

Stats. (1989-90). Marcia Mabie was paid one-half of the surplus proceeds.

The Circuit Court concluded that the surplus proceeds are not protected by the homestead exemption. The lien acquired

by the department is a statutory lien, and property is not exempt in any proceeding brought by any person against the holder of a statutory lien. The Circuit Court thus vacated its previous Order and found that

the balance of the surplus proceeds should be delivered to the department.

This decision has not been appealed.

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## TAX RELEASES

*"Tax Releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. In situations where the facts vary from those given herein, the answers may not apply. 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:

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## INDIVIDUAL INCOME TAXES

1. Sale of an Installment Obligation by a Nonresident of Wisconsin

Statutes: Sections 71.01(6) and 71.04(1)(a), Wis. Stats. (1989-90)

Wis. Adm. Code: Section Tax 2.95, March 1991 Register

Note: This Tax Release applies only with respect to sales and exchanges of installment obligations occurring on or after April 1, 1991.

Background and Question: Section 71.04(1)(a), Wis. Stats. (1989-90), provides that income or loss of nonresident individuals from the sale of real property or tangible personal property shall follow the situs of the property. Income or loss of nonresident individuals derived from land contracts, mortgages, stocks, bonds, and securities or from the sale of similar intangible personal property shall follow the residence of such persons.

Internal Revenue Code section 453B(a) provides that any gain or loss resulting from the disposition of an installment obligation shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

Is the gain or loss from the sale of an installment obligation by a nonresident taxable to Wisconsin?

Answer: Gain or loss on the sale of an installment obligation by a nonresident is taxable to Wisconsin where the installment obligation resulted from the sale of real property or tangible personal property located in Wisconsin. Gain or loss on the sale of an installment obligation by a nonresident is not taxable to Wisconsin where the installment obligation resulted from the sale of intangible personal property or from the sale of real property or tangible personal property located outside Wisconsin. Since Wisconsin has adopted the definition of adjusted gross income as defined by the Internal Revenue Code, section 453B(a) of the Internal Revenue Code controls to classify the sale of an installment obligation as the sale of real property, personal property, or intangible personal property before applying the situs of income rules prescribed by Wisconsin law.

Example: In 1989 a nonresident of Wisconsin sold real estate located in Wisconsin for \$140,000. The adjusted basis of the property was \$70,000 which resulted in a gross profit percentage of 50%. The taxpayer received \$40,000 down and an installment note for \$100,000. The gross profit of \$20,000 (\$40,000 x 50%) was included in 1989 Wisconsin taxable income. An additional \$50,000 was paid off in 1990 of which \$25,000 (\$50,000 x 50%) was included in 1990 Wisconsin taxable income. The installment obligation is sold for \$55,000 in May 1991. The gain on the sale of the installment obligation which is taxable to Wisconsin for 1991 is computed as follows:

Selling price of installment obligation	\$55,000
Basis:	
Unpaid balance	\$50,000
Less profit due (50% x \$50,000)	<u>25,000</u>
Basis	<u>25,000</u>
Gain on sale of installment obligation taxable to Wisconsin	<u>\$30,000</u>

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## 2. Taxability of Interest from Veterans' Administration Life Insurance Policy

**Statutes:** Section 71.05(6)(a)1, Wis. Stats. (1989-90)

**Note:** This Tax Release applies for all years open to adjustment and supersedes the Tax Release titled "Taxability of Interest from Veterans Administration Life Insurance Policy" in *Wisconsin Tax Bulletin* #57, July 1988.

**Background:** Previously, interest income earned on dividends left on deposit with the Veterans' Administration (now Department of Veterans' Affairs) was taxable for both federal and Wisconsin income tax purposes pursuant to Rev. Rul. 57-441. This Revenue Ruling held that interest credited to the account of a veteran on dividends accumulated by the Veterans' Administration on a converted United States Government Life Insurance policy, or on a National Service Life Insurance policy, was not a "veterans' benefit" under 38 U.S.C. § 3101(a). Payments of benefits by the Veterans' Administration are exempt from taxation under 38 U.S.C. § 3101(a). On February 15, 1991, the Internal Revenue Service issued Rev. Rul. 91-14 which revokes Rev. Rul. 57-441. As a result, interest earned on dividends left on deposit with the Veterans' Administration is not subject to federal income tax.

**Question:** Is interest income earned on dividends left on deposit with the Veterans' Administration (now Department of Veterans' Affairs) on a life insurance policy subject to Wisconsin income tax?

**Answer:** No. Because Rev. Rul. 57-441 no longer applies, such interest income is considered a "veterans' benefit." Wisconsin is prohibited by 38 U.S.C. § 3101(a) from taxing veterans' benefits. Therefore, no addition modification is required under sec. 71.05(6)(a)1, Wis. Stats., to add the amount of such interest to federal adjusted gross income when computing Wisconsin taxable income.

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## 3. Taxable Status of IRA Distribution Where Principal Contributed to the IRA Was Exempt from Wisconsin Tax

**Statutes:** Section 71.05(1)(a), Wis. Stats. (1989-90)

**Background:** Section 71.05(1)(a), Wis. Stats. (1989-90), provides an exemption from Wisconsin income tax for all payments received from certain retirement systems if such amounts are paid on the account of a person who was a member of, or retired from, the system as of December 31, 1963. The affected retirement systems are:

- (a) United States government civilian employee and military employee retirement systems.
- (b) Employee's Retirement System of the City of Milwaukee.
- (c) Milwaukee County Employees' Retirement System.
- (d) Sheriff's Annuity and Benefit Fund of Milwaukee County.
- (e) Police Officer's Annuity and Benefit Fund of Milwaukee.
- (f) Fire Fighter's Annuity and Benefit Fund of Milwaukee.
- (g) Public Employee Trust Fund as successor to the Milwaukee Public School Teachers' Annuity and Retirement Fund.
- (h) Wisconsin State Teachers' Retirement System.

**Facts and Question:** An individual was a member of the Wisconsin State Teachers' Retirement System as of December 31, 1963. The individual receives a lump-sum distribution from the Wisconsin Retirement System which is based on membership in the Wisconsin State Teachers' Retirement System and qualifies for the exemption in sec. 71.05(1)(a), Wis. Stats. (1989-90). The lump-sum distribution is rolled over into an Individual Retirement Account (IRA) and, therefore, is not includible in federal adjusted gross income in the year received.

When amounts are distributed from the IRA, will any portion of such distribution qualify for the exemption from Wisconsin tax provided by sec. 71.05(1)(a), Wis. Stats. (1989-90)?

**Answer:** No. The IRA distributions do not qualify for the exemption under sec. 71.05(1)(a), Wis. Stats. (1989-90). The distributions are payments from the IRA trust account and are not payments from the Wisconsin State Teachers' Retirement System. Only direct distributions to a taxpayer from the retirement systems listed in sec. 71.05(1)(a) are exempt from income tax.

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## CORPORATION FRANCHISE OR INCOME TAXES

### 1. Bad Debt Deduction Allowable to Credit Unions

**Statutes:** Section 71.26(1)(a) and (2)(a), Wis. Stats. (1989-90)

**Note:** This Tax Release applies with respect to the 1987 taxable year and thereafter.

**Background:** For federal income tax purposes, credit unions without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under sec. 501(c)(14) of the Internal Revenue Code (IRC). Federal credit unions may be exempt under IRC sec. 501(c)(1).

The federal exemptions under IRC sec. 501 do not apply for Wisconsin purposes but are replaced with the exemptions provided under Wis. Stat. sec. 71.26(1). Sec. 71.26(3)(p), Wis. Stats. (1989-90). A credit union is subject to Wisconsin franchise or income taxation only on the income that is derived from public deposits for any taxable year in which the credit union is approved as a public depository under chapter 34 of the Wisconsin Statutes and acts as a depository of state or local funds under Wis. Stat. sec. 186.113(20). Sec. 71.26(1)(a), Wis. Stats. (1989-90).

The income of a credit union that is derived from public deposits is the product of the credit union's gross annual income for the taxable year multiplied by a fraction, the numerator of which is the average monthly balance of public deposits in the credit union during the taxable year, and the denominator of which is the average monthly balance of all deposits in the credit union during the taxable year. Sec. 71.26(1)(a), Wis. Stats. (1989-90). A credit union may elect to compute its Wisconsin net income either by (a) applying the percentage of public deposits to its entire net income or (b) applying the percentage of public deposits to its annual gross income and to expenses indirectly related to public deposit income and deducting 100% of the expenses directly related to income from public deposits.

In computing its entire net income for Wisconsin purposes for 1986 and prior taxable years, a credit union was allowed to claim a bad debt deduction of either (a) two-thirds of the amount it was required to allocate to its 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), Wis. Stats. (1985-86)], or (b) the actual bad debts sustained during the year [sec. 71.04(7), Wis. Stats. (1985-86)]. Since this was an annual election, a credit union could claim whichever deduction was greater each year.

Beginning with the 1987 taxable year, Wisconsin net income is computed under the Internal Revenue Code as defined for Wisconsin purposes, with certain modifications. Sec. 71.26(2)(a), Wis. Stats. (1989-90). The modifications are provided in sec. 71.26(3), Wis. Stats. (1989-90). The Internal Revenue Code sections relating to the treatment of bad debts (secs. 166, 585, and 593) are not modified for Wisconsin purposes; they generally apply in computing Wisconsin net income.

Section 166(a), IRC, provides for the deduction of debts which become worthless during the taxable year. Thus, most taxpayers must use the direct write-off (or specific charge-off) method to deduct bad debts. However, in lieu of the deduction for bad debts actually written off, certain financial institutions may claim a deduction for a reasonable addition to a reserve for bad debts under IRC sec. 585 or sec. 593, as appropriate.

Section 585, IRC, allows "small banks" (those with assets of \$500 million or less) to use the reserve method of accounting for bad debts. Large banks must use the specific charge-off method. For purposes of the bad debt deduction under sec. 585, the term "bank" means any bank, as defined in IRC sec. 581, other than an organi-

zation to which sec. 593 applies. Section 581 defines a sec. 585 bank as

a bank or trust company incorporated and doing business under the laws . . . of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks . . . and which is subject by law to supervision and examination by State authority . . . .

Section 593, IRC, provides that the reserve method of computing deductions for bad debts may be used by (a) any domestic building and loan association, (b) any mutual savings bank, and (c) any cooperative bank without capital stock organized and operated for mutual purposes and without profit.

**Question 1:** Must a credit union use the specific charge-off method for deducting bad debts or may it elect to use the reserve method of accounting for bad debts and claim a deduction for an addition to a reserve for bad debts as provided under IRC sec. 585 or sec. 593?

**Answer 1:** If a credit union actually engages in either the business of making commercial loans or the exercise of trust powers, it will be treated as a sec. 585 bank and may elect to use the reserve method for deducting bad debts as provided under IRC sec. 585. A credit union is not a sec. 593 financial institution and, therefore, is not eligible for the bad debt deduction under IRC sec. 593. A credit union which does not make commercial loans or exercise trust powers must use the specific charge-off method for deducting bad debts.

**Question 2:** May a credit union annually elect to deduct the greater of the addition to the reserve for bad debts or the actual bad debts written off during the taxable year?

**Answer 2:** No, a credit union does not have the option of deducting the greater of the addition to the reserve for bad debts or the actual bad debts written off. The method for computing and deducting bad debts is a method of accounting under the Internal Revenue Code. A credit union may change its method of accounting for bad debts in the manner specified in federal law and must make any adjustments necessary to prevent the omission or duplication of a deduction as required under IRC sec. 481.

**Question 3:** How does a credit union compute its allowable bad debt deduction under the reserve method?

**Answer 3:** A credit union which uses the reserve method must compute its bad debt deduction under IRC sec. 585(b). For the 1987 taxable year, a credit union could base the addition to its reserve for bad debts on either the percentage-of-outstanding-debt method or the experience method. For 1988 and thereafter, only the experience method may be used.

Under the percentage method, deductions were permitted to the extent necessary to increase the bad debt reserve to 0.6% of the

outstanding eligible loans. Under the experience method, a credit union may add to its bad debt reserve the amount computed on the basis of its actual experience as shown by losses for the current year and the 5 preceding taxable years.



## 2. Sales Factor — No Throw Back of Sales Due to Nexus With Destination State

**Statutes:** Section 71.25(9)(b), Wis. Stats. (1989-90)

**Wis. Adm. Code:** Sections Tax 2.39(5)(c)6, January 1978 Register and Tax 2.82 (1)(a), (3)(b), and (4)(a)6, 8, and 10, January 1979 Register

**Note:** For additional information about throwback sales, refer to the Tax Releases titled "Sales Factor — Throw Back of Sales Due to Insufficient Nexus With Destination State," published in *Wisconsin Tax Bulletin* 69 (October 1990), and "Sales Factor — Throw Back of Sales From States in Which a Combined or Consolidated Return Is Filed," published in *Wisconsin Tax Bulletin* 63 (October 1989).

**Background:** A multistate corporation with operations in Wisconsin must report a portion of its net income to Wisconsin using the apportionment method if its Wisconsin operations are part of a unitary business. The apportionment formula used by most multistate corporations consists of a property factor, payroll factor, and sales factor. The numerator of the sales factor is the taxpayer's total sales allocated to Wisconsin during the taxable year and the denominator is the taxpayer's total sales everywhere.

For purposes of computing the sales factor, sales of tangible personal property are included in the numerator of the sales factor at 100 percent if shipped to a Wisconsin location and at 50 percent if the property is shipped from a location in Wisconsin to a location in another state and the taxpayer is not within the jurisdiction, for income or franchise tax purposes, of the destination state. Sec. 71.25(9)(b)3, Wis. Stats. Under Public Law 86-272, a state may not impose its income tax or franchise tax based on net income on a corporation selling tangible personal property if that corporation's only activity in the state is the solicitation of orders, which orders are approved outside the state and are filled by delivery from a point outside the state. If there is any activity in the state which exceeds solicitation, the immunity from taxation under Public Law 86-272 is lost. Sec. Tax 2.82(3)(b)1, Wis. Adm. Code.

**Facts and Question 1:** ABC Corporation does business in and outside Wisconsin and is subject to Wisconsin franchise tax. ABC Corporation's activities in State Y consist of employees who:

- a) Conduct training courses, seminars, and lectures
- b) Provide shipping information and coordinate deliveries

- c) Carry samples for sale, exchange or distribution in any manner for consideration or other value
- d) Solicit sales of services — sales of a computerized ordering service for the ordering of parts
- e) Repossess property

ABC Corporation also owns property in State Y in the form of tooling equipment used by suppliers to produce parts marketed by ABC Corporation. State Y imposes its income tax on corporations which have activities that create nexus in State Y. Public Law 86-272 applies to State Y's corporation income tax for the purpose of determining nexus.

Are ABC Corporation's sales shipped from Wisconsin to State Y treated as Wisconsin sales and thrown back to Wisconsin to be included in the numerator of its sales factor?

**Answer 1:** No. ABC Corporation's sales shipped from Wisconsin to State Y are not thrown back to Wisconsin because ABC Corporation has nexus in and is subject to State Y's corporation income tax. ABC Corporation's activities in State Y exceed the protection of Public Law 86-272.

**Facts and Question 2:** DEF Corporation, which is a wholly-owned subsidiary of XYZ Corporation, does business in and outside Wisconsin and is subject to Wisconsin franchise tax. The activities performed by DEF Corporation in State Y consist of engineering services which are performed by employees of XYZ Corporation but are under the direct control of DEF Corporation. In carrying out the contracts in State Y, XYZ Corporation's employees hold themselves out to customers as the employees of DEF Corporation. DEF Corporation pays management and service fees to XYZ Corporation for the personal services of XYZ Corporation's employees in State Y. DEF Corporation has no real or tangible personal property in State Y.

Is DEF Corporation required to throw back to Wisconsin sales shipped from Wisconsin to State Y?

**Answer 2:** No. A person under the direct control of a corporation may be considered an employee for purposes of determining nexus under Public Law 86-272 even though he or she is not an employee for other purposes such as payroll taxes. The duties performed by XYZ Corporation's employees, under the direct control of DEF Corporation, are not protected by Public Law 86-272. Because XYZ Corporation employees perform services for and are under the direct control of DEF Corporation, DEF Corporation has nexus in State Y and is not required to throw back to Wisconsin those sales shipped from Wisconsin to State Y.

