Report on Litigation

Summarized below are recent significant Wisconsin Tax Appeals Commission (WTAC) and Wisconsin Court decisions. The last paragraph of each decision indicates whether the case has been appealed to a higher Court.

The following decisions are included:

INDIVIDUAL INCOME TAXES

Independent contractor — defined. *Robert A. Vitt and Lisa A. Vitt vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 31, 1992). The issue in this case is whether the taxpayer was an independent contractor or an employe. In 1989 the taxpayer was a "training agent" for an insurance company whose duties were to sell insurance and help policy holders and the company with reporting and handling claims.

The case arises in the context of whether the taxpayer should have been allowed to deduct in full the expenses he incurred in performing the contract. Originally reporting the expenses as employe business expenses, the taxpayer later filed a claim for refund, putting the expenses on Schedule C, and reporting them as 100% deductible business expenses.

With the refund claim, the taxpayer recharacterized himself as an independent contractor rather than an employe. The department denied the refund claim and argues that the taxpayer was an employe.

The Commission weighed the following factors:

1. Minimal instruction was given to the taxpayer. The taxpayer was left almost completely alone as to the when, where, and how of his work.

2. The taxpayer had prior experience and needed virtually no training.

3. The degree to which the success or continuation of the company depended upon the taxpayer's performance of services.

4. The taxpayer had authority to delegate duties.

5. The taxpayer had authority to hire, fire, and supervise his own employes.

6. The taxpayer had a four-year affiliation with the company.

7. The taxpayer had no set hours of work.

8. The taxpayer was contractually prohibited from offering his services to others.

9. The taxpayer's headquarters was his own office.

10. The taxpayer was not required to perform services in a prescribed sequence.

11. The taxpayer was not required to submit regular reports, other than the insurance applications sent to get the insurance in force.

12. The taxpayer was paid a base compensation of $1,200 per month plus commissions and other incidental compensation of $3,839.

13. The taxpayer is contractually responsible for all his own expenses.

14. Except for some company literature, all "tools," materials and equipment were supplied by the taxpayer.

15. The taxpayer had a very significant investment in facilities — the office at a rental of $12,000 per year.

16. The taxpayer was at risk to realize a profit or suffer a loss as a result of his services, although the risk was somewhat mitigated by the $1,200 guaranteed payment.

17. The taxpayer's services were not available to the general public.

18. The company could not discharge the taxpayer at will, but only for the taxpayer's failure to meet contract specifications.

19. The taxpayer could quit instantaneously on notice.

The Commission concluded that the taxpayer was an independent contractor, allowing the refund claim.

The department has not appealed this decision.

CAUTION: This is a small claims decision of the Wisconsin Tax Appeals Commission and may not be used as a precedent. The decision is provided for informational purposes only. □

CORPORATION FRANCHISE AND INCOME TAXES

Accounting — 1986 and prior — change in accounting period; Interest income — 1986 and prior — U.S. obligations. *M. B. Investment Corp. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, November 5, 1992). The issue in this case is whether the taxpayer's final taxable year was a 1986 tax year, subjecting the taxpayer to the special franchise tax on interest income from obligations of the U.S. government.

As a result of its complete liquidation and dissolution on May 31, 1986, the taxpayer timely filed a Wisconsin franchise tax return for the period beginning September 1, 1985, and ending May 31, 1986. The taxpayer did not request the permission of the department to change the end of its Wisconsin tax year from August 31 to May 31.

It is the taxpayer's position that, because of its liquidation and dissolution, it was no longer in existence and was statutorily mandated to file a franchise tax return for the period September 1, 1985, to May 31, 1986, and, accordingly, it was not required to request or obtain the department's permission to change its taxable year.

It is the department's position that the taxpayer was required to obtain such permission.

During the period under review, although the federal taxable year was determined according to the *first* month of a fiscal year, Wisconsin law provided for a corporate taxable year determined according to its fiscal year-end, with those fiscal years ending during the period between July of one calendar year and June of the following year being considered as filings corresponding to the earlier calendar year.

For a dissolving corporation ending business prior to the end of its fiscal year and filing a final short-period return, the department's administrative practice was to treat the return as being for the taxable year ending at the (later) normal fiscal year-end without regard to the dissolution unless permission to change its tax year had been requested and granted. This was the treatment accorded the taxpayer's final return.

The Commission concluded that the taxpayer's final taxable year was a 1986 tax year. The taxpayer was subject to the special franchise tax on interest income from obligations of the U.S. government, pursuant to sec. 71.01(2), Wis. Stats. (1985-86).

The controlling statutory language, sec. 71.10(3m)(a) and (b), Wis. Stats. (1985-86), provides that corporations may not change their basis of reporting without first obtaining the department's approval and that in no case shall a separate income tax return be made for a period of more than 12 months.

The taxpayer has appealed this decision to the Circuit Court. □

Allocation of income — business or nonbusiness income. *Wisconsin Department of Revenue vs. Citizens Publishing Company of Wisconsin, Inc.* (Circuit Court for Dodge County, December 30, 1992). The department appeals the Wisconsin Tax Appeals Commission decision dated May 6, 1992, which modified a franchise tax determination by the department against the taxpayer.

The issues in this case are:

A. Whether, in 1982-1984, the taxpayer's income from the rental of equipment to a lessee in Minnesota was nonbusiness or business income within the meaning of sec. 71.07(1m), Wis. Stats. (1981-82).

B. Whether, in 1981, the taxpayer was required to include a portion of its total data processing, ac-

counting, and administration expenses in calculating expenses related to its income from the rental of equipment to a lessee in Minnesota under sec. 71.07(2), Wis. Stats. (1978-80), and, if so, what portion should be included.

As to the first issue presented, the department claims that the income received by the taxpayer from the rental of equipment in Minnesota was received in the regular course of the taxpayer's trade or business and is, therefore, business income. The Commission reached the opposite conclusion in its decision.

The Commission held that, under sec. 71.07(1m), Wis. Stats. (1981-82), and sec. 71.07(2), Wis. Stats. (1978-80), the rental income from the taxpayer's rental property "shall be allocable and 'follow the situs of the property from which derived' if that rental income constitutes 'nonbusiness' income." The Commission then found sec. Tax 2.39(6), Wis. Adm. Code, to be "determinative" in establishing that the taxpayer's rental income was nonbusiness income.

As to the second issue presented, the department claims that approximately 4% of the taxpayer's total data processing, accounting, and administrative expenses for 1981 should be allocated to the Minnesota rental activity income for 1981. The Commission, however, determined that only those expenses which related to the taxpayer's Minnesota rental activity should be included.

The Commission looked to sec. 71.07(2), Wis. Stats. (1978-80), which provided, in relevant part, "there shall first be deducted from the total net income of the taxpayer such part thereof (less related expenses, if any) as follows the situs of the property . . . of the recipient."

The Circuit Court affirmed the Commission's decision, concluding that:

A. Since the taxpayer's regular "trade or business" was commercial printing, the Commission reasonably concluded that the income from rental activity in Minnesota was nonbusiness income allocable to the State of Minnesota.

B. Since the situs of the rental property was the State of Minnesota, the Commission reasonably concluded that only the **related** expenses should be included in computing the income from the taxpayer's rental activity (emphasis added). The Commission accordingly rejected the department's allocation of 4% of the taxpayer's total expenses as an "arbitrary allocation" by the department.

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

Deductions — 1986 and prior — contingent liabilities. *Barrett Landfill, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, October 27, 1992). The issue in this case is whether the taxpayer, a landfill operator and accrual basis taxpayer, was entitled to deduct estimated future landfill closure costs it will have to pay, pursuant to state regulations, when the landfill reaches its full capacity and has to be closed.

In the years involved, 1985-86, federal law permitted landfill operators to deduct estimated landfill closure costs. However, Wisconsin law contained a provision that disallowed deductions for "contingent losses or liabilities." The department disallowed the taxpayer's estimated closure cost deductions in those years, as a "contingent" liability; but because Wisconsin "federalized" its corporate income tax as of 1987 and allowed transitional adjustments to reconcile federal and state accounting procedures, the department advised the taxpayer that it could file amended returns taking the claimed deductions over five years beginning in 1987.

The Commission concluded that the taxpayer was not entitled to deduct the estimated future landfill closure costs.

The case turns on whether the estimated landfill closure liability is "contingent" — that is, whether the liability is definite or not. In Wisconsin, for accrual basis taxpayers, a liability is definite and deductible if "the events which fix the amount of the taxpayer's liability . . . have come about or occurred before the end of the tax year in which the deduction is made."

The test contains two elements for deductibility. First, the liability must have been incurred in the sense that the events giving rise to the *fact* of liability must all have occurred in the deduction year — the "liability" cannot be merely potential. Second, the fact of some liability is not enough — the *amount* of the obligation must also be known in the deduction year.

Although the taxpayer met the first element of the deductibility test since there is a virtual certainty that the taxpayer will have to spend some money to close the landfill, the second element — a known amount of liability in the year the deduction was claimed — was not established. No one can say just what the closure will ultimately cost.

The taxpayer has not appealed this decision. □

Leases — 1986 and prior — safe harbor rules. *Wisconsin Department of Revenue vs. International Paper Company* (Circuit Court for Dane County, December 28, 1992).

The department appeals the Wisconsin Tax Appeals Commission decision of May 8, 1992. For a summary of that decision, see *Wisconsin Tax Bulletin* 79 (October 1992), page 14.

The issue in this case is whether the cash payments the taxpayer received from the transfer of federal tax benefits under "safe harbor leases" were includable in its gross income under sec. 71.03(1)(k), Wis. Stats. (1981-82).

The department's position was that the proceeds from the sale of the safe harbor leases are revenue and should be subject to tax under sec. 71.03(1)(k), Wis. Stats. (1981-82). Significant to the department's position is that for the years at issue, Wisconsin had not "federalized" its tax code and exemptions created under the federal law were not controlling in Wisconsin for state tax law issues. Sec. 71.03(1)(k), Wis. Stats. (1981-82) provides that gross income included all gains, profits, or income of any kind derived from any source whatever, except such as is exempt.

Ordinarily, without the enabling legislation, lease devices such as sanctioned by the federal legislation would be considered shams for tax treatment purposes. However, the federal law provided this special exception. Unfortunately, the federal legislation did not determine how state law should view safe harbor leases.

The Court agreed with the Commission that the issue is not one of "tax exemption," but is one of a recognized accounting practice, the treatment of the sale of an indivisible portion of a capital asset. The purchase of machinery and equipment by the taxpayer was the acquisition of capital assets which are not expensed, but depreciated. By the sale of the tax benefit provided by the federal law, the taxpayer is reducing the tax basis of the acquired capital assets. In two reported cases, both California and Oregon agree with this reasoning, as did the Commission. The reasoning is that the tax benefit is predicated upon it being an inseparable part of the equipment.

The Circuit Court concluded that the payments received under the safe harbor leases constitute a partial recovery of the taxpayer's basis in leased assets.

The department has not appealed this decision. □

SALES AND USE TAXES

Occasional sales — business assets. *Mail N' More, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 4, 1992). This is a decision on the department's petition for rehearing of the Commission's September 28, 1992, decision.

The issue in this case is whether the taxpayer is entitled to an exemption from sales tax on its sale of business assets. Wisconsin law allows an occasional sale exemption for sales of business assets used to conduct a trade or business at a location if the sale occurs after the seller has ceased operating the business at that location, and the seller surrenders its sellers permit to the department within 10 days after the last sale of personal property at that location.

On December 31, 1990, the taxpayer, a retailer, ceased its business operations, sold the business assets it used at that location, and filed a sales tax return in which it reported the sale of the assets. The taxpayer did not physically surrender its seller's permit to the state until several months later.

On September 28, 1992, the Commission concluded that since the ultimate objective of the permit surrender statute is to give the state timely notice of the sale of a business, and the taxpayer did notify the state in writing of the sale in time, it substantially complied with the condition precedent to the occasional sale exemption. The requirement of surrender of the physical permit was not necessary under the circumstances.

Upon review of the decision and the department's petition for rehearing, the Commission reversed its September 28, 1992, decision. The Commission concluded that since the language of the statute is clear and unambiguous, and since the taxpayer failed to comply with it by timely delivering its seller's permit to the department, the taxpayer is not entitled to an exemption from sales tax on its sale of business assets.

The taxpayer has appealed this decision to the Circuit Court.

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Rebates; Refunds — exhausting administrative remedies. *John Grall, et al., vs. Mark Bugher, Secretary of the Wisconsin Department of Revenue* (Circuit Court for Dane County, September 22, 1992).

The taxpayers are recent purchasers of new automobiles. They have challenged the department's refusal to exclude manufacturer's rebates from

the sales price for sales tax computation. The department has moved to dismiss on several grounds.

The issues are:

A. Whether the taxpayers are required to exhaust their administrative remedies before pursuing this action in Circuit Court.

B. Whether the complaint is barred under the doctrines of sovereign immunity and qualified immunity.

C. Whether the taxpayers' claim is barred because of their failure to comply with the notice of claim requirements under sec. 893.82, Wis. Stats.

Discounts on automobile purchase prices are routinely used by auto manufacturers and retailers to encourage customers to purchase cars. Different methods of price reductions include: manufacturers selling models to dealers at lower prices so the dealer can pass the savings on to the customer (manufacturer's reduction); manufacturers returning some portion of the purchase price paid by the dealer when the automobile is sold (a holdback); dealer incentives (dealers are remitted a certain amount of money for each car sold); and a manufacturer's rebate (the manufacturer reduces the sales price to the purchaser and remits the rebate to the dealer).

Each of the incentive programs has an identical impact on the automobile purchaser at the point of sale. If a person purchases a $15,000 car advertised as reduced to $14,000, he or she will pay only a net of $14,000 regardless of the particular reduction program in place.

The department, however, taxes these various incentive programs differently. Price reductions via manufacturers' reductions, holdbacks, and dealer incentives result in a sales tax on the reduced price of the automobile. However, a purchaser who pays a reduced price for a car because of a manufacturer's rebate is taxed on the full original price, although the purchaser's cash outlay is the same as the other automobiles purchased under one of the other price reduction schemes.

The taxpayers claim this taxing scheme violates sec. 77.51(15)(b)1, Wis. Stats., the Fourteenth Amendment of the United States Constitution, 42 U.S.C. sec. 1983, and Article VIII of the Wisconsin Constitution. The taxpayers are seeking a declaration of these violations and a permanent injunction against the continued enforcement of the taxation scheme. In addition, the taxpayers ask that the Secretary of the Department of Revenue be temporarily enjoined from disbursing taxes collected on rebates while this case is pending, requesting that the funds so collected be set aside and sequestered.

The department asserts that this Court has no jurisdiction to hear this action because the taxpayers have not exhausted their administrative remedies. In addition, the department argues the complaint fails to state a claim upon which relief can be granted because the complaint is barred under the doctrines of sovereign immunity and qualified immunity. Finally, the department claims that the state cause of action filed by the taxpayers is barred because the taxpayers failed to comply with the notice of claim requirement set out in sec. 893.82, Wis. Stats.

The Court concluded that:

A. The taxpayers must exhaust their administrative remedies if they wish to pursue declaratory relief.

   For state tax matters, a party challenging a state taxing scheme may be required to exhaust available administrative remedies before instituting a sec. 1983 challenge. The policy reasons behind requiring exhaustion are: 1) subsequent judicial review will be facilitated by allowing an agency to exercise its particular expertise in a given area; 2) exhaustion allows an agency to develop a factual record which can be reviewed in subsequent proceedings; 3) it gives the agency an opportunity to correct errors; and 4) judicial time is conserved because the agency may be able to grant the relief required.

B. The department has properly raised the defense of sovereign immunity, depriving the Court of jurisdiction over the taxpayers' monetary claims. The Wisconsin Legislature has made a clear determination of who should be eligible for refunds under the state tax laws, and the taxpayers do not fit into that category.

C. The taxpayers did not serve notice of their claim on the Attorney General as required by sec. 893.82, Wis. Stats.

Because the taxpayers' monetary claim is otherwise barred by the doctrine of sovereign immunity, and the taxpayers have failed to exhaust their administrative remedies for declaratory relief, the department's motion to dismiss is granted and the case is dismissed.

The taxpayers have appealed this decision to the Court of Appeals. □