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. *David G. and Patricia Stauffacher vs. Wisconsin Department of Revenue* (Circuit Court for Dane County, February 5, 1996). The department seeks dismissal of the taxpayers' petition for judicial review of a Wisconsin Tax Appeals Commission (Commission) decision and order, which determined that they were engaged in a farming venture and were therefore subject to farming business loss limitations. For a summary of that decision, see *Wisconsin Tax Bulletin* 95 (January 1996), page 23.

The department maintains that the Circuit Court is without subject matter jurisdiction because the decision and order issued by the Commission in this matter is an interlocutory order rather than a final order, since the merits of the taxpayers' tax assessment is still pending before the Commission. The Commission has only determined one issue as to that tax assessment - that the activities engaged in constituted farming and that the farming loss limitation applies. It has yet to determine to what extent those activities were farming. This determination is crucial to determining the full extent of the taxpayers' tax liability. The Commission has neither reversed nor affirmed the department's complete assessment of tax liability and cannot do so until it decides the issues relating to research and manufacturing.

The Circuit Court concluded that the Commission's decision is interlocutory and that it lacks jurisdiction over the subject matter. It granted the department's motion to dismiss the appeal. After the Commission has made a full determination of the tax liability and has decided all of the issues in the case, the taxpayers may seek review on all issues. The appeal time in this matter does not run until a final decision is issued by the Commission. □

Rental expenses – allocation among owners. *Scott and Pamela McQuide, and Guy T. and Deborah L. Mascari vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 12, 1995). The issue in this case is whether the special allocations of paragraph 10 in the partnership agreement of the taxpayers have "substantial economic effect" as that phrase is defined and applied in Treas. Reg. § 1.704-1(b)(1) & (2), such that the deductions taken by the McQuides for the years under review were permissible, or whether the terms of the paragraph lack "substantial economic effect," rendering the special allocations impermissible and enabling the McQuides to deduct only those rental expenses in accordance with their respective interest in the property. Because the disputed issue in the case involved assessments issued in the alternative under sec. 71.74(9), Wis. Stats., the above dockets were consolidated for review before the Commission, as required under sec. 73.01(4)(i), Wis. Stats.

During January 1986, taxpayers Scott and Pamela McQuide ("the McQuides"), and Guy T. and Deborah L. Mascari ("the Mascaris"), purchased as tenants in common a two-unit residence located at 4059-61 North Downer Avenue in Shorewood, Wisconsin ("the Downer property"). The parties intended that the Mascaris would live in and bear the expenses of one of the two units at the Downer property, and that the second unit would be rented to a third party, with the parties equally sharing the expenses of the rental unit. The practical result is that the Mascaris were to be responsible for 75% of the expenses associated with the Downer property investment, while the McQuides were to be responsible for 25%.

In February 1986, the McQuides and the Mascaris executed a partnership agreement governing the terms of the acquisition, ownership, possession, management, and ultimate disposition of liquidation proceeds of the Downer property ("the partnership agreement"). According to the terms of the partnership agreement, the relative ownership, capital improvement contributions, operating expense burden, share of profits or losses, and share of liquidation proceeds were each to be divided among the two couples, 75% allocable to the Mascaris and 25% allocable to the McQuides. The overall 75% to 25% percentage split accurately reflected the comparative ownership interests and practical expense burdens of the Mascaris and the McQuides, respectively, from 1986 through 1992.

Paragraph 10 of the partnership agreement provided for a special allocation for income tax purposes, however, whereby the McQuides would realize "all of the tax advantages of the lower rental unit." The McQuides purportedly would be entitled to deduct all of the expenses associated with the rental unit, without regard to the actual payor of those expenses. The partnership agreement did not provide for any adjustment to the capital accounts or share bases of the individual partners to reflect the effects of the special allocations provided in paragraph 10 of the agreement.

Beginning in 1986, and for each year through 1992, the taxpayers prepared their respective annual income tax returns. The Mascaris deducted for each year all expenses incurred by them relating to the rental portion of the Downer property, paragraph 10 of the partnership agreement notwithstanding. The Mascaris did not inform the McQuides about their deviation from the terms of paragraph 10, having drawn an independent conclusion that the special allocation clause was vitiated by the terms of the other paragraphs of the partnership agreement. In contrast, the McQuides prepared their returns in accordance with the terms of paragraph 10 of the partnership agreement, at least for the years 1988 through 1991. Per their interpretation of paragraph 10, they deducted all of the expenses allocable to the rental unit of the Downer property.

Partnership returns were never prepared by the Mascaris or the McQuides to summarize and reflect distributable shares of income, loss, expense, etc.

In October 1992, the taxpayers sold the Downer property. According to the terms of a partnership settlement agreement executed at the time of the sale, the proceeds were split, with 25% being allocated to the McQuides and 75% to the Mascaris, based upon the underlying ownership percentages of each couple at the time.

The Commission concluded that the special allocations of paragraph 10 in the partnership agreement lack "substantial economic effect" as that phrase is defined and applied in Treas. Reg. § 1.704-1(b)(1) & (2), rendering the paragraph's special tax deduction allocations impermissible and enabling the McQuides to deduct only those expenses associated with the rental portion of the Downer property in accordance with their respective interest in the Downer property. Paragraph 10 of the partnership agreement lacked "substantial economic effect" because the special allocation did not correspond to the practical economic burdens of the partners, and there existed no provisions in the partnership agreement for the adjustment of the partners' capital accounts to reflect the arrangement contemplated in paragraph 10, as required by Treas. Reg. § 1.704-1(b)(2)(iv).

As a result of the Commission's conclusion, the assessment issued to the McQuides is affirmed, and the assessments issued to the Mascaris are reversed.

Neither Scott and Pamela McQuide, Guy T. and Deborah L. Mascari, nor the department has appealed this decision. ☐

Tax Appeals Commission – class action claims; Petition for judicial review – timeliness. *Wisconsin Department of Revenue vs. J. Gerard and Delores M. Hogan, et al.* (Court of Appeals, District IV, December 21, 1995). This is an appeal from a judgment of the Circuit Court for Dane County. That judgment dismissed a petition for judicial review of the Tax Appeals Commission (Commission) decision directing that refunds be paid to the class comprising certain persons whose federal pensions had been taxed by the state, and ruled that the petition had not been filed by the department within the time prescribed by statute. For a review of the Circuit Court decision, see *Wisconsin Tax Bulletin* 90 (January 1995), page 19.

In early 1991, the Hogans wrote to the department, stating that they were changing their individual refund claim to one seeking refunds on behalf of the class certified by the Circuit Court in *Hogan v. Musolf* 163 Wis. 2d 1, 27, 471 N.W. 2d 216, 226 (1991). The department denied the claim, concluding that state law did not authorize the prosecution of class-action refund claims before the department. The denial was appealed to the Commission, and the department moved to dismiss the appeal.

On October 28, 1992, the Commission denied the motion to dismiss and granted the motion to recognize and certify the class. The order was not accompanied by the notice of appeal rights as a precondition for commencing the time limits in which petitions for rehearing or judicial review may be commenced. Thereafter, the Commission clarified its class-certification order and then clarified it again, each time modifying and altering the underlying rationale. Like the October 28, 1992, order, none of the amended orders was accompanied by an appeal notice.

On November 20, 1992, the department filed a "Respondent's Rehearing Petition" with the Commission. The Commission denied it, and that order was also unaccompanied by an appeal notice.

On May 27, 1993, the Commission rendered an oral decision, granting the motion to recognize and certify the class, and ordering refunds to all members of the class, together with statutory interest. Unlike all the decisions preceding it, the transcript of the oral decision provided to the parties was accompanied by the appeal notice. On June 16, 1993, twenty days after the oral decision, the department filed a petition for rehearing. The Commission denied the petition on June 29, 1993, and the department filed a petition for judicial review by the Circuit Court within thirty days of that date.

The Circuit Court ruled that the department's petition for judicial review of the Commission decision was untimely because it was not filed within thirty days of the date the oral decision was rendered. Because the Circuit Court dismissed the department's petition for review based on its conclusion that the petition had not been timely filed, it did not consider whether the Commission has the authority to certify and entertain a class action in refund proceedings. The Court of Appeals proceeded to decide that issue because it reviews the legal basis for the Commission decision independently, and because the parties fully briefed the issue.

The Court of Appeals concluded as follows:

A. The department's petition for review of the June 29, 1993, Commission decision was timely filed.

B. The Commission lacks authority to entertain a class-action proceeding seeking refunds of state income taxes collected over the years on the pension income of retired federal government employes living in Wisconsin. The Commission's class-action rulings in this case contravene two specific and plainly worded statutes.

   The first is sec. 71.75, Wis. Stats., which sets forth the requirements for filing and processing refund claims before the department. Section 71.75(6) mandates that "[e]very claim for refund" must be filed with the department "in the manner, and on a form ... signed by the person ... who filed the return on which the claim is based." By permitting the Hogans to change their appeal from one based on their individual returns to one representing a class of more than 25,000 other taxpayers, many of whom have never filed their own claims with the department, would effectively nullify the provisions of sec. 71.75(6), Wis. Stats., as to those taxpayers.

   Second, the statutes dealing with the Commission's appellate

> jurisdiction expressly state that, in order to prosecute an appeal from the department's assessment of a tax, the taxpayer must, among other things, testify under oath before the Commission as to his or her actual income. Section 71.89(2), Wis. Stats. This provision, too, would be nullified if the Commission could add thousands of "absent" parties to the proceeding by permitting the Hogans' individual appeal to proceed as a class action.

The taxpayers have appealed this decision to the Wisconsin Supreme Court. □

CORPORATION FRANCHISE AND INCOME TAXES

Bad debts. *Wisconsin Distributors, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 6, 1995). The issue in this case is whether the department properly disallowed the taxpayer's expense deduction for charging off a part of the promissory note indebtedness of Wisconsin Eagle Snack Company Inc. ("Eagle"), pursuant to sec. 166(a)(2), Internal Revenue Code (IRC), where the taxpayer and Eagle were owned by the same interests within the meaning of sec. 71.11(7m), Wis. Stats. (1985-86).

During the period under review, November 1, 1984, through October 31, 1987, the taxpayer was a Wisconsin corporation using the accrual method of accounting, with its stock owned 51% by Darrell Hanson and 49% by John DeWitt.

Eagle was a Wisconsin corporation with its stock owned 51% by Darrell Hanson and 49% by John DeWitt.

The taxpayer leased to Eagle part of its facilities in Madison, Janesville, and Stevens Point, and entered into a written agreement ("the service agreement") to provide administrative and warehousing services to Eagle, including acting as joint paymaster, which were allocated between the corporations based on monthly dollar sales.

On November 1, 1985, Eagle's obligations to the taxpayer under the lease and the service agreement were memorialized into an unsecured 10% promissory note ("the note") in the initial principal amount of $89,059.64, with the balance adjusted each month as additional charges were incurred or payments made. At the taxpayer's fiscal year-end on October 31, 1987, Eagle owed the taxpayer $351,964 on the note.

In January 1988, the taxpayer decided to "charge off" $146,131 of the indebtedness owed by Eagle on the note during the year ended October 31, 1987, thereby reducing the indebtedness to $205,833. The taxpayer's financial statements characterized this as a "reduction" of previous "overcharge[s]" for selling expenses ($43,122), warehouse expenses ($14,237), general and administrative expenses ($36,742), and interest expense ($52,030).

On its 1987 Wisconsin franchise tax return, the taxpayer expensed the $146,131, which reduced its income accordingly. Although Eagle's 1987 tax return conversely included the $146,131 as expense *reductions*, it reported $0 net income.

On May 4, 1989, the department issued a notice of additional tax due from the taxpayer. The taxpayer petitioned for redetermination, which petition was denied by the department for the following reason:

> Information has not been provided to establish that the accounts receivable for Eagle Snacks Co., Inc. was partially worthless in the year claimed. Also, it was not shown that the worthlessness could be predicted with reasonable certainty. Therefore the accounts receivable written off ... does not qualify as a partially worthless debt under the provisions of section 166(a)(2) IRC.

The taxpayer claims that the debt adjustment write-off should be allowed as an expense because it had a bona fide business purpose relating to "real world performance, and the expectation of future improvement" and served "as a means of allowing Eagle to survive, rather than simply liquidating ..."

The Commission reached the following conclusions:

A. The taxpayer and Eagle were businesses owned or controlled by the same interests within the meaning of sec. 71.11(7m), Wis. Stats. (1985-86).

B. The department properly disallowed the taxpayer's expense deduction under review because the taxpayer did not substantiate that it was a partially worthless debt subject to charge-off within the taxable year as required by sec. 166(a)(2), IRC, or that it was deductible under any other code or statutory provision.

The taxpayer has not appealed this decision. □

Insurance companies – addback of exempt or excluded interest and dividends received deduction. *Wisconsin Department of Revenue vs. Heritage Mutual Insurance Company* (Circuit Court for Sheboygan County, November 17, 1995). The department filed a petition for review of the

Wisconsin Tax Appeals Commission's March 31, 1995, decision requiring the department to grant the refund claim filed by the taxpayer. The Commission concluded that the department improperly determined that sec. 71.45(2)(a)3 and 4, Wis. Stats. (1987-88), required the addition, for Wisconsin franchise and income tax purposes, of the 15% portion of interest and dividend income which never effectively reduced the taxpayer's federal taxable income as carried forward for Wisconsin purposes. See *Wisconsin Tax Bulletin* 92 (July 1995), page 16, for a summary of the Commission's decision.

The taxpayer is a Wisconsin corporation organized as a mutual insurance company under ch. 611, Wis. Stats. On its initial Wisconsin franchise tax returns for 1987 and 1988, the taxpayer added all of its federally exempt interest income identified on line 3b of Schedule A of its federal return and all of its federally exempt dividend income identified on line 34a of Schedule A to its federal taxable income shown on line 35 of Schedule A in order to compute its Wisconsin net income. On or about November 22, 1989, the taxpayer filed a claim for refund for the 1987 and 1988 taxable years respectively.

In determining its federal taxable income for 1987 and 1988, as required by sec. 832(b)(5) of the Internal Revenue Code (IRC), the taxpayer took into account 15% of the tax-exempt interest income received on obligations acquired on and after August 8, 1986, and 15% of deductible dividends received on stock acquired on and after August 8, 1986. In determining its Wisconsin taxable income for purposes of its claim for refund for 1987 and 1988, the taxpayer added back to its federal taxable income the tax-exempt interest and deductible dividends only to the extent that such amounts were not used in calculating its federal taxable income and, therefore, did not include the 15% of the tax-exempt interest income and deductible dividends included in its federal taxable income as required by IRC sec. 832(b)(5).

The Commission pointed out in its decision and order that the department interpreted the language of sec. 71.45(2)(a), Wis. Stats. (1987-88), to require the "add back" for Wisconsin purposes of 100% of federally exempt interest and dividend income even though 15% of such income was applied to reduce a loss deduction in arriving at the taxpayer's federal taxable income.

The Circuit Court concurred with the Commission's reasoning that the department's strict interpretation of the statute would tax the same income twice and affirmed the Commission's determination.

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

SALES AND USE TAXES

Aircraft – certified or licensed carriers; Purchases for resale. *Majestic Balloons Ltd. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 14, 1995). The issues in this case are:

A. Whether the taxpayer's purchase of a replacement fabric envelope for a hot air balloon system is exempt from sales and use tax under sec. 77.54(5)(a), Wis. Stats., as aircraft sold to persons using such aircraft as certified or licensed carriers of persons or property in interstate or foreign commerce.

B. Whether the taxpayer's purchase of the replacement fabric envelope is exempt from sales and use tax under sec. Tax 11.29(4)(b), Wis. Adm. Code, as a purchase for resale.

The taxpayer is a Wisconsin corporation engaged in the business of providing hot air balloon rides and using its hot air balloon system at promotional events. Gregory N. Rasske is the president of the taxpayer corporation.

In 1987 or before, the taxpayer purchased a hot air balloon system for use in its business but paid no sales or use tax on this purchase. The department then issued a notice of assessment asserting that the purchase was subject to the sales tax. Following a conversation between Mr. Rasske and an employe of the department, the department removed the notice of assessment because the taxpayer "supplied information showing the aircraft was purchased for rental only." The basis for the removal was not the exemption found in sec. 77.54(5)(a), Wis. Stats. (1989-90) but, rather, the resale exemption referred to in sec. Tax 11.29(4)(b), Wis. Adm. Code.

In 1990, the taxpayer purchased a replacement fabric envelope for the hot air balloon system. The initial hot air balloon system as well as the replacement fabric envelope is registered with the Wisconsin Department of Transportation and carries a registration number assigned by the Federal Aviation Administration ("FAA"). The hot air balloon system as well as the replacement fabric envelope must carry a certificate of airworthiness issued by the FAA.

The taxpayer is not certified or licensed as a carrier by an agency of the federal government, nor is the taxpayer required to be. There is no