

chase fertilizer directly from the plant and apply it without using the Lor-Al machine.

Eldon Roesler, the executive secretary of the Wisconsin Feed, Seed and Farm Supply Association for 35 years, testified that the mixing which is done by the Lor-Al machine is regarded as manufacturing within his industry. Eldon Roesler testified that one must look at the Lor-Al mixing process as an extension of the manufacturing process since, if Pavelski recommends a certain blend of fertilizer, it

has to produce that blend and distribute it correctly or it will be subjected to complaints and lawsuits by the farmer.

The Court concluded that the Commission's finding that the two steps are part of a continuous process is supported by this evidence. Although other evidence suggests that the second step is separate, it is not the Court's function to weigh the evidence. The department concedes that the mixing which occurs at the plant is manufacturing. Since the finding that the two

steps are inseparable is supported by substantial evidence, the determination that the Lor-Al machines are entitled to the manufacturing exemption has a rational basis.

The department appealed this decision to the Wisconsin Supreme Court. The Wisconsin Supreme Court denied the department's petition for review.



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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Farmland Preservation Credit

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Corporation Franchise or Income Taxes

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Sales/Use Taxes

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INDIVIDUAL INCOME TAXES

1. Limitations on Farm Losses

Statute: Section 71.05(6)(a)10, Wis. Stats. (1987-88)

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

Background: A new add modification, sec. 71.05(1)(a)26, Wis. Stats., was created by 1985 Wisconsin Act 29, effective for taxable year 1986. That section was renumbered 71.05(6)(a)10 by 1987 Wisconsin Act 312, effective January 1, 1989. The modification limits the amount of combined net losses from farming businesses, exclusive of net gains and net profits, which may be claimed on a Wisconsin individual income tax return when non-farm income exceeds prescribed levels. The limitations are explained in a Tax Release, WTB #51, page 9.

Facts and Question: Taxpayer F is a farmer who owns an interest in three related farms and materially participates in their operation, for the purpose of making a profit. Two of the farms, A and B, are organized as tax-option (S) corporations, while the third farm, C, is a farm partnership. Taxpayer F is the sole shareholder of farm A. In 1987, farms B and C operated at a profit while farm A sustained a net loss. Taxpayer F received wages from farm A. If these wages are nonfarm income, the farm loss limitations will apply for 1987. Are the wages which F received from farm A in 1987 considered to be nonfarm income for purposes of applying the farm loss limitations in sec. 71.05(6)(a)10, Wis. Stats. (1987-88)?

Answer: No. The wages from farm A are considered farm income, rather than nonfarm income. F is operating the farm for a profit as the sole shareholder. Wages received by the owner of a farm for participating in its operation can be distinguished from wages received by a farm employee, which would be considered nonfarm income. Since F is the sole shareholder and operates farm A, F's wages from farm A are farm-related income.



2. Manufacturer's Sales Tax Credit Allowable to Shareholders of Tax-Option (S) Corporations

Statutes: Sections 71.26(2)(a), 71.28(3), 71.34(1)(e), and 71.47(2b), Wis. Stats. (1987-88), and sec. 71.04(3), Wis. Stats. (1985-86)

Note: This Tax Release supersedes the Tax Release with the same title which appeared in WTB 50. The questions are arranged in 3 sections. The years to which each section applies are indicated at the beginning of that section. The third section has been included as additional background information and does not extend the statute of limitations for years which are otherwise closed.

Background: Corporations may claim a credit equal to the sales and use tax under ch. 77, Wis. Stats., paid on fuel and electricity consumed in manufacturing tangible personal property in Wisconsin (sec. 71.28(3)(b), Wis. Stats. (1987-88)). If the credit computed is not entirely offset against Wisconsin franchise or income taxes otherwise due, the unused balance may be carried forward for up to 15 taxable years (sec. 71.28(3)(c), Wis. Stats. (1987-88)).

In *Wisconsin Department of Revenue v. Edwin F. Gordon*, 127 Wis. 2d 71 (1985), the Court of Appeals held that "the portion of Gordon's personal income tax that is measured by the net income of the tax-option corporation can be reduced by an amount equal to the corporation's tax credit under ch. 77, Wis. Stats." However, beginning with credits computed for the 1987 taxable year, secs. 71.07(10)(a), 71.28(3)(d), and 71.365(3)(b), Wis. Stats. (1987-88), provide that the shareholders of a tax-option (S) corporation may not claim the credit attributable to the corporation. Shareholders may continue to carry forward for up to 15 years unused manufacturer's sales tax credits generated in 1986 and prior taxable years.

For 1986 and prior taxable years, sec. 71.04(3), Wis. Stats. (1985-86), denied a deduction for sales and use taxes paid on fuel and electricity used in manufacturing where those taxes could be used in computing a manufacturer's sales tax credit.

Beginning with credits computed for taxable year 1987, the amount of credit claimed by a tax-option (S) corporation must be added to that corporation's net income pursuant to sec. 71.34(1)(e), Wis. Stats. (1987-88).

I. Computation of Amount of Credit or Credit Carryforward That May Be Claimed (This section applies for taxable year 1987 and thereafter with respect to unused credits carried forward from 1986 and prior taxable years. In addition, this section applies for 1986 and prior taxable years with respect to credits computed in or carried to those years.)

Facts and Question 1: A shareholder of a tax-option (S) corporation receives a pro rata share of the net income or loss of the corporation. In addition, the shareholder receives payments from the corporation such as salary for services performed, interest on

loans to the corporation, taxable dividends paid by the corporation, and rents and royalties from assets leased to the corporation. Which of these amounts are included for purposes of determining the shareholder's "personal income tax that is measured by the net income of the tax-option corporation?"

Answer 1: The shareholder's share of the net income from the tax-option (S) corporation for purposes of computing the allowable manufacturer's sales tax credit is limited to the shareholder's pro rata share of the corporation's net income which is taxable by Wisconsin. For 1987 and thereafter, this is the net amount of the tax-option items of income, loss, and deduction passed through to the shareholder on Wisconsin Schedule 5K-1 to the extent that those items are subject to Wisconsin income tax. For 1986 and prior taxable years, this was the shareholder's pro rata share of the net income before the tax-option (S) corporation deduction that the corporation reported on its Wisconsin franchise or income tax return, Form 4. (For 1986, this was the shareholder's pro rata share of the amount on Wisconsin Form 4, line 25.)

Salary for services performed, interest on loans made to the corporation, taxable dividends paid by the corporation, and rents and royalties from assets leased to the corporation are not included in the corporation's net income. Therefore, the shareholder's personal income tax on these items cannot be offset by the manufacturer's sales tax credit.

Example A: In 1988, a shareholder received the following items from a tax-option (S) corporation:

Salary	\$ 10,000
Interest on loan to the corporation	500
Pro rata share of corporation's interest income	100
Pro rata share of corporation's capital gain	10,000
Pro rata share of corporation's ordinary loss	(5,000)

The shareholder's share of the tax-option (S) corporation's net income or loss is a \$900 loss, which is computed as follows:

Pro rata share of corporation's interest income	\$100
Pro rata share of corporation's capital gain to extent taxable (\$10,000 x 40% taxable)	4,000
Pro rata share of corporation's ordinary loss	(5,000)
Net income (loss) from tax-option (S) corporation	<u>\$ (900)</u>

Example B: In 1986, a shareholder received the following income from a tax-option (S) corporation:

Salary	\$30,000
Interest on loan to the corporation	1,000
Taxable dividend of pre-1979 earnings	3,000
Rent from assets leased to the corporation (after deducting rental expenses, the shareholder incurred a \$2,500 loss)	5,000
Pro rata share of tax-option corporation net income (based on 1986 Wisconsin Form 4, line 25)	15,000

The shareholder's share of the tax-option (S) corporation's net income that may be used to compute the allowable manufacturer's sales tax credit is \$15,000, which is her pro rata share of tax-option (S) corporation net income from 1986 Form 4, line 25.

Example C: In 1986, a shareholder received the following amounts from a tax-option (S) corporation:

Royalties on assets leased to the corporation	\$50,000
Pro rata share of tax-option (S) corporation net loss (based on 1986 Wisconsin Form 4, line 25)	(40,000)

The shareholder's share of the tax-option (S) corporation's net income or loss is a \$40,000 loss. Therefore, the shareholder cannot claim a manufacturer's sales tax credit in 1986.

Facts and Question 2: A taxpayer is a shareholder of a tax-option (S) corporation which has generated net income. How is the shareholder's personal income tax measured by the tax-option (S) corporation's net income computed?

Answer 2: One method for computing a shareholder's personal income tax measured by the tax-option (S) corporation's net income is by using the following formula:

Shareholder's share of tax-option (S) corporation Wisconsin net income	X	Shareholder's net tax liability
Shareholder's total Wisconsin income		

The shareholder's net tax liability is the gross income tax minus any credits, including credit for taxes paid to other states. It does not include IRA penalties or the Endangered Resources Donation.

Example D: In 1986, a shareholder's pro rata share of a tax-option (S) corporation's net income was \$5,000 and his share of the corporation's manufacturer's sales tax credit was \$250. The shareholder had total Wisconsin income of \$30,000 and a net tax liability of \$1,800. He can claim \$250 of manufacturer's sales tax credit in 1986, which is the lesser of the manufacturer's sales tax credit available or the limitation computed as follows:

\$5,000 tax-option (S) corporation net income	X	\$1,800 net income	=	\$300 personal income tax measured by tax-option (S) corporation net income
\$30,000 total Wisconsin income				

Another method of determining the shareholder's personal income tax measured by the tax-option (S) corporation's net income is to subtract from the shareholder's net tax liability the amount that would be that person's net tax if all of the tax-option items were excluded.

Example E: In 1987, a tax-option (S) corporation passed through the following items to its sole shareholder: interest income of \$300, longterm capital gain income of \$15,000, and ordinary loss of \$2,000. In addition to the tax-option items, the shareholder earned \$20,000 of wages. The shareholder's total Wisconsin

income was \$24,300 and her net tax liability was \$1,255. The shareholder had carried forward \$500 of unused manufacturer's sales tax credit from 1986. To find out how much of the credit she can claim in 1987, she recomputed her Wisconsin income and net tax by excluding the tax-option items. Her total Wisconsin income would be \$20,000 and her net tax would be \$922. The \$333 difference between her actual net tax of \$1,255 and her recomputed net tax of \$922 is her personal income tax measured by tax-option (S) corporation net income. She may claim \$333 of the \$500 of manufacturer's sales tax credit carryforward for 1987.

Facts and Question 3: A shareholder of a tax-option corporation which incurs a net loss for the taxable year is subject to the Wisconsin minimum tax as a result of having tax preference items from the corporation. May the minimum tax be offset by the shareholder's share of the manufacturer's sales tax credit?

Answer 3: No. The shareholder may not claim the manufacturer's sales tax credit against the minimum tax since the minimum tax is not measured by the net income of the tax-option (S) corporation. In addition, sec. 71.28(3)(b), Wis. Stats. (1987-88), provides that the credit may be offset only against tax imposed under sec. 71.23(1) or (2), Wis. Stats. (1987-88), formerly numbered sec. 71.01(1) or (2). Since the minimum tax is imposed under sec. 71.08(1), Wis. Stats. (1987-88), formerly numbered sec. 71.60, the minimum tax cannot be reduced by the manufacturer's sales tax credit.

Example F: In 1985, a shareholder's pro rata share of a tax-option (S) corporation's net loss was \$400,000. Because of this loss, the shareholder owed no Wisconsin income tax for 1985. However, he was subject to Wisconsin minimum tax based on the following tax preference items: \$14,000 of accelerated depreciation passed through from the tax-option (S) corporation and \$30,000 of adjusted itemized deductions. The shareholder cannot offset his manufacturer's sales tax credit against his minimum tax due.

Facts and Question 4: If a taxpayer is a shareholder in more than one tax-option (S) corporation during the taxable year, how does the taxpayer compute the amount of manufacturer's sales tax credit that may be claimed for that year?

Answer 4: The amount of manufacturer's sales tax credit that may be claimed from each tax-option (S) corporation must be determined separately, based on the shareholder's personal income tax that is measured by the net income of that corporation. The shareholder cannot offset a manufacturer's sales tax credit from a tax-option (S) corporation which incurs a net loss against personal income tax measured by the shareholder's share of net income from another tax-option (S) corporation.

Example G: A taxpayer is a shareholder in two tax-option (S) corporations. In 1986, she received from Corporation P net income of \$15,000 and a manufacturer's sales tax credit of \$250. From Corporation M she received a net loss of \$20,000 and manufacturer's sales tax credit of \$500. The taxpayer's personal income tax measured by her share of Corporation P's net income

is \$900, which is computed as follows:

\$15,000 net income from Corp. P	X	\$2,400 net tax liability	=	\$900 personal income tax measured by Corp. P's net income
\$40,000 total Wisconsin income				

Therefore, the taxpayer may claim the \$250 of Corporation P's manufacturer's sales tax credit. She cannot claim any portion of Corporation M's manufacturer's sales tax credit on her 1986 individual income tax return. Since Corporation M incurred a net loss in 1986, no part of her net tax liability is measured by net income of Corporation M.

Example H: A taxpayer is a shareholder in two tax-option (S) corporations. In 1986, he received from Corporation L a net loss of \$20,000 and a manufacturer's sales tax credit of \$200. From Corporation G he received net income of \$50,000 and a manufacturer's sales tax credit of \$600. The taxpayer cannot claim any portion of the \$200 of credit from Corporation L since Corporation L incurred a net loss in 1986. The taxpayer may claim the \$600 of Corporation G's credit on his 1986 individual income tax return since it does not exceed his personal income tax measured by his share of Corporation G's net income, which is computed as follows:

\$50,000 net income from Corp. G	X	\$1,700 net tax liability	=	\$1,700 personal income tax measured by Corp. G's net income
\$35,000 total Wisconsin income				

II. Determination of Who May Claim a Credit or Credit Carryforward (This section applies with respect to credits computed in 1986 and prior taxable years.)

Facts and Question 5: A tax-option (S) corporation incurred net losses in 1985 and 1986. As a result, its shareholders would not be able claim their pro rata share of the corporation's manufacturer's sales tax credit available for those years. Since the shareholders did not receive a tax benefit from the credits, may the corporation in computing its net loss for 1985 and 1986 claim a deduction for the sales and use taxes paid on fuel and electricity used in manufacturing?

Answer 5: No. In computing its net loss, the corporation cannot deduct the sales and use taxes paid on the fuel and electricity which would be used to compute the manufacturer's sales tax credit. Although for taxable year 1987 and thereafter manufacturer's sales tax credits do not flow through to the shareholders, the shareholders are still able to carry forward for up to 15 years the unused credits from 1986 and prior taxable years. Alternatively, the corporation may claim the unused credits within the 15-year carryforward period against its franchise tax measured by U.S. government bond interest or, if it revokes its tax-option (S) status, against its franchise or income tax.

Facts and Question 6: A corporation which was a regular (C) corporation elects to be a tax-option (S) corporation. May this tax-option (S) corporation pass through to its shareholders unused manufacturer's sales tax credits from years in which it had been a regular (C) corporation?

Answer 6: If the corporation elected tax-option (S) corporation status to be effective for its 1986 taxable year or a prior taxable year, the corporation may pass through to its shareholders unused manufacturer's sales tax credits from years when it was taxed as a C corporation. If the corporation elected tax-option (S) corporation status effective for its 1987 taxable year or thereafter, the corporation cannot pass through unused credits to its shareholders.

Example I: A corporation was a regular (C) corporation for the 1983 through 1985 taxable years. In each of these years, the corporation incurred a loss. At the beginning of its 1986 taxable year, the corporation had \$2,000 of unused manufacturer's sales tax credits from its 1983 through 1985 taxable years. The corporation elected tax-option (S) status effective for its 1986 taxable year. For 1986, the corporation had net income of \$50,000 and a manufacturer's sales tax credit of \$750. The corporation may pass through to its shareholders the \$2,000 of unused manufacturer's sales tax credits from 1983 through 1985 in addition to the \$750 credit from its 1986 taxable year.

Example J: A corporation which had been a regular (C) corporation for 1980 through 1986 elected tax-option (S) corporation status effective for its 1987 taxable year. The corporation had unused manufacturer's sales tax credits available from its 1985 and 1986 taxable years. The corporation cannot pass through these unused credits to its shareholders.

Facts and Question 7: For taxable year 1986 or a prior taxable year, a tax-option (S) corporation computed its allowable manufacturer's sales tax credit. May the corporation elect not to pass through the credit to its shareholders and, instead, use the credit itself in a year when the corporation returns to C corporation status?

Answer 7: Yes. For 1986 and prior taxable years, a tax-option (S) corporation may elect whether or not to pass the manufacturer's sales tax credit through to its shareholders. If the credits that were passed through are not completely used by the shareholders, the unused portion may be claimed by the corporation in a year when the corporation returns to C corporation status. For taxable year 1987 and thereafter, unused credits may also be used by the corporation to offset its franchise tax measured by U.S. government bond interest.

Example K: A tax-option (S) corporation incurred losses for 1980 through 1986 which were passed through to the shareholders. Although the corporation had a manufacturer's sales tax credit available for each of these years, the shareholders didn't receive a benefit from these credits. If the corporation revokes its subchapter S election effective for the 1987 taxable year, the corpo-