

2 Renter's School Property Tax Credit — Tax-Exempt Housing

This tax release supersedes the tax release with the same title which was published in *Wisconsin Tax Bulletin* 85 (January 1994), page 27. The original tax release has been revised to reflect the Wisconsin Tax Appeals Commission decision of July 15, 1997 in *Jean B. Martin vs. Wisconsin Department of Revenue* (a summary of this case appears on page 17). Although the Martin decision involved Homestead credit, the Homestead and school property tax credit statutes regarding the treatment of rent paid for tax-exempt housing are virtually identical.

This change in position regarding the treatment of rent paid for tax-exempt housing for purposes of the school property tax credit first applies to rent paid in 1997.

Note: The department's position regarding the treatment of rent paid for tax-exempt housing for purposes of Homestead credit has not changed. The *Martin* case upheld the department's position as set forth in a tax release published in *Wisconsin Tax Bulletin* 35 (January 1984), page 19.

Statutes: Section 71.07(9)(a)4, Wis. Stats. (1995-96)

Background: The renter's school property tax credit is available to individuals who pay rent during the year for living quarters used as a principal residence.

The credit is equal to 10% of the first \$2,000 (\$1,000 if married filing a separate return) of rent constituting property taxes paid during the year. "Rent constituting property taxes" means 25% of rent if heat is not included or 20% of rent if heat is included.

Section 71.07(9)(a)4, Wis. Stats. (1995-96), provides that "rent" does not include rent paid for the use of housing which was exempt from property tax, except housing for which payments in lieu of taxes were made under sec. 66.40(22), Wis. Stats. (1995-96). Section 66.40(22) relates to housing authorities.

Facts and Question: The University of Wisconsin — Madison owns housing that is exempt from property taxes. The housing is rented to faculty, staff, and employees at rates set to reflect fair market rentals for similar housing in the private sector. The University makes payments to the municipality for services. However, these payments for services are not made under sec. 66.40(22), Wis. Stats. (1995-96).

Does the rent paid by an individual for the University faculty housing qualify for the renter's school property tax credit?

Answer: No. Section 71.07(9)(a)4, Wis. Stats. (1995-96), provides that rent paid for housing which is exempt from property tax may not be used to compute the renter's school property tax credit unless payments in lieu of taxes have been made under sec. 66.40(22), Wis. Stats. (1995-96), with respect to the property. The University of Wisconsin - Madison has not made payments in lieu of taxes under sec. 66.40(22), Wis. Stats. (1995-96). Therefore, rent paid by tenants may not be used to compute a renter's school property tax credit. □

3 Taxation of Stock Options

Statutes: Sections 71.01(6), 71.04(1)(a), 71.05(6)(b)9, 71.08(1)(bm), 71.63(6), and 71.64(1)(a), Wis. Stats. (1995-96)

Background: Corporations may grant employees the right to purchase stock in the corporation. The stock options are a form of compensation. Stock options may be granted to employees both as a reward for past services and as an incentive for future services. There are two types of stock options: (1) statutory or qualified options which are granted and the taxation determined under specific sections of the Internal Revenue Code (IRC), and (2) non-statutory or nonqualified options which are taxed under the general principles relating to compensation and recognition of income.

Federal Treatment of Nonstatutory Stock Options Under federal law, if an employee receives nonstatutory (nonqualified) stock options as payment for services, the excess of the fair market value of such property over the amount paid for the property is included in gross income of the person who performed such services in the first taxable year in which the rights are transferable or not subject to a substantial risk of forfeiture. (IRC sec. 83.)

If the nonqualified option does not have a readily ascertainable fair market value, the grant of the option is not a taxable event; the purchase of the optioned stock triggers taxation. The employee recognizes ordinary income (compensation) in the amount of the value of the stock purchased, minus any amounts paid for the stock or the option. Any gain or loss recognized when the employee subsequently sells the stock is capital in nature.

If a nonqualified option is actively traded or has a readily ascertainable fair market value, the employee must recognize ordinary income (compensation) in the amount of the fair market value less any amount paid for the option in the year the option

is granted. Any gain or loss recognized on the subsequent sale of the stock is capital in nature.

An employer is allowed to deduct the value of a nonqualified stock option as a business expense for the tax year in which the option is included in the gross income of the employee. The deduction amount is the same as the amount included as ordinary income by the employee in gross income. (IRC sec. 83(h).)

Federal Treatment of Statutory Stock Options There are two kinds of statutory (qualified) stock options. These are incentive stock options (IRC sec. 422) and options granted under employee stock purchase plans (IRC sec. 423). Employees who qualify under these statutory plans do not include any amount in gross income either at the time the option is granted or at the time it is exercised. Income or loss is reported only when the stock is sold, and any gain or loss from the sale is capital gain or loss. However, if a discount was given under an employee stock purchase plan, the value of the discount (i.e., the amount by which the fair market value at the time of grant exceeded the option price) is taxed as ordinary income, and any further gain is taxed as capital gain.

If the employee does not meet the required holding period tests, there is a disqualifying disposition and ordinary income (compensation) is reported in the year the stock is sold. The amount reportable as ordinary income is the amount by which the stock's fair market value, as of the date the option was exercised, is more than the option price. If the gain is more than the amount reported as ordinary income, the remaining amount is capital gain.

The employer is allowed a deduction for the tax year in which the

employee is required to recognize ordinary income for the amount of such ordinary income.

Wisconsin Treatment of Stock Options For a specific taxable year, Wisconsin generally follows the IRC in effect on December 31 of the prior year with some exceptions (sec. 71.01(6), Wis. Stats. (1995-96)). Thus income from a stock option is taxable by Wisconsin in the same manner and at the same time as for federal tax purposes. For example, for federal tax purposes, an employee who is granted an incentive stock option does not include any amount in gross income either at the time the option is granted or at the time it is exercised. Income or loss is reported only when the stock is sold and any gain or loss from the sale is capital gain or loss. This same treatment applies for Wisconsin tax purposes.

Whether income from a stock option granted to an employee as compensation for the performance of services is taxable by Wisconsin depends on the individual's residency status at the time the income is reportable for federal income tax purposes. Section 71.04(1)(a), Wis. Stats. (1995-96), provides that:

- All income or loss of resident individuals shall follow the residence of the individual, and
- Income from personal services of nonresident individuals shall follow the situs of the services.

Based on this statute, if an individual is a resident of Wisconsin (i.e., is domiciled in Wisconsin) at the time income from a stock option is required to be recognized for federal tax purposes, the same amount that is taxable for federal tax purposes is also taxable by Wisconsin, regardless of whether the stock option was attributable to personal services

performed in Wisconsin or outside Wisconsin.

If an individual is *not* a resident of Wisconsin (i.e., is not domiciled in Wisconsin) at the time income from a stock option is required to be recognized for federal tax purposes, the income is taxable by Wisconsin only to the extent it is attributable to personal services performed in Wisconsin.

For assets held more than one year, sec. 71.05(6)(b)9, Wis. Stats. (1995-96), provides an exclusion for 60% of the capital gain as computed under the IRC. Capital gains and losses for all assets are netted before applying the percentage.

Alternative Minimum Tax Incentive stock options are subject to the federal alternative minimum tax. The excess of the fair market value of the option (determined without regard to any lapse restriction) over the amount paid for the option must be included for alternative minimum tax purposes at the first time the employee's rights in the option become transferable or when these rights are no longer subject to a substantial risk of forfeiture. (IRC sec. 56(b)(3).)

The starting point for determining Wisconsin alternative minimum taxable income is federal alternative minimum taxable income. Thus the federal adjustment for incentive stock options will also be included in Wisconsin alternative minimum taxable income. In the case of a nonresident of Wisconsin, the portion of the amount included in federal alternative minimum taxable income which is attributable to personal services performed in Wisconsin must be included in Wisconsin alternative minimum taxable income. (Sec. 71.08, Wis. Stats. (1995-96).)

Section 71.08(1)(bm), Wis. Stats. (1995-96), provides that at the time that the incentive stock option is included in federal alternative minimum taxable income, the amount included in Wisconsin alternative minimum taxable income may be reduced by 20%. When the incentive stock is disposed of, 20% of the federal alternative minimum tax adjustment resulting from refiguring gain or loss on the disposition of the stock must be added to federal alternative minimum taxable income when computing Wisconsin alternative minimum taxable income.

Wisconsin Resident — Taxation of Stock Options

Question 1: A Wisconsin resident is required to report income related to a stock option on his/her federal income tax return. Is this income also taxable by Wisconsin?

Answer 1: Yes. Under sec. 71.04(1)(a), Wis. Stats. (1995-96), all income or loss of a Wisconsin resident is taxable by Wisconsin. Income related to a stock option is taxable by Wisconsin regardless of whether the income is attributable to personal services performed in Wisconsin or outside Wisconsin.

Example 1: An employee was granted a nonqualified stock option to purchase 1,000 shares of the company's stock for \$10 per share as part of a five-year contract, with the ability to exercise the option anytime after five years have passed. The employee was a resident of Ohio at the time the option was granted in 1992. For the first two years of the five-year contract, the employee worked in Ohio. The employee was then transferred to Wisconsin where he became a resident and worked the remaining three years of the contract. In 1997, while a Wisconsin resident, the employee exercised the option and purchased the stock for

\$10,000. At the time of exercise, the stock had a fair market value of \$20 a share or \$20,000.

For federal tax purposes, the employee must recognize ordinary income of \$10,000 (\$20,000 fair market value of stock less \$10,000 paid for the stock) for 1997. Because the employee is a resident of Wisconsin at the time the stock option was exercised, the same amount that is taxable for federal tax purposes is taxable by Wisconsin.

Example 2: An employee was granted an incentive stock option in 1992 while he was a nonresident of Wisconsin. The employee exercised the option in 1993. Because this was an incentive stock option, the employee did not include any amount in federal income at the time the option was granted or exercised. The employee became a resident of Wisconsin in January of 1997. In May of 1997, the employee sold the stock which had been acquired under the incentive stock option.

A long-term capital gain on the sale of the stock of \$10,000 will be reported on the employee's 1997 federal income tax return. The employee must also report the \$10,000 gain on the sale of the stock as Wisconsin income on his 1997 Wisconsin income tax return. Because under federal law the gain is treated as a long-term capital gain, for Wisconsin tax purposes the long-term capital gain will be netted with other capital gains and losses and be subject to the exclusion for 60% of net long-term capital gain.

Nonresident of Wisconsin — Taxation of Stock Options

Question 2: A nonresident of Wisconsin is required to report income related to a stock option on his/her federal income tax return. Is this income also taxable by Wisconsin?

Answer 2: Because the individual is not a resident of Wisconsin at the time income related to the stock option is required to be recognized for federal tax purposes, the income is taxable by Wisconsin only to the extent it is attributable to personal services performed in Wisconsin.

The amount of income related to the stock option which is taxable for federal purposes must be allocated to reflect only the portion of the income which is attributable to personal services performed in Wisconsin. Depending on the facts and circumstances, one method that may produce a fair and equitable result is an allocation on the basis of time worked in and outside Wisconsin.

Under this method, if personal services are performed both in and outside Wisconsin, the portion taxable by Wisconsin in the case of a nonresident is the income recognized for federal tax purposes multiplied by the ratio of the days worked in Wisconsin during the employment contract period granting the option over the total days worked under the contract.

If recognition of the income on an employer-provided stock option occurs when the stock purchased under the option is sold and the individual is not a resident of Wisconsin, the income taxable by Wisconsin will be the lesser of the gain recognized on the sale of the stock or the amount which would have been recognized at the exercise of the option, multiplied by the ratio of the days worked in Wisconsin under the employment contract granting the option over the total days worked under the contract.

Note: In this tax release, when income from a stock option is taxable to a nonresident of Wisconsin, the portion of the income attributable to personal services performed in

Wisconsin will be determined on the basis of time worked in and outside Wisconsin during the employment contract period granting the option. The department recognizes that, depending on the facts and circumstances in a particular case, other methods of allocation may be appropriate.

Example 3: An employee is granted a nonqualified stock option to purchase 1,000 shares of the company's stock for \$10 per share as part of a five-year contract, with the ability to exercise the option anytime after five years have passed. For the first two years of the five-year contract, the employee worked in Wisconsin. The employee was then transferred to Ohio where he became a resident and worked the remaining three years of the contract. In 1997, while an Ohio resident, the employee exercised the option and purchased the stock for \$10,000. At the time of exercise, the stock had a fair market value of \$20 a share or \$20,000.

For federal tax purposes, the employee must recognize ordinary income of \$10,000 (\$20,000 fair market value of stock less \$10,000 paid for the stock) for 1997. The portion of the income from the nonqualified stock option which is attributable to personal services performed in Wisconsin and taxable by Wisconsin for 1997 is \$4,000, determined as follows:

$$\frac{2 \text{ (years worked in Wisconsin)}}{5 \text{ (total years under employment contract)}} \times \$10,000 = \$4,000$$

Assuming the employee is not a resident of Wisconsin at the time of disposition, any future gain or loss on the disposition of the stock acquired under the nonqualified stock option is not taxable by Wisconsin.

Example 4: In 1990 an employee was granted an incentive stock option to purchase 1,000 shares of the company's stock for \$6 per share as part of a five-year contract, with the ability to exercise the option anytime after five years. The individual worked in Wisconsin for the five-year contract period and exercised the option in 1995. The fair market value of the stock at the time the option was exercised was \$12 per share. Because this option qualified as an incentive stock option, the employee was not required to report income from the exercise of the option on either his 1995 federal or Wisconsin income tax return.

The employee subsequently retired and moved to Florida in 1997. While a Florida resident, the individual sold the 1,000 shares of stock for \$15,000. He reports the \$9,000 gain (\$15,000 selling price less \$6,000 cost) on the sale of the stock as a long-term capital gain on Schedule D of federal Form 1040.

In this situation, all personal services were performed in Wisconsin during the five-year employment contract period. Therefore, the amount taxable by Wisconsin is \$6,000 (the lesser of the gain recognized on the sale of the stock or the amount that would have been recognized at the exercise of the option).

Because under federal law the taxable amount is treated as a long-term capital gain, the \$6,000 which is taxable by Wisconsin is also treated as a long-term capital gain for Wisconsin tax purposes. The \$6,000 long-term capital gain will be netted with other capital gains and losses and be subject to the Wisconsin exclusion for 60% of net long-term capital gain.

Example 5: An employee is granted an incentive stock option to purchase 1,000 shares of the company's stock

for \$5 per share as part of a three-year contract, with the ability to exercise the option after three years have passed. The employee worked two years under the contract in Wisconsin and one year in Georgia. The employee exercised the option in December of 1996 at the end of the three-year period. The fair market value of the stock at the time the option is exercised is \$11 per share or \$11,000. Because the option qualifies as an incentive stock option, the employee did not report income from the exercise of the option on his 1996 federal income tax return.

While a resident of Georgia, the employee sells the stock for \$15 a share (\$15,000) in August of 1997. This sale is treated as a disqualifying disposition as the stock was disposed of within one year from the date the shares were transferred to the employee.

For federal tax purposes, the employee must report \$6,000 as ordinary income (the difference between the \$11,000 fair market value of the stock at the time the option was exercised and the \$5,000 cost of the stock). The balance of the gain (\$4,000) is reported as a capital gain.

The amount attributable to personal services performed in Wisconsin and taxable by Wisconsin is \$4,000, determined as follows:

$$\frac{2 \text{ (years worked in Wisconsin)}}{3 \text{ (total years under employment contract)}} \times \$6,000 = \$4,000$$

Because the difference between the cost and the fair market value of the stock at the time the option was exercised is treated as ordinary income for federal tax purposes, it does not qualify for the Wisconsin capital gain exclusion.

Alternative Minimum Tax Treatment

Question 3: A nonresident of Wisconsin is required to include an incentive stock option adjustment in federal alternative minimum taxable income. The adjustment is for the difference between the fair market value of stock acquired under his employer's incentive stock option plan and the amount paid for the option. Does the adjustment to alternative minimum taxable income apply for Wisconsin alternative minimum tax purposes?

Answer 3: The adjustment to federal alternative minimum taxable income applies for Wisconsin alternative minimum tax purposes to the extent the adjustment amount is attributable to personal services performed in Wisconsin. The portion of the income attributable to personal services performed in Wisconsin is determined on the basis of time worked in and outside Wisconsin during the employment contract period granting the option. For Wisconsin alternative minimum tax purposes, the federal adjustment for an incentive stock option may be reduced by 20%, as provided by sec. 71.08(1)(bm)1, Wis. Stats. (1995-96).

Example 6: An employee was granted an incentive stock option in 1992 to purchase 10,000 shares of the company's stock for \$10 per share as part of a five-year contract. The employee worked two years under the contract in Wisconsin. He was then transferred to Texas. He became a resident of Texas and worked the remaining three years of the five-year contract in Texas. The employee exercised the option in 1997 when the stock had a fair market value of \$30 per share. For 1997, the employee was required to include \$200,000 in his federal alternative minimum taxable income as an

adjustment for the incentive stock option.

Under sec. 71.08(1)(bm)1, Wis. Stats. (1995-96), the federal adjustment may be reduced by \$40,000 (20% of \$200,000). The portion of the adjustment for the incentive stock option which is attributable to personal services performed in Wisconsin and which must be included in Wisconsin alternative minimum taxable income is \$64,000, determined as follows:

$$\frac{2 \text{ (years worked in Wisconsin)}}{5 \text{ (total years under employment contract)}} \times \$160,000 = \$64,000$$

Question 4: Must Wisconsin income tax be withheld on the compensation element of qualified and nonqualified stock options?

Answer 4: Yes, Wisconsin income tax is required to be withheld from the compensation element of stock options. Under secs. 71.63(6) and 71.64(1)(a), Wis. Stats. (1995-96), an employer is required to withhold from wages. "Wages" means all remuneration for services performed by an employee for an employer. (There are exceptions to the definition of "wages" which do not apply to this tax release.)

Wisconsin withholding is required when the employee (or former employee) recognizes the income for Wisconsin income tax purposes. For example, an employee exercises a nonqualified stock option on October 10, 1997. Income from the exercise of the option is required to be reported on the employee's 1997 federal and Wisconsin income tax returns. Wisconsin withholding is required for the pay period in which the option was exercised.

For a nonresident of Wisconsin, withholding is required only to the

extent the compensation is attributable to personal services performed in Wisconsin.

Where recognition of the income on an employer-provided stock option occurs when the stock purchased under the option is sold and the gain is treated as a long-term capital gain for federal tax purposes, withholding is required on only 40% of the compensation element reportable to Wisconsin. Because of the Wisconsin exclusion for 60% of the capital gain as computed under the Internal Revenue Code, 60% of the compensation element reportable to Wisconsin will not be subject to Wisconsin tax and is therefore not subject to Wisconsin withholding.

If the employee's salary is insufficient to pay the additional taxes due, the employee and employer must arrange to have enough money available so the employer can remit the proper amount of withholding tax. □

4 Gasoline Service Station Equipment

Statutes: Sections 77.51(2) and (20) and 77.52(2)(a)10, Wis. Stats. (1995-96)

Wis. Adm. Code: Section Tax 11.68, April 1994 Register

Note: This tax release supercedes the tax release titled "Gasoline Service Station Equipment" that appeared in *Wisconsin Tax Bulletin 4* (July 1977).

Question: Is property described in the table below that is installed and repaired at a gasoline service station real property or tangible personal property?

Answer: Beginning January 1, 1998, for sales by contractors to service stations of the property