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:

INDIVIDUAL INCOME TAXES

1 Distributions From IRAs, Keoghs, and Deferred Compensation Plans Which Invest in U.S. Government Securities

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

Note: This tax release supersedes the tax release titled "Distributions From IRAs Which Invest in U.S. Government Securities" which appeared in *Wisconsin Tax Bulletin* 61 (July 1989), page 13, and the tax release titled "Distributions From Keogh and Deferred Compensation Plans" which appeared in *Wisconsin Tax Bulletin* 65 (January 1990), page 17, to consolidate and clarify the department's position by providing a more detailed explanation. No change in policy is intended.

This tax release also supersedes the tax release titled "Rollover of a Retirement Plan Distribution Which Includes U.S. Government Interest to an IRA" which appeared in *Wisconsin Tax Bulletin* 78 (July 1992), page 13, to limit the scope to distributions from IRAs, Keoghs, and Deferred Compensation Plans.

Background: Federal law (31 USCS § 3124) prohibits states from taxing interest on United States Government obligations. Section 71.05(6)(b)1, Wis. Stats. (1989-90), provides a subtraction from federal adjusted gross income for U.S. Government interest when computing Wisconsin taxable income.

A July 21, 1988, decision by the Wisconsin Court of Appeals, District IV, in *Capital Preservation Fund, Inc. vs. Wisconsin Department of Revenue*, held that interest from direct obligations of the United States Government retains its tax-exempt character when it passes through a mutual fund. As a result, a mutual fund distribution received by a shareholder is exempt from Wisconsin income tax to the extent it is attributable to U.S. government interest that the mutual fund received.

Policy: The flow-through of tax-exempt interest principle applies to (1) individual retirement arrangements (IRAs), (2) Keogh retirement plans, and (3) deferred compensation plans (such as Internal Revenue Code section 401(k), 403(b), and 457 deferred compensation plans). Therefore, a distribution from an IRA, Keogh, or deferred compensation plan which is the direct owner of U.S. government securities or invests in a mutual fund which holds U.S. government securities is exempt from Wisconsin income tax to the extent the distribution is attributable to interest from those U.S. government securities.

It is the department's position that tax-exempt interest does not retain its character when it passes through qualified retirement plans other than the three plans identified in the preceding paragraph. See Question and Answer 9 below. (Note: As of January 1993, application of the flow-through principle to a qualified employer-provided plan is being litigated in Minnesota. Resolution of that case, or c litigation in Wisconsin courts, may provide further guidance on this issue.)

Facts and Question 1: A taxpayer establishes an individual retirement account (IRA). The amounts contributed to the IRA are invested in securities issued by the United States Government (e.g., U.S. Treasury bonds).

When amounts are withdrawn from this IRA, will a portion of the amount withdrawn constitute interest from a United States Government security which is exempt from Wisconsin income tax?

Answer 1: Yes. The portion of the amount withdrawn from the IRA which is attributable to interest from U.S. Government securities may be excluded from Wisconsin taxable income. An individual who receives distributions from an IRA which either (1) directly owns U.S. Government securities, or (2) owns shares of a mutual fund which invests in U.S. Government securities, is considered to have received exempt interest from a U.S. Government obligation.

Facts and Question 2: A taxpayer establishes an IRA at a bank. The amounts contributed to the IRA are invested in bank certificates of deposit. The bank receives interest income from its own investment in U.S. Government securities.

When amounts are withdrawn from this IRA, will any portion of the amount withdrawn constitute interest from U.S. Government securities which is exempt from Wisconsin income tax?

Answer 2: No. In this situation, the IRA is not the direct owner of the U.S. Government securities. U.S. Government interest received by the bank does not pass through as exempt U.S. interest to the owner of the IRA.

Facts and Question 3: A taxpayer establishes an IRA by purchasing an annuity contract from a life insurance company. The life insurance company receives interest income from its own investment in U.S. Government securities.

When amounts are withdrawn from this IRA, will any portion of the amount withdrawn constitute interest from U.S. Government securities which is exempt from Wisconsin income tax?

Answer 3: No. In this situation, the IRA is not the direct owner of the U.S. Government securities. U.S. Government interest received by the insurance company does not pass through as exempt U.S. interest to the owner of the IRA.

Question 4: When amounts are withdrawn from a Keogh or deferred compensation plan which invests in securities issued by the U.S. Government, will a portion of the amount withdrawn constitute interest from U.S. Government securities which is exempt from Wisconsin income tax?

Answer 4: Yes. The portion of the amount withdrawn from a Keogh plan or deferred compensation plan attributable to interest from U.S. Government securities may be excluded from Wisconsin taxable income under sec. 71.05(6)(b)1, Wis. Stats. (1989-90), pursuant to 31 USCS § 3124, provided the plan is a "qualified retirement plan." The plan must be the direct owner of the U.S. Government securities or own shares of a mutual fund which invests in U.S. Government securities.

Facts and Question 5: The taxpayer received a total distribution from a 401(k) deferred compensation plan. The assets of the 401(k) plan had been partially invested in U.S. Government securities. The taxpayer has records to show what portion of the distribution is attributable to interest from U.S. Government securities. Within the allowable time period, the taxpayer rolls over the distribution to an IRA which does not invest in U.S. Government securities.

When amounts are withdrawn from this IRA, does any portion of the amount withdrawn constitute interest from U.S. Government securities which is exempt from Wisconsin income tax?

Answer 5: Yes. The U.S. Government interest portion of the distribution from the 401(k) plan retains its tax-exempt character when it is rolled over to the IRA. The portion of the amount withdrawn from the IRA which is attributable to the interest from U.S. Government securities which was included in the 401(k) plan distribution is exempt from Wisconsin income tax.

Question 6: When U.S. Government interest is accumulated in an IRA, what portion of a distribution from the IRA is considered U.S. Government interest?

Answer 6: The portion of an IRA distribution which is considered U.S. Government interest is based on the following formula:

$$\text{Amounts distributed from all IRAs during the year} \times \frac{\text{Total U.S. Government interest received by the IRAs for all years minus the amounts of U.S. Government interest withdrawn in prior years}}{\text{Total value of all IRAs at the end of the year plus amounts distributed during the year}}$$

The following worksheet can be used to determine the portion of an IRA distribution which is considered U.S. Government interest. If the taxpayer has more than one IRA, they must be considered together, as if they were a single IRA, when completing the worksheet.

1. Amounts distributed from all IRAs during the year	$ ______
2. Total U.S. Government interest received by the IRAs for all years minus the amounts of U.S. Government interest withdrawn in prior years	$ ______
3. Total value of all IRAs at end of year plus amount on line 1	$ ______
4. Divide line 2 by line 3. Enter decimal figure	______
5. Multiply line 1 by line 4. This is the amount of the IRA distribution which is considered U.S. Government interest	$ ______

Example 1: A taxpayer has an IRA which has a fair market value of $40,000 on December 31, 1991. Over the years, the taxpayer contributed $25,000 of deductible contributions to the IRA and the IRA was credited with $10,000 of interest from U.S. Government securities and $11,000 of other interest. During 1991, the taxpayer received a distribution of $6,000 from the IRA. The taxpayer did not receive any distributions in prior years.

The Wisconsin subtraction for U.S. Government interest for 1991 is $1,304.40, computed as follows:

1. Amounts distributed from all IRAs during the year	$ 6,000.00
2. Total U.S. Government interest received by the IRAs for all years minus the amounts of U.S. Government interest withdrawn in prior years	$10,000.00
3. Total value of all IRAs at end of year plus amount on line 1 ($40,000.00 + $6,000.00)	$46,000.00
4. Divide line 2 by line 3	.2174
5. Multiply line 1 by line 4. This is the amount of the IRA distribution which is considered U.S. Government interest	$ 1,304.40

Example 2: During 1992, the taxpayer in Example 1 receives an additional distribution of $8,000 from the IRA. No additional contributions are made to the IRA during 1992. Interest income credited to the IRA during 1992 is $4,000 of which $1,800 is interest from U.S. Government securities and $2,200 is other interest. The fair market value of the IRA on December 31, 1992, is $36,000.

The Wisconsin subtraction for U.S. Government interest is $1,908.00, computed as follows:

1. Amounts distributed from all IRAs during the year	$ 8,000.00
2. Total U.S. Government interest received by the IRAs for all years minus the amounts of U.S. Government interest withdrawn in prior years ($10,000.00 + $1,800.00 - $1,304.40)	$10,495.60
3. Total value of all IRAs at end of year plus amount on line 1 ($36,000.00 + $8,000.00)	$44,000.00
4. Divide line 2 by line 3	.2385
5. Multiply line 1 by line 4. This is the amount of the IRA distribution which is considered U.S. Government interest	$ 1,908.00

Question 7: If an IRA which was funded with both deductible and nondeductible contributions accumulates U.S. Government interest, what portion of a distribution from the IRA is considered U.S. Government interest?

Answer 7: The following worksheet may be used when nondeductible contributions have been made to an IRA which invests in U.S. Government securities.

1. Amounts distributed from all IRAs during the year	$______
2. Total nondeductible contributions and U.S. Government interest received by the IRAs for all years minus any tax-free withdrawals in prior years	$______
3. Total value of all IRAs at end of year plus amount on line 1	$______
4. Divide line 2 by line 3. Enter decimal figure	______
5. Multiply line 1 by line 4. This is the total amount not taxable for Wisconsin	$______
6. Subtract line 5 from line 1. This is the amount of the IRA distribution that must be included in Wisconsin income	$______
7. Amount of IRA distribution included in federal adjusted gross income	$______
8. Subtract line 6 from line 7. This is the amount of the IRA deduction which is considered U.S. Government interest	$______

Example: A taxpayer has an IRA which has a fair market value of $60,000 on December 31, 1991. Over the years, the taxpayer contributed $40,000 of deductible contributions and $2,000 of nondeductible contributions to the IRA, and the IRA was credited with $20,000 of interest from U.S. Government securities and $8,000 of other interest. During 1991, the taxpayer received a distribution of $10,000 from the IRA. Of this amount, $9,700 is included in federal adjusted gross income. The taxpayer did not receive any distribution in prior years.

The Wisconsin subtraction for U.S. Government interest for 1991 is $2,843.00, computed as follows:

1. Amounts distributed from all IRAs during the year	$10,000.00
2. Total nondeductible contributions and U.S. Government interest received by the IRAs for all years minus any tax-free withdrawals in prior years	$22,000.00
3. Total value of all IRAs at end of year plus amount on line 1 ($60,000.00 + $10,000.00)	$70,000.00
4. Divide line 2 by line 3	.3143
5. Multiply line 1 by line 4. This is the total amount not taxable for Wisconsin	$ 3,143.00
6. Subtract line 5 from line 1. This is the amount of the IRA distribution that must be included in Wisconsin income	$ 6,857.00
7. Amount of IRA distribution included in federal adjusted gross income	$ 9,700.00
8. Subtract line 6 from line 7. This is the amount of the IRA distribution which is considered U.S. Government interest	$ 2,843.00

Question 8: Is the formula for determining what portion of a Keogh plan or deferred compensation plan distribution is considered U.S. Government interest the same as the formula used for IRAs?

Answer 8: Yes. The formula used to determine what portion of an IRA distribution is U.S. Government interest should also be used to determine what portion of a Keogh plan or deferred compensation plan distribution is U.S. Government interest.

Facts and Question 9: The taxpayer is a retired employe of Corporation X. He receives retirement benefits from Corporation X's retirement system. The retirement system receives a portion of its investment income from U.S. Government securities.

Does any portion of the retirement benefit constitute interest from U.S. Government securities which is exempt from Wisconsin income tax?

Answer 9: No. Tax-exempt interest does not retain its character when it passes through qualified retirement plans (except IRAs, Keoghs, and deferred compensation plans, as indicated in the Policy section above). Therefore, no portion of the retirement benefit the taxpayer receives from Corporation X's retirement system may be treated as nontaxable U.S. Government interest. □

2 Short Period Returns as a Result of Bankruptcy

Statutes: Sections 71.03(3) and 71.05(5) and (22)(b)3, Wis. Stats. (1989-90)

Background: If an individual debtor files for bankruptcy under Chapter 7 (liquidation) or 11 (reorganization) of the federal Bankruptcy Code, a separate "estate" is created consisting of property that belonged to the debtor before the filing. The bankruptcy estate is a new taxable entity, completely separate from the individual.

Generally, an individual's tax year does not change when the bankruptcy petition is filed. However, an individual debtor who files for bankruptcy under Chapter 7 or 11 and who has assets other than those treated as exempt property may, for federal tax purposes, elect to end his or her tax year on the day before the filing of the bankruptcy case. If this choice is made, the individual's tax year is divided into two "short" tax years of less than 12 months each. The first year ends on the day before the filing date, and the second year begins with the filing date and ends on the date the individual's tax year normally ends. Section 1398(d), Internal Revenue Code (IRC).

The taxable income for the short period must be placed on an annual basis by multiplying taxable income for the short period by 12, and dividing the result by the number of months in the short period. The total tax is then multiplied by the number of months in the short tax year and divided by 12. Section 443(b)(1), IRC.

Wisconsin law provides that if an individual or fiduciary files a federal income tax return for a fractional part of the year, he or she must file a Wisconsin return for that fractional year. Section 71.03(3), Wis. Stats. (1989-90). Wisconsin taxable income is also placed on an annual basis using the federal method in sec. 443(b)(1), IRC. Section 71.05(5), Wis. Stats. (1989-90). An individual who files a short period return may not claim the Wisconsin standard deduction. Section 71.05(22)(b)3, Wis. Stats. (1989-90).

This tax release provides information on reporting certain Wisconsin credits and adjustments and the Wisconsin alternative minimum tax on a short period return. Further information on bankruptcy may be found in the federal Internal Revenue Service Publication 908, *Bankruptcy and Other Debt Cancellation*. Further information on short period returns can be found in Internal Revenue Service Publication 538, *Accounting Periods and Methods*.

Question 1: Where are nonrefundable credits, such as the school property tax credit, dependent credit, senior citizen credit, itemized deduction credit, and married couple credit, included in the computation of net tax for a short period return, and how are these credits computed?

Answer 1: Any nonrefundable credit that is based on an income or deduction amount is computed upon the amount of related income or deduction annualized separately. The computed credit offsets the gross tax on the basis of the annualized taxable income. This results in an annualized net tax which is then prorated for the number of months in the short period. (Refundable credits are addressed in questions 5 through 7.)

Example 1: A single taxpayer has $5,000 of wages for the short period January 1, 1991, to March 31, 1991. During the short period, the taxpayer paid $1,000 of property taxes. The taxpayer's net tax is computed as follows:

Taxable income for the short period	$ 5,000.00
Multiply by 12	x 12
	$ 60,000.00
Divide by months in short period	÷ 3
Annualized income	$ 20,000.00
Gross tax on annualized income	$ 1,205.25
Less school property tax credit*	200.00
Annualized net tax	$ 1,005.25
Prorate for months in short period	x 3/12
Net tax for short period	$ 251.31

* Computation of school property tax credit:

Property taxes for short period	$ 1,000.00
Multiply by 12	x 12
	$ 12,000.00
Divide by months in short period	÷ 3
	$ 4,000.00
Maximum property taxes allowed	$ 2,000.00
Credit per table	$ 200.00

Example 2: A single taxpayer has $8,000 of wages for the short period January 1, 1991, to May 31, 1991. The taxpayer has one dependent child. The taxpayer's net tax is computed as follows:

Taxable income for the short period	$ 8,000.00
Multiply by 12	x 12
	$ 96,000.00
Divide by months in short period	÷ 5
Annualized income	$ 19,200.00

Gross tax on annualized income	$ 1,149.81
Less dependent credit*	50.00
Annualized net tax	$ 1,099.81
Prorate for months in short period	x 5/12
Net tax for short period	$ 458.25

* Any dependent credit or senior citizen credit is not annualized since these credits already reflect the allowable credit for the entire year.

Example 3: A single taxpayer has wages of $5,000 for the short period January 1, 1991, to March 31, 1991. The taxpayer paid investment interest of $500 during the short period that may be used in computing the itemized deduction credit. The taxpayer's net tax would be computed as follows:

Income for the short period	$ 5,000.00
Multiply by 12	x 12
	$ 60,000.00
Divide by months in short period	÷ 3
Annualized taxable income	$ 20,000.00

Gross tax on annualized income	$ 1,205.25
Itemized deduction credit*	60.00
Annualized tax	$ 1,145.25
Prorate tax for short period	x 3/12
Net tax for short period	$ 286.31

* Computation of itemized deduction credit:

Investment interest for short period	$ 500.00
Multiply by 12	x 12
	$ 6,000.00
Divide by months in short period	÷ 3
	$ 2,000.00
Limitation on investment interest for 1991	$ 1,200.00
Less standard deduction	-0-
	$ 1,200.00
Multiply by 5%	x .05
Annualized credit	$ 60.00

Example 4: A married couple (spouse has joined in the election to end the tax year) file a joint return for the short period January 1, 1991, to June 30, 1991. The husband has wages of $10,000 for the short period and the wife has wages of $8,000 for the short period. During the short period, the husband contributed $1,500 to his IRA. The net tax on the joint return is computed as follows:

Taxable income for the short period	$ 16,500.00
Multiply by 12	x 12
	$198,000.00
Divide by months in short period	÷ 6
Annualized income	$ 33,000.00

Gross tax on annualized income	$ 2,045.90
Less married couple credit*	300.00
Annualized net tax	$ 1,745.90
Prorate for months of short period	x 6/12
Net tax for short period	$ 872.95

* Computation of married couple credit:

	Husband	Wife
Annualized earned income (husband - $10,000 x 12 ÷ 6; wife - $8,000 x 12 ÷ 6)	$ 20,000	$ 16,000
Less annualized IRA deduction ($1,500 x 12 ÷ 6 but limited to $2,000)	$ 2,000	
Qualified earned income	$ 18,000	$ 16,000

Smaller of the qualified earned income of each spouse, but limited to $15,000	$ 15,000
Multiply by 2%	x .02
Married couple credit	$ 300

Facts and Question 2: Section 71.05(6)(a)10, Wis. Stats. (1989-90), limits the amount of farm losses that may be deducted each year. The deduction for farm losses is limited if nonfarm Wisconsin adjusted gross income is more than $55,000 ($27,500 if married filing separately). Farm losses in excess of the allowable loss must be added to federal adjusted gross income in computing Wisconsin taxable income. (For further information on the farm loss limitation, see the tax release titled "Limitations on Farm Losses" in *Wisconsin Tax Bulletin* 51 (July 1987), page 9).

How is the farm loss limitation computed when a farm loss occurs in a short period?

Answer 2: Nonfarm income and farm loss are annualized separately to determine if an add modification is required.

Example: A single taxpayer has the following income/loss for the short period January 1, 1991, to March 31, 1991:

Wages	$ 15,000
Dividends	1,000
Farm loss	(30,000)
Federal adjusted gross income	$ (14,000)

The modification is computed as follows:

Annualized nonfarm income ($16,000 x 12 ÷ 3)	$ 64,000