

5. Taxable Status of Interest Income Received From Certain Securities

Non
taxable Taxable

Statutes: Section 71.05(6)(a)1 and (b)1, Wis. Stats. (1987-88)

Wis. Adm. Code: Section Tax 3.095, April 1988 Register

Background: Section 71.05(6)(a)1, Wis. Stats. (1987-88), provides that interest income which is taxable for Wisconsin purposes, but which is not included in federal adjusted gross income, must be added to federal adjusted gross income in computing Wisconsin taxable income. Therefore, if interest from the securities listed below as taxable was not included in federal adjusted gross income, such interest must be added to federal adjusted gross income in computing Wisconsin taxable income.

Section 71.05(6)(b)1, Wis. Stats. (1987-88), provides that the amount of interest or dividend income which is by federal law exempt from taxation by Wisconsin may be subtracted from federal adjusted gross income in computing Wisconsin taxable income. Therefore, if interest from the securities listed below as nontaxable was included in federal adjusted gross income, such interest may be subtracted from federal adjusted gross income in computing Wisconsin taxable income.

For Wisconsin individual income tax purposes, the taxable status of interest from the following securities is as indicated below:

| | Non taxable | Taxable |
|--|----------------|---------|
| a. Armed Services Housing Mortgage Insurance debentures (12 USC § 1748b(f)) | X | |
| b. Asian Development Bank bonds (22 USC § 290i-9) | | X |
| c. College Construction Loan Insurance Association obligations (20 USC § 1132) | | X |
| d. Commodity Credit Corporation bonds (15 USC § 713a-5) | X | |
| e. Farm Credit System Financial Assistance Corporation notes, bonds, and debentures (12 USC § 2278b-10(b)) | X | |
| f. Federal Assets Financing Trust participation certificates (12 USC § 1717(c)) | | X |
| g. Federal Deposit Insurance Corporation bonds (12 USC § 1825) | X | |
| h. Federal Financing Bank bonds (12 USC § 2288) | | X |
| i. Federal Home Loan Mortgage Corporation obligations (12 USC § 1455) | | X |
| j. Federal Land Bank Association bonds, notes, and debentures (12 USC § 2055) | X | |

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|--|---|---|
| k. Federal Savings and Loan Insurance Corporation bonds (12 USC § 1725(e)) | X | |
| l. Financial Assistance Corporation bonds, notes, and debentures (12 USC § 2278b) | X | |
| m. Financing Corporation obligations (12 USC § 1441) | X | |
| n. General Insurance Fund debentures issued to acquire housing projects (12 USC § 1747g(g)) | X | |
| o. General Insurance Fund debentures issued under the War Housing Insurance Law (12 USC § 1739(d)) | X | |
| p. Guam Bonds (48 USC § 1423a) | X | |
| q. Industrial Development bonds of East Samoa (48 USC § 1670) | X | |
| r. Puerto Rico Water Resource Authority Series B debentures (48 USC § 745) | X | |
| s. Rural Telephone debentures (7 USC § 947(a)) | | X |
| t. Small Business Administration notes (15 USC § 633) | | X |
| u. Virgin Islands general obligation bonds (48 USC § 1574(b)(ii)(A)) | X | |
| v. Virgin Islands Public Improvement bonds (48 USC § 1574(b)(ii)) | X | |



6. Taxation of Dependents With Unearned Income

Statutes: Section 71.02(2)(a)3, Wis. Stats., as amended by sec. 1808 of 1989 Wisconsin Act 31. Initial applicability: Section 3202(48)(bm) of 1989 Wisconsin Act 31 establishes its treatment first applies to taxable years beginning on or after January 1, 1989.

Background: For federal tax purposes, certain unearned income of children under age 14 is taxed at the parent's highest marginal tax rate. For tax years beginning after 1988, a child under age 14 is treated as having no gross income and is not required to file a federal income tax return if:

- 1) The child has gross income only from interest and dividends,
- 2) The child's gross income from interest and dividends is more than \$500 and less than \$5,000,
- 3) No estimated tax payments were made in the child's name and the child was not subject to backup withholding, and
- 4) The child's parent elects to include the gross income of the child in excess of \$1,000 in his or her income for the tax year. (Section 1(i)(7), Internal Revenue Code)

The parent makes the election to report the child's interest and dividends on federal Form 8814.

For Wisconsin tax purposes, sec. 71.03(2)(a)3, Wis. Stats., as amended by sec. 1808 of 1989 Wisconsin Act 31, provides that a person who can be claimed as a dependent on another taxpayer's return must file a Wisconsin income tax return if his or her unearned income is \$500 or more.

Question 1: For federal tax purposes, the parents elect on Form 8814 to report a child's interest and dividend income on their federal income tax return. Thus, the child is not required to file a federal income tax return. Is the child required to file a Wisconsin income tax return?

Answer 1: Yes. The child must file a Wisconsin income tax return even though the parents elect to include the child's income on their federal income tax return. There is no provision in Wisconsin law which provides an exception to the filing requirement for dependents with unearned income of \$500 or more.

Question 2: When the parents elect for federal tax purposes to include the child's interest and dividend income on their federal income tax return, is the child's interest and dividend income also included on the parents' Wisconsin income tax return?

Answer 2: No. The child's interest and dividend income should not be included on the parents' Wisconsin income tax return but rather such income must be reported on the child's Wisconsin income tax return. Including the child's income on the parents' Wisconsin income tax return would result in the same income being taxed to both the parents and the child. Even though the parents have elected to include the child's income on their federal income tax return, this election is not available for Wisconsin.

Note: The federal return that the parents file with the Internal Revenue Service would include the child's interest and dividend income. The federal return that is attached to the parents' Wisconsin income tax return would not include the child's interest and dividend income.



7. Wisconsin Tax Treatment of Lump-Sum Distributions

Statutes: Section 71.05(6)(a)4, (b)(intro.), and 9, Wis. Stats. (1987-88)

FEDERAL LAW

A lump-sum distribution is the distribution to a person of his or her entire balance in a qualified pension, profit sharing, stock bonus, or annuity plan. The amount qualifies as a lump-sum distribution only if the employee participated in the plan for at least 5 taxable years before the taxable year of the distribution, unless the distribution

was paid because the employee died. The distribution must occur because of attaining age 59½, sustaining permanent disability, separating from service, or dying (sec. 402, Internal Revenue Code (IRC)).

The Tax Reform Act of 1986 (P.L. 99-514) made several changes to the federal tax treatment of lump-sum distributions. Ten-year averaging was repealed and replaced with 5-year averaging and capital gain treatment for the portion of a lump-sum distribution that applies to pre-1974 coverage was repealed.

However, several elections continue to be available to certain taxpayers:

1. A taxpayer may elect to use 5-year averaging on federal Form 4972 for lump-sum distributions made after the individual reaches age 59 1/2 (sec. 402(e)(1)(B), IRC).
2. A taxpayer who reached age 50 before 1986 may elect either 5-year or 10-year averaging on federal Form 4972 (sec. 1122(h)(5) of the Tax Reform Act of 1986).
3. A taxpayer may elect long-term capital gain treatment for the portion of the lump-sum distribution attributable to pre-1974 participation based on a phase-out percentage (sec. 1122(h)(4) of the Tax Reform Act of 1986). The percentage is: 95% in 1988; 75% in 1989; 50% in 1990; and 25% in 1991. In 1992 and thereafter, this long-term capital gain treatment will not be available. (This capital gain is reported on federal Schedule D. The balance of the distribution is reported as ordinary income on federal Form 1040 or on Form 4972 if the taxpayer reached age 50 before 1986 and elects either 5-year or 10-year averaging.)
4. A taxpayer who reached age 50 before 1986 may elect to retain the capital gain character of the portion of the distribution attributable to pre-1974 participation (sec. 1122(h)(4) of the Tax Reform Act of 1986). No phase-out applies. The entire amount attributable to pre-1974 participation is treated as long-term capital gain. (This capital gain is reported on Part II of federal Form 4972 and is taxed at a 20% rate. This taxpayer treats the balance of the distribution as ordinary income and may elect either 5-year or 10-year averaging for the balance.)

The above elections can be made for only one distribution received by a taxpayer in respect to an employee. Individuals who receive a lump-sum distribution as a beneficiary of a deceased employee can make the above elections if the participant in the plan met the age requirements.

WISCONSIN LAW

Section 71.05(6)(a)4, Wis. Stats. (1987-88), provides for an addition to federal adjusted gross income for "The amount of any lump-sum distribution taxable under section 402(e)(1) of the internal revenue code" Section 402(e)(1), IRC, provides for the imposition of a separate tax on lump-sum distributions.

Section 71.05(6)(b)9, Wis. Stats. (1987-88), provides a subtraction for 60% of the capital gain for assets held more than one year to the extent the capital gain is included in federal adjusted gross income.

Question 1: What portion of an eligible taxpayer's lump-sum distribution from a qualified pension, profit sharing, stock bonus, or annuity plan is added to his or her federal adjusted gross income to arrive at Wisconsin adjusted gross income?

Answer 1: The portion of a lump-sum distribution from a qualified plan which is reported on federal Form 4972 is subject to the separate federal tax on lump-sum distributions and is not included in federal adjusted gross income. Therefore, amounts reported on federal Form 4972 (either as ordinary income for 5-year or 10-year averaging or as capital gain) must be added to federal adjusted gross income to arrive at Wisconsin adjusted gross income (sec. 71.05(6)(a)4, Wis. Stats. (1987-88)).

Any portion of a lump-sum distribution which is reported as ordinary income on federal Form 1040 or as long-term capital gain on federal Schedule D is included in federal adjusted gross income. Because the starting point for computing Wisconsin adjusted gross income is federal adjusted gross income, an addition is not required for the portion of a lump-sum distribution which is included in federal adjusted gross income.

Question 2: Does the capital gain portion of a lump-sum distribution attributed to pre-1974 participation in a plan, which is identified as capital gain on Form 1099-R, qualify for the Wisconsin capital gain exclusion?

Answer 2: Yes, but only the amount of long-term capital gain which, for federal tax purposes, is included in federal adjusted gross income qualifies for the Wisconsin 60% capital gain exclusion. The only federal lump-sum distribution election that results in the capital gain being included in federal adjusted gross income is the election to report the capital gain portion of the lump-sum distribution on federal Schedule D, subject to the phase-out. Thus, the year and the percentage of the capital gain portion of a lump-sum distribution which qualifies for the Wisconsin capital gain exclusion is as follows:

| | |
|------|-----|
| 1988 | 95% |
| 1989 | 75% |
| 1990 | 50% |
| 1991 | 25% |

The capital gain portion of a lump-sum distribution received after December 31, 1991, will not qualify for the Wisconsin capital gain exclusion.

Question 3: May an eligible taxpayer who elects federally to report the capital gain portion of the lump-sum distribution at a 20% tax rate on Form 4972 claim a capital gain exclusion for Wisconsin?

Answer 3: No. The taxpayer's election to report 100% of the capital gain portion of a lump-sum distribution at a 20% tax rate on Form

4972 does not qualify for a Wisconsin capital gain exclusion. However, the taxpayer may make a different election for Wisconsin tax purposes. A taxpayer who reports the capital gain portion of a lump-sum distribution on federal Form 4972 can elect for Wisconsin purposes to report the capital gain portion on Schedule D, subject to the phase-out (see Answer 2). The amount reported on Schedule D qualifies for the Wisconsin capital gain exclusion. The remaining portion of the lump-sum distribution (total taxable portion less amount reported on Schedule D) is taxed as ordinary income for Wisconsin.



HOMESTEAD CREDIT

1. Homestead Credit — Ownership of Homestead

Statutes: Section 71.52 (3) and (7), Wis. Stats. (1987-88)

Facts and Question: Section 71.52 (3), Wis. Stats. (1987-88), refers to a homestead as a dwelling, whether rented or owned, and sec. 71.52 (7), Wis. Stats. (1987-88), refers to property taxes accrued as taxes levied on a homestead owned by the claimant or a member of the household. What constitutes "ownership" for purposes of the homestead credit?

Answer: Generally, if a claimant has a recorded legal title to a homestead (his or her name is on a deed or other legal document recorded at the register of deeds), the claimant is considered to be an owner of that homestead. However, there are situations in which an "equitable ownership interest" is recognized in lieu of a recorded legal title. One such situation is where property passes to an heir by virtue of death, either through a will or by laws of intestacy if a person dies without a will. Each case must be considered on an individual basis, as each case will likely include some facts unique to that case. Sufficient facts pertaining to a claimant's ownership interest must be obtained and documented before a determination can be made. Some examples of an allowed equitable ownership interest are as follows:

Example 1: Mrs. A and her two adult children, John and Mary, reside in a homestead titled solely to Mrs. A. Mrs. A dies and her will leaves the homestead to John and Mary. Legal title vests in the personal representative of Mrs. A's estate upon her death and the appointment of the personal representative. John and Mary continue to reside in the homestead after Mrs. A's death but do not have the title changed. There are no other claims against the property and the will is not contested. Based on these facts, for homestead credit purposes John and Mary are considered to have an equitable ownership interest (one-half each) in the property, effective on the date of Mrs. A's death, and each of them is eligible to claim a homestead credit based on their one-half share of the property taxes.

Example 2: Assume the same facts as Example 1, except Mrs. A did not have a will and legal title vests in her estate. John and Mary are

her only heirs and there are no other claims against the ownership of the homestead. Again, for homestead credit purposes, John and Mary are considered to have an equitable ownership interest in the property as of the date of Mrs. A's death, and each of them is eligible to claim a homestead credit based on their one-half share of the property taxes, even though legal title vests in Mrs. A's estate.

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CORPORATION FRANCHISE OR INCOME TAXES

1. Difference Between Wisconsin Basis and Federal Basis of Assets Disposed of in Taxable Transactions

Statutes: Section 71.26(2)(a) and 71.26(3)(y), Wis. Stats. (1987-88); section 3203(47)(za), 1987 Wis. Act 27.

Background: 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 Internal Revenue Code (IRC), with certain exceptions. Specifically, section 71.26(2)(a), Wis. Stats. (1987-88), provides in part that net income of a corporation means the gross income as computed under the IRC, as modified for Wisconsin, minus deductions computed under the IRC, as modified for Wisconsin, plus or minus, as appropriate, an amount equal to the difference between the federal basis and Wisconsin basis of any asset sold, exchanged, abandoned, or otherwise disposed of in a taxable transaction during the taxable year.

Question 1: When will there be a difference in the Wisconsin basis and federal basis of an asset?

Answer 1: There are many situations which may result in a basis difference. The most common involves a different depreciation or amortization method being used for Wisconsin tax purposes than for federal tax purposes. Section 71.26(3)(y), Wis. Stats. (1987-88), provides that depreciation or amortization shall be determined under the IRC. This is effective for assets placed into service on or after January 1, 1987 (s. 3203(47)(za), 1987 Wis. Act 27). Section 71.26(3)(y), Wis. Stats. (1987-88), also provides that, for assets placed in service prior to January 1, 1987, the depreciation or amortization method allowed by Wisconsin at the time the asset was placed in service must be continued until the disposal of the asset.

For assets placed in service prior to January 1, 1987, Wisconsin law provided that a deduction under the Accelerated Cost Recovery System (ACRS) was not allowed for certain assets. These assets included utility property placed in service during the 1981 taxable year or thereafter and assets located outside of Wisconsin placed in service on or after January 1, 1983.

Other reasons for basis differences include the 1986 and prior Wisconsin tax treatment of waste treatment facilities, forest croplands, renewable energy resource systems, research or experimental expenditures, trademark or trade name expenditures, ordered charge downs or write-offs, intangible drilling costs, assets subject to depletion, and corporate liquidations. See the Tax Release titled "Taxpayer Elections For Wisconsin Income and Franchise Taxes," in WTB 48 (October 1986), for a discussion of most of these items.

Question 2: How is a basis difference to be reported on a Wisconsin tax return? Is it simply an addition or subtraction to federal net income or must the capital gains and/or losses from the federal return be reclassified?

Answer 2: Section 71.26(2)(a), Wis. Stats. (1987-88), provides that the basis difference shall be added or subtracted, as appropriate, in arriving at Wisconsin net income. Therefore, if the Wisconsin basis of an asset is less than the federal basis, the difference is reported as an addition to federal income. If the Wisconsin basis is larger than the federal basis, the difference is reported as a subtraction from federal income. The basis difference doesn't change the nature of the capital gain or loss in arriving at federal income.

Example 1: In 1988, Corporation P sells the stock of a subsidiary, Corporation S, for \$10 million. Its federal basis in the subsidiary is \$5 million, but its Wisconsin basis is \$29 million. Corporation P had other income (less expenses) of \$45 million for both federal and Wisconsin purposes.

Corporation P's Wisconsin income is determined as follows:

| | |
|------------------------------|---------------|
| Federal income less expenses | \$ 45,000,000 |
| Federal capital gain | 5,000,000 |
| Total federal income | \$ 50,000,000 |
| Subtract basis difference | (24,000,000) |
| Wisconsin income | \$ 26,000,000 |

Example 2: Assume that in Example 1, Corporation P's federal basis in the subsidiary is \$12 million and its Wisconsin basis is \$5 million. Corporation P's Wisconsin income is determined as follows:

| | |
|---|---------------|
| Federal income less expenses | \$ 45,000,000 |
| Federal capital loss (deductible to extent of capital gain) | -0- |
| Federal taxable income | \$ 45,000,000 |
| Add basis difference | 7,000,000 |
| Wisconsin income | \$ 52,000,000 |

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SALES/USE TAXES

1. Cost-Sharing of Telecommunications Equipment and Services

Statutes: Sections 77.51(1), (10), (12), (13), and (14) and 77.52(2)(a)4, Wis. Stats. (1987-88)

Wis. Adm. Code: Sections Tax 11.32(1) and (2), October 1986 Register and Tax 11.66, July 1987 Register

Facts and Question: Company ABC (ABC) a wholly-owned subsidiary of Company XYZ (XYZ), was established to centralize the management of the separate voice and data communications of XYZ and its affiliates and to coordinate their telecommunication needs.

The goals of ABC were first, to control XYZ's internal telecommunication expense and provide cost effective communication services to various XYZ business groups. Further savings could result from pooling XYZ communication expenses and negotiating contracts for significant volume discounts on equipment and facilities. Secondly, ABC was to provide XYZ and its affiliates enhanced network services giving ABC the flexibility to support new business group applications.

ABC centrally controls the ordering and billing functions for the XYZ family of companies to insure efficient use of purchased telecommunications. ABC also monitors communication expenses and makes appropriate adjustments to maximize use of existing telecommunications services.

ABC does not offer telecommunication services to nonaffiliated companies or the general public. ABC is not a registered telephone company or communications service provider under any state's public utility law.

ABC purchases services and equipment from traditional telecommunications providers and vendors on a tax paid basis. It then seeks reimbursement for its costs from XYZ and its affiliates that use the services.

In its operations, ABC incurs three types of costs: facilities costs, equipment related expenses, and overhead costs. Facilities costs are the amounts paid for telephone services purchased from telephone companies (including taxes). Equipment related expenses are maintenance, depreciation, and interest expenses for communications equipment, payments for use of the equipment, and software to run the network. Overhead costs are expenses associated with bill paying, placing orders, coordination of network, personnel, planning, and other administrative functions.

The facilities costs and equipment related expenses account for approximately 85% of the costs allocated by ABC to XYZ and its affiliates. The objective of the allocation of costs to XYZ and its affiliates is for ABC to break even. No profit is intended. Any

excess charges are redistributed to XYZ and its affiliates in the form of future cost reductions.

Is Company ABC a retailer of telecommunications services whose gross receipts are subject to Wisconsin sales and use tax?

Answer: Yes. Company ABC is a retailer of telecommunication services, the gross receipts of which, are subject to Wisconsin sales tax. ABC is not the consumer of telecommunication services and is not merely engaged in a cost-sharing arrangement with its parents and affiliates since ABC's charge includes more than the sharing of telecommunication costs. Only 85% of ABC's charge to XYZ and its affiliates goes to cover costs of actual equipment or services purchased and reallocated. ABC's overhead costs are also covered by the charge. In addition, ABC is also purchasing equipment to enhance the telecommunication services it provides.

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2. Electricity Used in Industrial Waste Treatment Facility

Statutes: Section 77.54(2) and (26), Wis. Stats. (1987-88)

Wis. Adm. Code: Section Tax 11.11, September 1984 Register

Background: Section 77.54(26), Wis. Stats. (1987-88), and sec. Tax 11.11(4), Wis. Adm. Code, provide that when an industrial waste treatment facility qualifies for the property tax exemption under sec. 70.11(21)(a), Wis. Stats. (1987-88), the gross receipts from the sale, use, or other consumption of tangible personal property which become a component part of the waste treatment facility are exempt from Wisconsin sales and use tax. The sales and use tax exemption also applies to replacement parts, chemicals, and supplies used or consumed in operating the waste treatment facility.

Question: May electricity used in operating an industrial waste treatment facility be purchased exempt from Wisconsin sales and use tax as a supply under sec. 77.54(26), Wis. Stats. (1987-88)?

Answer: No. The sale of electricity to an industrial waste treatment facility is not exempt from Wisconsin sales and use tax under sec. 77.54(26), Wis. Stats. (1987-88).

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3. Leased Automobiles Used by Employees

Statutes: Sections 77.51(4)(a) and (c)5, (13)(k) and (14)(intro.) and (j) and 77.58(6), Wis. Stats. (1987-88)

Wis. Adm. Code: Sections Tax 11.29(3) and (5), July 1977 Register and Tax 11.79(1), September 1984 Register