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
Assessments - authority of Internal Revenue Service determinations over
Assessments - correctness
Assessments - interest imposed on
Assessments - timeliness
Assessments - validity of defense to
La Verne I. Iverson 19

Sales and Use Tax
Aircraft - taxable use
G & G Trucking, Inc. 21

Exemptions - manufacturing machinery and equipment
Wissota Sand and Gravel Company 22

Exemptions - printed advertising materials
Plaza Publications, Inc. 23

INDIVIDUAL INCOME TAXES

Assessments – authority of Internal Revenue Service determinations over; Assessments – correctness; Assessments – interest imposed on; Assessments – timeliness; Assessments – validity of defense to. *La Verne I. Iverson vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, November 12, 2003). The issues in this case are:

A. Whether the department's assessment was made in a timely manner.

B. Whether the department's alleged motivation to generate revenues to cover the state's budget deficit is a valid defense to the assessment.

C. Whether the department properly assessed interest at a rate of 12%.

D. Whether the department is bound by a previous Internal Revenue Service determination concerning some of the same issues as in the assessment.

E. Whether the department properly disallowed capital gain treatment on Termination Payments received by the taxpayer.

F. Whether the department properly assessed the taxpayer for unreported gambling winnings.

G. Whether the department properly disallowed the deduction for health insurance premiums claimed by the taxpayer.

H. Whether the department properly included in the taxpayer's income the face value of a promissory note portion of a settlement distribution.

From October 16, 1965 until November 1, 1967, the taxpayer was a salaried employee of one of the State Farm insurance companies, with the title of Trainee Agent. From November 1, 1967, until his retirement on October 31, 1995, he was an independent insurance agent for several affiliated State Farm insurance companies. At no time prior to or during his service for State Farm, either as an employee or an independent insurance agent, did the taxpayer purchase from State Farm an agency or policies then or previously in effect.

As of the date the taxpayer became an independent insurance agent for State Farm, he entered into a State Farm Agent's Agreement ("Initial Agent's Agreement"). The Initial Agent's Agreement provided that the taxpayer would be an independent contractor and responsible for most of his own expenses. It also provided that the agreement between State Farm and the taxpayer could be terminated by State Farm at will, simply by providing notice to the taxpayer. Upon termination of the Agreement, either by the taxpayer or State Farm, the Agreement provided for Termination Payments to be paid to the taxpayer based upon a formula. Under the formula, the taxpayer was entitled to Termination Payments based on various percentages of premiums collected or commissions that would have been due had the Agreement not been terminated.

Prior to his retirement in 1995, the taxpayer entered into at least one subsequent Agent's Agreement ("Subse-

quent Agent's Agreement") that superceded all prior agreements between himself and State Farm. The Subsequent Agent's Agreement does not materially differ from the Initial Agent's Agreement in any respect pertinent to this matter. When he retired, the taxpayer did not execute any separate agreement with State Farm with respect to or obtain any valuation of the value of his agency, any of its assets, or the Termination Payments. The taxpayer received Termination Payments based on the Subsequent Agent's Agreement in the following amounts: $17,370.57 in 1997, $16,594.04 in 1998, $14,836.18 in 1999, and $15,536.76 in 2000.

When he filed his Wisconsin income tax returns for the years 1997 through 2000, the taxpayer characterized the Termination Payments he received as capital gain income and excluded 60% of the payments from Wisconsin taxable income. In each of these years, on his federal Schedule D, he reported a zero basis in the Termination Payments. On each of these same schedules, he did not include a sales price for the Termination Payments, but instead inserted a notation referring to agency premium renewal service compensation.

On April 5, 1998, the taxpayer was playing dollar slot machines at a casino in Marquette, Iowa, when he hit the jackpot, winning $1,350. The casino withheld $67.50 in Iowa state income tax and issued a federal Form W-2G reflecting the amount of the gross winnings and the tax withheld. The taxpayer did not report the winnings on his 1998 Wisconsin income tax return, and filed no 1998 Iowa income tax return.

The taxpayer and his ex-wife were plaintiffs in a class action suit against certain corporations venued in the U.S. District Court for the Southern District of Florida. In December of 1998, they received a settlement distribution consisting of a check in the amount of $1,511.68 and a promissory note in the amount of $2,318.21. The law firm transmitting the settlement distribution advised them that "under most circumstances the distribution represents income that you must report on your tax return." The law firm also filed a 1099-MISC that listed $3,829.89 as other income paid to the taxpayer and his ex-wife.

On his 1998 Wisconsin income tax return, the taxpayer reported $1,511.68 of the settlement proceeds as a long-term capital gain, excluding 60% of this amount from Wisconsin taxable income. He did not report any portion of the promissory note on his 1998 Wisconsin income tax return.

On his 1998 through 2000 Wisconsin income tax returns, the taxpayer claimed a deduction for self-employed health insurance premiums in the amounts of $1,164.35, $1,762.63, and $1,934.85, respectively. During these years, he was not self-employed and did not file a federal Schedule SE.

Under the date of February 18, 2002, the department issued an income tax assessment against the taxpayer consisting of additional tax of $3,445.38 plus 12% interest of $1,262.61, for the years 1997 through 2000. The department's assessment included the following elements:

1. Disallowance of capital gains treatment of the Termination Payments for all four years.

2. Inclusion of gambling winnings in income for 1998.

3. Disallowance of capital gains treatment of the settlement proceeds for 1998.

4. Inclusion of the amount of the promissory note in income for 1998.

5. Disallowance of the deduction for self-employed health insurance premiums for 1998, 1999 and 2000.

The taxpayer filed a timely petition for redetermination with the department, the department denied it, and the taxpayer filed a timely petition for review with the Commission.

The arguments raised by the taxpayer were as follows:

- The department took too long to issue the assessment.

- The department targeted him because of the state's ongoing budget crunch.

- The 12% interest rate is excessive.

- With respect to a number of issues, the Internal Revenue Service has accepted his position.

- When he retired, he sold to State Farm his right to continue to receive "service fee compensation," i.e., compensation on policies he sold or maintained. Therefore, the Termination Payments he received should be allowed capital gain treatment.

- The department should contact the State of Iowa to retrieve the amount withheld from his gambling

winnings, and he actually lost more money gambling than he won.

- It is unfair for the department to disallow his deductions for health insurance premiums, when employers may pay health insurance premiums for their employees without tax consequence to those employees.
- The cash portion of the settlement distribution he received should be treated as capital gain, and he should not have to realize any income upon receipt of the note until he is actually paid on the note.

The commission concluded as follows:

A. The assessment was issued in a timely manner, within the statute of limitations. The department was completely within its authority to issue the assessment when it did. If the taxpayer believes that assessments should be issued in a timelier manner, his only recourse is to the legislature.

B. The department's alleged motivation to generate revenues to cover the state's budget deficit is not a valid defense to the assessment.

C. The department is required by law to impose interest on assessments at the specified rates. Sec. 71.82(1) Wis. Stats. (2001-2002) sets the rate at 12%. Complaints about the statutorily mandated interest rate are better directed to the legislature.

D. The record contains no substantiation of any issues raised by the Internal Revenue Service, or the resolution of any such issues. But even if the taxpayer had offered such substantiation, it would be immaterial. The definition of "federal taxable income" and "federal adjusted gross income" allows that such amounts may be determined by the department or on appeal from the department (Sec. 71.01(4) Wis. Stats. (2001-2002)). Therefore, neither the department nor the Commission is bound by any determination of the Internal Revenue Service.

E. The Termination Payments are not entitled to capital gain treatment. The record indicates that the taxpayer never owned the right to service fee compensation, and nothing in the Agent's Agreements indicates that State Farm is buying the taxpayer's right to service fee compensation with Termination Payments.

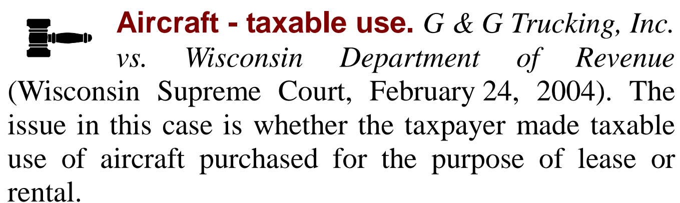
F. The taxpayer is liable for Wisconsin income tax on his gambling winnings, and he has failed to substantiate any potentially offsetting gambling losses. It is the taxpayer's, not the department's, obligation to claim a refund from the State of Iowa, if he is indeed entitled to a refund.

G. The taxpayer is not entitled to a deduction for health insurance premiums because he is not self-employed. Fair or not, it is the law.

H. The taxpayer is liable for the face value of the promissory note portion of his settlement distribution. The taxpayer offered no substantiation that the claim the settlement is based on involved replacement of capital destroyed or lost, so capital gain treatment is not allowed. Also, the taxpayer offered no evidence that the maker of the note is other than responsible or solvent or that the fair market value of the note is anything other than its face value. Thus, the value of the note is included in the taxpayer's income in the year that it is received.

The taxpayer has not appealed this decision.

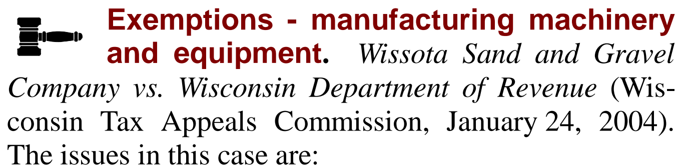
SALES AND USE TAXES



Aircraft - taxable use. *G & G Trucking, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Supreme Court, February 24, 2004). The issue in this case is whether the taxpayer made taxable use of aircraft purchased for the purpose of lease or rental.

On November 10, 2003, the taxpayer appealed to the Wisconsin Supreme Court a Court of Appeals decision that held the taxpayer's use of aircraft was subject to Wisconsin sales or use tax. On February 24, 2004, the Supreme Court denied the petition for review. Therefore, the Court of Appeals decision is final.

See *Wisconsin Tax Bulletin* 137 (January 2004), page 28, *Wisconsin Tax Bulletin* 132 (October 2002), page 25, and *Wisconsin Tax Bulletin* 129 (April 2002), page 23, for summaries of the Court of Appeals, Circuit Court, and Commission decisions.



Exemptions - manufacturing machinery and equipment. *Wissota Sand and Gravel Company vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, January 24, 2004). The issues in this case are:

A. Whether the taxpayer's activity of picking up material (bank run) which has fallen from the face of its quarry and conveying it to its primary crusher is part of the taxpayer's manufacturing operation.

B. Whether the taxpayer's purchases of wheel loaders, skid steers, an excavator and light towers for use in its quarry operations qualify for the exemption for manufacturing machinery and equipment.

C. Whether the taxpayer was negligent under sec. 77.60(3), Wis. Stats., for failure to report use tax on the purchases of taxable tangible personal property on which no sales or use tax was charged at the time of purchase.

The taxpayer is a Wisconsin corporation engaged in the business of selling sand and gravel. The taxpayer operates three quarries at which it crushed, sorted, and washed aggregate products into approximately ten products.

The taxpayer separates rock from quarry walls by first removing overburden (topsoil) from on top of the rock, then allowing the forces of nature to cause the rock material (bank run) to slough off and fall to the ground.

During the period under review, the taxpayer purchased two 988F wheel loaders, both of which were used exclusively to lift the bank run from the quarry face and carry the bank run to and deposit it in the primary crusher. There are no intermediate steps or storage of bank run between the lifting of the bank run from the base of the face and its deposit into the primary crusher. The primary crusher reduces the size of the largest rocks in the bank run to no larger than three inches in diameter. Once the bank run has gone through the primary crusher, it is called breaker run, and includes sand and rocks up to three inches in diameter. The breaker run moves by conveyor through a series of additional crushers, screens and washers to produce different sizes of sand and gravel which are deposited in drying piles. The taxpayer purchased two skid steer loaders which are used to pick up breaker run that has fallen off conveyors, and replace it back onto the conveyors to be crushed. The taxpayer purchased a 980F II wheel loader which is used to move the sand and gravel from the drying piles to large storage piles where it is ready to be sold to customers.

Water that was used to wash the sand and gravel is pumped to a series of settling ponds where minute particles of sand, called fines, settle to the bottom of the ponds. About once per month, the taxpayer removes the fines from the four upstream settling ponds using a 322BL hydraulic excavator, a device specifically designed for this purpose when purchased by the taxpayer. The 322BL hydraulic excavator has a small bucket at the end of a 65-foot boom. The 322BL hydraulic excavator deposits the fines into a dump truck that transports the fines to a stockpile, where they dry. Once dry, the resulting product is called silt or bedding sand, and is moved to a storage pile where it is ready to be sold.

From time to time, the taxpayer operated one of its plants at night. In order to operate during evening hours, the taxpayer used two light towers, each powered with a self-contained diesel generator. Light towers illuminated the primary crusher and head pulley that drives the conveyor so that the taxpayer's employees could monitor the effective and safe operation of this equipment.

The Commission concluded as follows:

A. The taxpayer's activity of picking up material (bank run) which has fallen from the face of its quarry and conveying it to its primary crusher is part of the taxpayer's manufacturing operation.

B. The taxpayer's purchases of two 988F and one 980F II wheel loaders, two skid steers, and 322BL hydraulic excavator for use in its quarry operations qualify for the exemption for manufacturing machinery and equipment. The two 988F wheel loaders were used to convey raw material from plant inventory to the primary crusher. The two skid steers were used entirely within the scope of manufacturing. The 980F II wheel loader is used to convey to the point of first storage. The 322BL hydraulic excavator was used within the scope of manufacturing because it removed fines from the settling ponds so they could be moved to a drying area.

   The taxpayer's purchase of light towers for use in its quarry operations do not qualify for the exemption for manufacturing machinery and equipment.

C. The taxpayer was negligent under sec. 77.60(3), Wis. Stats., for failure to report use tax on the purchases of taxable tangible personal property on which no sales or use tax was charged at the time of purchase.

The department has appealed this decision to the Circuit Court.

Exemptions - printed advertising materials. *Plaza Publications, Inc. vs. Wisconsin Department of Revenue* (Circuit Court for Dane County, September 22, 2003). This is a judicial review of a Wisconsin Tax Appeals Commission decision dated January 31, 2003. See *Wisconsin Tax Bulletin* 134 (April 2003), page 25, for a summary of the Commission's decision. The issue in this case is whether purchases of printed advertising materials by Plaza Publications, Inc. (Plaza) during the years 1996 through 1999 (the period under review), that were shipped to locations to Plaza's customer for later shipment outside Wisconsin, qualify for the exemption in sec. 77.54(25), Wis. Stats., for printed advertising materials in Wisconsin.

Plaza is a Wisconsin corporation engaged in the publication of printed advertising materials. Plaza's primary business is the publication of tourism-related publications for which Plaza sells advertising. A major client was the Greater Milwaukee Convention and Visitor's Bureau (GMCVB), for which Plaza published the *Milwaukee Visitor's Guide* and the 1994 *Greater Milwaukee Meeting Planner's Guide*. Plaza was not paid by GMCVB, but kept revenues it generated from the sales of advertising in the publications.

Plaza had a Wisconsin seller's permit, but did not report any sales during the period under review, and had the seller's permit inactivated in December 1997. Plaza purchased taxable printed advertising materials or printing services from the printer during the period under review, paying no sales tax to the printer, and providing the printer with a continuous exemption certificate stating "Our publications are always given away free. Never sold." The printed advertising materials were delivered by contract carrier, at Plaza's direction, to two locations in Wisconsin designated by GMCVB. None of the publications were sold by Plaza. GMCVB gave away and did not sell the publications.

The department contended the exemption in sec. 77.54(25), Wis. Stats., did not apply because the printed advertising materials were not transported outside the state "by the purchaser."

The Court found the Commission's conclusion that Plaza's purchases of printed advertising materials during the years 1996 through 1999, were shipped outside Wisconsin, was not supported by the record. There was no evidence showing that either of the two locations designated by GMCVB was outside Wisconsin. The Commission had no evidence from which to find that Plaza or its agent in fact transported the materials outside of Wisconsin. Therefore, the decision of the Commission finding the materials qualify for the exemption in sec. 77.54(25), Wis. Stats., is reversed.

The taxpayer has not appealed this decision.