Except as indicated in Answers 2 and 3 below, once a Wisconsin corporation franchise or income tax return has been filed in accordance with the "opt-out" election, the election is completed and remains effective for the corporation and its successors for at least the next 4 taxable years after the taxable year to which the election first applies.

Facts and Question 2: The facts are the same as in Question 1 except that Corporation X filed its 1992 Wisconsin corporation franchise or income tax return on February 1, 1993, as a regular (C) corporation.

May Corporation X withdraw the "opt-out" election prior to the March 15, 1993, due date of its Wisconsin corporation franchise or income tax return?

Answer 2: Yes. Although a Wisconsin corporation franchise or income tax return was filed in accordance with the "opt-out" election, Corporation X may withdraw the "opt-out" election prior to the March 15, 1993, due date of its Wisconsin return.

To withdraw the election, Corporation X must take the following action on or before March 15, 1993:

- Send a letter, signed by shareholders holding more than 50% of the corporation's stock, to the department requesting the withdrawal of the election, and
- File an amended Wisconsin franchise or income tax return, Form 5S, as a tax-option (S) corporation.

Note: After the due date for filing the Wisconsin return has passed, the "opt-out" election cannot be withdrawn, and it remains effective for the corporation and its successors for at least the next 4 taxable years after the taxable year to which the election first applies.

Facts and Question 3: The facts are the same as in Question 1 except that Corporation X receives a federal extension until September 15, 1993, to file its 1992 federal income tax return, and this extension also applies for Wisconsin. On June 1, 1993, Corporation X files its Wisconsin corporation franchise or income tax return as a regular (C) corporation.

May Corporation X withdraw the "opt-out" election prior to the September 15, 1993, extended due date of its Wisconsin corporation franchise or income tax return?

Answer 3: Yes. Although a Wisconsin corporation franchise or income tax return was filed in accordance with the "opt-out" election, Corporation X may withdraw the "opt-out" election prior to the September 15, 1993, extended due date of its Wisconsin return.

To withdraw the election, Corporation X must take the following action on or before September 15, 1993:

- Send a letter, signed by shareholders holding more than 50% of the corporation's stock, to the department requesting the withdrawal of the election, and
- File an amended Wisconsin franchise or income tax return, Form 5S, as a tax-option (S) corporation.

Note: After the extended due date for filing the Wisconsin return has passed, the "opt-out" election cannot be withdrawn, and it remains effective for the corporation and its successors for at least the next 4 taxable years after the taxable year to which the election first applies.

Facts and Question 4: Corporation Y, a calendar year S corporation, files its 1992 Wisconsin franchise or income tax return as a tax-option (S) corporation on February 1, 1993.

May Corporation Y elect to opt out of Wisconsin tax-option status for the 1992 taxable year prior to the March 15, 1993, due date of its Wisconsin corporation franchise or income tax return?

Answer 4: Yes. The "opt-out" election must be made by the due date or extended due date of the corporation's Wisconsin franchise or income tax return for the first year affected by the election.

To make the election, Corporation Y must take the following action on or before March 15, 1993:

- File Wisconsin Form 5E, "Election by an S Corporation Not to Be Treated as a Tax-Option (S) Corporation," and
- File an amended Wisconsin franchise or income tax return, Form 4 or 5, as a regular (C) corporation.

Once a Wisconsin return has been filed in accordance with the "opt-out" election, the election is completed and remains effective for the corporation and its successors for at least the next 4 taxable years after the taxable year to which the election first applies.

Facts and Question 5: The facts are the same as in Question 4 except that Corporation Y receives a federal extension of time until September 15, 1993, to file its 1992 federal income tax return, and this extension also applies for Wisconsin. On May 15, 1993, Corporation Y files its Wisconsin corporation franchise or income tax return as a tax-option (S) corporation.

May Corporation Y elect to opt out of Wisconsin tax-option status for the 1992 taxable year prior to the September 15, 1993, extended due date of its return?

Answer 5: Yes. The "opt-out" election must be made by the extended due date of the corporation's Wisconsin franchise or income tax return for the first year affected by the election.

To make the election, Corporation Y must take the following action on or before September 15, 1993:

- File Wisconsin Form 5E, "Election by an S Corporation Not to Be Treated as a Tax-Option (S) Corporation," and
- File an amended Wisconsin franchise or income tax return, Form 4 or 5, as a regular (C) corporation.

Once a Wisconsin return has been filed in accordance with the "opt-out" election, the election is completed and remains effective for the corporation and its successors for at least the next 4 taxable years after the taxable year to which the election first applies. □

6 Wisconsin Tax Treatment of Safe Harbor Leases

Statutes: Sections 71.01(4)(g)5-10, 71.02(1)(a)6-11, and 71.04(15)(b), Wis. Stats. (1985-86) and section 3047(1)(b), 1987 Wisconsin Act 27

Note: This tax release modifies the tax release with the same title which was published in *Wisconsin tax Bulletin* 38 (July 1984), page 17, to the extent that the positions taken in that tax release were invalidated by the Dane County Circuit Court decision in *Wisconsin Department of Revenue vs. International Paper Company* (December 28, 1992) and the Wisconsin Tax Appeals Commission decision in *U.S. Oil Co., Inc. vs. Wisconsin Department of Revenue* (July 18, 1990). For summaries of these decisions, see *Wisconsin Tax Bulletins* 81 (April 1993), page 12, and 69 (October 1990), page 13.

Background:

Federal Law: The federal Economic Recovery Tax Act of 1981 (ERTA) added Internal Revenue Code sec. 168(f)(8), which provided "safe harbor" leasing rules for qualifying property placed into service on or after January 1, 1981. Under these rules, certain transactions were treated as leases for federal income tax purposes whether or not they would have qualified as leases under the pre-ERTA federal guidelines. If a transaction met the safe harbor requirements, the lessor in the agreement was treated as the property owner for federal income tax purposes and was entitled to cost recovery deductions under the Accelerated Cost Recovery System (ACRS) and investment credits. The non-safe harbor leasing rules continued to apply for transactions not meeting the safe harbor requirements or when safe harbor leasing treatment was not elected.

The federal Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) substantially modified the safe harbor leasing rules for agreements entered into or property placed in service between July 1, 1982, and January 1, 1984, with certain exceptions. In addition, TEFRA repealed safe harbor leasing treatment for transactions entered into on or after January 1, 1984, and provided new finance lease rules for leases with economic substance entered into on or after that date. Before the finance lease rules went into effect, the federal Tax Reform Act of 1984 generally postponed their effective date for four years until 1988 and the federal Tax Reform Act of 1986 completely repealed them. Thus, the pre-ERTA common law again governs the treatment of lease transactions.

Wisconsin Law: The Wisconsin corporation franchise and income tax law did not recognize the safe harbor leasing rules in IRC sec. 168(f)(8). For the 1981 through 1986 taxable years, the computation of net income for regular corporations and tax-option (S) corporations was not federalized; income and deductions were computed under Wisconsin law rather than under the Internal Revenue Code. Although Wisconsin depreciation deductions generally were computed under the Internal Revenue Code, for taxable year 1981 and thereafter, the Internal Revenue Code did not include sec. 168(f)(8). Section 71.04(15)(b), Wis. Stats. (1985-1986).

Insurance companies, regulated investment companies, and real estate investment trusts computed their net income for Wisconsin purposes under the Internal Revenue Code; however, for taxable year 1981 and thereafter, sec. 168(f)(8) was specifically excluded from the Internal Revenue Code. Sections 71.01(4)(g)5-10 and 71.02(1)(a)6-11, Wis. Stats. (1985-86).

With the enactment of 1987 Wisconsin Act 27, Wisconsin adopted the Internal Revenue Code, with modifications, for computing a regular corporation's and a tax-option (S) corporation's net income for taxable years 1987 and thereafter. However, the federal safe harbor leasing rules were not adopted since they were not part of the Internal Revenue Code as amended to December 31, 1986. Section 3047(1)(b) of this Act provided that leases to which IRC sec. 168(f)(8) (before its repeal) applies and any differences between the federal and state treatment of income, loss, or deduction arising from those leases do not apply for Wisconsin

purposes. As a result, corporations must continue making adjustments to reverse the amount of rental expense or income, interest expense or income, and depreciation expense reportable for federal income tax purposes under the safe harbor leasing rules.

In the tax release published in *Wisconsin Tax Bulletin* 38, the department had taken the position that the initial payment made by the purchaser/lessor to the seller/lessee, representing the purchase price of the tax benefits, was income to the seller/lessee subject to tax. However, in the *International Paper* decision, the court determined that the cash received from the sale of federal tax benefits under safe harbor leases was not income to the seller/lessee but the sale of one of the rights in its property. Therefore, the initial payment should be accounted for as a reduction in the seller/lessee's basis in the property.

The department had also taken the position that the purchaser/lessor could not deduct the cost of the tax benefits. However, pursuant to the *U.S. Oil* decision, if the purchaser/lessor sells the property back to the seller/lessee, the purchaser/lessor may recognize a gain or loss on the transaction.

The following example illustrates the Wisconsin treatment of safe harbor leasing transactions as a result of the *International Paper* and *U.S. Oil* decisions.

Example: In taxable year 1981, Seller/Lessee Corporation purchased equipment from a manufacturer for $1,000,000 and then "sold" (but did not transfer title to) the equipment to Purchaser/Lessor Corporation. The selling price was $200,000 in cash plus an $800,000 nonrecourse note receivable from Purchaser/Lessor Corporation bearing interest at the market rate. The note was payable over nine years in equal annual principal and interest payments of $168,000. The $200,000 was the agreed upon price of Seller/Lessee Corporation's tax benefits, consisting of its ACRS depreciation deductions and investment tax credit on the equipment.

Purchaser/Lessor Corporation simultaneously "leased" the equipment back to Seller/Lessee Corporation for nine years (90% of its useful life). The annual rental payments of $168,000 were due on the same date and exactly offset the principal and interest payments Purchaser/Lessor Corporation was required to make to Seller/Lessee Corporation under the note. The only money changing hands between Seller/Lessee Corporation and Purchaser/Lessor Corporation was the $200,000 payment in 1981 for the tax benefits. Seller/Lessee Corporation used the $200,000 as a downpayment to the equipment manufacturer and financed the remaining $800,000 with a financial institution.

The Wisconsin treatment of this transaction is as follows:

A. *Sale of equipment by Seller/Lessee Corporation.* Sale is not recognized.

B. *Initial $200,000 Payment by Purchaser/Lessor Corporation to Seller/Lessee Corporation.*

   (1) The transfer of federal tax benefits for $200,000 is considered to be the sale of such benefits.

   Seller/Lessee Corporation must decrease the basis of the equipment by the $200,000 received in 1981. Under the *International Paper* decision, this payment constitutes a reduction of the underlying asset account. Therefore, Seller/Lessee Corporation's basis for depreciation purposes is $800,000. (Prior to the *International Paper* decision, the department had stated that the $200,000 payment was taxable as income in 1981 and that Seller/Lessee Corporation's basis in the equipment for depreciation purposes was $1,000,000.)

   (2) Purchaser/Lessor Corporation may not deduct the $200,000 cost of these benefits since the law contains no provision for such deduction. However, if Purchaser/Lesser Corporation were to sell the assets back to Seller/Lessee Corporation, Purchaser/Lessor Corporation may recognize a gain or loss on that transaction. The cost basis is $200,000 minus any federal tax benefits (such as depreciation and investment tax credits) already realized, as provided in the *U.S. Oil* decision.

C. *Depreciation of Equipment.* Seller/Lessee Corporation deducts depreciation using a basis of $800,000.

D. *Rental Expense/Income.* Neither Seller/Lessee Corporation nor Purchaser/Lessor Corporation recognizes rental expense or income.

E. *Interest Expense/Income.* Seller/Lessee Corporation may deduct interest it pays to the financial institution on the $800,000 loan. However, neither Seller/Lessee Corporation nor Purchaser/Lessor Corporation recognizes interest income or expense on the $800,000 nonrecourse note that the two parties executed.

F. *Apportionment Basis Taxpayers — Effect Upon Property and Sales Factors*. Seller/Lessee Corporation includes the equipment in the property factor at its $800,000 net cost. Rental payments under the safe harbor agreement are not considered rental payments for purposes of the property factor.

Purchaser/Lessor Corporation may not include the property in its property factor.

The manufacturer includes $1,000,000 in its sales factor. However, Seller/Lessee Corporation may not include the $1,000,000 in its sales factor.

G. *Wisconsin Sales or Use Tax*. The sale of equipment by the manufacturer to Seller/Lessee Corporation is a taxable sale unless a specific exemption applies to the transaction, such as the farming or manufacturing exemptions in sec. 77.54(3), (3m), or (6)(a), Wis. Stats. Seller/Lessee Corporation may not give the manufacturer a resale certificate since there is not an actual resale to Purchaser/Lessor Corporation.

The $200,000 received by Seller/Lessee Corporation is not taxable for sales tax purposes because it represents proceeds from the sale of intangible tax benefits associated with the purchase of this equipment.

Other offsetting principal, interest, and rental amounts recognized for federal income tax purposes have no Wisconsin sales or use tax consequences.

H. *Nexus Issues*. Purchaser/Lessor Corporation will not have nexus with Wisconsin for franchise or income tax purposes if its only "activity" in Wisconsin is the safe harbor "rental" property located in Wisconsin.

The presence of this property in Wisconsin, however, will cause the Seller/Lessee Corporation to have Wisconsin nexus for franchise and income tax and sales and use tax purposes.

Facts and Question 1: Assume that the Seller/Lessee Corporation in the example above had followed the department's instructions in *Wisconsin Tax Bulletin* 38 and reported the initial $200,000 payment as income. It has been using the entire $1,000,000 cost of the equipment as its basis for depreciation purposes. All of the years affected by the safe harbor leasing transaction are still open under the statute of limitations due to net business loss carryforwards and/or pursuant to a written agreement between the department and Seller/Lessee Corporation.

May the Seller/Lessee Corporation file a claim for refund of the tax paid on the initial $200,000 payment which had been reported as income?

Answer 1: Yes, in this situation the Seller/Lessee Corporation may file a claim for refund to exclude the initial $200,000 payment from its taxable income, provided it reduces its basis for depreciation by the $200,000 payment received and recomputes its depreciation deductions using the $800,000 basis in that property for each of the succeeding years. Net business loss carryforwards may be adjusted as long as the income year against which the loss is used is open to adjustment and refunds may be issued for open years.

Note: If any of the years affected by the safe harbor leasing transaction are closed under the statute of limitations, no refund of the tax paid on the initial payment will be permitted.

Facts and Question 2: Assume that the Seller/Lessee Corporation in the example above had followed the department's instructions in *Wisconsin Tax Bulletin* 38 and reported the initial $200,000 payment as income. It has been using the entire $1,000,000 cost of the equipment as its basis for depreciation purposes. The year in which the initial payment was reported as income (1981) is closed under the statute of limitations. However, several of the years in which the property is being depreciated are still open under the statute of limitations.

Must the Seller/Lessee Corporation file amended returns to reduce its basis in the property to $800,000 and recompute its depreciation deductions for the years that are still open to adjustment?

Answer 2: No, in this situation the Seller/Lessee Corporation is not required to file amended returns to reduce its depreciation deductions for the years that are still open under the statute of limitations. Since the year in which the initial $200,000 payment was reported as income is closed, the Seller/Lessee Corporation may continue to claim depreciation on its entire $1,000,000 basis in the property, including the amount attributable to the federal tax benefits. □

SALES AND USE TAXES

Note: The following tax releases interpret the Wisconsin sales and use tax law as it applies to the 5% state sales and use tax. The ½% county sales and use tax may also apply. For information on sales or purchases that are subject to the county sales and use tax, refer to the December 1992 issue of the *Sales and Use Tax Report*. A copy can be found in *Wisconsin Tax Bulletin* 80 (January 1993), page 45.

7 Credit for Tax Paid on Leased Vehicle Brought Into Wisconsin

Statutes: Section 77.51(4)(c)5 and (14)(j), Wis. Stats. (1991-92)

Facts and Question 1: In January 1990, Individual A, a resident of New Jersey, began leasing a motor vehicle from Company B. The term of the lease is four years. Lease payments are $300 per month.

The sale of the motor vehicle by Vendor C to Company B was subject to New Jersey sales tax. Company B paid Vendor C sales tax on the selling price of the motor vehicle ($10,000). (Note: Under New Jersey's sales and use tax law, the lessor of tangible personal property is subject to New Jersey sales tax on the purchase price of the property leased or the total lease payments, whichever is less. New Jersey sales and use tax law does not impose sales tax on the individual lease payments made by a lessee.)

In January 1992, Individual A became a resident of Wisconsin. Under sec. 77.51(14)(j), Wis. Stats. (1991-92), a lease is a continuing sale. Therefore, Company B is subject to Wisconsin sales tax on the individual lease payments made by Individual A, beginning when Individual A became a resident of Wisconsin.

Company B files its Wisconsin sales and use tax returns on an annual basis.

Is Company B allowed a credit for Wisconsin sales and use tax purposes for the sales tax it paid to Vendor C on the purchase of the motor vehicle it leases to Individual A, where the individual lease payments are subject to Wisconsin sales or use tax?

Answer 1: Company B may offset its lease receipts subject to Wisconsin sales or use tax by the amount previously taxed by New Jersey on its purchase of the motor vehicle it leases to Individual A, until such lease receipts equal the amount subject to New Jersey sales tax.

Section 77.51(4)(c)5, Wis. Stats. (1991-92), provides that if a lessor of tangible personal property reimbursed the vendor for sales tax on the sale of the property by the vendor to the lessor, the tax due from the lessor on the rental receipts may be offset by a credit equal to but not exceeding the tax otherwise due on the rental receipts from this property for the reporting period.

The lease receipts from the lease of the motor vehicle by Company B to Individual A subject to Wisconsin sales or use tax are computed as follows:

	1990	1991	1992	1993
Lease payments	$3,600	$3,600	$3,600	$3,600
Amount subject to New Jersey sales tax	3,600	3,600	2,800	0
Amount subject to Wisconsin sales tax	$ 0	$ 0	$ 800	$3,600

Lease payments received by Company B from Individual A are not subject to Wisconsin sales or use tax until the lease receipts exceed the amount on which New Jersey sales tax was computed ($10,000).

Facts and Question 2: Will the credit against gross receipts under sec. 77.51(4)(c)5, Wis. Stats. (1991-92), apply if the lessor paid a use tax to the vendor on the purchase of the motor vehicle it leases to Individual A?

Answer 2: Yes. Sales tax, for purposes of the credit against gross receipts under sec. 77.51(4)(c)5, Wis. Stats. (1991-92), includes a use or excise tax imposed on the sale of tangible personal property by another state in which the sale occurred.

Note: If the sales, use, or excise tax paid did not reimburse the vendor on the sale of the motor vehicle by the vendor to the lessor, the credit under sec. 77.51(4)(c)5, Wis. Stats. (1991-92), does not apply.

Example: Assume the same facts as in Facts and Question 1, except that Vendor C did not impose sales tax on the sale of the motor vehicle to Company B. Company B paid the tax owing on its purchase of the motor vehicle directly to the State of New Jersey.

Company B is not allowed to offset its lease receipts by the amount subject to tax that it paid directly to the State of New Jersey. Section 77.51(4)(c)5, Wis. Stats. (1991-92), provides that for the offset to apply, the lessor (Company B) must have reimbursed the vendor (Vendor C) for the sales tax on the sale of the motor vehicle. □