reimbursement paid to the employe. The employe is not allowed to deduct the $10 ($50 – $40) of expense for which he or she did not receive reimbursement.

Example 2: Assume the same facts as Example 1 except that only $37.50 of the meal expense was reimbursed by the employer. The employer would be allowed to deduct the full reimbursement because the amount reimbursed did not exceed the portion of total expense deductible. The employe is not allowed to deduct $12.50 ($50 – $37.50) of the total expense he or she paid.

Answer 3b: If the expense relates to the employe and others (e.g., customers or clients), the limitations apply to both the employe and employer except as described below. The employer may not deduct a portion of the reimbursement based on the following equation:

$$\frac{\text{Reimbursement}}{\text{Total expense}} \times \text{Expense not deductible} = \text{Amount which may not be deducted}$$

The employe may not deduct a portion of his or her expense based on the following equation:

$$\frac{\text{Expense not reimbursed}}{\text{Total expense}} \times \text{Expense not deductible} = \text{Amount which may not be deducted}$$

Exception: If the expense is treated as compensation and wages paid to the employe, the limitations apply to the employe, not the employer.

Example 1: An employe receives a monthly allowance of $1,000 which is used to entertain clients. The employe incurs $1,500 of expenses. A nondeductible amount of $600 is determined for Wisconsin purposes. The employe may not deduct $200 ($500/$1,500 x $600). The employer may not deduct $400 ($1,000/$1,500 x $600).

Example 2: Assume the same facts as in Example 1 except that the employer treats the reimbursement as wages on the employe's W-2 form. The employer deducts $1,000 as wage expense. The employe reports the $1,000 as wages and may claim a deduction of $900 ($1,500 – $600).

Question 4: An employe receives no reimbursement from his or her employer for entertainment expenses he or she incurred. The entertainment expenses are deductible for federal tax purposes and are partially or fully not deductible for Wisconsin tax purposes. Do the limitations apply to the employe, employer or both?

Answer 4: The limitations apply only to the employe.

Question 5: Will the limitations apply to an independent contractor, his or her customers or clients, or both when an independent contractor is being reimbursed by his or her customers or clients for expenses not deductible for Wisconsin tax purposes?

Answer 5: If the independent contractor does not "account" (itemize all expenses) to the client or customer, the limitations apply to the independent contractor. If the independent contractor does "account" to the client or customer, the limitations apply to the client or customer.

Example 1: A manufacturer's representative deducts certain travel expenses for federal tax purposes that are not deductible for Wisconsin tax purposes. The manufacturer's representative accounts to his or her client itemizing all expenses he or she incurred. The client reimburses the manufacturer's representative for the entire amount of travel expenses he or she incurred. The limitations apply to the client.

Example 2: Assume the same facts as Example 1 except the manufacturer's representative does not account to his or her client; instead, the client gives the independent contractor a monthly allowance to use as he or she wishes. The limitations apply to the manufacturer's representative.

Question 6: A multistate company incurs various expenses for travel, business meals, entertainment and gifts that are deductible for federal purposes but are not deductible for Wisconsin tax purposes. Will the limitations apply to only those expenses relating to Wisconsin or to all expenses incurred by the multistate company?

Answer 6: All travel, entertainment and gift expenses, whether or not the expenses are incurred in Wisconsin or elsewhere or by employes located in Wisconsin or elsewhere, are subject to the Wisconsin limitations.

Question 7: A Wisconsin taxpayer is a partner in an out-of-state partnership. The partnership incurs various travel and entertainment expenses that are not deductible for Wisconsin tax pur-

poses. The partnership does not file Wisconsin partnership returns and is not required to do so. To whom do the Wisconsin limitations apply?

Answer 7: Because the partnership is incurring the expense, the partnership would be subject to the Wisconsin limitations; however, this is not possible because the partnership does not file a Wisconsin partnership return. The Wisconsin partner of a partnership which conducts no business in Wisconsin is not subject to the limitations on his or her Wisconsin individual income tax return. This principle will also apply to a Wisconsin shareholder in an out-of-state tax-option (S) corporation that is not required to file a Wisconsin franchise or income tax return.

Part II

ENTERTAINMENT EXPENSES (Sections 71.01(4)(a)6m. a., 71.04(2)(b)11 and 71.05(1)(a)27.a, 1985 Wis. Stats.). Expenses allowable for federal tax purposes with respect to an activity, except admissions to an organized athletic event or other public event or performance that takes place in Wisconsin, that is of the type generally considered to constitute entertainment, amusement or recreation, or with respect to a facility used in connection with those activities, except to the extent that food, beverage and facility expenses are allowed as a deduction for business meals (see Part IV, BUSINESS MEALS, below), are not deductible for Wisconsin tax purposes.

Question 1: For purposes of entertainment expense limitations, will entertainment meals be subject to the entertainment expense limitations?

Answer 1: No. Expenses for all meals are subject to the limitations explained in Part IV, "BUSINESS MEALS", below.

Question 2: The law relating to entertainment expense provides that entertainment expenses are generally not deductible except for certain admission expenses and to the extent that food, beverage and facility expenses are allowed as a deduction for business meal expenses. Since there is no mention of facility expense in the business meal portion of the law, are facility expenses allowed as entertainment deductions?

Answer 2: No. Facility expenses are not allowed as a deduction with one exception. Expenses for facilities used in providing meals for employes, on an employer's premises, are still deductible in full as stated in the Part IV, "BUSINESS MEALS" introduction, below.

Question 3: A taxpayer owns a yacht which is used exclusively for entertaining clients. For federal tax purposes, the taxpayer deducts interest on a loan used to purchase the yacht. The operating expenses (including depreciation) are not deductible for federal tax purposes. May the taxpayer deduct the interest for Wisconsin tax purposes?

Answer 3: No. Interest paid on a loan used to purchase an entertainment facility is not deductible for Wisconsin tax purposes. While federal law as of December 31, 1985 provides that interest, taxes and casualty losses on an entertainment facility used in connection with a trade or business are deductible, Wisconsin law does not allow a deduction for all expenses with respect to an entertainment facility.

Question 4: A company owns a swimming pool which is used primarily by its employes. For federal tax purposes, the taxpayer deducts all interest, taxes and the costs of operating the pool, including depreciation and maintenance. The company sells the pool in 1986 and claims a loss on its federal tax return. Are any of the expenses or the loss on the sale allowable for Wisconsin purposes?

Answer 4: No. A loss on the sale of an entertainment facility is an expense with respect to the facility. Thus for Wisconsin tax purposes the taxpayer may not deduct the loss on the sale of the swimming pool or any of the expenses for interest, taxes and operating costs, including depreciation and maintenance.

Question 5: A taxpayer incurs expenses in giving a party (e.g., Christmas party, summer picnic) to his or her employes. The taxpayer deducts the cost on his or her federal income tax return. Do the Wisconsin entertainment limitations apply?

Answer 5: No. Such entertainment is considered to be a "de minimus fringe benefit." These fringe benefits are considered to be wages and compensation to the employe but are excluded from the employe's federal income. Because such entertainment is considered wages and compensation to employes, the limitations on entertainment expenses do not apply.

Question 6: An employe, who is an outside salesperson, takes several customers to the local golf course to play golf and discuss business. The cost of the outing is $125. The employe is reimbursed $50 by his or her employer which is not treated as wages on the employe's W-2 form. The employe takes a deduction on his or her federal tax return of $75 and the employer takes a deduction of $50 for federal tax purposes. How will the limitations apply for Wisconsin tax purposes?

Answer 6: The cost of golfing is a nondeductible entertainment expense for Wisconsin tax purposes. The employe and employer will not be allowed their entire deductions of $75 and $50, respectively, for Wisconsin tax purposes.

Part III

BUSINESS GIFTS (Sections 71.01(4)(a)6m.b and 71.04(2)(b)12, 1985 Wis. Stats.). Business gifts allowable for federal tax purposes are not deductible for Wisconsin tax purposes except for business gifts of Wisconsin agricultural commodities, not to exceed $15 per recipient per year.

Note: These provisions apply only to corporations, including tax-option (S) corporations.

Question 1: What are Wisconsin agricultural commodities?

Answer 1: Wisconsin agricultural commodities are defined in s. 96.01(3), 1985 Wis. Stats., as "any agricultural, horticultural (excepting floriculture), viticultural, vegetable, poultry and livestock produced in this state, including milk and milk products, bees and honey, or any class, variety or utilization thereof, either in their natural state or as processed by a producer for the purpose of marketing such product or by a processor, but not including timber and wood products."