

Answer 8: The answer depends on whether the merger is into a new corporation or into a surviving corporation, and which stock shares are reissued, illustrated as follows:

- A. When two or more corporations merge into a new corporation which issues all replacement stock shares, all of the shares issued pursuant to the merger are considered small business stock if the new corporation meets the requirements at the time it issues the replacement stock and so certifies, and the taxpayer holds the replacement stock for at least five years. Since the acquisition is not by gift, the capital gains exclusion applies, provided the taxpayer submits the certification with the tax return on which the capital gains are reported.

Example 3: Corporations A and B merge into new Corporation C on November 1, 1987. On that date, C issues replacement stock shares to the shareholders of the previous A and B stock. C meets the small business stock requirements as of November 1, 1987 and so certifies to each shareholder.

Since the replacement stock was not acquired by gift, the capital gains exclusion applies to each taxpayer who holds the stock until at least November 1, 1992, and who submits the certification with the tax return on which the capital gain is reported.

- B. When two or more corporations merge into a surviving corporation which reissues all stock shares, the replacement stock is considered small business stock if the surviving corporation meets the requirements as of the December 31 before the stock is reissued (assuming the surviving corporation was originally incorporated in a year prior to reissuance of the stock), the surviving corporation so certifies, and the taxpayer holds the replacement stock for at least five years. Since the replacement stock is not a gift, the capital gains exclusion applies, provided the taxpayer submits the certification with the tax return on which the capital gains are reported.

Example 4: Corporations A and B, both incorporated in 1986, merge into Corporation B on November 1, 1987. On that date, B issues replacement stock shares to all of the shareholders of the previous A and B stock. B meets the small business stock

requirements as of December 31, 1986 and so certifies to each shareholder.

The solution is the same as in example 3.

- C. When two or more corporations merge into a surviving corporation which reissues stock shares to replace those of the liquidated corporation but does not reissue those shares of stock previously issued by that surviving corporation, the small business requirements and five year holding period with respect to the shares which are not reissued go back to the original applicable date. The capital gains exclusion for those shares applies as if no merger had occurred.

Example 5: Corporations A and B merge into Corporation B on November 1, 1987. On that date, B issues shares of stock to previous A shareholders to replace their A shares but does not reissue stock to B shareholders. Taxpayer Q had purchased stock from B on August 1, 1986, which qualified as small business stock and received a certification from B. Q sells the stock at a gain on September 1, 1991, and attaches the certification to the 1991 income tax return.

The capital gains exclusion applies, since the stock was held for more than five years (August 1, 1986 to September 1, 1991.) This is true even though Q held the stock for less than five years after the merger (November 1, 1987 to September 1, 1991).

Example 6: In example 5, assume Q had purchased stock from both A and B on August 1, 1986, and received certifications from both corporations. Q then sells all of the stock on September 1, 1991, consisting of both August 1, 1986, original B stock and November 1, 1987, replacement stock.

The capital gains exclusion applies with respect to the August 1, 1986, stock as in example 5. However, the capital gains exclusion does not apply with respect to the replacement stock, because the five year holding period had not been met for those shares (those shares were held only from November 1, 1987 to September 1, 1991).

“A” SAMPLE CERTIFICATION OF SMALL BUSINESS STOCK REQUIREMENTS

(ABC Corporation Letterhead)

July 3, 1986

Mr. John Doe
123 Main Street
Anytown, WI 53000

NOTE: This sample certification is for stock issued from January 1, 1986, to August 30, 1987. Refer to Part A of answer 1 for a description of the requirements.

Dear Mr. Doe:

On July 1, 1986 you acquired 100 shares of stock of ABC Corporation for \$5,000. You are the original owner of this stock, and you did not acquire it by gift.

For purposes of meeting the small business stock certification requirement under sec. 71.01(10), Wis. Stats., I, the undersigned officer of ABC Corporation, hereby certify that ABC Corporation fulfills all of the following requirements:

1. At least 50% of ABC Corporation's property and at least 50% of its payroll were in Wisconsin on December 31, 1985.
2. ABC Corporation had no more than 200 employees covered by Wisconsin unemployment insurance, including employees of any corporation that owned more than 50% of ABC Corporation's stock, on December 31, 1985.
3. ABC Corporation derived no more than 25% of its gross receipts from rents, interest, dividends, and sales of assets combined in calendar year 1985.
4. ABC Corporation had no stock listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers' Automated Quotation system on December 31, 1985.
5. ABC Corporation had not conducted a trade or business in corporate or noncorporate form, or a combination thereof, prior to December 31, 1980.
6. ABC Corporation had never liquidated its assets in whole or in part for tax purposes only in order to fulfill requirements 1 to 5 above and then reorganized, as of December 31, 1985.

To qualify for the small business stock capital gains exclusion under sec. 71.05(6)(b)6, Wis. Stats., you must attach a copy of this certification to your Wisconsin income tax return on which the exclusion is claimed. Please save this certification for that purpose. The certification is not transferable. You, as the original owner of this stock, are the only taxpayer who may use the certification or qualify for the exclusion.

Signed _____
Iona Business
President, ABC Corporation

“B” SAMPLE CERTIFICATION OF SMALL BUSINESS STOCK REQUIREMENTS

(ABC Corporation Letterhead)

July 3, 1990

Mr. John Doe
123 Main Street
Anytown, WI 53000

NOTE: This sample certification is for stock issued on or after August 31, 1987, by a corporation incorporated prior to the calendar year in which the stock is issued. Refer to Part B of answer 1 for a description of the requirements.

Dear Mr. Doe:

On July 1, 1990 you acquired 100 shares of stock of ABC Corporation for \$5,000. You are the original owner of this stock, and you did not acquire it by gift.

For purposes of meeting the small business stock certification requirement under sec. 71.01(10), Wis. Stats., I, the undersigned officer of ABC Corporation, hereby certify that ABC Corporation fulfills all of the following requirements:

1. At least 50% of ABC Corporation's property and at least 50% of its payroll were in Wisconsin on December 31, 1989.
2. ABC Corporation had no more than 500 employees covered by Wisconsin unemployment insurance, including employees of any corporation that owned more than 50% of ABC Corporation's stock, on December 31, 1989.
3. ABC Corporation derived no more than 25% of its gross receipts from rents, interest, dividends, and sales of intangible investment assets combined in calendar year 1989.
4. ABC Corporation had no stock listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers' Automated Quotation system on December 31, 1989.
5. ABC Corporation had never liquidated its assets in whole or in part for tax purposes only in order to fulfill requirements 1 to 4 above and then reorganized, as of December 31, 1989.

To qualify for the small business stock capital gains exclusion under sec. 71.05(6)(b)6, Wis. Stats., you must attach a copy of this certification to your Wisconsin income tax return on which the exclusion is claimed. Please save this certification for that purpose. The certification is not transferable. You, as the original owner of this stock, are the only taxpayer who may use the certification or qualify for the exclusion.

Signed _____
Iona Business
President, ABC Corporation

“C” SAMPLE CERTIFICATION OF SMALL BUSINESS STOCK REQUIREMENTS

(ABC Corporation Letterhead)

July 3, 1990

Mr. John Doe
123 Main Street
Anytown, WI 53000

NOTE: This sample certification is for stock issued on or after August 31, 1987, by a corporation incorporated during the calendar year in which the stock is issued. Refer to Part C of answer 1 for a description of the requirements.

Dear Mr. Doe:

On July 1, 1990 you acquired 100 shares of stock of ABC Corporation for \$5,000. You are the original owner of this stock, and you did not acquire it by gift.

For purposes of meeting the small business stock certification requirement under sec. 71.01(10), Wis. Stats., I, the undersigned officer of ABC Corporation, hereby certify that ABC Corporation fulfills all of the following requirements:

1. At least 50% of ABC Corporation's property and at least 50% of its payroll were in Wisconsin on July 1, 1990.
2. ABC Corporation had no more than 500 employees covered by Wisconsin unemployment insurance, including employees of any corporation that owned more than 50% of ABC Corporation's stock, on July 1, 1990.
3. ABC Corporation derived no more than 25% of its gross receipts from rents, interest, dividends, and sales of intangible investment assets combined from the date of incorporation to July 1, 1990.
4. ABC Corporation had no stock listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers' Automated Quotation system on July 1, 1990.
5. ABC Corporation had never liquidated its assets in whole or in part for tax purposes only in order to fulfill requirements 1 to 4 above and then reorganized, as of July 1, 1990.

To qualify for the small business stock capital gains exclusion under sec. 71.05(6)(b)6, Wis. Stats., you must attach a copy of this certification to your Wisconsin income tax return on which the exclusion is claimed. Please save this certification for that purpose. The certification is not transferable. You, as the original owner of this stock, are the only taxpayer who may use the certification or qualify for the exclusion.

Signed _____
Iona Business
President, ABC Corporation

□

6. Gain or Loss on the Sale of a Partnership Interest by a Nonresident

Statutes: Section 71.04(1), Wis. Stats. (1987-88).

Note: This tax release supersedes the tax release with the same title that was published in *Wisconsin Tax Bulletin* 48 (October 1986). This tax release applies for all periods open to adjustment.

Facts and Question 1: Taxpayer X, an Illinois resident, was a general partner in ABC Partnership and a limited partner in DEF Partnership. Both partnerships operated solely in Wisconsin. In 1989, Taxpayer X sold his partnership interests in both partnerships. Under terms of the agreement for the sale of his interest in ABC Partnership, Taxpayer X received payment for a specified percentage of the value of the partnership's outstanding receivables plus an amount for selling his interest in the other partnership assets. Although DEF Partnership held inventory items which had substantially appreciated in value, no part of the selling price was specifically allocated to these items in the sale agreement.

For federal purposes, Taxpayer X must treat the sale of his interest in each of the partnerships as the sale of two separate assets as provided in sec. 751 of the Internal Revenue Code. ABC Partnership's receivables and DEF Partnership's inventory items are sec. 751 property that, upon sale, are treated as ordinary gain or loss for federal purposes. Taxpayer X's interest in each partnership's non-sec. 751 property, upon sale, is treated as a capital gain or loss for federal purposes.

Is either the ordinary gain or loss on the sale of the sec. 751 property or the capital gain or loss on the sale of the non-sec. 751 property that Taxpayer X realized on the sale of his general partnership interest in Partnership ABC taxable income or a deductible loss for Wisconsin purposes? Is either the ordinary gain or loss on the sale of the sec. 751 property or the capital gain or loss on the sale of the non-sec. 751 property that Taxpayer X realized on the sale of his limited partnership interest in DEF Partnership taxable income or a deductible loss for Wisconsin purposes?

Answer 1: No. Taxpayer X's share of the ordinary gain or loss on the sale of the sec. 751 property and the capital gain or loss on the sale of the non-sec. 751 property of either partnership is not taxable income or a deductible loss for Wisconsin purposes. Both a general partnership interest and a limited partnership interest in a partnership are considered to be intangible personal property. In general, intangible assets follow the residence of the taxpayer for Wisconsin purposes. Sec. 71.04(1)(a), Wis. Stats. (1987-88). Because Taxpayer X is a nonresident and his partnership interests are intangible personal property, his shares of the sales of his interests in Partnerships ABC and DEF are not taxable by Wisconsin. The sale is considered to be one transaction consisting of the sale of the partnership interest, regardless of whether separate payments are made for partnership receivables or inventory items which have substantially appreciated in value. *Wisconsin Department of Revenue v. William B. Riley*, No. 79-CV-127, Dane County Circuit Court, November 27, 1979, CCH 201-534 and 201-749.

Facts and Question 2: Taxpayer Y, a Texas resident, is a general partner in Partnership GHI and a limited partner in Partnership JKL. Both partnerships have been operating solely in Wisconsin. In 1989, both partnerships sold all of the partnership assets located in Wisconsin, including land, buildings, office equipment, and goodwill.

Is Taxpayer Y's distributive share of the gain or loss realized by Partnership GHI on the sale of its assets taxable income or a deductible loss for Wisconsin purposes? Is Taxpayer Y's distributive share of the gain or loss realized by Partnership JKL on the sale of its assets taxable income or a deductible loss for Wisconsin purposes?

Answer 2: Taxpayer Y's share of the gain or loss realized by Partnership GHI, other than on the sale of its goodwill, is taxable income or a deductible loss for Wisconsin purposes. A partnership that sells its assets passes through any gain or loss realized on the sale to its partners. The income or loss from the sale of property of a nonresident follows the situs of the property. Sec. 71.04(1), Wis. Stats. (1987-88). Because the property was located in Wisconsin, Taxpayer Y's distributive share of Partnership GHI's gain or loss on the sale of its tangible property is taxable by Wisconsin.

Taxpayer Y's share of the gain or loss from the sale of Partnership GHI's goodwill is not taxable income or a deductible loss for Wisconsin purposes. Goodwill is an intangible asset. In general, intangible assets follow the residence of the taxpayer for Wisconsin purposes. Sec. 71.04(1)(a), Wis. Stats. (1987-88). Because the goodwill is intangible personal property, Taxpayer Y's share of the gain or loss from its sale is not taxable by Wisconsin.

Finally, Taxpayer Y's share of the gain or loss from the sale of Partnership JKL's assets is not taxable income or a deductible loss for Wisconsin purposes. A limited partner's share of the gain or loss from the sale of partnership assets is intangible personal property. *Sweitzer v. Revenue*, 65 Wis. 2d 235 (1974). In general, intangible assets follow the residence of the taxpayer. Sec. 71.04(1)(a), Wis. Stats. (1987-88). Because Taxpayer Y is a limited partner, his share of the gain or loss on the sale of Partnership JKL's assets is not taxable by Wisconsin.

□

7. Penalties on Retirement Plans

Statutes: Sections 71.05(1)(a) and 71.83(1)(a)6, Wis. Stats. (1987-88)

Background: Section 71.05(1)(a), Wis. Stats. (1987-88), provides that certain payments received from the following retirement systems are exempt from Wisconsin taxation:

- (1) Employee's Retirement System of the City of Milwaukee
- (2) Milwaukee County Employees' Retirement System
- (3) Sheriff's Annuity and Benefit Fund of Milwaukee County
- (4) Police Officer's Annuity and Benefit Fund of Milwaukee
- (5) Fire Fighter's Annuity and Benefit Fund of Milwaukee

- (6) Milwaukee Public School Teachers' Annuity and Retirement Fund
 (7) Wisconsin State Teachers Retirement System

To be exempt from Wisconsin tax, the payments must be paid on the account of a person who was a member of the retirement system or fund as of December 31, 1963, or was retired from any of the systems or funds as of December 31, 1963.

(Note: Effective for tax years beginning on or after January 1, 1989, sec. 71.05(1)(a), Wis. Stats. (1987-88), was amended by sec. 1817m of 1989 Wisconsin Act 31 to provide that payments received from federal retirement systems are also exempt from Wisconsin tax if paid on the account of any person who was a member of the retirement system as of December 31, 1963, or was retired from the retirement system as of December 31, 1963.)

Section 71.83(1)(a)6, Wis. Stats. (1987-88), provides a penalty for any person who is liable for certain federal penalties on retirement plans. One of the federal penalties is the 10% penalty on early distributions from qualified retirement plans (sec. 72(t), Internal Revenue Code). The Wisconsin penalty is 33% of the federal penalty.

Facts and Question: A person was a member of one of the above retirement systems as of December 31, 1963, and thus payments from the retirement system are exempt from Wisconsin tax. The person quit his/her job in 1989 and received a lump-sum distribution from the retirement system. The distribution is subject to the federal 10% penalty on an early distribution from a qualified retirement plan.

Is the person subject to the 33% Wisconsin penalty under sec. 71.83(1)(a)6, Wis. Stats. (1987-88), even though the payment from the retirement plan is exempt from Wisconsin income tax?

Answer: Yes, a person who is subject to the federal penalty on an early distribution from a qualified retirement plan is subject to the Wisconsin penalty, even though the payment from the retirement plan is exempt from Wisconsin income tax. The exemption in sec. 71.05(1)(a), Wis. Stats. (1987-88), is only from taxation. There is no exception for the penalty imposed under sec. 71.83(1)(a)6, Wis. Stats. (1987-88), for retirement plans when the payment from those plans is exempt from taxation.

□

8. Wisconsin Income Tax Treatment of Passive Activity Losses

Statutes: Section 71.01(13), Wis. Stats. (1987-88).

Note: This tax release applies with respect to the 1987 taxable year and thereafter.

Background: Section 469 of the Internal Revenue Code (IRC) limits the deduction of passive activity losses for individuals, estates, trusts,

closely held C corporations, and personal service corporations. Passive activities consist of trade or business activities in which the taxpayer does not materially participate during the taxable year and rental activities. Although the passive loss limits do not apply to grantor trusts, partnerships, and tax-option (S) corporations directly, they do apply to the individuals (or other covered taxpayers) who are beneficiaries, partners, or shareholders of such entities.

The passive activity loss limits also apply for Wisconsin purposes. However, the amount of passive activity income or loss depends on certain Wisconsin adjustments, including the following:

- (A) Calculating Wisconsin adjusted gross income of individuals and fiduciaries based on federal adjusted gross income with the modifications prescribed in sec. 71.05(6) to (12), (19), and (20), Wis. Stats. (1987-88). Sec. 71.01(13), Wis. Stats. (1987-88).
- (B) Determining federal adjusted gross income for Wisconsin purposes under the Internal Revenue Code as amended to a specified date and disregarding federal law changes enacted after that date which do not apply. Additionally, Wisconsin law may exclude certain provisions of the Internal Revenue Code. Sec. 71.01 (6), Wis. Stats. (1987-88). These differences between the federal Internal Revenue Code and the Internal Revenue Code in effect for Wisconsin purposes are called "Schedule I adjustments." They are accounted for on Wisconsin Schedule I.
- (C) Deciding to recalculate federal adjusted gross income for Wisconsin purposes when the Internal Revenue Code permits an individual or fiduciary to make an election and the taxpayer decides to make one election for federal purposes and a different election for Wisconsin purposes.

Facts and Question 1: Taxpayer Z, a full-year Wisconsin resident, is a limited partner in ABC Partnership. Taxpayer Z determines that she must treat her interest in ABC Partnership as a passive activity. In 1986, ABC Partnership had placed in service residential rental property located in Wisconsin. For federal purposes, the partnership has been depreciating that rental property using the accelerated cost recovery system (ACRS) as provided in IRC sec. 168. Taxpayer Z's distributive share of ABC Partnership's federal ordinary loss for 1989 is \$10,000.

For federal purposes, Taxpayer Z enters all of her passive activity income and losses, including her ordinary loss of \$10,000 from ABC Partnership, on federal Form 8582, Passive Activity Loss Limitations. She determines that \$10,600 of her passive activity losses, including \$3,530 of her ordinary loss from ABC Partnership, is allowable in computing her 1989 federal adjusted gross income.

For Wisconsin purposes, federal ACRS deductions are not available for residential rental property placed in service in 1986. Instead, depreciation on such property must be computed under the Internal Revenue Code as amended to December 31, 1980. Sec. 71.02(2)(d)12, Wis. Stats. (1985-86), and sec. 71.05(16), Wis. Stats. (1987-88). As a result of these differing depreciation deductions, Taxpayer Z's dis-

tributive share of ABC Partnership's ordinary loss in 1989 is \$6,000 for Wisconsin purposes.

Since her ordinary loss from ABC Partnership differs for federal and Wisconsin purposes, must Taxpayer Z recompute her allowable passive activity losses for Wisconsin purposes?

Answer 1: Yes. Taxpayer Z must recompute her allowable passive activity losses. She prepares another Form 8582 for Wisconsin purposes and substitutes her ordinary loss, as computed under Wisconsin law, from ABC Partnership of \$6,000 for her federal ordinary loss of \$10,000.

She must recompute the allowable passive activity losses because she must recalculate her federal adjusted gross income under the Internal Revenue Code in effect for Wisconsin purposes. Wisconsin law excludes certain depreciation provisions of the Internal Revenue Code in arriving at Wisconsin adjusted gross income.

Assume that Taxpayer Z recomputes Form 8582 for Wisconsin purposes, and she determines that \$9,800 of her passive activity losses, including \$2,260 of her ordinary loss from ABC Partnership, is allowable in 1989 for Wisconsin purposes. The \$800 difference between the \$10,600 of passive activity losses allowable on Taxpayer Z's federal return and the \$9,800 of passive activity losses allowable on her recomputed Form 8582 is a "Schedule I adjustment."

Taxpayer Z then must recompute her federal adjusted gross income for Wisconsin purposes by completing Wisconsin Schedule I. She will enter the \$800 adjustment to the allowable passive activity losses on Wisconsin Schedule I as an addition to the federal adjusted gross income reported on her federal income tax return.

Finally, Taxpayer Z will enter her recomputed federal adjusted gross income from Schedule I on line 1 of her Wisconsin income tax return, Form 1.

Facts and Question 2: Taxpayer Y, a full-year Wisconsin resident, is a shareholder in DEF Corporation, a tax-option (S) corporation. Taxpayer Y determines that he must treat his interest in DEF Corporation as a passive activity. For federal purposes, DEF Corporation elected to claim the federal targeted jobs credit in 1989 in lieu of a deduction for that portion of the wages paid or incurred equal to the jobs credit computed. Taxpayer Y's pro rata share of DEF Corporation's federal ordinary income for 1989 is \$4,000.

For federal purposes, Taxpayer Y enters all of his passive activity income and losses, including his ordinary income of \$4,000 from DEF Corporation, on federal Form 8582. He determines that \$10,600 of his passive activity losses is allowable in computing his 1989 federal adjusted gross income.

For Wisconsin purposes, DEF Corporation may not claim the federal targeted jobs credit. Instead, DEF Corporation elects to deduct the wages paid or incurred which were not allowed federally. As a result of deducting these wages, DEF Corporation realizes an ordinary loss

in 1989 for Wisconsin purposes. Taxpayer Y's pro rata share of that loss is \$7,000.

Since his ordinary income or loss from DEF Corporation differs for federal and Wisconsin purposes, must Taxpayer Y recompute his allowable passive activity losses for Wisconsin purposes?

Answer 2: Yes. Taxpayer Y must recompute his allowable passive activity losses. He prepares another Form 8582 for Wisconsin purposes and substitutes his ordinary loss, as computed for Wisconsin purposes, from DEF Corporation of \$7,000 for his federal ordinary income of \$4,000.

He must recompute the allowable passive activity losses because he is making a different election under the Internal Revenue Code with respect to the treatment of wages paid or incurred and he must figure his federal adjusted gross income accordingly for Wisconsin purposes.

Assume that Taxpayer Y recomputes Form 8582 for Wisconsin purposes, and he determines that \$6,600 of his passive activity losses, including \$1,250 of his ordinary loss from DEF Corporation, is allowable in 1989 for Wisconsin purposes.

Taxpayer Y then must recompute his federal adjusted gross income for Wisconsin purposes by preparing a pro forma federal return. He will substitute the \$6,600 of passive activity losses allowable for Wisconsin for the \$10,600 of passive activity losses allowable on the federal income tax return that he filed with the Internal Revenue Service.

Finally, Taxpayer Y will enter his recomputed federal adjusted gross income on line 1 of his Wisconsin income tax return, Form 1.

Facts and Question 3: Taxpayer X, a full-year Wisconsin resident, is a limited partner in GHI Partnership. He determines that he must treat his interest in GHI partnership as a passive activity. In 1989, GHI Partnership sold property used in its trade or business (section 1231 assets) which had been held more than one year and realized a gain on the sale. Taxpayer X's distributive share of that gain is \$3,000. He determines that he must treat his share of the gain as a long-term capital gain.

For federal purposes, Taxpayer X enters all of his passive activity income and losses, including his section 1231 gain of \$3,000 from GHI Partnership, on federal Form 8582. He determines that \$10,600 of his passive activity losses is allowable in computing his 1989 federal adjusted gross income.

For Wisconsin purposes, Taxpayer X determines that his section 1231 gain qualifies for the 60% capital gain deduction under sec. 71.05(6)(b)9, Wis. Stats. (1987-88).

Since only \$1,200 of his section 1231 gain is taxable for Wisconsin purposes, must Taxpayer X recompute his allowable passive activity losses for Wisconsin purposes?

Answer 3: No. Taxpayer X is not required to recompute his allowable passive activity losses. He must subtract from his federal adjusted