REPORT ON LITIGATION

This portion of the WTB summarizes recent significant Tax Appeals Commission and Wisconsin court decisions. The last paragraph of each decision indicates whether the case has been appealed to a higher court.

The last paragraph of each WTAC decision in which the department's determination has been reversed will indicate one of the following: 1) "the department appealed", 2) "the department has not appealed but has filed a notice of nonacquiescence" or 3) "the department has not appealed" (in this case the department has acquiesced to Commission's decision).

The following decisions are included:

Individual Income Taxes

Wendy L. LaBadie
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Allocation of income

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Penalty - underpayment of taxes

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International Business Machines Corporation
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INDIVIDUAL INCOME TAXES

Wendy L. LaBadie vs. Wisconsin Department of Revenue (Wisconsin Tax Appeals Commission, February 12, 1985). The issue in this case is whether or not the taxpayer is required to pay Wisconsin income tax on gain incurred from constant basis assets (namely, her shares of Clark Oil & Refining Corporation stock) occurring during a period of nonresidency.

Prior to January 1, 1978, Wendy LaBadie was domiciled in and a resident of Wisconsin. From January 1, 1978 through August 31, 1980, the taxpayer was not domiciled in and was not a resident of Wisconsin. On September 1, 1980, she reestablished her Wisconsin domicile and residence.

Prior to January 1, 1965, the taxpayer acquired 58,936 shares of common stock of Clark Oil & Refining Corporation, a Wisconsin corporation ("Clark stock"), by gifts on various dates. The aggregate fair market values of these shares on the various dates she received them totalled $62,894.32. The aggregate fair market value of these shares on December 31, 1977 and September 1, 1980 was $360,983 and $1,312,246.85, respectively.

During the period January 1, 1965 through December 31, 1977, the taxpayer acquired 7,408 shares of Clark stock by gifts on various dates. The aggregate fair market value of these shares on December 31, 1977 and September 1, 1980 was $45,374 and $164,943.75, respectively.

During the period January 1, 1978 through August 31, 1980, the taxpayer acquired 1,054 shares of Clark stock by gifts on various dates. The aggregate fair market value of these shares on September 1, 1980 was $23,467.97.

On September 18, 1981, Wendy LaBadie sold her 67,398 shares of Clark stock on the installment basis with 5% of the purchase price being paid in 1981 and the balance thereafter. For federal income tax purposes the basis of these shares was $5,391.84. The aggregate purchase price for these shares was $2,493,726 or $37 per share. She received payment of $124,686.30 of the total purchase price in 1981 and reported $124,387.05 as capital gain taxable in 1981 for federal income tax purposes.

The taxpayer's original 1981 Wisconsin income tax return reported her 1981 installment gain on the sale of the 67,398 shares of Clark stock as $124,387.05, basing her Wisconsin basis for the shares on her federal adjusted basis in order to determine the amount of the 1981 Wisconsin taxable capital gain. She filed her original 1981 Wisconsin income tax return and paid the $16,571.31 Wisconsin income tax shown on or before April 15, 1982.

Wendy LaBadie filed an amended Wisconsin income tax return on January 14, 1983 claiming a refund of $5,762.15 in Wisconsin income tax due to Wisconsin basis adjustments to the 67,398 shares of Clark stock aggregating $57,621.46 for 1981 as follows:

A. *58,936 shares acquired prior to Janaury 1, 1965.*

(i)

Aggregate fair market value of shares on date of gifts	$ 62,894.32
Less: federal basis of shares	(4,682.52)
Wisconsin basis adjustment	58,211.80
Percent of basis recovered in 1981	5%
1981 Wisconsin basis adjustment	2,910.59
Reduction in 1981 reported Wisconsin capital gain	$ 2,910.59

(ii)

Fair market value of shares on September 1, 1980	$1,312,246.85
Less: Fair market value of shares on Dec. 31, 1977	(360,983.00)
Wisconsin basis adjustment	951,263.85
Percent of basis recovered in 1981	5%
1981 Wisconsin basis adjustment	47,563.19
Reduction in 1981 reported Wisconsin capital gain	$ 47,563.19

B. *1,054 shares acquired January 1, 1978 - August 31, 1980.*

Fair market value of shares on September 1, 1980	$ 23,467.97
Less: federal basis of shares	(84.32)

Wisconsin basis adjustment	23,383.65
Percent of basis recovered in 1981	5%
1981 Wisconsin basis adjustment	1,169.18
Reduction in 1981 reported Wisconsin capital gain	$ 1,169.18

C. *7,408 shares acquired January 1, 1965 - December 31, 1977.*

Fair market value of shares on September 1, 1980	$ 164,943.75
Less: fair market value of shares on December 31, 1977	(45,374.00)
Less: federal basis of shares	(592.64)
Wisconsin basis adjustment	119,569.75
Percent of basis recovered in 1981	5%
1981 Wisconsin basis adjustment	5,978.48
Reduction in 1981 reported Wisconsin capital gain	$ 5,978.48

By notice of refund dated April 14, 1983, the department allowed the Wisconsin basis adjustments and reductions in the taxpayer's reported 1981 Wisconsin capital gains set forth in paragraphs *A(i)* and *B* of this stipulation. The department denied the Wisconsin basis adjustments and reductions in her reported Wisconsin capital gains set forth in paragraphs *A(ii)* and *C* of this stipulation. The department based this denial upon the conclusion that gain incurred from the appreciation of constant basis assets during a period of nonresidency may not be excluded from Wisconsin taxable income if the assets were acquired while the taxpayer was a resident of Wisconsin.

The Commission held that a Wisconsin taxpayer who purchased and sold corporate stock, while a resident of Wisconsin, may not exclude from the computation of taxable gain realized from the sale appreciation on the stock which occurred during a period of nonresidence.

The taxpayer has appealed this decision to the Circuit Court.

Robert M. Lawn vs. Wisconsin Department of Revenue (Wisconsin Tax Appeals Commission, March 26, 1985). The sole issue for the Commission to determine is whether a wage settlement of $8,234.78, received in 1981 as a result of a lawsuit commenced in Florida involving wages owed in 1977 and 1978, is income for Wisconsin tax purposes.

During 1981, Robert M. Lawn, a cash basis taxpayer, was a resident of Wisconsin. In 1981, the taxpayer received payment of $8,234.78 as a result of a settlement of a legal action for payment of wages owed by Logistic Services, Inc. The taxpayer did not declare this payment as income on his 1981 Wisconsin tax return. The taxpayer contends that since the wages were earned while a resident of Florida, but not received until a resident of Wisconsin, the amount is not includable as income in his 1981 return.

The Commission held that all income of resident individuals shall follow the residence of the individual. A wage settlement received in 1981, but earned in 1977 and 1978, is income in the year of receipt to a cash basis taxpayer.

The taxpayer has not appealed this decision.

Wayne Schultz, Marjorie Schultz, Wendell Schultz and Daniel Schultz vs. Wisconsin Department of Revenue (Wisconsin Tax Appeals Commission, March 21, 1985). The taxpayers are objecting to the imposition of the underpayment penalty.

All four of the taxpayers were Wisconsin residents during 1981 and shareholders in Schultz Farms, Inc., a Subchapter S corporation.

By March 1, 1982, all four taxpayers filed their 1981 Wisconsin income tax returns reporting undistributed taxable income of Schultz Farms, Inc. and making full payment of taxes due. In addition, the taxpayers reported salary and interest received from Schultz Farms, Inc. The taxpayers did not file quarterly estimated tax returns and payments to Wisconsin during 1981. The department issued a Notice of Penalty for Underpayment of Estimated Tax for the year 1981 against the taxpayers.

The taxpayers object to the imposition of penalties for underpayment of estimated tax on the grounds that they are farmers within the meaning of s. 71.21(3), Wis. Stats., and that, therefore, they should be entitled to the special filing provisions for farmers under s. 71.21(8), Wis. Stats. The taxpayers argue that by filing their 1981 Wisconsin returns by March 1, 1982, they had complied fully with s. 71.21(8), Wis. Stats., and should not have been assessed any penalties.

The Commission held that for purposes of s. 71.21(3), Wis. Stats., neither a farm employe receiving wages nor a Subchapter S shareholder receiving undistributed income treated as dividends from the corporation, even though the corporation may be engaged exclusively in farming, qualifies as a farmer to be entitled to special treatment under s. 71.21(8), Wis. Stats. The income received by the taxpayers both as wages and as undistributed income from Schultz Farms, Inc. was not subject to the provisions of ss. 71.21(3) and (8), Wis. Stats., for purposes of estimated tax reporting requirements. The department acted properly in imposing the penalties for underpayment of estimated taxes for the year 1981.

The taxpayers have not appealed this decision.

CORPORATION FRANCHISE INCOME TAXES

International Business Machines Corporation vs. Wisconsin Department of Revenue (Wisconsin Tax Appeals Commission, May 9, 1985). International Business Machines Corporation (IBM), is and was at all relevant times incorporated under the laws of the State of New York and had its corporate headquarters in Armonk, New York.

The issues in this case are as follows:

A. Whether dividends received by IBM, from its subsidiary, IBM World Trade Corporation, constitute apportionable income, subject to taxation in Wisconsin.

B. If IBM's dividends from IBM World Trade Corporation are taxable by Wisconsin, then whether they are includable as "total sales" in the sales factor of the apportionment formula.

C. Whether investment income received by IBM is subject to apportionment and taxation in Wisconsin.

D. If IBM's investment income is subject to taxation in Wisconsin, then whether the interest and proceeds from the sales of investments are includable as "total sales" in the sales factor of the apportionment formula.

E. Whether royalties received by IBM are includable in the sales factor of the apportionment formula.

F. IBM also raises objections to the department's action on constitutional grounds.

On June 6, 1978, the Wisconsin Department of Revenue gave IBM notice of assessment of additional franchise tax for the calendar years 1973, 1974 and 1975, in the amount of $736,935.09, consisting of $606,779.01 tax and $130,156.08 interest. IBM petitioned for redetermination of the assessment. On March 29, 1979, the department gave IBM notice that the petition for redetermination was denied.

On January 11, 1980, IBM filed with the department a claim for refund of franchise taxes paid by IBM for the calendar years 1973, 1974 and 1975 in the amount of $32,769.32, plus interest. On February 1, 1980, the department gave IBM notice that the claim for refund was denied. IBM has appealed from this denial of its petition for redetermination and its claim for refund.

IBM owns and at all relevant times owned all the issued and outstanding stock of World Trade. World Trade is and was at all relevant times incorporated under the laws of the State of Delaware. During the calendar years 1973, 1974 and 1975, World Trade's regular trade and business was similar to that of IBM, except that World Trade operated outside the United States.

During the calendar years 1973, 1974 and 1975, IBM's business activity included the development, manufacture, sale, rental and service of data processing and office equipment. IBM maintained marketing branch offices in each state and manufacturing facilities in many states. It had no manufacturing facilities in Wisconsin. As part of IBM's unitary business, IBM performed substantial research and experimental activities regarding data processing and office equipment. These activities resulted in a substantial number of patents. IBM licensed World Trade, as well as other parties that are unrelated to IBM, to use these patents in their business operations. In exchange, IBM received royalty payments, and in some cases, cross-licenses to use the licensees' patents. As part of IBM's unitary business, IBM also owned and leased a substantial number of office buildings, plants, laboratories and other office space throughout the United States. In many cases, IBM was unable fully to utilize all of the space it owned or leased. IBM then leased this unused space to others.

IBM received royalty income of $156,012,595.02 for 1973, $181,537,206.13 for 1974, and $222,296,167.39 for 1975. IBM treated this income as subject to apportionment under s. 71.07(2), Wis. Stats., on its Wisconsin corporate franchise tax returns. IBM included this income in the sales factor. The department treated the royalties as income subject to apportionment, but excluded the royalties from the sales factor. The department's position is that, even though the royalties are business income, they must be excluded from the sales factor of the apportionment formula, because they are not derived from IBM's "mainstream" or "principal business".

IBM received rental income from real estate of $12,678,016.13 in 1973, $17,403,041.19 in 1974, and $21,098,060.28 in 1975. IBM treated this income as apportionable under s. 71.07(2), Wis. Stats., on its Wisconsin corporate franchise tax returns. IBM included this income in the sales factor. The department treated the rentals as income subject to apportionment, but excluded the rentals from the sales factor.

During the calendar year 1975, IBM owned and administered an investment portfolio which in 1975 had a value in excess of $3.6 billion and made substantial investments in various money market instruments. IBM's investment portfolio was managed by IBM's Investment Department, whose sole function and responsibility was to manage these assets. The Investment Department was headed by a professional portfolio manager, who was hired from the investment community specifically for portfolio management. Other personnel in the department were hired from the investment community. The employes of the Investment Department were located at IBM's corporate headquarters at Armonk, New York. The placing of buy and sell orders for securities originated at that location. The securities in the investment portfolio were physically kept at Banker's Trust Company, 16 Wall Street, New York, New York. All funds relating to the purchase and sale of such securities were channeled through Banker's Trust Company.

The investment policy applied by the Investment Department was one of safety and liquidity. Within these constraints, its goal was to obtain the most attractive return possible. The portfolio composition has consistently been in U.S. Treasury, government guaranteed, tax exempts, certificates of deposit, and investment grade non-government securities. As part of the goal of maximum safety, the Investment Department also maintained adequate diversification as to type of securities, maturity and credit. In managing a fixed income portfolio, the security selection was based on several criteria: (a) expectations regarding the direction of interest rates; (b) maintenance of a prudent security mix and maturity structure; (c) relative value as determined by yield relationships; and (d) forecast of future cash needs. Because of IBM's investment policy, the Investment Department has been limited to the type of securities it has been able to purchase in the open market. IBM's investment in short-term or long-term securities was dictated by financial market and economic conditions.

During 1975, IBM received net interest income of $211,989,098 and capital gains of $16,238,950 as a result of its portfolio investments. IBM treated this income on its Wisconsin corporate franchise tax return as nonapportionable income. The department treated this income as subject to apportionment under s. 71.07(1m), Wis. Stats.

During the calendar year 1975, IBM held investments in subsidiary corporations. IBM owned all the issued and outstanding stock of World Trade. Effective January 1, 1950, IBM transferred to World Trade all of IBM's foreign net assets, IBM's securities of foreign subsidiaries and branches, and IBM's advances to foreign subsidiaries and branches, exclusive of foreign patents under which World Trade was granted a nonexclusive license. The objective of this transfer of assets from IBM to World Trade was to expand sales, service and production outside of the United States. In 1950, World Trade was doing business in 65 countries.

Because of its size and scope, World Trade developed a management philosophy of building strong responsive organizations at the country level. These organizations (branches, subsidiaries and agencies) were coordinated through policies and guidelines, and supported by a technological capability which develops standard products to meet the needs of international markets. World Trade's business quadrupled from 1951 to 1957 necessitating an organizational realignment with particular emphasis on delegation and decentralization of authority for on-the-spot decision making. The realignment divided overseas operations into five major geographical areas: Europe, Latin America, Asia Pacific, South Africa and Canada. Each area was covered by a separate staff organization reporting to an area general manager.

The European Area was typical of the new plan. The area general manager provided advice and counsel for the activities of the European Area. Six regional managers reported to him. Four of the regional managers also served as general managers of the largest countries. The other two regional managers were responsible for several countries, and these country general managers reported to the regional manager. Within each country in which World Trade did business was a World Trade country organization. In most cases the organization was a subsidiary of World Trade. In some cases it was a branch of World Trade. In either case it was the single operating entity for that country with full operational responsibility. The country manager was responsible for setting coordinated policies, salaries, benefits, management development program, training, customer satisfaction and day-to-day operating decisions. The country manager also prepared initial operating plans and budgets. Their principal contact was with the World Trade area headquarters. The staff organization in Europe consisted of specialists in their respective fields, and provided closer counsel for country managers than was possible from World Trade headquarters. The major staff members, reporting directly to the area general manager, were the director of marketing services, the director of finance, the director of manufacturing services and the director of personnel.

One of the important provisions of the new plan was the projection of daily operational responsibility and authority to the field. As a result, the five area general managers reported directly to the president of World Trade. To strengthen further the teamwork concept and allow greater decentralization of authority, a functional staff was organized at World Trade. The staff, specialists in their respective fields, functioned as a long-range planning group to counsel and advise the president on matters of a corporate nature and on plans and programs for specific areas of the business. The functional staff did not enter into the day-to-day operating decisions of the various areas and countries. The headquarters staff informed the president of all developments in all areas and disseminated information.

From 1957 to 1974, several modifications in the organizational structure became necessary. However, the underlying principle of geographical decentralization continued as a cornerstone throughout and the modifications up to 1974 consisted of a variety of consolidations and separations within and among area groups.

In 1974, World Trade, in order to further decentralize its management of overseas operations, transferred all of its foreign net assets (except royalty agreements between World Trade and its foreign subsidiaries) and investments in subsidiaries to two newly created corporations in exchange for all of their capital stock. The two corporations were IBM World Trade Europe/Middle East/Africa Corporation and IBM World Trade Americas/Far East Corporation. And as their names suggest, the assets were divided along the already established geographic areas of World Trade operation. IBM World Trade Europe/Middle East/Africa is responsible for IBM operations in approximately 80 countries and IBM World Trade Americas/Far East is responsible for approximately 45 countries.

During the calendar year 1975, IBM received $350,000,000 in dividends from its investment in World Trade. IBM excluded the dividends from apportionable income on its Wisconsin returns. The department treated the dividends as income subject to apportionment under s. 71.07(1m), Wis. Stats.

As and for additional Findings of Fact, the Commission hereby finds and decides as follows:

1. IBM's data processing and office equipment business is conducted in 128 countries. Its business outside the United States is conducted through IBM World Trade Americas/Far East Corporation and IBM World Trade Europe/Middle East/Africa Corporation, wholly owned subsidiaries of IBM World Trade Corporation, a wholly owned subsidiary.
2. IBM World Trade obtained licenses from IBM for the use of IBM's patents. Any company of IBM may use any patent developed by IBM, assuming an appropriate royalty is paid.
3. IBM World Trade marketed its products in foreign countries. There was a national organization in each country where World Trade operated. The legal form was either a subsidiary incorporated in that country or a branch of the operating company or, occasionally, IBM World Trade itself.
4. Products sold by IBM World Trade were manufactured abroad to meet local specifications.
5. The volume of business done by IBM World Trade was entirely independent of the volume of business done in IBM's domestic data processing and office equipment business.
6. IBM World Trade, through its subsidiaries and branches, manufactured, sold or leased and serviced its data processing and office equipment products in foreign countries.
7. IBM World Trade had extensive manufacturing facilities abroad in all major and many middle-sized countries.
8. Marketing and servicing of IBM World Trade products was organized as a national effort — on the customer's premises and in the customer's language.
9. Within the IBM World Trade structure, day-to-day management was at the national level.
10. Within IBM World Trade, personnel decisions, credit terms, billings and collections, advertising,

labor relations, banking relations, compensation of employes and payroll activities, payments to vendors, accounting, employe benefit plans, tax return preparation and financing of plant expansion were all done primarily on the national level.

11. In Poughkeepsie, New York, the Field Engineering Division operates a new Field Systems Performance Control Center which serves all IBM customers.

12. In IBM's annual reports IBM's employes are presented in terms of its worldwide operations.

13. IBM's financial statements are presented in terms of its worldwide operations.

14. The members of the Board of Directors of IBM World Trade Corporation are elected by IBM. The IBM World Trade Corporation Board of Directors includes several officials of IBM. Some officers of IBM are also officers of IBM World Trade Corporation.

15. There is a direct beneficial relationship between IBM's worldwide business and its total employment in the United States.

16. The IBM 3600 finance communications system was developed to serve the world market of financial institutions. This system was engineered to deal with variations in electrical power, currencies and language among countries. Significant help was obtained from IBM marketing people brought in from all the major banking countries.

17. Two-year operating plans for IBM World Trade are reviewed, analyzed, etc., by IBM top management and then approved.

18. The hiring of people holding senior positions in IBM World Trade receive the approval of IBM's top management.

19. Excess funds generated by IBM World Trade are advanced to IBM and managed by IBM.

20. The operations of IBM World Trade Corporation are part of IBM's worldwide integrated business.

21. IBM's overseas operations have supported approximately one out of five of IBM's U. S. manufacturing jobs.

22. IBM's Research Division has laboratories devoted to basic scientific studies in Yorktown Heights, New York; San Jose, California; and Zurich, Switzerland.

23. Most IBM products are both leased and sold throughout IBM's worldwide marketing organizations.

24. IBM Business Conduct Guidelines, translated into numerous languages, are distributed to employes throughout the world.

25. Before a new product is put on the market for sale anywhere in the world, it must receive the approval of IBM's top management.

26. Expenditures for plant expansion anywhere in the world in excess of two million dollars must have the approval of IBM's top management.

27. In addition to patent rights, IBM World Trade uses IBM's know-how and technology, all of which is made available to IBM World Trade.

28. There are transfers of key personnel between IBM and IBM World Trade.

29. No IBM operating unit is wholly self-sufficient; there are interdependencies at every level throughout IBM's worldwide operations. Each unit draws upon the resources of the worldwide organization.

30. The principal office of IBM World Trade Corporation is in White Plains, New York. IBM's corporate offices were located in Armonk, New York.

31. IBM's investment portfolio was developed from excess money generated by IBM's unitary business operations, including the sale and rental of data processing equipment and office machines, and earnings (dividends) from IBM's unitary worldwide business operations.

32. Excess money generated by IBM's U.S. business operations was transferred from local collection banks to a New York bank, Banker's Trust. The funds from various sources were commingled. Banker's Trust was the custodian of IBM's investment portfolio.

33. The investment portfolio was shown as a current asset on IBM's balance sheet.

34. Income earned by the investment portfolio was not in any way related to the sale of IBM products.

35. Changes in the maturity structure of the investment portfolio were in response to changes in market conditions and not in response to any need of IBM's business operations.

36. When funds were drawn out of the investment portfolio, this was done by the IBM corporate cash management group, a department separate and distinct from the investment portfolio management.

37. The director of the investment portfolio, an employe of IBM, reported within the company to the director of cash management and planning, who in turn reported to the treasurer of IBM.

38. IBM's investment portfolio generated profits totally separate and apart from the data processing and office equipment business of IBM.

39. No required ratios were imposed by IBM management on the investment portfolio. IBM relied upon professional portfolio managers to optimize investment income. The maturity distribution and security mix were determined by the portfolio manager.

40. The investment portfolio department was a separate profit center, treated separately for accounting purposes, and had no involvement with operating divisions of IBM in day-to-day operations.

41. IBM's investment portfolio was apparently the largest corporate portfolio of any industrial company in the world, and exceeded the portfolio of all but the largest one or two banks in the U.S.

42. IBM treated the income from the investment portfolio as allocable to New York State. IBM's portfolio investment business was managed solely within the State of New York.

43. The investment portfolio department was located at IBM's corporate headquarters in Armonk, New York. All orders to buy and