perfected security interest in the sold goods.

B. Before the department may be found to have attempted adequate collection efforts from the predecessor, the department must also attempt collection efforts from Uncle Harry's president, Harry Dembrowski; and any other officer, employe, or responsible person pursuant to sec. 77.60(9), Wis. Stats. Since the department made no collection efforts against Dembrowski, it may not proceed against the taxpayer.

The department has appealed this decision to the Court of Appeals. □

DRUG TAX

Drug tax — double jeopardy. *State of Wisconsin vs. Quinn J. Riley* (Court of Appeals, District IV, December 19, 1991). The issue in this case is whether the tax assessed against the taxpayer by the department under sec. 139.95, Wis. Stats., for possession of controlled substances, was punishment within the meaning of the double jeopardy clauses of the United States and Wisconsin Constitutions.

The taxpayer appeals from a judgment convicting him of delivery of cocaine and possession of drugs without paying the requisite drug tax. The taxpayer pled guilty to both counts. Between the plea hearing and sentencing, the department notified him that he owed taxes, interest, and a penalty based on his possession of the cocaine. He was taxed at a rate of $200 per gram on 217 grams for a total of $43,600. He was also notified that he owed $2,616 in interest and a $34,600 penalty, for a total of $89,816.

The taxpayer was sentenced to five years in jail on the delivery charge and placed on probation for fifteen years for failing to pay the drug tax. The taxpayer moved the court for reconsideration, arguing that he had been punished twice for the same crime. The Circuit Court denied the motion, and this appeal followed.

The Court of Appeals concluded that the tax assessed against the taxpayer was not punishment within the meaning of the double jeopardy clauses of the United States and Wisconsin Constitutions. The penalty assessed against the taxpayer was merely equal to the tax he failed to pay.

The taxpayer appealed this decision to the Wisconsin Supreme Court. The petition for review was denied. □

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 Election to Capitalize Real Estate Taxes and Carrying Charges

Statutes: Section 71.01(6), Wis. Stats. (1989-90)

Facts: The taxpayer paid real estate taxes in 1991 on the following properties:

Principal residence	$ 1,500
Cottage in Wisconsin	$ 1,300
Unimproved lot	$ 400
Hunting property	$ 700

For federal tax purposes, all real estate taxes are claimed on federal Schedule A as itemized deductions.

For Wisconsin tax purposes, only the real estate taxes paid on the principal residence may be used in computing the school property tax credit. No credit or deduction is allowed for the real estate taxes paid on the cottage, unimproved lot, or hunting property.

Question 1: Since the property taxes for the cottage, unimproved lot, and hunting property are not eligible for the school property tax credit, may these taxes be capitalized for Wisconsin purposes, even though such taxes are claimed as an itemized deduction for federal purposes?

Answer 1: Yes, subject to the provisions of Internal Revenue Code (IRC) sec. 266. IRC sec. 266 and related Regulation 1.266-1 provide that an election is available to capitalize real estate taxes and certain carrying charges if certain conditions are met. In the case of unimproved and unproductive real property, such as the unimproved lot, an election to capitalize real estate taxes is available without any restrictions. In the case of other types of real property, an election to capitalize real estate taxes is available only for taxes paid or incurred during a period when the real property is being developed, or an improvement to the property is being constructed. The taxpayer may make an election under IRC sec. 266 for Wisconsin tax purposes even if the election is not made for federal tax purposes.

Question 2: What must the taxpayer do to notify the department that an election is being made to capitalize real estate taxes, and must the election also be made in each subsequent year?

Answer 2: To make an election to capitalize real estate taxes, the taxpayer must include a statement with his/her return indicating which charges are being capitalized. The statement must be attached to the original tax return for the year the choice is to be effective. With respect to the unimproved lot, the election is effective only for the year in which it is made. A separate election must be made for any future years. In the case of the cottage and hunting properties, an election will be effective until the development or construction work which qualifies the taxpayer for the election has been completed.

Question 3: If the taxpayer capitalizes real estate taxes only for Wisconsin purposes, the property will have a different basis for Wisconsin and federal purposes. How will the basis difference be accounted for in the year of sale for Wisconsin purposes?

Answer 3: Since the difference in basis results from an election to compute federal adjusted gross income for Wisconsin purposes differently than it is computed for federal purposes, federal adjusted gross income in the year the property is sold must be computed in a manner which reflects the election. In other words, the taxpayer will be required to prepare a "pro-forma" federal return for Wisconsin purposes in the year the election is made, and in all subsequent years to the extent necessary to reflect such election. □

2 Rollover of a Retirement Plan Distribution Which Includes U.S. Government Interest to an IRA

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

Facts: Taxpayer A retired and received a lump-sum distribution from the retirement plan of his employer. The assets of the retirement plan had been partially invested in U.S. Government securities (for example, U.S. Treasury bonds). Taxpayer A has records to show what portion of the lump-sum distribution is attributable to interest from U.S. Government securities. Within the allowable time period, Taxpayer A rolls over the distribution to an individual retirement arrangement (IRA).

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

Answer: Yes. Any portion constituting interest from a U.S. Government security is exempt from state income tax. Federal law (31 USCS §3124) prohibits states from taxing interest from U.S. Government obligations. When Wisconsin taxable income is computed, sec. 71.05(6)(b)1, Wis. Stats. (1989-90), treats interest from U.S. Government securities as nontaxable by providing a subtraction from federal adjusted gross income. The U.S. Government interest portion of the lump-sum distribution retains its tax-exempt character when it is rolled over to an IRA. Thus the portion of the amount withdrawn from the IRA which is attributable to interest from U.S. Government secu-

rities is exempt from Wisconsin income tax.

(**Note:** For information on how to compute the portion of an IRA distribution which is considered interest from U.S. Government securities, see the tax release titled "Distributions From IRAs Which Invest in U.S. Government Securities" in *Wisconsin Tax Bulletin* 61, July 1989.) □

CORPORATION FRANCHISE AND INCOME TAXES

3 Adjustment to Manufacturer's Sales Tax Credit Carryover

Statutes: Sections 71.28(3) and 71.77(2), Wis. Stats. (1989-90)

Wis. Adm. Code: Section Tax 2.11, February 1990 Register

Background: Section 71.28(3), Wis. Stats. (1989-90), provides for the manufacturer's sales tax credit. This credit is available to corporations and is equal to the Wisconsin and county sales and use tax paid during the taxable year on fuel and electricity consumed in manufacturing tangible personal property in Wisconsin. The credit is first used to reduce the franchise or income tax liability for the same taxable year. If the credit exceeds the tax liability, the unused balance of the credit may be offset against the tax liability of the subsequent year and each succeeding year up to 15 years.

Section 71.77(2), Wis. Stats. (1989-90), provides that the department has 4 years from the date a franchise or income tax return is filed within which to issue a notice of assessment of tax or an assessment to recover all or part of a tax credit.

Facts and Question: Corporation A claimed the manufacturer's sales tax credit on its 1986 Wisconsin franchise tax return. Its computed credit exceeded Corporation A's 1986 tax liability which resulted in an unused credit. The unused credit was carried forward and used to offset the tax liability on the corporation's 1987 Wisconsin franchise tax return.

The department conducts an audit of Corporation A's 1986 and 1987 income tax returns. At the time of the audit, the 1987 return is open to assessment by the department; the 1986 return is closed to assessment by the statute of limitations (sec. 71.77(2), Wis. Stats. (1989-90)). It is determined during the audit that Corporation A underreported income on its 1986 tax return and made an error in the computation of the 1986 manufacturer's sales tax credit. May the department adjust both the 1986 income and the manufacturer's sales tax credit?

(Note: An adjustment to the taxpayer's income would increase the 1986 tax liability and mean that an additional amount of credit is used to offset that tax liability. This would in turn reduce the carryover to 1987.)

Answer: Yes, even though the department cannot issue an assessment for 1986, it can adjust both Corporation A's reported 1986 income and manufacturer's sales tax credit. The statute of limitations only relates to assessments, and does not prevent income or a credit from being recomputed so as to determine the correct amount of carryover credit to a future year. In this situation, once the department has determined the correct manufacturer's sales tax credit carryover from 1986, it can issue an assessment to Corporation A to reflect adjustments to the carryover credit claimed on its 1987 Wisconsin franchise tax return. □

4 Insurance Companies — Add Back Modifications for Exempt or Excluded Interest Income and Dividends Received Deduction

Statutes: Section 71.45(2)(a)3 and 4, Wis. Stats. (1987-88) and (1989-90)

Background: For federal income tax purposes, the taxable income of a property and casualty insurance company generally includes investment income, underwriting income, and certain other items. Investment income includes interest, dividends, and rents. Internal Revenue Code (IRC) sec. 832(b)(2). Underwriting income is the amount of premiums earned on insurance contracts during the taxable year, minus losses incurred and expenses incurred. IRC sec. 832(b)(3). The deduction for losses incurred generally reflects losses paid during the year and the increase in reserves for losses incurred but not paid. IRC sec. 832(b)(5).

A property and casualty insurance company whose investment income includes state or local bond interest which is exempt from federal tax under IRC sec. 103 may deduct this interest under IRC sec. 832(c)(7) when computing its federal taxable income. Also, property and casualty insurance companies are allowed a dividends received deduction under IRC sec. 832(c)(12). Although these interest and dividend items are not subject to federal tax, the amounts are added to the company's reserves, thus entering into the loss reserve deduction.

Prior to the Tax Reform Act of 1986 (TRA-86), no reduction in the loss reserve deduction was required for additions to reserves that come out of income not subject to federal income tax. Therefore, the pre-TRA-86 law permitted a double deduction to property and casualty insurance companies

for additions to reserves that were funded by tax-exempt income.

For taxable years beginning after December 31, 1986, a property and casualty insurance company must reduce its deduction for losses incurred by 15 percent of tax-exempt interest income and 15 percent of the deductible portion of dividends received (with special rules for dividends from affiliates). IRC sec. 832(b)(5)(B) as amended by TRA-86. The proration rules do not apply to tax-exempt interest and the deductible portion of dividends received or accrued on obligations or stock acquired before August 8, 1986.

Facts and Question: For Wisconsin franchise tax purposes, sec. 71.45(2)(a)3 and 4, Wis. Stats. (1987-88), provides that an insurance company must add back to its federal taxable income an amount equal to interest income received or accrued during the taxable year and dividend income received during the taxable year to the extent such interest income and dividend income were used as deductions in determining the company's federal taxable income.

The language of sec. 71.45(2)(a)3 and 4, Wis. Stats. (1989-90), is similar to that in the 1987-88 statutes, although sec. 71.45(2)(a)3 was revised to require the addition of any interest income which is not included in federal taxable income.

May the 15 percent reduction amounts discussed above be used to reduce the Wisconsin addition modifications for federally tax-exempt or excluded interest income and the federal dividends received deduction?

Answer: No. The entire amount of federally tax-exempt or excluded interest income received during the taxable year and the entire federal dividends received deduction must be added back to federal taxable income to arrive at Wisconsin net income.

The 15 percent reduction in the losses incurred deduction required by IRC sec. 832(b)(5)(B) is a separate calculation that must be made for Wisconsin purposes, since it is an adjustment necessary to arrive at federal taxable income. The 15 percent reduction amount is a required federal adjustment for which there is no Wisconsin modification.

Example: Insurer A receives $3,000,000 of federally tax-exempt state bond interest during 1991. For federal purposes, Insurer A must reduce its losses incurred deduction by $450,000 ($3,000,000 x 15%). For Wisconsin purposes, Insurer A must add back to its federal taxable income the $3,000,000 of federally tax-exempt interest income to arrive at its Wisconsin net income. The $450,000 reduction in the losses incurred deduction applies for Wisconsin purposes as well as for federal purposes. □

5 Manufacturer's Sales Tax Credit — Taxes Paid to Other States Not Allowed

Statutes: Sections 71.28(3) and 77.53(16), Wis. Stats. (1989-90)

Background: Section 71.28(3), Wis. Stats. (1989-90), provides a credit against Wisconsin corporation franchise or income tax for sales or use tax under Chapter 77 of the Wisconsin Statutes paid by a corporation on fuel and electricity consumed in manufacturing tangible personal property in Wisconsin. This section further provides that for this purpose, sales and use tax under Chapter 77 of the Wisconsin Statutes paid by a corporation includes use taxes paid directly by the corporation and sales and use taxes paid by the corporation's supplier and passed on to the corporation whether separately stated on the invoice or included in the total price.

Section 77.53(16), Wis. Stats. (1989-90), provides a credit against Wisconsin use tax for sales or use tax paid in another state on sales of tangible personal property which occurred in that other state, when that property is used or consumed in Wisconsin.

Facts and Question: Corporation A, a Wisconsin manufacturer, purchases natural gas at the wellhead in another state and contracts with a pipeline, which is a contract carrier, to have it transported to Wisconsin where it is consumed in an activity that qualifies as manufacturing for purposes of the manufacturer's sales tax credit. Corporation A pays sales tax to the state where it takes possession of the natural gas and claims such taxes as a credit against the Wisconsin use tax due when the natural gas is used in Wisconsin.

May Corporation A claim a manufacturer's sales tax credit for the sales tax paid to the other state and claimed as a credit against Wisconsin use tax?

Answer: No. The manufacturer's sales tax credit is available only on sales or use taxes under Chapter 77 of the Wisconsin Statutes paid by a corporation. The taxes paid to the other state by Corporation A are not sales or use taxes under Chapter 77 of the Wisconsin Statutes paid by Corporation A. □

SALES AND USE TAXES

6 Admissions to Athletic or Recreational Events or Places

Statutes: Sections 77.51(14)(f), 77.52(2)(a)2, 6 and 9 and 77.52(2m)(a), Wis. Stats. (1989-90)