In the Commission's reconsideration of its previous decision in this case, it concluded that it reached the right result, even though the mode of analysis was wrong. It concluded that the taxpayer established the elements of manufacturing and held that the taxpayer is a manufacturer. It also concluded that in the taxpayer's operation, the materials processed by the taxpayer have no actual market value as bumpers, before processing, and consequently the taxpayer's operations cannot be deemed to be repairs.

The department has not appealed this decision.

❑

Allocation of income—separate accounting. *Nelson Brothers Furniture Corporation vs. Wisconsin Department of Revenue* (Court of Appeals, District IV, October 26, 1989). This is an appeal from a judgment affirming a decision of the Wisconsin Tax Appeals Commission, which upheld a determination of the Department of Revenue that Nelson Brothers, an Illinois corporation carrying on a portion of its business in Wisconsin, had underpaid Wisconsin franchise taxes in the years 1974 through 1978. The issues in this case are:

(A) The appropriate scope of the Court of Appeals' review of the Commission's decision where its inquiry was limited to whether the department abused its discretion in carrying out a specific statutory duty.

(B) Whether the department abused its discretion in directing a change in the taxpayer's accounting methods which led to increased Wisconsin franchise tax liability.

(C) Whether the change violated the taxpayer's right to due process of law.

The department cross-appeals from that portion of the judgment remanding the matter to the Commission with directions to consider the taxpayer's argument that, should the assessment stand, it is entitled to an "equitable recoupment" in the form of an adjustment to the apportionment formula.

The Department of Revenue, after an audit, determined that because Nelson Brothers' Wisconsin operations were an integral part of a "unitary" business, the separate accounting method failed to properly reflect taxable income for the years in question. The department recomputed the company's income using a different method — the "apportionment" or "formula" method — and ordered Nelson Brothers to use the apportionment method to calculate its Wisconsin income in the future.

Nelson Brothers also raised an "alternative" argument before the Commission, contending that, should the assessment be affirmed, the company should be allowed an "equitable recoupment" — an offset against the newly-assessed liability representing an adjustment to the "sales factor" of the apportionment equation to reflect intangible income. The net effect of the adjustment would be to lower the tax due. Because Nelson Brothers had not raised the recoupment issue before the department, but argued it for the first time in its brief to the Commission, the Commission held that it lacked jurisdiction to consider it.

The Court concluded that:

(A) The scope of its review is to look to the facts found by the Commission, and the evidentiary basis for such findings; and then to consider whether, on those facts, the department exercised its discretion in a reasonable, nonarbitrary manner. The Court owes no deference to the Commission's conclusions.

(B) The record satisfies the Court that the decision to require the change in Nelson Brothers' accounting methods was neither unconsidered nor irrational. It was a reasoned and reasonable decision and thus a proper exercise of discretion. Therefore, in light of the directions in sec. 71.07(2), Wis. Stats. (1985-86), the department reasonably and properly exercised its discretion to direct the change in Nelson Brothers' accounting practices.

(C) The fact that application of the apportionment formula results in an increase of Wisconsin-allocated income—according to the department, an average 13.68 percent increase over the five-year audit period — and thus an increase in the company's Wisconsin tax liability has been upheld over similar objections in *Container Corp. vs. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983) and *Underwood Typewriter Co. vs. Chamberlain*, 254 U.S. 113 (1920). The Court was not persuaded that the increase in Nelson Brothers' tax liability renders the department's action unconstitutional.

In the matter of the department's cross-appeal, the court concluded that the statutory procedures for appealing department decisions do not specify the contents of the appeal documents, and nothing in the statutes suggests that the review must be strictly confined to the claims raised before the department. In addition, the Court was not convinced that Nelson Brothers' recoupment claim is a "grievance [ ] to the assessment," within the meaning of sec. Tax 3.91(1), Wis. Adm. Code. It is an equitable claim for an offset to the reassessment which is not barred from the Commission's consideration by the taxpayer's failure to argue it to the department.

The taxpayer and the department have not appealed this decision.

❑

Allocation of income—between affiliates. *Wisconsin Department of Revenue vs. Sentry Financial Services Corporation, and Sentry Financial Services Corporation vs. Wisconsin Department of Revenue* (Circuit Court of Portage County, February 20, 1990). This decision arises from petitions by both parties to review a decision of the Wisconsin Tax Appeals Commission. The petitions for review involve two issues:

(A) Whether the Commission's finding that a bargain sale occurred was supported by substantial evidence in the record.

(B) Whether the department abused its discretion when it reallocated income to Sentry Financial Services Corporation (SENCO) pursuant to sec. 71.11(7m), Wis. Stats. (1981-82).

This case arises out of a transaction between SENCO, a wholly owned subsidiary of the Sentry Corporation (SENCOR), and

SENCOR, which itself is a wholly owned subsidiary of Sentry Insurance, a Mutual Company (SIAMCO). In 1972, SENCO purchased an aircraft for $4,623,560.85, with the intention to lease it to SIAMCO. On September 1, 1973, SENCO as lessor, and SIAMCO as lessee, entered into a written lease for the aircraft. The lease term was for 10 years, including a period of use beginning January 1, 1973. The lease expired on December 31, 1982. During the term of the lease, SENCO included in its income a total amount of $6,355,560.85, pursuant to the lease. Records and testimony of SENCO employes indicated an intention to sell the aircraft to SIAMCO at the expiration of the lease, for 10% of its original purchase price. The right to purchase was not contained in the lease document.

On December 31, 1982, the lease ended. On that date, SENCO transferred the aircraft to SENCOR and received in return from SENCOR a payment of $453,560.85, or 10% of the original purchase price of the aircraft. The transfer was made to SENCOR, SIAMCO's subsidiary, rather than to SIAMCO itself due to a corporate decision to house all aircraft owned by the Sentry group of companies in SENCOR. The sale price was included in SENCO's income for 1982. SENCO paid sales tax on the sale. The sale of the aircraft by SENCO to SENCOR was not done pursuant to a plan of tax avoidance, and the department stipulated that it did not base its assessment on the grounds that an adjustment was necessary in order to prevent evasion of taxes within the meaning of sec. 71.11(7m), Wis. Stats. After the December 31 transfer, the aircraft continued in use by corporations within the Sentry group. For that use, SENCOR received fees and reimbursements. In June 1986, SENCOR sold the aircraft to an unrelated third-party for approximately $4,600,000.00.

The department assessed SENCO for additional income taxes for 1982, based upon the allocation of a taxable gain for the sale of the aircraft to SENCOR. The assessment was determined by adding the fair market value of the aircraft less its adjusted basis, to SENCO's taxable income. The Commission found that the sale of the aircraft by SENCO to SENCOR was a "bargain sale", and was not made pursuant to an arms length right to purchase under the lease. The Commission also held: 1) that the department failed to properly consider the substantive provision of secs. 71.301 and 71.311, Wis. Stats., which govern the tax consequences of a "subsidiary to parent" bargain sale, 2) that the sale of assets by a corporation to its shareholders for less than fair market value is treated as a distribution under IRC sec. 301 (sec. 71.301, Wis. Stats.), and 3) that therefore, by reallocating income under sec. 71.11(7m), Wis. Stats., despite the tax-free provisions of secs. 71.301 and 71.311, Wis. Stats., the department abused its discretion, applying the wrong legal standard to the facts.

The Circuit Court concluded that the Commission clearly had substantial evidence in the record to support its decision that the transfer of the aircraft from SENCO to SENCOR was a "bargain sale". The Court also concluded that the original plan to lease with the option to purchase and the resulting tax consequences to SENCO did not require a reallocation of income to correctly reflect its income upon a transfer of the aircraft between related companies, and thus declined to reverse the Commission's decision that the department abused its discretion in reallocating the income.

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

❐

SALES/USE TAXES

Waste reduction and recycling. *Parks-Pioneer Corporation vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, March 23, 1990). The issue is whether the purchases and sales described below were exempt under sec. 77.54(26m), Wis. Stats., which exempts from sales and use tax the gross receipts from the sale of or use or other consumption of waste reduction or recycling machinery and equipment, including parts therefor, exclusively and directly used for waste reduction or recycling activities which reduce the amount of solid waste generated or recycle solid waste. The exemption applies even though an economically useful end product results from the use of the machinery and equipment.

During the period under review, the taxpayer was a corporation registered to operate a business in Wisconsin and engaged in recycling solid waste, including scrap metal. The taxpayer's business operation includes all functions which directly relate to the preparing, sorting, weighing, and processing scrap metal into prepared grades of metal so as to be used by industries such as smelting, foundries, and steel mills. These functions commenced with the initial collection of scrap metal and ended with sale and delivery of the prepared grades of metal to its customers.

The taxpayer purchased scrap metal from various suppliers. In most instances, the taxpayer picked up and transported to its place of business the scrap metal from various collection sites on the suppliers' premises. The suppliers would fill the taxpayer's lugger and roll-off boxes with scrap metal. When full, the taxpayer picked them up and left replacement boxes.

The following items were purchased for the taxpayer's operations without payment of sales/use tax:

(A) Lugger boxes and roll-off boxes used to collect and transport scrap metal to the premises and recycled metal to the taxpayer's customers.

(B) Tarps and bands used to cover the lugger boxes when scrap metal was in transit.

(C) Starting fluid used to start diesel engines in cold weather on cranes used in the recycling yard to move heavy pieces of scrap metal.

(D) Truck scales, including repairs and replacement parts, used to weigh the scrap metal on the taxpayer's premises.

(E) Platform scales used to weigh scrap metal to assist in pricing of recycled metal held for sale.

(F) A dead lift roll-off hoist mounted on one of the taxpayer's trucks and used at the collection points of scrap metal.

(G) Replacement hydraulic hose for trucks used to collect and transport scrap metal.

The lugger and roll-off boxes were equipment used by the taxpayer for the sole purpose of collecting and transporting of scrap metal to the taxpayer's place of business and delivering recycled metal to customers. Use in customer delivery did not exceed 10% of the time used. Tarps and bands were equipment used solely to cover the boxes to prevent material from falling out in transit. The scales in question were equipment used solely in weighing the unprepared and prepared scrap metal to determine purchase or sale price. Weight and grade of metal combined is the industry's method of pricing scrap metal. The dead lift roll-off hoist was mounted on a truck and used only to lift lugger and roll-off boxes on to and off trucks for movement and scales in order to weigh and price the scrap metal. The hydraulic hoses were used as replacement parts in the taxpayer's trucks used in metal transportation. Although appropriated on the taxpayer's books to trucks, the starting fluid in question was used in cold weather to start diesel engines on cranes used on the taxpayer's premises solely to move heavy pieces of scrap metal. The fluid is sprayed into the engine, clearing moisture and enabling starting.

The taxpayer sold a load lugger box in October 1984 to Johnson Metal of Racine. The taxpayer collected no sales tax, believing that the sale would be exempt under the recycling exemption in question. The use of the equipment by the purchaser, however, was not established. The taxpayer sold 3 self-dumping hoppers to A.E.F. Salvage, a small, one-man trucking operation. The testimony of the taxpayer's witness concerning possible resale by A.E.F. was somewhat contradictory and was insufficient to establish that or any other exemption to the sales tax requirement.

The Department of Revenue's assessment included sales or use tax on the items discussed previously.

The Commission concluded that items purchased by the taxpayer were "recycling machinery and equipment, including parts therefor, exclusively and directly used for ... or recycling activities which reduce the amount of solid waste generated [or] ... recycle solid waste," within the meaning of sec. 77.54(26m), Wis. Stats. The Commission also held that the burden of proving that a sale of tangible personal property is not a taxable sale at retail is upon the seller unless a certificate of resale or exemption described in sec. 77.52(14), Wis. Stats., is taken from the purchaser. The taxpayer's sales were not supported by a resale or exemption certificate produced by the purchasers and were not otherwise shown to be exempt from tax.

This decision has been appealed to the Circuit Court.

❑

When and where sale takes place. *Republic Airlines, Inc. vs Wisconsin Department of Revenue* (Circuit Court of Dane County, February 12, 1990). This is a petition for judicial review of a decision of the Wisconsin Tax Appeals Commission which affirmed the Wisconsin Department of Revenue's assessment against Republic Airlines, Inc. (Republic) for the sales and use tax in 1981-1984 on liquor and soda pop served to passengers during flights in Wisconsin's airspace. The decision also denied the department's assessment of a use tax on complimentary peanuts that Republic gave to passengers. See *Wisconsin Tax Bulletin* 61, page 11, for a review of this case.

Republic Airlines, Inc., now Northwest Airlines, Inc., was a Wisconsin corporation engaged in the business of interstate commercial air transportation in Wisconsin and elsewhere, with principal offices in Minneapolis, Minnesota. Republic maintained offices in Wisconsin, had equipment and personnel located at airports in Wisconsin, and flew regularly-scheduled flights into, between, and out of a number of Wisconsin cities. Some of Republic's flights used Wisconsin airspace but never touched down. The latter are referred to as "overflights".

Republic sold liquor on its flights and gave out complimentary soda pop, peanuts, and sometimes also liquor to its passengers. Republic did not keep records of the location of its aircraft during the above transactions, i.e., whether the aircraft was in Wisconsin airspace or in another state's airspace.

To apportion Wisconsin sales tax to Republic's gross receipts for liquor sales, and Wisconsin use tax to Republic's purchases of complimentary items, Republic applied a ratio of revenue passenger miles (RPMs) flown in Wisconsin (the numerator) to RPMs flown everywhere (the denominator). The ratio's numerator included flights which either departed from or landed in Wisconsin but did not include overflights. The department adjusted the numerator to include RPMs for overflights.

The taxpayer contended that:

(A) The Commission was erroneous in its findings that sales occurring over Wisconsin are sales "in this state" as that phrase is used in sec. 77.52(1), Wis. Stats., and that the use or consumption of complimentary soda pop, peanuts, and liquor used or consumed on overflights are used and consumed "in this state" as that phrase is used in sec. 77.53(1), Wis. Stats. The taxpayer contended that the language "in this state" in secs. 77.52(1) and 77.53(1) does not mean "over this state".

(B) The application of Wisconsin's sales and use tax to overflights violates the Commerce Clause and Due Process Clause of the United States Constitution.

(C) The taxes at issue lack internal consistency because of the potential for cumulative burdens posed by multiple taxation.

(D) The final prong of *Complete Auto* is not satisfied because the taxation of overflights is not fairly related to benefits provided by the state.

Regarding the department's use tax assessment on complimentary peanuts and other snacks served by Republic, the Commission found that these items are exempt from use tax under sec. 77.54(20), Wis. Stats. The department argued that the Commission was without jurisdiction to raise sec. 77.54(20), Wis. Stats., because Republic did not affirmatively assert the exemption as a defense.

The Circuit Court concluded that:

(A) The phrase "in this state" in those sections is unambiguous, and that it does mean "over this state."

(B) The mere fact that the taxpayer's airplanes fly over Wisconsin does not suffice to meet the substantial nexus test, but that the substantial nexus test is satisfied by the fact that the taxpayer maintains offices, equipment, and personnel in Wisconsin and is incorporated in Wisconsin.

(C) The mere possibility of multiple taxation is insufficient to invalidate the tax.

(D) The United States Supreme Court has held that the "fairly related" prong is satisfied literally by the state providing "the advantages of a civilized society." *Exxon Corp. vs. Wisconsin Department of Revenue*, 447 U.S. 207, 228 (1980). Wisconsin has indeed provided Republic with such advantages, for example, the protection of Wisconsin's laws, opportunities for further commerce, the availability of fire and other emergency services, and ground preparation for emergency landings.

Pursuant to sec. 227.57(9), Wis. Stats., the Court also concluded that the complimentary snacks and peanuts provided by Republic are exempt from Wisconsin use tax under sec. 77.54(20), Wis. Stats.

The taxpayer and the department have appealed this decision to the Court of Appeals.

❑

Boats, vessels and barges—storage outside Wisconsin. *Leonard W. Vanasse vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, February 19, 1990). The issue in this case is whether the Department of Revenue correctly assessed a use tax against the taxpayer on the purchase of the boat in question, pursuant to sec. 77.53, Wis. Stats.

The taxpayer, a resident of Hudson, Wisconsin, entered into a purchase agreement regarding a 44 foot Trojan boat from a Minnesota resident. The closing on the sale occurred in August 1981, and the boat was delivered by a marina service to the taxpayer at a marina near Hudson, Wisconsin. No sales tax was paid to the state of Minnesota. On the first trip out with the boat, about 75 feet from the dock, the prop and other component parts were damaged by rocks. This necessitated towing the boat to the Hudson marina. The boat remained there for a few weeks while arrangements were made to take it to Stillwater, Minnesota for repairs. It was moved to Stillwater and remained there for the winter. The next season, in 1982, the boat was kept at dock in Stillwater, taken out once, and the taxpayer decided to sell the boat. Harris Yacht Sales of Prescott, Wisconsin handled the sale in July 1982. The boat, because of its type, was documented with the Coast Guard and not registered by the State of Wisconsin.

The Commission concluded that the taxpayer, a Wisconsin resident, did purchase the boat for use in Wisconsin, and that since the taxpayer did not pay a use tax on the boat, the department correctly assessed a use tax under Wisconsin Statutes.

The taxpayer has not appealed this decision.

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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: