



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

Farm loss limitation — 1986 and thereafter

Net operating loss — Wisconsin — carryforward
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Corporation Franchise and Income Taxes

Allocation of income — business or nonbusiness income
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Apportionable income

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Coin-operated laundry machines
Charles M. Malone (p. 16)

Exemptions — water, bottled
Artesian Water Company, Inc. (p. 17)

Successor's liability

Robert Kastengren (p. 17)

INDIVIDUAL INCOME TAXES

➔ **Farm loss limitation — 1986 and thereafter; Net operating loss — Wisconsin — carryforward.**
Stuart C. and Faye L. Pedersen vs. Wisconsin Department of Revenue (Wisconsin Tax Appeals Commission, February 23, 1994). The issues in this case are:

- A. Whether the 1986 wages earned by the taxpayers as salaries paid by Pedersen Farms of Warrens, Inc. ("Pedersen Farms") constituted "nonfarm Wisconsin adjusted gross income" for calculating a farm loss limitation under sec. 71.05(1)(a)26, Wis. Stats. (1985-86).
- B. Whether the department erred in its application of the taxpayers' net operating loss carryforward in the calculation of 1986 taxable income according to secs. 71.02(2)(j) and 71.05(1)(d), Wis. Stats. (1985-86).

The taxpayers are husband and wife and throughout 1986 jointly owned 89% of the issued and outstanding stock of Pedersen Farms. They were also officers and employees of Pedersen Farms, a Wisconsin "C" corporation whose business in 1986 consisted primarily of farming, from cultivation through harvesting, of a for-profit cranberry marsh. The taxpayers were residents of Wisconsin in 1986 and performed services for Pedersen Farms, for which they earned wages. The services consisted primarily of farming activities but included an incidental amount of administrative tasks.

Taxpayer Stuart Pedersen was a partner in three separate partnerships engaged in the business of owning and operating cranberry marshes, and the taxpayers' allocable share of losses from these partnerships in 1986 was, in the aggregate, \$203,516. In addition, the taxpayers had a net operating loss carryforward to 1986, in the amount of \$75,530.

The Commission concluded as follows:

- A. The 1986 income earned by the taxpayers in the form of wages or salaries paid by Pedersen Farms did not constitute "nonfarm Wisconsin adjusted gross income" for purposes of calculating any farm loss addition modification under sec. 71.05(1)(a)26, Wis. Stats. (1985-86).
- B. The department correctly applied the taxpayers' Wisconsin net operating loss carryforward in its calculation of 1986 income tax due.

Neither the department nor the taxpayer have appealed this decision. □

CORPORATION FRANCHISE AND INCOME TAXES

➔ **Allocation of income — business or nonbusiness income.** *Wisconsin Department of Revenue vs. Citizen Publishing Co. of Wisconsin, Inc.* (Court of Appeals, District IV, May 26, 1994). The department appealed an order of the Circuit Court for Dodge County which upheld a Wisconsin Tax Appeals Commission decision dated May

6, 1992. See *Wisconsin Tax Bulletin* 81 (April 1993), page 10, for a summary of the Circuit Court's decision.

The issues in this case are as follows:

- A. For taxable years 1982 through 1984, was the income the taxpayer derived from the rental of printing equipment in Minnesota "business" income within the meaning of Wis. Adm. Code sec. Tax 2.39(6)?
- B. For taxable year 1981, did the department erroneously allocate to the taxpayer's Minnesota rental income expenses incurred by the taxpayer in the regular course of its printing business?

Citizen Publishing Co. of Wisconsin, Inc. (Citizen) publishes and prints a daily newspaper in Beaver Dam, Wisconsin, and does commercial printing. In 1979, Citizen leased and equipped an empty plant in New Hope, Minnesota. It began printing advertising inserts at the facility. Citizen ended its Minnesota printing operations in April 1980 and never resumed such operations.

Thereafter, Citizen and a Nebraska corporation, Snell Publishing Company, incorporated a Minnesota corporation, Lithoweb, Inc. Citizen and Snell each owned fifty percent of its stock. Lithoweb subleased the New Hope real estate from Citizen. Citizen modified the plant equipment and leased it to Lithoweb for a term of ten years. Neither Citizen nor any of its officers, employees, or shareholders were involved in the day-to-day operation of Lithoweb.

Lithoweb was responsible for the taxes, insurance, and maintenance charges on the equipment. Citizen occasionally contracted with Lithoweb to service and repair the equipment. However, generally Citizen's involvement with Lithoweb consisted of

receiving rent and minimal monthly bookkeeping.

For taxable year 1981, Citizen and the department treated the income from the rental of the printing equipment to Lithoweb as allocable to Minnesota under sec. 71.07(1m), Wis. Stats. (1979-80). After the statute was amended in 1981, the department treated Citizen's 1982 through 1984 rental income as apportionable and assessed additional taxes and interest.

The Commission held that Citizen's rental activity in Minnesota did not arise in the regular course of its printing business but "was clearly a passive and isolated lease transaction entered into by [Citizen] in an attempt to utilize idle printing equipment left from an earlier failed business transaction." The Commission found it significant that the parties stipulated that for purposes of this case, Citizen and Lithoweb do not constitute a unitary business. The Commission did not view Citizen's joint venture with Snell Publishing as continuing Citizen's publishing business but solely as a rental arrangement. Because Citizen is not in the rental business, the Commission held that its joint venture with Snell was not conducted in the regular course of its trade or business.

Citizen stipulated that its 1981 interest expense and depreciation on the leased equipment were properly allocated to Minnesota. However, it disputed the department's allocation of a percentage of its company-wide data processing, accounting, and administrative expenses to Minnesota. The department allocated approximately four percent or \$26,824 of these expenses to Citizen's Minnesota rental income. The Commission held that the department made no showing that these were "related expenses" as required by sec. 71.07(2), Wis. Stats. (1979-80).

The Court of Appeals affirmed the Circuit Court's decision that the 1982 through 1984 rental income was not "business" income, concluding that the Commission's construction of Wis. Adm. Code sec. Tax 2.39(6) was reasonable. In addition, the Court of Appeals found that the Commission correctly concluded that the department erred when it allocated a percentage of Citizen's company-wide expenses to Citizen's rental income from the lease to Lithoweb.

The department has not appealed this decision. □

← Apportionable income; Unitary business; Dividends — deductible dividends. *Albany International Corp. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, May 23, 1994). The issues in this case are as follows:

- A. Was the department's inclusion in the taxpayer's apportionable income of interest and dividends received from majority-owned subsidiaries proper under sec. 71.07(1m)(b)9, Wis. Stats. (1985), and under the Due Process or Commerce Clauses of the U.S. Constitution?
- B. Was the department's inclusion in the taxpayer's apportionable income of interest and dividends received from sources other than such subsidiaries proper under sec. 71.07(1m)(b)9, Wis. Stats. (1985), and under the Due Process or Commerce Clauses of the U.S. Constitution?
- C. Was the department's inclusion in the taxpayer's apportionable income of royalties received proper under sec. 71.07(1m)(b), Wis. Stats. (1985), and under the Due Process or Commerce Clauses of the U.S. Constitution?

- D. Was the department's inclusion in the taxpayer's apportionable income of capital gains received proper under sec. 71.07(1m)(b)9, Wis. Stats. (1985), and under the Due Process or Commerce Clauses of the U.S. Constitution?
- E. Was the department's inclusion in the taxpayer's apportionable income of dividends, interest, royalties, and gain received by the taxpayer from foreign corporations violative of the Foreign Commerce Clause of the U.S. Constitution?
- F. Was the inclusion in the taxpayer's apportionable income of dividends, interest, royalties, and gains without the proceeds received by the taxpayer from the sale of intangible assets, and the property, payroll, and sales of the payor corporations and the divested corporations giving rise to the gains being represented in the Wisconsin apportionment factors of the taxpayer violative of the Due Process or Commerce Clauses of the U.S. Constitution?
- G. Was the inclusion in the taxpayer's apportionable income of dividends received by the taxpayer from corporations that apportion less than 50% of their income to Wisconsin violative of the Commerce or Equal Protection Clauses of the U.S. Constitution?
- H. Is the department required to pay the taxpayer's legal fees and costs by reason of 42 U.S.C. secs. 1983 and 1988?

Albany International Corp. (AI) is a Delaware corporation, with its principal place of business in Albany, New York. During the period under review, 1981 through 1986, AI's main business was the design, manufacture, and marketing of woven fabrics

known as "paper machine clothing." "Paper machine clothing" is custom designed fabric installed in papermaking machines to carry paper stock through each stage of the production process. The papermaking process involves the forming of paper stock into a continuous sheet of paper or paperboard and the removal of most of the water from the paper stock.

A papermaking machine has three sections (forming, pressing, and drying) with a total of 12 to 15 individual positions, each of which requires paper machine clothing. AI manufactures clothing for each of the three sections of the papermaking machine.

Appleton Wire is the only U.S. division of AI that manufactures forming fabrics. At all times relevant, Appleton Wire's business was the manufacture of forming fabrics used in the papermaking process and of industrial process fabrics used to manufacture disposable diapers and other paper products. Appleton Wire has two plants in Wisconsin, one in Tennessee, and one in Alabama.

During the period under review, except as otherwise noted, AI owned nearly all of the outstanding capital stock of 11 subsidiaries (the "Subsidiaries") which, with one exception, manufactured and sold paper machine clothing throughout the world primarily for markets in the subsidiaries' part of the world. AI received dividends, interest income, and royalties from the Subsidiaries, all of which were included by the department in AI's Wisconsin apportionable income.

AI controlled the operation of its domestic operations and the Subsidiaries through three senior vice presidents, an executive vice president, a president and chief executive officer, and the chairman of the AI Board of Directors. Operating plans for Subsidiaries

and divisions were presented to the senior operating management of AI for approval. The final version of the operating plan had to be approved by the AI chairman of the board and by its president, after consultation with the responsible senior vice president. Subsidiaries and divisions could not make expenditures in excess of \$30,000 without the approval of the senior vice president for the area or the AI president.

AI had a policy manual which contained a variety of policies applicable to the Subsidiaries. The policies were general guidelines, and some were regarded more seriously than others by AI's senior management.

AI and its Subsidiaries were functionally integrated, particularly with respect to the development and sharing of new products and technology. AI had its major research facility for the development of new products and manufacturing processes in the United States. In addition, its Swedish subsidiary had a research facility. AI had technical services agreements with its Subsidiaries, whereby the subsidiary paid AI an amount equal to a percentage of its gross sales as royalties for the use of AI technology.

There was also functional integration with respect to provision by AI of management services to the Subsidiaries, for which AI charged a pro rata management fee.

Although AI did not generally guarantee or secure loans for its Subsidiaries, it did so for Australia in the years 1982 through 1986, for Holland in 1983 and 1984, and for Canada in 1984 through 1986. AI received interest on loans it made to the Subsidiaries.

AI and its subsidiaries' worldwide operations produced economies of scale. Its greatest economy was to utilize its research facilities to devel-

op new products and processes, and then to produce and sell its products in a manner customized to paper makers in particular markets in the world. In this way it improved its market share through its name identification, technologically advanced products efficiently produced, and its delivery services. Besides economies of scale in research (i.e., many units sharing the cost of research), it achieved economies by many units sharing corporate services of its centralized management. It achieved economies by being able to produce products at its most efficient unit and by supplying the products to a subsidiary in another area market for resale, at a profit to both. In addition, it achieved economies in advertising, worldwide insurance coverage, accounting and auditing, quality assurance, and environmental policy.

During the years 1982 through 1986, AI owed minority percentages of the outstanding capital stock of six companies (the "Affiliates") and reported for federal income tax purposes dividends from the Affiliates, all of which were included by the department in AI's Wisconsin apportionable income.

AI received royalty income from the Affiliates, all of which was included by the department in AI's Wisconsin apportionable income.

There was neither centralized management nor functional integration between AI and the Affiliates. None of the Affiliates submitted to AI operating plans of the type submitted by the Subsidiaries, nor were the Policy Manual or the Accounting Manual applicable to the Affiliates. Economies of scale with respect to the Affiliates were limited.

During the period 1984 through 1986, AI reported interest income from "IPG Notes" and "Installment Lease." The "IPG Notes" were re-

ceived by AI from Charterhouse upon Charterhouse's purchase of the assets of AI's Industrial Products Division in December 1983. The interest income associated with the IPG Notes was the accrued interest earned by AI on the promissory notes that it accepted as partial payment on the sale of the Industrial Products Division assets. Charterhouse, as the buyer, was in no way related to AI.

The "Installment Lease" on which AI accrued interest is an agreement between AI, as lessor of certain real property it owned in Georgia, and an unrelated plastics company, as lessee. The lessee became bankrupt in 1985, and, as a result, there were "negative interest" adjustments in 1985 and 1986 which reflected negative adjustments to interest income that had previously been accrued.

Lastly, the parties agree that interest AI received from banks, other inter-company loans, municipal bonds, and other resources shall be included in apportionable income.

During the period 1982 through 1986, AI reported royalty income, all of which was included by the department in AI's apportionable income. Scentry, BI Industries, Kimre, and Millipore License were all companies unrelated to AI and engaged in businesses other than the paper machine clothing business. The royalty payments made by these companies to AI were for the license of technology which was unrelated to the paper machine clothing industry.

AI reported royalty income from Lindsey, Nippon Felt, BTR Huyuk, and JWI, which were all unrelated to AI and were direct competitors of AI in the paper machine clothing business. The royalties paid by these companies to AI were for the license of technology related to the paper machine clothing industry.

AI also reported royalty income from Beier, a partnership with operations in South Africa. The partnership was owned 50% by AI and 50% by a South African company, OTH Beier. The operation involved the manufacture and sale of certain paper machine clothing and industrial products, primarily in South Africa. OTH Beier provided the day-to-day operating management of the partnership, and the only contact AI had with the operations were occasional visits and contacts by phone.

AI reported capital gains on the sale of assets, all of which were included by the department in AI's apportionable income. The gains reported by AI on the sale of "trade secrets" in the years 1982 through 1984 resulted from the sale of technology that was developed by the Research and Development Division of AI located in Massachusetts. The technology related to ultra or micro-filtration of liquids and gasses through membrane structures and was entirely unrelated to AI's principal business of paper machine clothing. The technology was sold to Millipore License, a company wholly unrelated to AI.

The \$115,000 gain reported in 1985 related to the sale of a division of AI located in Albany, New York, which was then the only domestic manufacturer of billiard balls. The sale was made to a company which was wholly unrelated to AI.

The \$94,000 gain reported by AI in 1986 resulted from the redemption of a note held by AI in connection with the sale to an unrelated company of certain assets in 1983. The amount received by AI upon the redemption of the note exceeded the face value of the note and constituted a gain.

The amounts reported by AI in 1985 and 1986 relating to the transfer of its interests in Finland and Norway are