

issued by the corporation at the time of incorporation.

Question 12: If stock that qualifies as small business stock is held by a spouse as individual property and later reclassified as marital property, may the entire gain on the sale of the stock qualify for the small business stock capital gains exclusion?

Answer 12: No. Only the gain realized on the ownership interest retained by the original owner may qualify for the small business stock capital gains exclusion. At the time of reclassification, the shareholder's spouse becomes the owner of one-half of the stock that is reclassified as marital property. The gain on the portion of the stock owned by the shareholder's spouse as a result of the reclassification does not qualify for the small business stock capital gains exclusion.

For transfers occurring prior to August 16, 1991, the small business stock capital gains exclusion applies only to the person who initially acquired the stock from the corporation. Stock acquired by gift does not qualify for the exclusion. Under Internal Revenue Code sec. 1041, the transfer of property from an individual to a spouse is treated as a gift.

For stock transferred on or after August 16, 1991, the exclusion is available only to the original purchaser of small business stock that is purchased at the time that the business is incorporated.

Example: Prior to his marriage in 1989, Taxpayer K acquired 100 shares of GHI Corporation stock that qualify as small business stock under sec. 71.01(10), Wis. Stats. The stock is Taxpayer K's individual property. On September 1, 1991, Taxpayer K and his spouse executed a marital property agreement that reclassified the GHI stock as marital property. Taxpayer K and his spouse sell the GHI

stock on October 1, 1996, and realize a gain of \$12,000.

The one-half of the gain (\$6,000) attributable to Taxpayer K's ownership interest qualifies for the small business stock capital gains exclusion, provided he attaches a copy of the certification to his separate tax return or to their joint tax return. The remaining \$6,000 of the gain, which is attributable to his spouse's ownership interest, does not qualify for the capital gains exclusion for small business stock.

Question 13: If the owner of stock that qualifies as small business stock contributes it to a revocable living trust of which he or she is the principal beneficiary, may the gain on the sale of the stock qualify for the small business stock capital gains exclusion?

Answer 13: Yes. The gain on the sale of the stock may qualify for the small business stock capital gains exclusion, provided the taxpayer holds the stock for at least five years and submits the certification with the tax return on which the capital gain is reported. In this situation, the revocable trust does not report any gain on the sale of the stock even though the trust has record title to the shares. Instead, the creator of the trust must report the gain on the sale of the stock. The creator of a revocable trust is considered the owner of the shares of stock both for the imposition of the income tax liability and for purposes of the small business stock capital gains exclusion.

Example 1: On February 1, 1987, Taxpayer J acquired 100 shares of JKL Corporation stock that qualify as small business stock under sec. 71.01(10), Wis. Stats. During 1991, Taxpayer J contributed the JKL stock to a revocable living trust of which he is the principal beneficiary. Record title to the stock was transferred to Taxpayer J as trustee of the trust. Taxpayer J, as trustee, sold the JKL stock on August 1, 1992.

Taxpayer J may claim the small business stock capital gains exclusion for the gain realized on the sale of the 100 shares of JKL stock, provided he attaches the certification to his tax return. In this situation, the revocable trust does not report any gain on the sale of the stock even though the trust has record title to the shares. Instead, Taxpayer J must report the gain on the sale of the JKL stock on his individual income tax return. Taxpayer J is considered the owner of the shares of stock both for the imposition of the income tax liability and for purposes of the small business stock capital gains exclusion.

Example 2: On January 15, 1987, Taxpayer I and his spouse acquired 100 shares of MNO Corporation stock that qualify as small business stock under sec. 71.01(10), Wis. Stats. The stock was acquired as marital property and continues to be classified as marital property. During 1991, they contributed the MNO stock to a revocable living trust created by them for their benefit. Record title to the stock was transferred to Taxpayer I as trustee of the trust. The MNO stock was sold on April 1, 1992.

Taxpayer I and his spouse may claim the small business stock capital gains exclusion for the gain realized on the sale of the 100 shares of MNO stock, provided they attach the certification to their joint or separate tax returns. The revocable trust does not report any gain on the sale of the stock even though the trust has record title to the shares. Taxpayer I and his spouse must report the gain on the sale of the stock as if they had retained record title.

Question 14: If a partnership or limited liability company treated as a partnership acquires stock that meets the requirements under sec. 71.01(10), Wis. Stats., may the gain on the sale of the stock qualify for the small business stock capital gains exclusion?

Answer 14: If a partnership or limited liability company treated as a partnership holds the small business stock for at least five years, an indi-

vidual or fiduciary who is a partner or member of the entity may qualify for the small business stock capital gains exclusion, provided the partner or member owned an interest in the entity at the time the stock was acquired and the partner or member submits the certification with the tax return on which the capital gain is reported. Since a partnership or limited liability company treated as a partnership is a pass-through entity, items of income, gain, loss, or deduction retain their character when passed through to the partners or members. Therefore, stock that meets the requirements under sec. 71.01(10), Wis. Stats., retains its character as small business stock when gain flows through to the partners or members. However, persons who become partners or members after the stock is acquired do not qualify for the small business stock capital gains exclusion. In addition, corporations that are partners or members do not qualify for the capital gains exclusion.

Example 1: FGH Partnership consists of three individuals, Taxpayers F, G, and H, who each have a one-third interest in partnership profits and losses. On March 1, 1993, FGH Partnership acquired 500 shares of stock that qualify as small business stock under sec. 71.01(10), Wis. Stats. FGH Partnership sells the stock on December 31, 1998.

Taxpayers F, G, and H may claim the small business stock capital gains exclusion for their share of the gain realized on the sale of the 500 shares of stock, provided they attach the certification to their individual income tax returns. The gain on the stock retains its character as gain on small business stock when it flows through to Taxpayers F, G, and H.

Example 2: CD Partnership consisted of two individuals, Taxpayers C and D, who each had a one-half interest in partnership profits and losses. On August 1, 1993, CD Partnership acquired 400 shares of stock that qualify as small business stock under sec. 71.01(10), Wis. Stats. On

January 1, 1995, CD Partnership admits Taxpayer E, another individual, as a partner with a one-third interest in partnership profits and losses. CDE Partnership sells the stock on March 1, 1999.

Taxpayers C and D may claim the small business stock capital gains exclusion for their share of the gain realized on the sale of the 400 shares of stock, provided they attach the certification to their individual income tax returns. Any gain allocated to Taxpayer E does not qualify for the small business stock capital gains exclusion. □

3 Passive Activity Losses Allowable to a Nonresident Individual

Statutes: Sections 71.01(13), 71.04(1), and 71.05(6)(a)2, Wis. Stats. (1993-94)

Background: Section 469 of the Internal Revenue Code (IRC) limits the deduction of passive activity losses. Generally, passive activities consist of trade or business activities in which the taxpayer does not materially participate during the taxable year and rental activities. Passive activity losses that are not allowed in the current year are carried forward to future years.

The passive activity loss limits also apply for Wisconsin. [Sec. 71.01(13), Wis. Stats. (1993-94).] All income or loss of resident individuals follows the residence of the individual. Income or loss of nonresident individuals follows the situs of the business from which derived. [Sec. 71.04(1)(a), Wis. Stats. (1993-94).]

In addition, losses not allocable to Wisconsin are added to federal adjusted gross income to calculate an individual's Wisconsin taxable income. [Sec. 71.05(6)(a)2, Wis. Stats. (1993-94).]

Facts and Question 1: An individual incurs losses from passive activities

for years in which the individual is a Wisconsin resident. Because of the passive activity loss limitations, the losses are not allowed as a deduction on the federal or Wisconsin income tax returns for those years.

The individual subsequently moves from Wisconsin and becomes a resident of another state. The passive activity losses which were incurred while the individual was a Wisconsin resident are carried forward and allowed as a deduction on the individual's federal income tax return for a year in which the individual is a nonresident of Wisconsin.

May the individual deduct the passive activity losses on his or her Wisconsin income tax return for that same year?

Answer 1: Yes. Passive activity losses incurred while an individual is a Wisconsin resident may be carried forward and deducted on a Wisconsin income tax return for a year in which the individual is a nonresident of Wisconsin. This is true even though income from the passive activity may no longer be taxable to Wisconsin.

Passive activity losses which are allocable to a Wisconsin resident under sec. 71.04(1)(a), Wis. Stats. (1993-94), retain their status as allocable to Wisconsin when the individual becomes a nonresident. **The passive activity losses are allowed as a deduction on the Wisconsin income tax return for the same year in which they are allowed as a deduction on the federal income tax return.**

Example: For 1993 Taxpayer X was a full-year resident of Wisconsin. Taxpayer X became a partner in three partnerships: Partnership A which conducts business solely in Illinois; Partnership B which conducts business solely in Wisconsin; and Partnership C which conducts business in both Wisconsin and Illinois. Taxpayer X determines that he must treat

the partnership interests as passive activities. His unallowed passive activity losses which may be carried forward to 1994 for federal and Wisconsin tax purposes are as follows:

Partnership A (Illinois)	\$6,200
Partnership B (Wisconsin)	\$8,000
Partnership C (Wisconsin and Illinois)	\$5,000.

On January 1, 1994, Taxpayer X became an Illinois resident. For 1994, Taxpayer X has additional passive activity losses of \$600 from Partnership A and \$1,000 from Partnership C of which \$500 is allocated to Wisconsin and \$500 to Illinois. Taxpayer X reported \$800 of income from Partnership B on both his federal and Wisconsin income tax returns and was allowed to deduct \$800 of the prior year unallowed passive activity losses. The unallowed passive activity losses which may be carried forward to 1995 for federal tax purposes are as follows:

Partnership A (Illinois)	\$6,800
Partnership B (Wisconsin)	\$7,200
Partnership C (Wisconsin and Illinois)	\$6,000.

For 1995, Taxpayer X reports passive activity income of \$2,000 from partnership A, \$30,000 from Partnership B, and \$8,000 from Partnership C of which \$5,000 is allocable to Wisconsin. For federal tax purposes, Taxpayer X is allowed to deduct all of the unallowed passive activity losses which were carried forward to 1995.

The amount of income and loss from passive activities which Taxpayer X reports on his 1995 Wisconsin income tax return is as follows:

Partnership A: Income from Partnership A, which does business solely in Illinois, is not taxable to Wisconsin. Taxpayer X is allowed to deduct \$6,200 of previously unallowed passive activity loss which was incurred while he was a Wisconsin resident.

Partnership B: The income (\$30,000) from Partnership B, which does business solely in Wisconsin, is taxable to Wisconsin. Taxpayer X is allowed to deduct the \$7,200 of previously unallowed passive activity loss which was carried forward to 1995.

Partnership C: The portion (\$5,000) of the income from Partnership C which is attributable to business transacted in Wisconsin is taxable to Wisconsin. Taxpayer X is allowed to deduct \$5,500 of the previously unallowed passive losses (\$5,000 from 1993 and \$500 from 1994).

Therefore, the 1995 federal and Wisconsin income tax returns would include the following passive income and losses:

	Federal	Wisconsin
Passive activity income:		
Partnership A	\$ 2,000	\$ - 0 -
Partnership B	30,000	30,000
Partnership C	8,000	5,000
Allowable passive activity losses:		
Partnership A	\$ (6,800)	\$ (6,200)
Partnership B	(7,200)	(7,200)
Partnership C	<u>(6,000)</u>	<u>(5,500)</u>
Total	\$20,000	\$16,100.

Facts and Question 2: An individual incurs losses from passive activities for years in which the individual is a nonresident of Wisconsin. The losses are not allocable to Wisconsin under sec. 71.04(1)(a), Wis. Stats. (1993-94). Because of the passive activity loss limitations, the losses are not allowed as a deduction on the federal income tax returns for those years.

The individual subsequently becomes a Wisconsin resident. The passive activity losses which were incurred while the individual was a nonresident of Wisconsin are carried forward and allowed as a deduction on the individual's federal income tax return for a year in which the individual is a Wisconsin resident.

May the individual deduct the passive activity losses on his or her Wisconsin income tax return for that same year?

Answer 2: No. Passive activity losses incurred while an individual is a nonresident of Wisconsin and which are not allocable to Wisconsin under sec. 71.04(1)(a), Wis. Stats. (1993-94), may not be carried forward and deducted on a Wisconsin income tax return for a year in which the individual is a Wisconsin resident.

Example: Taxpayer Y is a Minnesota resident. He is a partner in Partnership D which conducts business solely in Minnesota. Taxpayer Y determines that he must treat the partnership interest as a passive activity. His unallowed passive activity losses which may be carried forward to 1995 for federal tax purposes are \$12,000.

On January 1, 1995, Taxpayer Y became a Wisconsin resident.

On his 1995 federal income tax return, Taxpayer Y reports passive activity income of \$20,000 from Partnership D. For federal tax purposes, he is allowed to deduct the \$12,000 of unallowed passive activity losses which were carried forward to 1995.

Taxpayer Y must report \$20,000 of income from Partnership D on his 1995 Wisconsin income tax return. He is not allowed to deduct the pre-1995 passive activity losses which were carried forward to 1995. □

4 Taxation of Air Carrier Employees

Statutes: Section 71.05(6)(b)3, Wis. Stats. (1993-94)

Note: With respect to wages an airline employee receives for performing services on behalf of the employee's airline union, this tax release applies only to wages received on or after August 23, 1994.

Background: Under federal law (Public Law 96-193, enacted February 15, 1980), the compensation an airline employee receives for performing services on an aircraft may be taxed only in the employee's state of residence and the state in which the employee performs more than 50% of his or her duties. Compensation is defined as "all moneys received for services rendered by the employee in the performance of his duties and shall include wages and salary."

Effective August 23, 1994, federal law was amended (Public Law 103-305) to provide that compensation paid by an airline to an employee in connection with the employee's authorized leave or other authorized absence from regular duties to perform services on behalf of the employee's airline union may be taxed only in the employee's state of residence and the state in which the employee's scheduled flight time would have been more than 50% of the employee's total scheduled flight time for the calendar year had the employee been engaged full time in the performance of regularly assigned duties on the carrier's aircraft.

Question: Under what conditions are wages earned by an airline employee subject to Wisconsin tax?

Answer: Airline employees are subject to Wisconsin income tax as follows:

- A. *Airline employees who are legal residents of Wisconsin for the entire taxable year* — All wages are subject to Wisconsin income tax.
- B. *Airline employees who are not legal residents of Wisconsin for any portion of the taxable year (i.e., nonresidents for the entire year)* — Wages earned on an aircraft in Wisconsin are subject to Wisconsin income tax only if

the airline employee performs more than 50% of his or her airline duties in Wisconsin in the calendar year. In the case of wages paid by the airline to an employee on authorized leave or other authorized absence from regular duties to perform services on behalf of the employee's airline union in Wisconsin, such wages are taxable to Wisconsin only if the employee's scheduled flight time in Wisconsin would have been more than 50% of the employee's total scheduled flight time for the calendar year had the employee been engaged full time in the performance of regularly assigned duties on the carrier's aircraft.

C. *Airline employees who are legal residents of Wisconsin for a portion of the taxable year (i.e., part-year residents of Wisconsin)* —

1. During the period in which the airline employee is a legal resident of Wisconsin, all wages are subject to Wisconsin income tax.
2. During the period in which the employee is a nonresident of Wisconsin, wages earned on an aircraft in Wisconsin are subject to Wisconsin income tax only if the airline employee performs more than 50% of his or her airline duties in Wisconsin in the calendar year. In the case of wages paid by the airline to an employee on authorized leave or other authorized absence from regular duties to perform services on behalf of the employee's airline union in Wisconsin, during the period in which the employee is a nonresident of Wisconsin such wages are taxable to

Wisconsin only if the employee's scheduled flight time in Wisconsin would have been more than 50% of the employee's total scheduled flight time for the calendar year had the employee been engaged full time in the performance of regularly assigned duties on the carrier's aircraft. □

5 Waiver of Interest on Underpayment of Estimated Tax

Statutes: Sections 71.09(11)(intro.), (c) and (d) and 71.84(1), Wis. Stats. (1993-94)

Background: Under sec. 71.84(1), Wis. Stats. (1993-94), individuals and fiduciaries, except those exempted under sec. 71.09, Wis. Stats. (1993-94), are subject to interest charges of 12% per year on underpayments of estimated tax. Section 71.09(11), Wis. Stats. (1993-94), provides exceptions under which the interest charges do not apply.

Under sec. 71.09(11)(c) and (d), Wis. Stats. (1993-94), the underpayment interest may be waived if the Secretary of Revenue determines that either:

- A. It is not equitable to impose interest because of a casualty, disaster, or other unusual circumstance; or
- B. The taxpayer retired during the taxable year or the preceding taxable year after attaining age 62 or becoming disabled, and the underpayment was due to reasonable cause rather than willful neglect.

The procedures for applying for a waiver of underpayment interest can

be found in the instructions for completing Wisconsin Schedule U, "Underpayment of Estimated Tax by Individuals and Fiduciaries." Upon application for a waiver by the taxpayer, the department will consider each case on its own merits. The number of quarterly installments for which the department will waive the interest and the amount of interest to be waived will be determined based on the circumstances of each case.

Question 1: What are some situations in which interest may be waived under the "casualty, disaster, or other unusual circumstances" provision?

Answer 1: Under this provision, all or a portion of the interest on estimated tax underpayments may be waived if any of the following events has occurred:

- A. The taxpayer was involved in a natural disaster, such as a fire, a flood, or a tornado.
- B. The taxpayer or an immediate family member suffered a debilitating illness, such as a heart attack, a stroke, or cancer, or an injury (for example, due to an auto accident).
- C. The taxpayer entered a nursing home or other treatment facility.
- D. The taxpayer requested an employer to withhold Wisconsin tax, but the employer withheld another state's tax.
- E. The taxpayer began working in a state with which Wisconsin has reciprocity (Illinois, Indiana, Kentucky, Michigan, or Minnesota), and the employer withheld tax of the reciprocal state rather than Wisconsin tax.
- F. The taxpayer moved to Wisconsin from a reciprocal state, and the employer continued to with-

hold tax of the reciprocal state rather than Wisconsin tax.

- G. The taxpayer or the taxpayer's spouse died.

Question 2: What are some situations in which interest may be waived under the "retirement and reasonable cause" provision?

Answer 2: Under this provision, the taxpayer must have retired during the taxable year or the preceding taxable year; prior to retirement the taxpayer must have become disabled or reached age 62; and the underpayment must have been due to reasonable cause rather than willful neglect. The taxpayer's retirement is not in itself considered "reasonable cause."

If the taxpayer meets the "retirement" provision outlined above, all or a portion of the interest may be waived in the following "reasonable cause" situations:

- A. For the preceding year, the taxpayer did not make estimated tax payments, was not assessed underpayment interest, and was not granted an underpayment interest waiver.
- B. The taxpayer erroneously thought Wisconsin tax was being withheld from retirement income because federal tax was withheld.
- C. The taxpayer received incorrect information from the employer or other payer about the taxability of retirement income.
- D. The taxpayer suffered a disabling illness or injury that led to retirement.

Question 3: What are some situations in which interest on an estimated tax underpayment will not be waived?

Answer 3: The department considers each application for waiver separately. It will not waive interest on an underpayment of estimated tax based solely on any of the following criteria:

- A. The taxpayer was not aware of the estimated tax payment requirements.
- B. The taxpayer was away on vacation or business when the payments were due.
- C. The taxpayer willfully neglected to make the payments. ☐

INDIVIDUAL INCOME AND CORPORATION FRANCHISE AND INCOME TAXES

6 Franchise or Income Tax Nexus — Effect of Intangibles in Wisconsin

Statutes: Sections 71.02(1) and 71.23(1) and (2), Wis. Stats. (1993-94)

Wis. Adm. Code: Section Tax 2.82, November 1993 Register

I. Introduction

This tax release describes how the presence of various types of intangibles in Wisconsin may create nexus for Wisconsin income or franchise tax purposes. This tax release applies to all types of taxpayers (i.e. individuals, partnerships, corporations, estates, and trusts).

II. Background

The licensing (as licensor) of intangible rights for use in Wisconsin is a nexus creating activity pursuant to sec. Tax 2.82(4)(a) 9, Wis. Adm. Code.