

customers, and not the tapes themselves. *Data Center* therefore controls the decision.

The department has appealed this decision to the Supreme Court.



## 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.)*

The following Tax Releases are included:

### Individual Income Taxes

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2. Reporting Gain on the Sale of a Home Under Wisconsin's Marital Property Law (p. 13)

### Individual and Corporation Franchise or Income Taxes

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### Corporation Franchise or Income Tax

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## INDIVIDUAL INCOME TAXES

### 1. Reclassifying Income Received Under Wisconsin's Marital Property Law

Statutes: Sections 71.02(2)(me) and 71.11(2m) and (2r), Stats. (1985-86), as amended by 1987 Wisconsin Act 393

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

Background: Generally, under Wisconsin's marital property law, income of spouses received up until the date of divorce is marital property and one-half is reportable by each spouse. However, certain income may be classified as individual property by a marital property agreement, unilateral statement, or court decree. Income classified as individual property is reportable by the owner.

Facts: A husband and wife, who have been separated since January 1987, are divorced on May 31, 1988. The husband earned wages of \$15,000 from January 1 to May 30, 1988, and \$25,000 thereafter. The wife earned wages of \$2,000 from January 1 to May 30, 1988, and \$8,000 thereafter. Incorporated into their divorce decree is a property settlement agreement which provides that the wages earned up until the date of divorce are individual income and must be reported by the wage earner on his or her tax return.

**Question 1:** Does this court order, which classifies the spouses' wages as individual property, apply for Wisconsin income tax purposes?

**Answer 1:** No. The court order would not apply for Wisconsin income tax purposes, since for tax purposes spouses may not agree to retroactively reclassify income previously received.

**Question 2:** What amount of wages must the spouses report on their 1988 Wisconsin individual income tax returns?

**Answer 2:** The amount of wages reportable by the spouses on their individual returns depends on whether the spouses notified each other of the amount and nature of their marital property income.

A. If both spouses notified the other of the amount and nature of their marital income—

	Total	Husband	Wife
Husband's wages 1/1-5/30	\$15,000	\$7,500	\$ 7,500
Husband's wages 5/31-12/31	25,000	25,000	-0-
Wife's wages 1/1-5/30	2,000	1,000	1,000
Wife's wages 5/31-12/31	8,000	-0-	8,000
Total	<u>\$50,000</u>	<u>\$33,500</u>	<u>\$16,500</u>

B. If the husband notified the wife of his marital property income but the wife didn't notify the husband of her marital property income—

	Total	Husband	Wife
Husband's wages 1/1-5/30	\$15,000	\$ 7,500	\$ 7,500
Husband's wages 5/31-12/31	25,000	25,000	-0-
Wife's wages 1/1-5/30	2,000	-0-	2,000
Wife's wages 5/31-12/31	8,000	-0-	8,000
Total	<u>\$50,000</u>	<u>\$32,500</u>	<u>\$17,500</u>

C. If the wife notified the husband of her marital property income but the husband didn't notify the wife of his marital property income—

	Total	Husband	Wife
Husband's wages 1/1-5/30	\$15,000	\$15,000	\$ -0-
Husband's wages 5/31-12/31	25,000	25,000	-0-
Wife's wages 1/1-5/30	2,000	1,000	1,000
Wife's wages 5/31-12/31	8,000	-0-	8,000
Total	<u>\$50,000</u>	<u>\$41,000</u>	<u>\$ 9,000</u>

D. If neither spouse notified the other of the amount and nature of their marital property income—

	Total	Husband	Wife
Husband's wages 1/1-5/30	\$15,000	\$15,000	\$ -0-
Husband's wages 5/31-12/31	25,000	25,000	-0-
Wife's wages 1/1-5/30	2,000	-0-	2,000
Wife's wages 5/31-12/31	8,000	-0-	8,000
Total	<u>\$50,000</u>	<u>\$40,000</u>	<u>\$10,000</u>

**Question 3:** If the husband was required to pay the wife \$5,000 of alimony between January 1, 1988, and May 30, 1988, is this amount deductible by the husband and taxable to the wife?

**Answer 3:** No. The \$5,000 of alimony paid up until the date of divorce is not deductible by the husband nor taxable to the wife. Until the payor spouse's payments exceed one-half of the total combined marital property income (in this case, \$17,000), there has been no transfer recognized for tax purposes. The husband's payment merely gave the wife control of the \$5,000, not ownership, which she already had under the marital property law. This position is consistent with that of the Internal Revenue Service (see IRS Publication 504). The answer would be unchanged even if the "innocent spouse" rules in sec. 71.11(2m) and (2r), Stats. (1985-86), as amended by 1987 Wis. Act 393, apply since those provisions do not reclassify marital property income to individual income.



## 2. Reporting Gain on the Sale of a Home Under Wisconsin's Marital Property Law

**Facts and Question:** A husband and wife were married in 1984. In 1974, while single, the husband bought a home. He made major improvements to the home between 1974 and 1980. No improvements were made after 1984. In December 1986, the home was sold at a gain of \$25,000, which was computed as follows:

Selling price	\$45,000
Cost plus improvements	20,000
Gain on sale	<u>\$25,000</u>

Title to the home was in the husband's name alone. Mortgage payments were made from the husband's wages, which in 1986 were classified as marital property. No marital property agreement, unilateral statement, or court order reclassifying the property exists.

The couple is divorced in 1988. The husband intends to buy a replacement home, but the wife doesn't.

How must the gain on the sale of the home be reported?

**Answer:** The treatment of the gain on the sale of the home depends on how the property is classified. Is it marital, individual, mixed, or unclassified (and thus treated "as if" individual) property?

The Wisconsin Marital Property Act presumes that all property of spouses is marital property (sec. 766.31(2), Stats. (1985-86)). However, this presumption may be rebutted, either by the taxpayer or by the department, when there is adequate proof to show that the property's classification is something other than marital property. In the case of mixed property (property having marital and nonmarital components), the property is entirely reclassified to marital property if the nonmarital component cannot be traced (sec. 766.63(1), Stats. (1985-86)).

The following steps would be taken to classify the home in this instance:

Step 1. Establish the determination date for the spouses: January 1, 1986.

Step 2. Establish the initial classification: The home is predetermination date property because it was acquired before January 1, 1986.

Step 3. Establish whether an agreement, statement, gift, or court order affects the initial classification: No.

Step 4. Establish whether mixing has occurred: Yes, mixing has occurred because the taxpayer used wages (marital property) for the mortgage payments made during 1986. Since it appears that the marital and nonmarital components can be traced, the home would be classified as mixed property.

Step 5. Establish the value of the marital and nonmarital components: Wisconsin's marital property law does not specify how this is to be done. Instead, it will be up to the courts to determine, on a case-by-case basis, the value of the marital and nonmarital components of mixed property. Under sec. 766.63(1), Stats. (1985-86), the burden is on the party objecting to the classification of the asset as marital property to show how much is not marital property. The department may rely on the presumption, if the evidence is determined to be inadequate, or it may take the position that the Tax Appeals Commission must determine the amount of nonmarital property in the mixed asset.

If the home in this example is presumed to be marital property, one-half of the gain would be allocated to each spouse. The husband could defer his \$12,500 gain if he purchases a qualifying replacement home. The wife would be taxed on her \$12,500 gain if she doesn't purchase a replacement home. However, if the spouses can show the value of the marital and nonmarital components, the non-marital component plus one-half of the marital component would be allocated to the husband and the other half of the marital component would be allocated to the wife. The department's position coincides with the Internal Revenue

Service's position, based on conversations with federal personnel.

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## INDIVIDUAL AND CORPORATION FRANCHISE OR INCOME TAXES

### 1. Deductibility of Federal Minimum Tax

**Statutes:** Sections 71.02(2)(c), (d) and (i) and 71.04(3), Stats. (1985-86), sec. 71.02(1)(bg), Stats. as created by 1987 Wis. Act 27 and sec. 71.02(1)(c) and (3), Stats. (1985-86) as amended by 1987 Wis. Acts 27 and 399

**Facts and Question:** Section 55 of the Internal Revenue Code (IRC) imposes an alternative minimum tax on all taxpayers which is equal to the amount by which the minimum tax exceeds the regular tax for the taxable year.

Is this federal alternative minimum tax deductible for Wisconsin tax purposes?

**Answer: Persons other than corporations** - No. Sections 71.02(1)(c) and (d), Stats. (1985-86), as amended by 1985 Wis. Acts 27 and 399 and sec. 71.02(2)(c), (d) and (i), Stats. (1985-86), provide that Wisconsin adjusted gross income or net income is determined under the Internal Revenue Code in effect on a given date. In the case of *Trainer vs. U.S.*, the U.S. Court of Appeals held that the federal minimum tax is an income tax and not an excise tax. It cannot be deducted for federal tax purposes under IRC Section 275. Therefore, because the tax is not deductible for federal tax purposes in determining adjusted gross income, it is not deductible for Wisconsin tax purposes.

**Corporations (Prior to 1987 taxable year)** - No. Section 71.04(3), Stats. (1985-86), provides that income taxes are not deductible. Because the federal alternative minimum tax is an income tax, it is not deductible for Wisconsin tax purposes.

**Corporations (1987 taxable year and thereafter)** - No. Section 71.02(1)(bg), Stats., as created by 1987 Wis. Act 27, and sec. 71.02(1)(c), Stats. (1985-86) as amended by 1987 Wis. Acts 27 and 399 provide that a corporation's net income is computed under the Internal Revenue Code in effect on a given date. Therefore, because the federal alternative minimum tax is not deductible for federal tax purposes, it is not deductible for Wisconsin tax purposes.

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## CORPORATION FRANCHISE OR INCOME TAXES

### 1. Bad Debt Deduction Transitional Adjustments Required for Certain Financial Institutions

**Statutes:** Section 71.02(1)(bg), Stats., as created by 1987 Wis. Act 27, sec. 71.02(1)(c), Stats. (1985-86) as amended by 1987 Wis. Acts 27 and 399, sec. 71.04(7) and (9)(b), Stats. (1985-86), and sec. 3047(1)(a), 1987 Wisconsin Act 27

**Background:** For 1986 and prior taxable years, savings and loan associations, mutual savings banks, production credit associations, and credit unions were allowed to claim a bad debt deduction of either (a) two-thirds of the amount they were required to allocate to their loss reserves pursuant to statutory provisions or rules and regulations or orders of any state or federal governmental supervisory authority (sec. 71.04(9)(b), Stats. (1985-86)), or (b) the actual bad debts sustained during the year (sec. 71.04(7), Stats. (1985-86)).

For the 1987 taxable year and thereafter, sec. 71.02(1)(bg), Stats., as created by 1987 Wis. Act 27 and sec. 71.02(1)(c), Stats. (1985-86) as amended by 1987 Wis. Acts 27 and 399, provide that Wisconsin corporation net income is determined under the Internal Revenue Code (IRC) as amended to December 31, 1986, with certain exceptions. Therefore, for the 1987 taxable year, financial institutions must determine their deduction for bad debts under the method allowed by the IRC as amended to December 31, 1986.

Sections 585 and 593 of the IRC as amended to December 31, 1986, provide that financial institutions, other than large banks, are allowed to deduct bad debts on either the specific charge-off method or an allowable reserve method. A bank, for purposes of the deduction for bad debts, is a large bank if the average adjusted bases of all assets of the bank exceeded \$500,000,000 or the bank was a member of a parent-subsidiary controlled group and the average adjusted bases of the group exceeded \$500,000,000. Large banks must use the specific charge-off method.

As a result of the change in the Wisconsin corporate franchise or income tax law for the 1987 taxable year, a nonstatutory transitional provision in sec. 3047(1)(a) of 1987 Wisconsin Act 27 provides that each corporation must calculate, as of the close of its 1986 taxable year, the amount that, because of the Wisconsin law change, is required to be added to, or subtracted from, income in order to avoid the double inclusion, or omission, of any item of income, loss, or deduction. If the amount required to be added or subtracted (transitional adjustment) is \$25,000 or less, the amount must be added or subtracted for taxable year 1987. If the transitional adjustment is more than \$25,000, it must be added or subtracted ratably over 5 taxable years beginning with 1987.

**Facts and Question 1:** Corporation X, a calendar year Wisconsin savings and loan association incorporated on January 1, 1967, deducts bad debts on a reserve method for federal income tax

purposes. Corporation X made annual additions to the bad debt reserve of \$100,000 for each year from 1967 through 1986 for a total deduction of \$2,000,000. For each of 10 years, actual bad debt losses of \$80,000 were charged off. For each of the other 10 years, actual bad debt losses of \$50,000 were charged off. Therefore, the federal bad debt reserve balance was \$700,000 on December 31, 1986.

For Wisconsin tax purposes, for the 20 years prior to the 1987 taxable year, the actual bad debt losses of \$80,000 were deducted for 10 years and a bad debt deduction of two-thirds of the addition to the federal insurance reserve (\$66,667) was deducted for the other 10 years for a total deduction of \$1,466,670 for the 20 year period.

Since, for the 1987 taxable year and thereafter, the Wisconsin deduction for bad debts is determined under the IRC, what adjustment, if any, is necessary in order to account for the difference between the federal and Wisconsin bad debt deductions for 1986 and prior years?

**Answer 1:** The difference of \$533,330 (total federal deductions of \$2,000,000 minus total Wisconsin deductions of \$1,466,670) should be subtracted, as a transitional adjustment, in arriving at Wisconsin net income in order to prevent the omission of a deduction. The \$533,330 is netted with any other required transitional adjustments. If the total adjustment is greater than \$25,000, the adjustment is amortized ratably over 5 taxable years, starting in 1987. Assuming that the bad debt adjustment is the only transitional adjustment required to be made by Corporation X, \$106,666 should be deducted in arriving at Wisconsin net income for 1987 and each of the next 4 taxable years.

**Facts and Question 2:** Corporation A, a calendar year Wisconsin savings and loan association incorporated in 1980, deducts bad debts on a reserve method for federal income tax purposes and had a reserve balance of \$420,000 on December 31, 1986. For 1986 and prior taxable years, the Wisconsin bad debt deduction claimed by Corporation A was always two-thirds of the amount transferred to its federal insurance reserve. The balance of the Wisconsin bad debt reserve was \$280,000 on December 31, 1986. The Wisconsin reserve balance is determined by increasing the reserve by two-thirds of the amount transferred to the federal insurance reserve for each year (1980 through 1986), reducing the reserve by the bad debts actually charged off during each year, and increasing the reserve by the amount of any recoveries of amounts previously charged off.

Since, for the 1987 taxable year and thereafter, the Wisconsin deduction for bad debts is determined under the IRC, what adjustment, if any, is necessary in order to account for the difference between the federal and Wisconsin bad debt reserve on December 31, 1986?

**Answer 2:** Since the federal reserve exceeds the Wisconsin reserve, the difference (\$140,000) should be subtracted, as a

transitional adjustment, in arriving at Wisconsin net income in order to prevent the omission of a deduction. The \$140,000 is netted with any other transitional adjustments that are required. If the total adjustment is greater than \$25,000, the adjustment is amortized ratably over 5 taxable years, starting in 1987. Assuming that the bad debt adjustment is the only transitional adjustment required to be made by Corporation A, \$28,000 should be deducted in arriving at Wisconsin net income for 1987 and each of the next 4 taxable years.

**Facts and Question 3:** Corporation B, a calendar year bank located in Wisconsin, deducts bad debts on a reserve method for federal purposes and had a reserve balance of \$300,000 on December 31, 1986. For 1986 and prior taxable years, the Wisconsin bad debts were deducted on the direct write-off method.

Since, for the 1987 taxable year and thereafter, the Wisconsin deduction for bad debts is determined under the IRC, what adjustment, if any, is necessary in order to account for the federal bad debt reserve of \$300,000 on December 31, 1986?

**Answer 3:** Since for 1987, the Wisconsin bad debt deduction will be on the reserve method and since the \$300,000 has not previously been deducted for Wisconsin corporate franchise or income tax purposes, the \$300,000 should be subtracted, as a transitional adjustment, in arriving at Wisconsin net income. Assuming that this is the only transitional adjustment required to be made by Corporation B, \$60,000 should be deducted in arriving at Wisconsin net income for 1987 and each of the next 4 taxable years.

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## 2. Deductible Dividends Received From Subsidiaries

**Statutes:** Section 71.04(4)(b), Stats. (1985-86), and sec. 71.02(1)(bg)11, Stats., as created by 1987 Wis. Act 27

**Law:** Section 71.02(1)(bg)11, Stats., as created by 1987 Wis. Act 27, provides in part that a corporation may deduct from its income, dividends received from a corporation with respect to its common stock if the corporation receiving the dividends owns, directly or indirectly, during the entire taxable year at least 80% of the total combined voting stock of the payor corporation. Prior to 1987 Wisconsin Act 27, which created sec. 71.02(1)(bg)11, the same deduction was allowed by sec. 71.04 (4)(b), Stats., (1985-86). However, the deduction under sec. 71.04 (4)(b) was limited to cash dividends, while under sec. 71.02 (1)(bg)11, which is effective for the 1987 taxable year and thereafter, both cash and property dividends may be deducted if the conditions are met.

**Facts and Question 1:** Corporation A does business in Wisconsin

and files its Wisconsin franchise tax return on a calendar year basis. On March 1, 1987, Corporation A forms a new subsidiary, Corporation B. Corporation A holds 100% of the voting stock of Corporation B from March 1, 1987, through December 31, 1987. Corporation B does not apportion more than 50% of its net income to Wisconsin for 1987.

If Corporation B pays Corporation A \$100,000 of common stock dividends on December 1, 1987, is the \$100,000 deductible by Corporation A in determining its Wisconsin net income for 1987?

**Answer 1:** No. Since Corporation A did not own during the entire taxable year at least 80% of the total combined voting stock of Corporation B, the \$100,000 of dividends received is not deductible in arriving at Wisconsin net income.

**Facts and Question 2:** Corporation X, a calendar year Wisconsin holding company, formed a subsidiary, Corporation Y, in Ohio during 1986. Corporation X owned 100% of the stock of Corporation Y for all of 1987. On July 1, 1987, Corporation Y acquired 100% of the stock of Corporation Z, a Texas corporation. Neither Corporation Y nor Corporation Z conducts any business in Wisconsin.

On September 1, 1987, Corporation Z paid Corporation Y \$50,000 of common stock dividends. On December 15, 1987, Corporation Y paid Corporation X \$100,000 of common stock dividends. Part of the \$100,000 in dividends paid by Corporation Y to Corporation X is comprised of the \$50,000 of dividends paid by Corporation Z to Corporation Y.

Is the \$100,000 of dividends received from Corporation Y deductible by Corporation X in arriving at its Wisconsin net income for 1987 even though the dividends are comprised of dividends received from Corporation Z, the stock of which was not owned by Corporation Y for all of 1987?

**Answer 2:** Yes. Since Corporation X owned at least 80% of the total combined voting stock of Corporation Y during the entire 1987 taxable year, the \$100,000 of dividends received from Corporation Y is deductible in arriving at the 1987 Wisconsin net income of Corporation X. The fact that part of the dividends was comprised of dividends received by Corporation Y from Corporation Z has no bearing on the deductibility of the dividends by Corporation X.

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## 3. Deduction for Bad Debts by Corporations Other Than Certain Financial Organizations

**Statutes:** Section 71.02(1)(bg) Stats. as created by 1987 Wis. Act 27, sec. 71.02(1)(c), Stats. (1985-86), as amended by 1987 Wis.

Acts 27 and 399, sec. 71.04(7), Stats. (1985-86), and sec. 3047, 1987 Wisconsin Act 27

**Background:** Prior to the Tax Reform Act of 1986 (Act), section 166(c) of the Internal Revenue Code (IRC) allowed most corporations to claim a deduction for bad debts on the reserve method. Section 805 of the Act repealed sec. 166(c), IRC, effective for taxable years beginning after December 31, 1986. Therefore, corporations, other than certain financial organizations which may continue to claim a deduction for bad debts on the reserve method, may not claim a deduction for bad debts on the reserve method for federal purposes for taxable years beginning after December 31, 1986. A deduction for bad debts is allowed on the direct write-off (or charge-off) method.

Section 805 of the Act also provides that the change from the reserve method to the direct write-off method is a change in accounting method initiated by the taxpayer with IRS' consent. To prevent the duplication of deductions, the balance in any reserve account on the effective date of the change must be taken into income ratably over 4 years. For reserves for guaranteed debt obligations, the reserve balance is first reduced by the suspense account balance. The remaining balance is taken into income ratably over 4 years.

Effective for the Wisconsin 1987 taxable year (which is taxable years ending July 31, 1987, through June 30, 1988) and thereafter, 1987 Wisconsin Act 27 provides that a corporation must determine its Wisconsin net income under the IRC as amended to December 31, 1986, as it applies to the taxable year 1987 and subsequent years, with certain exceptions. Therefore, for the 1987 taxable year and thereafter, Wisconsin allows bad debts to be deducted under the method provided in the IRC as amended to December 31, 1986. For corporations, other than certain financial organizations, that is the direct write-off method.

For 1986 and prior taxable years, Wisconsin allowed bad debts to be deducted on the direct write-off method (except for certain financial organizations). Therefore, the changes in Wisconsin's corporate franchise or income tax law brought about by 1987 Wisconsin Act 27 did not result in any change in the allowable method of deducting bad debts for corporations, other than financial organizations.

**Facts and Question 1:** Corporation A, a calendar year taxpayer, deducted bad debts on the reserve method for federal tax purposes through the 1986 taxable year. As of December 31, 1986, the bad reserve balance of Corporation A was \$100,000. For federal tax purposes, \$25,000 of the reserve balance will be included in income for each of 4 years, starting with the 1987 taxable year.

How will the \$25,000 adjustment be treated on the 1987 Wisconsin corporate franchise or income tax return?

**Answer 1:** Since Corporation A had deducted bad debts on the direct write-off method for Wisconsin for 1986 and prior taxable

years, the \$100,000 reserve balance has not been previously deducted for Wisconsin corporate franchise or income tax purposes and does not have to be included in income for Wisconsin for 1987 through 1990. The \$25,000 should be subtracted from federal net income in arriving at Wisconsin net income for 1987. This is true for 1988, 1989, and 1990 as well.

**Facts and Question 2:** Corporation B, a July 31 fiscal year taxpayer, has deducted bad debts on the reserve method for federal tax purposes. Corporation B claimed a \$12,000 deduction for an addition to the bad debts reserve account on its federal return for the year ended July 31, 1987, a 1986 federal tax return. (This is the last year for which Corporation B may deduct bad debts on the reserve method for federal tax purposes.)

How is the \$12,000 deduction treated on the Wisconsin corporate franchise or income tax return for the year ended July 31, 1987?

**Answer 2:** Since, for Wisconsin, a July 31, 1987, fiscal year is a 1987 taxable year, and since for the 1987 taxable year Wisconsin corporation net income is determined under the IRC as amended to December 31, 1986, as it applies to the 1987 taxable year, a deduction for bad debts is not allowed on the reserve method for Wisconsin.

In determining Wisconsin net income for the year ended July 31, 1987, Corporation B should add back to federal taxable income the \$12,000 bad debt reserve expense and any recovery of bad debts written off in previous taxable years. The actual amount of any bad debts that become worthless during the year should be subtracted from federal taxable income.

Starting with the year ended July 31, 1988, Corporation B will be required to make adjustments similar to those required to be made by Corporation A in Question 1 above.



#### 4. Sales Included in Sales Factor in Same Year That Income Is Recognized

**Statutes:** Section 71.07(2)(c), Stats. (1985-86)

**Wis. Adm. Code:** Section Tax 2.39(5), January 1978 Register

**Question:** In a situation where a taxpayer receives payment in one year but, due to the method of accounting employed, doesn't recognize the income for Wisconsin tax purposes until the following year(s), should the payment be included in the sales factor for Wisconsin apportionment purposes in the year received or in the year(s) the income is recognized?

**Answer:** Section 71.07(2)(c), Stats. (1985-86), provides in part that the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and