

Chapter Tax 3

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Tax 3.01 Rents paid by corporations. (s. 71.04 (2), Stats.) Rents paid on property used in producing taxable income are deductible from gross income. The cost of leaseholds, acquired for cash or property, represents rent paid in advance and as such is deductible from gross income in equal amounts over the life of the leaseholds. Taxes paid by the lessee for the lessor are to be treated as additional rent paid and are a deductible expense.

History: 1-2-56; am. Register, March, 1966, No. 123. eff. 4-1-66.

Tax 3.03 Dividends received, deductibility of. (s. 71.04 (4), Stats.) (1) In determining whether 50% or more of the net income or loss for the preceding year of the corporation paying the dividend was used in computing taxable income, if the corporation paying the dividend was subject to the franchise tax measured by net income, interest income from the federal government and its instrumentalities must be included but deduct-

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ible dividends must be disregarded. If the corporation paying the dividend was subject to the net income tax, non-taxable interest from the federal government or its instrumentalities and deductible dividends must both be disregarded.

(2) When a corporation keeps its records on the basis of a fiscal year ending not later than June 30, the dividends received from such corporation during the calendar year will be presumed to have been paid from the income of the corporation for its fiscal year ending within the calendar year when such dividends are paid. When a corporation keeps its records on the basis of a fiscal year ending subsequent to June 30, the dividends received from such corporation during the calendar year will be presumed to have been paid from the income of the corporation for its fiscal year ending in the year prior to the calendar year when such dividends are paid.

(3) All dividends must be reported in full on the income tax return of the person receiving them, regardless of the deductibility of certain dividends received by corporations. Corporate taxpayers should deduct such dividends as they believe to be deductible. Whether or not the dividends are deductible will be determined in accordance with the records on file with the department of revenue and proper adjustment will be made.

(4) All corporations doing business within Wisconsin must report the dividends paid to residents of Wisconsin on forms 9b. (See s. Tax 2.04).

(5) Distributions received from corporations which may deduct dividends paid from gross income for tax purposes do not qualify as deductible dividends.

History: 1-2-56; am. Register, September, 1964, No. 105, eff. 10-1-64; am. (1), Register, March, 1966, No. 123, eff. 4-1-66; am. Register, February, 1975, No. 230, eff. 3-1-75; cr. (5), Register, July, 1978, No. 271, eff. 8-1-78.

Tax 3.05 Profit-sharing distributions by corporations. (s. 71.04 (1), Stats.) (1) Payments made to officers and employees for services rendered under the terms of a profit-sharing agreement, in lieu of or in addition to fixed salaries or other compensation, are proper deductions from gross income. Payments made to the stockholders of a corporation who are not actively engaged in the business are not allowable deductions. If profit-sharing distributions are based on stock holdings, they will be treated as dividends and, therefore, are not allowable deductions.

(a) The form or method of fixing compensation is not decisive as to the deductibility thereof. If payments are made pursuant to a profit-sharing agreement entered into between employer and employe before services are rendered, which is not influenced by any consideration on the part of the employer other than that of securing the services of the employe on fair and advantageous terms, they will be allowable as deductions from gross income even though in the actual working out of the contract such payments may prove to be greater than the amounts which would ordinarily be paid.

History: 1-2-56; am. Register, March, 1966, No. 123, eff. 4-1-66.

Tax 3.07 Bonuses and retroactive wage adjustments paid by corporations. (s. 71.04 (1), Stats.) Bonuses for services actually rendered but not based upon a prearranged bonus agreement or established policy are allowable when actually paid, provided the payments when added to the stipulated Register, April, 1988, No. 388

salaries or other compensation do not exceed a reasonable compensation for the services rendered. Bonuses paid to employes and others which do not have in them the element of compensation or are excessive in comparison to the services rendered are not deductible from gross income. Christmas bonuses, if paid as additional compensation, are proper deductions from gross income if included on federal form W-2 or Wisconsin form 9b as a part of the compensation paid. Retroactive wage adjustments, if reasonable in amount, may be taken as a deduction from gross income in the year in which they are finally determined to be payable. The adjustments are to be reported on federal form W-2 or Wisconsin form 9b.

History: 1-2-56; am. Register, March, 1966, No. 123, eff. 4-1-66; am. Register, July, 1987, No. 379, eff. 8-1-87.

Tax 3.08 Retirement and profit-sharing payments by corporations. (s. 71.04, Stats.) (1) Retirement payments to retired officers or employes or to their families or dependents, to be deductible from gross income must:

- (a) Qualify as ordinary and necessary expense.
- (b) Be made pursuant to a retirement plan agreement.
- (c) Be reasonable in amount.
- (d) Have been reported on informational returns when required by s. Tax 2.04 or 2.06.

Credits to retirement reserves are not deductible, but actual retirement payments made and charged against such reserves may be deductible in the year made.

(2) Payments to an employe retirement or profit-sharing trust are deductible if:

- (a) Such payments qualify as ordinary and necessary expense.
- (b) The trust is an irrevocable trust and no part of its funds may revert to the employer.
- (c) Payments to the trust are made in accordance with an established policy or agreement.
- (d) The trust is established for the benefit of officers or employes.
- (e) Such payments are reasonable in amount.

History: 1-2-56; am. Register, March, 1966, No. 123, eff. 4-1-66.

Tax 3.085 Retirement plan distributions. (s. 71.07 (1), Stats.) (1) **NON-RESIDENTS.** Employe annuity, pension, profit-sharing or stock bonus plan distributions (including self-employed retirement plan distributions) received by a person while a nonresident of Wisconsin shall be exempt from the Wisconsin income tax, regardless of whether any of these distributions may be attributable to personal services performed in Wisconsin.

(2) **RESIDENTS.** Employe annuity, pension, profit-sharing or stock bonus plan distributions (including self-employed retirement plan distributions) received by a person while a resident of Wisconsin shall be subject to the Wisconsin income tax, regardless of whether any of these distribu-

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tions may be attributable to personal services performed outside of Wisconsin.

History: Cr. Register, March, 1978, No. 267, eff. 4-1-78.

Tax 3.09 Exempt compensation of military personnel. (s. 71.01 (3) (f), Stats.) For purposes of the income tax exemption of the first \$1,000 of compensation received from the United States as a reserve or active member of the armed forces under s. 71.01 (3) (f), Stats.:

(1) Compensation received by members of the Wisconsin national guard from the state for weekend highway patrol duty, civil disturbance or riot duty shall not qualify for this exemption.

(2) Compensation received by retired officers and enlisted personnel of the armed services from the United States shall not qualify for this exemption except as provided under sub. (4).

(3) Compensation received by commissioned officers of the United States, such as public health officers or coast and geodetic survey officers, who are not members of the armed services shall not qualify for this exemption.

(4) Compensation received by retired, enlisted personnel of the armed services who upon retirement are transferred to reserve units until completion of 30 years of service shall qualify for this exemption. This includes compensation received by retired army and air force personnel who are transferred to reserve units and by retired navy and marine personnel who are transferred to fleet reserve and fleet marine corps reserve, respectively.

Note: Under s. 71.01 (3) (f), Stats., the first \$1,000 of compensation received from the United States for service as a reserve or active member of the armed forces is exempt from income taxation. This rule clarifies how several types of payments will be treated under this exemption.

History: Cr. Register, August, 1976, No. 248, eff. 9-1-76.

Tax 3.095 Income tax status of interest and dividends from municipal, state and federal obligations received by individuals and fiduciaries. (s. 71.05 (1) (a) 1 and (b) 1, Stats.) (1) Interest and dividends, less related expenses, payable on the following securities shall be subject to state income tax on individuals and fiduciaries:

(a) District of Columbia Development Land Agency bonds, 42 U.S.C. § 1452.

(b) Export-Import Bank of the United States debentures, 12 U.S.C. § 635.

(c) Farmer's Home Administration insured notes, 7 U.S.C. §§ 1928 and 1929.

(d) Federal Home Loan Bank dividends, 12 U.S.C. §§ 1426 and 1436.

(e) Federal National Mortgage Association certificates, 12 U.S.C. § 1718.

Note: In 1968, the Federal National Mortgage Association became 2 separate corporations. One corporation retained the original name and the other is known as the Government National Mortgage Association.

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(f) Federal National Mortgage Association dividends, 12 U.S.C. § 1719.

(g) Government National Mortgage Association (Ginnie Mae) bonds, 12 U.S.C. §§ 1720 and 1721.

(h) Insured Merchant Marine bonds, 46 U.S.C. § 1273.

(i) Inter-American Development Bank bonds, 22 U.S.C. § 283.

(j) Interest paid on deposits in any federal bank or agency.

(k) International Bank for Reconstruction and Development bonds, 22 U.S.C. § 286.

(l) Small Business Investment Company debentures, 15 U.S.C. §§ 683 and 687.

(m) Tennessee Valley Authority bonds, 16 U.S.C. § 831n-3.

(n) Transit bonds of the Washington Metropolitan Area Transit Authority.

(2) Interest and dividends payable on the federal securities listed in pars. (a) to (zb) shall be exempt from state income tax on individuals and fiduciaries. For purposes of this subsection, the term, "federal securities" means only securities which are direct and primary obligations of the United States and securities the interest of which federal law prohibits states from taxing. Federal securities do not include securities for which the United States is merely a guarantor and, therefore, has an obligation which is secondary and contingent to that of the issuer of the security.

(a) Bank for Cooperative debentures, 12 U.S.C. § 2134.

(b) Bank repurchase agreements for U.S. Government treasury bills, notes, and bonds, if interest is paid by the federal government directly to the taxpayer.

(c) Commonwealth of Puerto Rico public improvement bonds, 48 U.S.C. § 745.

(d) Federal Farm Credit Banks Consolidated Systemwide Securities, 12 U.S.C. § 2055.

(e) Federal Home Loan Bank bonds, debentures, and notes, 12 U.S.C. § 1433.

(f) Federal Housing Authority debentures, 12 U.S.C. §§ 1710 (d) and 1747g (g).

(g) Federal Intermediate Credit Bank debentures, 12 U.S.C. § 2079.

(h) Federal Land Bank bonds, 12 U.S.C. § 2055.

(i) Federal Reserve Bank dividends, 12 U.S.C. § 531.

(j) Production Credit Association debentures, 12 U.S.C. § 2098.

(k) Puerto Rico Aqueduct and Sewer Authority revenue bonds, 48 U.S.C. § 745.

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(l) Puerto Rico Electric Power Authority electric revenue bonds, 48 U.S.C. § 745.

(m) Puerto Rico Electric Power Authority power revenue bonds, 48 U.S.C. § 745.

(n) Puerto Rico Highway Authority revenue bonds, 48 U.S.C. § 745.

(o) Puerto Rico Industrial Development Company bonds, 48 U.S.C. § 745.

(p) Puerto Rico Municipal Finance Agency 1974 Series A bonds, 48 U.S.C. § 745.

(q) Puerto Rico Ports Authority revenue bonds, 48 U.S.C. § 745.

(r) Puerto Rico Public Buildings Authority revenue bonds, 48 U.S.C. § 745.

(s) Puerto Rico Public Buildings Authority public education and health facility bonds, 48 U.S.C. § 745.

(t) Puerto Rico Telephone Authority revenue bonds, 48 U.S.C. § 745.

(u) Student Loan Marketing Association obligations, 20 U.S.C. § 1087-2l.

(v) Tennessee Valley Authority bonds, 16 U.S.C. § 831n-4(d).

(w) Territory of Hawaii bonds.

(x) Territory of Puerto Rico bonds, 48 U.S.C. § 745.

(y) United States Postal Service bonds, 39 U.S.C. § 2005.

(z) United States savings bonds, 31 U.S.C. § 3124.

(za) United States Treasury bills and notes, 31 U.S.C. § 3124.

(zb) University of Puerto Rico university system revenue bonds, 48 U.S.C. § 745.

(3) Interest and dividends, less related expenses, payable on the state, municipal, and other local government securities listed in pars. (a) to (f) shall be subject to the state income tax on individuals and fiduciaries.

(a) District of Columbia general obligation bonds issued after January 28, 1987, s. 47-33, District of Columbia Code.

(b) Municipal bonds.

(c) Public housing authority bonds issued by municipalities located outside Wisconsin.

(d) Virgin Islands Housing Authority bonds issued after January 28, 1987, 48 U.S.C. § 1408(a).

(e) Wisconsin Health Education Assistance Loan revenue obligation bonds, s. 39.374, Stats.

(f) Wisconsin Housing and Economic Development Authority bonds issued after January 28, 1987, s. 234, Stats.

(4) Interest and dividends payable on the housing authority bonds listed below shall be exempt from the state income tax on individuals and fiduciaries.

(a) Public housing authority bonds issued by municipalities located in Wisconsin, s. 66.40 (14) (a), Stats.

(b) Wisconsin Public Housing Authority bonds, 42 U.S.C. § 1437i(b).

Note: This rule sets out examples of interest and dividends payable on state, municipal and federal obligations which are taxable and tax exempt.

Section 71.05 (1) (a) 1, Stats., provides for the inclusion in Wisconsin income of natural persons and fiduciaries of any interest, less related expenses, received on state and municipal obligations.

Section 71.05 (1) (b) 1, Stats., provides for the exclusion from Wisconsin income of natural persons and fiduciaries of any interest or dividend income which is by federal law exempt from taxation by Wisconsin.

For periods prior to August 1, 1987, interest accrued from District of Columbia Development Land Agency bonds, Export-Import Bank of the United States debentures, Farmer's Home Administration insured notes, Government National Mortgage Association bonds, Small Business Investment Company debentures and transit bonds of the Washington Metropolitan Area Transit Authority was not subject to the Wisconsin income tax if payment of principal and interest on such obligations was guaranteed by the United States. As a result of the U.S. Supreme Court decision in the case of *Rockford Life Insurance Company v. Illinois Department of Revenue et al.*, the Department of Revenue does not consider these financial instruments to be direct and primary obligations of the United States so as to qualify for exemption from state income taxation. Therefore, by emergency rule effective August 1, 1987, the Department of Revenue amended this rule to reverse its prior interpretation and to provide that interest which accrues on these financial instruments on or after August 1, 1987, is subject to Wisconsin income tax.

Interest accrued on the following securities issued on or before January 28, 1987, is not subject to Wisconsin income tax because no modification is provided for in Wisconsin law that would add to federal adjusted gross income interest excluded from federal adjusted gross income by any reason other than section 103 of the Internal Revenue Code:

1. District of Columbia general obligation bonds.
2. Virgin Island Housing Authority bonds.
3. Wisconsin Housing and Economic Development Authority bonds.

Interest accruing on these securities is subject to Wisconsin income tax if the security was issued after January 28, 1987. 1987 Wisconsin Act 27 amended s. 71.05 (1) (a) 1, Wis. Stats., to provide for the addition to federal adjusted gross income, of interest, less related expense, which is not included in federal adjusted gross income and not specifically exempted from state taxation. Previously this addition only applied to interest excluded from federal adjusted gross income by section 103 of the Internal Revenue Code.

Interest on Wisconsin Health Education Assistance Loan revenue obligation bonds is subject to Wisconsin income tax whether the security was issued before, on, or after January 28, 1987.

History: Cr. Register, August, 1976, No. 248, eff. 9-1-76; emerg. cr. (1) (g) to (i), am. (2) (intro.), r. (2) (b), (h) and (j), eff. 7-31-87; r. and recr. Register, April, 1988, No. 388, eff. 5-1-88.

Tax 3.096 Interest paid on money borrowed to purchase exempt government securities (s. 71.05 (1) (b) 1, Stats.). (1) Any amount of interest or dividend income which is by federal law exempt from the Wisconsin income tax shall be reduced by any related expense before it is claimed as a subtraction modification on a Wisconsin income tax return.

(2) Interest expense is a "related expense" if it is incurred to purchase securities producing exempt interest or dividend income and if it is deducted in computing Wisconsin taxable income.

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(3) Interest expense is not a "related expense" if it is incurred to purchase securities producing exempt interest or dividend income but is not deducted in computing Wisconsin taxable income (for example, because the taxpayer elects the standard rather than to itemize deductions).

Note: The following examples illustrate the proper treatment of the interest expense described in this rule:

<i>Example A:</i>	U.S. bond interest exempt from Wisconsin income tax.	\$ 600
	Interest which was paid on funds used to acquire exempt securities and which was claimed as an itemized deduction.	<u>400</u>
	Subtraction modification.	<u>\$ 200</u>
<i>Example B:</i>	U.S. bond interest exempt from Wisconsin income tax.	\$ 400
	Interest paid to acquire the exempt securities which was claimed as an itemized deduction.	<u>600</u>
	Subtraction modification.	<u>\$ 0</u>
<i>Example C:</i>	U.S. bond interest exempt from Wisconsin income tax.	\$ 400
	Interest paid to acquire the exempt securities but not claimed as an itemized deduction	<u>600</u>
	Subtraction modification	<u>\$ 400</u>

History: Cr. Register, January, 1977, No. 253, eff. 2-1-77.

Tax 3.098 Railroad retirement supplemental annuities. (s. 71.05 (1) (b) 4, Stats.). Railroad retirement supplemental annuities paid under 45 U.S.C.A. s. 228c are exempt from the Wisconsin taxable income of their recipients.

Note: The Railroad Retirement Act (45 U.S.C.A. s. 428L) provides that, "Notwithstanding any other law of the United States, or of any State . . . no annuity or pension payment shall be . . . subject to any tax. . . ."

Another provision of the Act (45 U.S.C.A. s. 228c (j) (3)), however, relates specifically to supplemental Retirement Annuities paid in amounts between \$45 and \$70 per month, and qualifies the above provision by stating "The provisions of Section 228L of this title shall not operate to exclude the supplemental annuities herein provided for from income taxable pursuant to the Federal income tax provisions of Title 26."

While such supplemental annuities are taxable for federal income tax purposes, 45 U.S.C.A. s. 228 (c) (j) 3 continues to prohibit states from taxing the payments. As the supplemental annuity must be reported for federal income tax purposes, a Wisconsin taxpayer may make a modification to federal adjusted gross income to remove such income from Wisconsin adjusted gross income.

History: Cr. Register, January, 1977, No. 253, eff. 2-1-77.