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

Interest — deduction limitation. *Robert and Margaret Yunker vs. Wisconsin Department of Revenue* (Court of Appeals, May 24, 1994). The taxpayers appeal from an order of the Circuit Court for Milwaukee County affirming a decision of the Wisconsin Tax Appeals Commission. See *Wisconsin Tax Bulletin* 85 (January 1994), page 16, for a summary of the Circuit Court decision.

The issue in this case is whether an apartment complex owned by the taxpayers was investment property, and thus deductions for mortgage interest payments were limited to $1,200 per year, or whether the property was held for sale in the course of a business, and thus the deductibility of the interest payments for Wisconsin tax purposes was not subject to the $1,200 limitation.

In 1974, Robert Yunker built a 120-unit apartment complex in Fond du Lac. From the time the complex was completed until it was sold in 1982, the apartments were rented out. The complex was sold on a land contract, with the taxpayer maintaining the underlying mortgage on the complex. On their Wisconsin income tax returns for 1986, 1987, and 1988, the taxpayers deducted interest paid on the mortgage. The Department of Revenue reviewed the taxpayers' Wisconsin tax returns, concluded that the complex was investment property and that the interest deduction was thus subject to a $1,200 limitation, and adjusted their tax returns for those years accordingly. The taxpayers appealed to the Commission, which upheld the department's assessment. The taxpayers again appealed, to the Circuit Court, which also affirmed the assessment. On appeal, the Court of Appeals reviewed the Commission's decision, not that of the Circuit Court.

The taxpayers claim that the Commission's decision resulted from an erroneous application of the law. They contend that the Commission improperly focused almost exclusively on the manner in which they characterized the apartment complex on their tax returns, which is irrelevant, and that the Commission should have looked at other factors when considering whether the property was held for investment or for sale in the course of business. The taxpayers also claim that the Commission's decision is not supported by substantial evidence.

The Court of Appeals affirmed the Commission's decision, concluding that the apartment complex was held as investment property and that therefore the interest expense deduction was subject to the $1,200 per year limitation.

The Court held that the Commission applied the correct analysis in its decision. The information on a tax return is relevant, and in addition the Commission's decision clearly indicated that sufficient other factors were considered. The Court also concluded that the Commission's decision was supported by substantial evidence, including the following:

1. The complex was held for eight years before it was sold.

2. There were never any "For Sale" signs in front of the complex, and the taxpayer did not appear to have a written contract with brokers to sell the property.

3. There was no evidence that he ever advertised the property for sale.

4. Most importantly, the taxpayers reported the gain from the sale of the apartment complex as a capital gain on their tax returns, which is not permissible for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Further, as the taxpayers admit, if the apartment was held for sale in the ordinary course of business, this activity should have been, but was not, reported on Schedule C of their tax returns.

The taxpayers have not appealed this decision. □

Nonresidents — S corporation liquidations. *William W. and Cecelia G. Hansen, and Harry D. and Nancy W. Jacobs, Jr. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, June 27, 1994). The sole issue in this case is whether the disparity of income tax treatment between Wisconsin residents and nonresidents renders sec. 71.337(1), Wis. Stats. (1985-86), unconstitutional under either the Privileges and Immunities Clause or the Interstate Commerce Clause of the United States Constitution.

All of the taxpayers were at all relevant times residents of Illinois and were shareholders of two Wisconsin tax-option (S) corporations. Prior to September 30, 1986, both of the corporations were liquidated under Internal Revenue Code Section 337.

The final Wisconsin corporate tax returns for both corporations, for their taxable years ending September 30, 1986, were filed in December 1986. Both returns showed income allocable to the corporations' shareholders, which consisted of both net profit or loss from operations and gain upon liquidation.

In April 1987, amended final Wisconsin tax returns were filed for both corporations, eliminating from the net income allocable to their shareholders the gains upon liquidation which the corporations had previously recognized. The basis of the amendments was that the statute requiring the reporting of gains upon liquidation by nonresidents but not by Wisconsin residents had been declared unconstitutional. The income from the gains upon liquidation were not reported on the 1986 individual income tax nonresident returns of any of the taxpayers.

The Commission concluded that the taxpayers failed to meet their burden to show in what respects sec. 71.337(1), Wis. Stats. (1985-86), unjustifiably discriminates against nonresident shareholders and contravenes either the Privileges and Immunities Clause or the Interstate Commerce Clause of the United States Constitution.

The taxpayers have appealed this decision to the Circuit Court. □

INDIVIDUAL INCOME AND CORPORATION FRANCHISE AND INCOME TAXES

Liquidating corporations — installment sales. *Mil/Cos, Inc., Mil/Tan, Inc., Lucille A. Knoernschild, and Carl Knoernschild Estate vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, June 20, 1994). The issue in this case is whether the taxpayers are liable, under sec. Tax 2.19(2), Wis. Adm. Code (1985), for additional franchise or income taxes on unreported gain from a 1981 installment agreement distributed in liquidation in 1985, notwithstanding the language of sec. 71.336, Wis. Stats. (1985-86).

Taxpayers Mil/Cos, Inc. and Mil/Tan, Inc. were Wisconsin corporations. Taxpayer Carl Knoernschild Estate was a Florida estate, created upon the death of Carl Knoernschild on or about April 2, 1983. Taxpayer Lucille Knoernschild is the surviving spouse of Carl Knoernschild, was the recipient of all of the assets of the estate, and at all times relevant to this matter was a Florida resident.

All of the matters in this case involve tax assessments based upon one event, the distribution of an installment obligation by Mil/Cos, Inc. during the taxpayer corporations' respective 1985 tax years. During the 1985 tax years, pursuant to plans of complete liquidation, all of the assets of both corporations were distributed to their respective shareholder(s) (Mil/Tan, Inc. owned all of the stock of Mil/Cos, Inc., and Carl and Lucille Knoernschild owned all of the Mil/Tan, Inc. stock). The 1985 tax year was the final fiscal year for both corporations.

Liquidation of taxpayer Mil/Cos, Inc. took place pursuant to secs. 71.332 and 71.336, Wis. Stats. (1983-84). The liquidation qualified under sec. 71.332, Wis. Stats., because at all times taxpayer Mil/Tan, Inc. owned at least 80 per cent of its stock. Liquidation of taxpayer Mil/Tan, Inc. took place pursuant to sec. 71.336, Wis. Stats. (1983-84).

In July 1988, the department issued a notice of assessment to taxpayer Mil/Cos, Inc. for 1985, for the gain remaining to be reported on a 1981 installment sale at the time the corporation was liquidated. In December 1991, the department issued additional notices of assessment to taxpayers Mil/Tan, Inc., Carl Knoernschild Estate, and Lucille Knoernschild. In making the assessments, the department relied in part upon sec. Tax 2.19, Wis. Adm. Code, which provides that the installment method of reporting gains on the sale of property is contingent upon the implied agreement of the taxpayer to take into

income in the year of distribution all of the unreported balance of gain upon the installment sale.

The Commission concluded that sec. 71.336, Wis. Stats. (1985-86), exempts the taxpayers from recognizing their unreported gain on the liquidation distribution of the 1981 installment agreement. Section Tax 2.19(2), Wis. Adm. code, is unenforceable against the taxpayers because it directly conflicts with sec. 71.336, Wis. Stats. (1985-86), and because its companion provision, sec. Tax 2.19(1), has been held to be invalid because it exceeds the bounds of correct interpretation, in the decision of *Castle Corp. v. Rev. Dept.*, 142 Wis. 2d 716 (Ct. App. 1987).

The department has not appealed this decision. □

SALES AND USE TAXES

Computer software — tangible vs. intangible. *Manpower International, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, August 15, 1994). The issues in this case are:

A. Whether the computer software leased by the taxpayer from various vendors is tangible personal property and subject to sales or use tax.

B. Whether the taxpayer's lease of computer software from various vendors is a purchase of taxable services.

The taxpayer is a corporation organized in Delaware with its main offices located in Milwaukee, Wisconsin.

A typical sequence of events for the taxpayer in utilizing a new computer program is that the program arrives in the taxpayer's location on magnetic tape or diskettes and is placed by the taxpayer into the magnetic tape or disk drive. Using a "utility" program, the taxpayer loads the new program, which is "read" from the tape or diskette and copied or reproduced on the computer's drive from which it can be conveniently used later on.

All the software involved in this matter is non-custom software, often referred to as "pre-written" or "canned" software, as opposed to "custom" software. "Custom" software is produced to the special order of the customer, usually after extensive review of the customer's computer hardware and operational needs. "Canned" software is produced in quantity, available for sale to the public, selected by the customer to meet the customer's hardware requirements, is generally usable by the customer as written, and is "loaded" into the computer memory by the customer.

A loaded program flows to the central processing unit of the computer electronically to perform the task of, or "execute," the program. If the program is provided in the form of magnetic tape or a diskette, the program is first usually copied into one of the tape or disk drives of the computer. When the program is to be used, it is copied from the disk drive into the computer's memory. Assuming nothing goes wrong with the process of copying the program onto the disk drive, the program can be used without making further use of the tape or diskettes originally provided. As long as the program remains stored in the disk drive intact, the program can continue being used without ever having to go back to the original tape or diskette. The program remains on the original tape or diskette unless obliterated by (1) recording new material over that already on the media or (2) by magnetic erasure. A copy of the tape or diskette is often retained by the customer for "archive" or backup purposes.

The heart of the computer is the "instruction processing unit" which actually "interprets" the coded instructions. The instructions are kept in a memory unit, either that of the computer itself — the "primary memory" — or in mass storage units such as a "disk drive" or a magnetic tape drive — the "secondary memory." When the program is to be used, instructions are transferred from memory into the instruction processing units where they are acted upon.

The coded instructions which flow to the instruction processing unit are sequences of zeros and ones referred to as "bits." These "bits" are copied from disk to memory, and one small group at a time is loaded into the instruction processing unit. A bit can be represented non-electronically by the presence or absence of a hole in a punched card or by magnetic impulses or electronically, all indicating either zeros or ones.

Bits have a physical presence. Every time a bit is copied, or "read," from a tape or disk, the presence of polarized signals on magnetic material is "observed." A "bit" in the form of a magnetic impulse has mass and volume. A "bit" represented on a keypunch card is a location on the card which either does or does not have a hole punched. The computer reads and acts on the bits and transforms them into the original form in which they were originally presented to the tape or disk drive when the recording took place.

The taxpayer received one or more magnetic tapes or diskettes, along with written manuals, for each purchase of software involved here. The cost of the blank medium used to transmit a copy of a program to the taxpayer is minimal in comparison to the total charge. The cost of blank diskettes would be about $1.00 each, and the cost of blank magnetic tapes would be about $5.00 each. The cost

of the magnetic tape(s) or diskette(s) used in transferring each purchased program to the taxpayer was not separately stated from the cost of the program.

The taxpayer is unable to demonstrate for any of the programs at issue whether it was instructed by any vendor or software producer to return any magnetic tapes or diskettes after "reading" or "loading" a program into the taxpayer's computer memory unit, or whether any such tapes or diskettes were in fact returned, retained, or destroyed.

The Commission concluded as follows:

A. The computer software leased by the taxpayer from various vendors is not tangible personal property and is therefore not taxable under secs. 77.52(1) and 77.53, Wis. Stats.

B. The taxpayer's lease of computer software from various vendors is not the purchase of a service enumerated in sec. 77.52(2), Wis. Stats., and is therefore not taxable under secs. 77.52(2) and 77.53, Wis. Stats.

The essence of the taxpayer's transactions under review was the lease of coded data, albeit "pre-written" or "canned," which brings it squarely within the articulated holding in *Janesville Data Center vs. Wisconsin Department of Revenue,* 84 Wis. 2d 341 (1977). In *Janesville Data*, the Wisconsin Supreme Court held that the sale of magnetic tapes which had been encoded by the seller with data furnished by the purchaser was neither the transfer of taxable tangible personal property nor the furnishing of a taxable service.

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

Waste reduction and recycling. *Ruef's Sanitary Service, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, June 13, 1994). The issue in this case is whether the taxpayer qualifies for exemption from sales and use tax under sec. 77.54(26m), Wis. Stats. (1991-92), on its purchase of equipment used for collecting, sorting, and transporting recyclable items.

The taxpayer's principal business was the collection and disposal of rubbish and recyclables from several communities in southern Wisconsin. The taxpayer purchased two Kann Truck Side Dump Series Curb Sorters and two chassis upon which the Curb Sorters were mounted.

The two Curb Sorters were driven by the taxpayer's employes on regular routes. At curbside collection sites, the Curb Sorter operator separated recyclable items into five hydraulically operated compartments of the Curb Sorter and placed newspapers in a rack.

The taxpayer used the Curb Sorters to transport the recyclables to the taxpayer's truck yard where the recyclables were hydraulically lifted and dumped from the Curb Sorter bins into individual roll-off and yard boxes for each of the various items.

The taxpayer did not do any activity to convert the recyclables into usable items. The taxpayer sold or gave away the recyclables to others who converted the recyclables into usable products.

Section 77.54(26m), Wis. Stats., provides an exemption for "waste reduction or recycling machinery and equipment ... exclusively and directly used for waste reduction or recycling activities which reduce the amount of solid waste generated, reuse solid waste, recycle solid waste, compost solid waste or recover energy from solid waste ...."

The Wisconsin Court of Appeals analyzed this exemption language in *Wisconsin Department of Revenue vs. Parks-Pioneer Corporation* (Court of Appeals, District IV, June 25, 1992), a case involving the taxability of, among other things, lugger and roll-off boxes used to collect scrap metal from the premises of the taxpayer's suppliers, which it then transported to its own premises for recycling and sale. The Court of Appeals determined that although the boxes were "exclusively used for recycling activities," they were *not* also "directly" used therefor because they did not perform "integral functions" in Parks-Pioneer's recycling activities since "[T]he scrap is recycled after it is collected and transported to the plant." In so ruling, the Court adopted the "integral function" test to find machinery there was "directly used" in a manufacturing process. For a summary of the Parks-Pioneer decision, see *Wisconsin Tax Bulletin* 79 (October 1992), page 16.

The Commission concluded that the taxpayer's Curb Sorters were not exempt from sales and use tax under sec. 77.54(26m), Wis. Stats. The Curb Sorters were used only "to transport the recyclables to the taxpayer's truck yard where the recyclables were ... dumped ..." and ultimately sold or given away for recycling. Although the taxpayer's Curb Sorters may have been used "exclusively" for recycling and/or waste reduction activities, they were not also used "directly" in such activities because they did not perform an "integral function" therein.

The taxpayer has not appealed this decision. □