



## WISCONSIN TAX CHANGES AFFECTING FINANCIAL INSTITUTIONS

### COMBINED REPORTING

Combined Reporting was included in the state's Budget Repair Bill (Wisconsin Act 2) passed in February 2009. This legislation was introduced on February 17, passed by both houses on February 18, and signed into law on February 19. It is effective for taxable years that begin on or after January 1, 2009, and will affect C corporation banks that are part of a combined group of corporations. Combined Reporting is comparable to consolidated returns which are filed for federal purposes, but get more complicated when trying to measure how much income is reportable to the state if you do business inside and outside the state.

#### What does this mean for investment subsidiaries?

All income is included in the combined report and probably none is allocated back to the investment subsidiary because investment receipts are not counted for apportionment or sourcing purposes. (This is different from Illinois which does allow investment receipts to be apportioned outside the state. It is also different from Minnesota which apportions investment income based on deposits in each state.) This means that for Wisconsin purposes all the investment subsidiary's income will likely be allocated to the bank (assuming all its receipts are from investments). State taxes should be accrued for the investment subsidiary's earnings for 2009.

You may want to keep your subsidiary in place for federal TEFRA benefits (while they are still in place). You need to be careful about the timing if you choose to shut down your subsidiary.

- If you have a large municipal portfolio, your annual TEFRA benefit may exceed your costs of keeping the subsidiary in place. The IRS has the power to issue guidance which could take away this benefit prospectively, but they have not done so yet. Until they do, you may want to keep the structure in place. This assumes, of course, that you had a business purpose for the subsidiary at the time it was created.
- You need to own the investment subsidiary stock "during the entire taxable year" in order to exclude any dividends paid prior to liquidation. It is possible that these dividends could qualify for the new dividends received deduction related to the earnings for the current year which are included in the combined return for 2009, but the rules are so new that you may not want to take this chance. For this reason, you should not dissolve the corporation until after the end of the year if you paid dividends in 2009 prior to the decision to liquidate.

#### Executive Summary:

The cost of doing business in Wisconsin has just gone up for financial institutions.

- Combined reporting both hurts and helps, but probably hurts more than it helps.
- Increases in the individual tax rates for ordinary income and capital gains will affect stockholders, employees, and customers, especially those owning pass-through businesses.
- We may not see the impact initially as earnings are down, but the tax increases will take a larger share of the profits.

### **What does this mean for investment subsidiaries? (Continued)**

- Securities that are sold at a gain or loss by the investment subsidiary will generate capital gain or loss. Securities that are transferred to the bank in a liquidating distribution will not create a gain or loss for federal or state purposes. (Wisconsin follows the federal treatment for liquidation of a subsidiary under Sections 332 and 337.) The bank will acquire a carryover cost basis for the securities.

### **What does this mean for holding companies?**

Current and future losses directly offset the income of the combined group. This is an advantage of combined reporting, just as it is a federal advantage of a consolidated return.

Net Operating Loss (NOL) carryforwards from prior years will only be allowed to the extent that combined income of the group is allocated back to the holding company. As mentioned earlier, receipts from investments do not get counted for this purpose. Also, receipts from other members of the combined group are eliminated. Therefore, the holding company would need to generate some Wisconsin-source gross receipts from outside the group in order to have any of the combined income allocated to it which could be sheltered by the NOL carryforward.

- Lease receipts from renting Wisconsin property to tenants outside the combined group
- Interest from loans, including participations, are counted as Wisconsin receipts if they are secured by property in Wisconsin or if they are unsecured and the borrower is located in this state
- Wisconsin gross receipts from an LLC or partnership owned by the holding company

### **What does this mean for banks?**

Because of a definition included in the Budget Repair Bill, every bank holding loans secured by real or tangible personal property located outside Wisconsin is now "doing business" both in and outside Wisconsin. This means that most community banks that previously considered themselves to be only doing business in Wisconsin will now have an incentive to track the source of their receipts. You may not have a filing requirement in the other state under that state's definition of nexus ("doing business" in the state), but under Wisconsin's definition you are doing business in the other state. This will allow you to report less than 100 percent of your combined income to Wisconsin, while not changing your reporting obligation to the other states (unless the other states adopt the same definition as Wisconsin).

Every bank should get a copy of Rule 2.49 and go through the sourcing rules for the various types of receipts for financial organizations. It will be important that your systems can provide this sourcing information for tax preparation purposes.

Note that this change will also affect S corporations that have significant ownership by out-of-state shareholders. The in-state shareholders will still report income from all their sources of income, but the out-of-state shareholders only need to report income from Wisconsin sources, which should be a smaller number now. It may not affect their overall state taxes if they were getting full credit for their Wisconsin taxes on their home state return, but it could make a difference if they are residents of Florida, Texas, or Nevada with no state income tax.

## **BUDGET BILL (WISCONSIN Act 28)**

The Budget Bill (Wisconsin Act 28) was signed into law on June 29, 2009. It contains a number of tax changes and increases that will affect banks and their shareholders and customers.

First, the conformity (non)update will hurt certain banks with FNMA or FHLMC losses. The statute was updated to conform, with exceptions, to the Internal Revenue Code (IRC) as of December 31, 2008. One of the exceptions was the Emergency Economic Stabilization Act (EESA) passed in October 2008. This law included a provision that would allow losses from FNMA or FHLMC preferred stock to be treated as ordinary losses, rather than capital losses. Since Wisconsin did not adopt this federal change, those institutions that have losses on these stocks will need to determine strategies to generate capital gains if they want to be able to claim these losses for state purposes. For the institutions that have these losses, they are material in size. A \$2 million loss will cost you \$104,000 in taxes (net of the federal impact) if you can't deduct it for state purposes.

The top rate for individuals has been increased for 2009. A 1 percent increase (creating a new rate of 7.75 percent) will apply to income over \$300,000 on a joint return, or \$225,000 on a single return. Prior to this change, Wisconsin had a very "flat" rate structure where a 6.75 percent rate applied to all income above \$20,000. This will affect S corporation banks that pay out tax distributions based on the highest marginal rate.

Capital gains will be taxed at a higher rate regardless of your level of income. Previously, Wisconsin allowed a 60 percent exclusion for net long-term capital gains. Therefore, if your marginal rate was 6.75 percent, your effective rate on net long-term capital gains was 2.7 percent. Starting in 2009 (retroactive to the beginning of the year) the capital gain exclusion will only be 30 percent. This means that for taxpayers in the 6.75 percent marginal rate, their net effective rate on capital gains will be 4.725 percent. And for those in the new 7.75 percent range, the effective rate on capital gains will be 5.425 percent. This is over twice what it was before!

Withholding for nonresident shareholders must now be paid through estimated payments, starting with September 15 for this year. Pass-through entities, such as S corporations, partnerships, LLCs, and trusts have been paying a tax on behalf of their nonresident shareholders, partners, members, or beneficiaries for several years now. It has been done after the end of the year when the actual share of taxable income is calculated and returns are prepared. Now the state will require payments to be made on a quarterly basis as estimated payments.

## **CONTACT INFORMATION**

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