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

Appeals - timeliness; Exemptions from income - application of tax treaties. *Alexei R. Faustov vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, February 25, 2004). The issues in this case are:

A. Whether the Commission has jurisdiction over the taxpayer's petition for review with respect to the department's assessment for the year 2001.

B. Whether the income received by the taxpayer as a teaching assistant is exempt under the Income Tax Convention with the Russian Federation.

The taxpayer is a citizen of the Russian Federation who attends the University of Wisconsin-Milwaukee ("UW-Milwaukee") as a Ph.D. candidate in physics. He entered into and continues to reside in this country under an F-1 student visa.

During the spring semester of 2000, the taxpayer was employed by UW-Milwaukee as a teaching assistant. His duties as a teaching assistant included instructing undergraduate students during discussion sections and lab sessions, and grading examinations under the direction and guidance of a UW-Milwaukee physics professor. During the fall semester of 2000, the taxpayer was employed by UW-Milwaukee as a research assistant. His duties as a research assistant included research with lasers, under the direction and guidance of a UW-Milwaukee physics professor. When the taxpayer filed his Wisconsin income tax returns for 2000 and 2001, he did not report any income from UW-Milwaukee for his services as a research assistant and teaching assistant.

Under the date of March 18, 2002, the department issued an income tax assessment against the taxpayer in the total amount of $148.74 for 2001. The taxpayer filed a timely petition for redetermination with the department. Under the date of September 30, 2002, the department denied the petition for redetermination. The taxpayer physically received the department's action on the petition for redetermination no later than October 30, 2002. On October 30, 2002, the taxpayer paid the department the amount due under the assessment for 2001.

Under the date of November 11, 2002, the department issued an income tax assessment against the taxpayer in the total amount of $733.12 for 2000. The assessment imposed the income tax against the taxpayer's earnings as both a research assistant and a teaching assistant. The taxpayer filed a timely petition for redetermination with the department. Under the date of June 2, 2003, the department issued its notice of action letter, granting in part and denying in part the petition for redetermination. The department determined that the income the taxpayer received as a research assistant was exempt, but that the income he received as a teaching assistant was not exempt. The taxpayer physically received the department's action on the petition for redetermination no later than June 4, 2003.

On July 21, 2003, the Commission received from the taxpayer a single petition for review seeking review of

the department's action on the petitions for redetermination with respect to both the assessment for 2000 and the assessment for 2001. The petition was sent by certified mail date stamped July 18, 2003, and was considered filed on that date.

At trial, the department moved the Commission to dismiss the petition for review with respect to the assessment for 2001. The taxpayer raised the argument that the income received by him as a teaching assistant is exempt under the Income Tax Convention with the Russian Federation.

The Commission concluded as follows:

A. The petition for review with respect to the assessment for 2001 was not filed within the 60-day period required by sec. 73.01(5)(a), Wis. Stats., and, therefore, the Commission lacks jurisdiction over the petition for review with respect to 2001.

B. The taxpayer's teaching assistant position did not compensate the taxpayer for studying or for research and, therefore, is not exempt under the Income Tax Convention with the Russian Federation. Article 18 of this treaty provides that the taxpayer is not liable for income tax "with respect to the grant, allowance, or other similar payments." This language appears in the last of the eligible purposes stated in article 18:

> c) studying or doing research as a recipient of a *grant, allowance, or other similar payments* from a governmental, religious, charitable, scientific, literary, or educational organization (emphasis supplied).

Internal Revenue Service ("IRS") Publication 515 at Table 2, note 41, provides:

> Applies to grants, allowances, and other similar payments received for studying or doing research.

Article 18 of the treaty and the guidance from the IRS clearly provide that payments for studying and research are exempt from the income tax.

The language of the treaty and the guidance offered by the IRS do not unambiguously encompass income for teaching. Because the treaty is in the nature of a tax exemption, it is a matter of legislative grace and is to be given a strict but reasonable construction against a taxpayer who claims it, and a taxpayer who claims the exemption must show that the terms thereof clearly apply to him. The taxpayer has not met this burden. He has not shown that the plain language of the treaty applies to his income from his teaching assistant position.

The taxpayer argues that the teaching assistant position is tantamount to financial aid that he needed to stay in school, especially considering the limitations in his visa on outside income. That may be. But the payments made to the taxpayer for his teaching assistant position were for teaching, not compensation for studying or research. The payments may have facilitated the taxpayer's study; they were not, however, in exchange for his study.

At this time it is not known whether the taxpayer will appeal 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.

Assessments - timeliness; Earned income credit - responsibility to be aware of qualifications. *Angela C. Elliott vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, January 22, 2004). The issues in this case are:

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

B. Whether the taxpayer's failure to be apprised of the qualifications for the earned income credit ("EIC") prevented the department from assessing her for the amounts she erroneously claimed under this credit.

For each of the years 1998 through 2001, the taxpayer claimed head-of-household filing status and the EIC. During each of these years, she resided with her mother, and her mother's income exceeded her income.

Page 73 of the Internal Revenue Service ("IRS") publication *Reference Copies of Federal Tax Forms and Instructions* (Package X, Vol. 1) for 1998 contains the following example with respect to the EIC:

> **Example.** You and your 5-year-old daughter moved in with your mother in April 1998. You are not a qualifying child of your mother. Your daughter meets the conditions to be a qualifying child for both you and your mother. Your modified AGI for 1998 was $8,000 and your mother's was $14,000. Because your mother's modified AGI was higher, your daughter is your mother's qualifying child. You **cannot** take any EIC, even if your mother does not claim the credit. [Emphasis in original.]

Substantially the same example is found in the corresponding IRS publications for 1999 and 2000.

Under the date of August 12, 2002, the department issued an income tax assessment against the taxpayer for each of the years 1998 through 2001 in the principal amount of $6,439 and interest in the amount of $1,510.29. In its assessment, the department determined that the taxpayer was ineligible for head-of-household filing status because she did not pay more than half the cost of keeping up the cost of her home. The department also determined that the taxpayer was not eligible for the EIC because her mother's adjusted gross income was higher than hers.

The taxpayer filed a timely petition for redetermination with the department. Under the date of December 9, 2002, the department denied the petition for redetermination. The taxpayer filed a timely petition for review with the Commission.

The taxpayer challenged only the adjustment denying her the EIC for each of the years 1998 through 2001. She argued that it was the obligation of the IRS and/or the department to do a better job in providing notice to her that she was not eligible for the EIC. She also claimed that the department should have issued its assessment sooner so that she would not have continued to erroneously claim the EIC.

The Commission concluded as follows:

A. Section 71.77(2), Wis. Stats., authorizes the department to issue assessments up to four years after an income tax return is filed. The assessment was issued on August 12, 2002, well within the four-year statute of limitations for 1998, the first year at issue.

B. The taxpayer's failure to be apprised of the qualifications for the EIC does not prevent the department from assessing her for amounts she erroneously claimed under this credit.

   It is as true in tax law as it is in other areas of the law: ignorance of the law is no excuse. While changes in the tax statutes and regulations are published in various official and unofficial media, neither the IRS nor the department are responsible to list every possible permutation or situation in the booklets and forms that it provides to taxpayers. The taxpayer has the obligation to understand the tax laws as they apply to her situation or find someone, e.g. a tax preparer, who does.

   The taxpayer is not without resources. The department and the IRS offer publications, telephone hotlines and web sites. In fact, IRS instructions for 1998 through 2000 provided an example containing facts very similar to the taxpayer's situation. In this example, it is clear that a person in the taxpayer's situation was not eligible for the EIC.

The taxpayer has not appealed this decision.

Imposition of tax - covenant not to compete. *Frank D. and Billie J. Leach vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, March 29, 2004). The issue in this case is whether sec. 71.02(1), Wis. Stats., imposes tax on the income paid to a nonresident from a covenant not to compete.

The taxpayers were residents of Wisconsin prior to September 1998, and filed Wisconsin full-year resident income tax returns for each year through and including 1997. They have been residents of the state of Florida since September 15, 1998, and filed a 1998 Wisconsin Form 1NPR as part-year residents of Wisconsin from January 1, 1998 to September 11, 1998.

Frank D. Leach individually, Greenbriar Products, Inc., a Wisconsin manufacturing company located in Spring Green, Wisconsin ("Greenbriar"), and N.G.P., Inc. ("N.G.P."), entered into an asset purchase agreement dated April 16, 1999. Under the agreement, Greenbriar sold the business and substantially all of its assets to N.G.P. N.G.P. also purchased from Mr. Leach certain real property which was part of the facilities used by Greenbriar, but which was owned individually by Mr. Leach. Also under the agreement, Mr. Leach entered into a covenant not to compete with N.G.P. for five years for

the sum of $1 million in cash paid to him at closing, which occurred on April 16, 1999. The covenant not to compete applied to the entire United States and all foreign nations.

The taxpayers filed a 1999 Wisconsin Form 1NPR, indicating that they were nonresidents of Wisconsin and residents of Florida for calendar year 1999, and on which they did not report the $1 million payment for the covenant not to compete.

Under the date of December 24, 2001, the department issued an income tax assessment against the taxpayers in the amount of $82,338.73. The assessment adjusted the 1999 return to include the $1 million payment pursuant to the covenant not to compete. The taxpayers filed a timely petition for redetermination of the department's assessment. The petition for redetermination was denied, in part, by the department's notice of action dated August 12, 2002.

In its notice of action, the department adjusted the taxpayers' taxable income by prorating the income from the covenant not to compete based on the use of a three-factor formula. The proration generated a percentage of 39.31 percent, which was applied to the payment under the covenant not to compete, generating additional net income of $339,100 beyond the amount that was originally reported. The notice of action adjusted the assessment to $26,445.81 in tax and $7,929.40 in interest.

The three-factor formula used by the department was based upon sales, payroll, and property from Greenbriar. Amounts for the sales factor were double-weighted and included Greenbriar's sales in Wisconsin in the numerator and their gross receipts for sales everywhere in the denominator. Since all of Greenbriar's payroll and property are located in Wisconsin, the ratio for these two factors was each 100 percent. The data for the sales and property factors applied to Greenbriar's fiscal year ending August 31, 1999.

The parties stipulated that the sole issue for the Commission to decide was whether the taxpayers met their burden of proof that the department's notice of action incorrectly apportioned to Wisconsin a part of their 1999 income from the $1 million paid under the covenant not to compete. The taxpayers did not challenge the methodology of the apportionment, but rather the department's right in the first place to consider any portion of the $1 million payment Wisconsin income.

The department argued that Mr. Leach's right to compete, which he forfeited by signing the covenant not to compete, was a "property right with situs where the competition would occur in the absence of the covenant." They relied on a case decided by the California State Board of Equalization (*In re Appeals of Milhous*), in which it was concluded that a right to compete is an intangible right, with situs in any location where such competition would occur in the absence of such a covenant.

The Commission concluded that the Wisconsin income tax is not imposed on the $1 million payment received under the covenant not to compete. Section 71.02(1), Wis. Stats., imposes the income tax on "income…derived from property located" in Wisconsin. "Property" in sec. 71.02(1), Wis. Stats., is construed as not including intangible property rights, for two reasons:

- When an imposition statute is ambiguous, all doubts are resolved against taxability. Limiting "property" to tangible property certainly augurs against taxability in all cases.

- Context mandates the conclusion that "property" in sec. 71.02(1), Wis. Stats., does not include intangible property. In order for income to be taxable to nonresidents, it must be "derived from property *located*" in Wisconsin. [Emphasis supplied.] By its very nature, intangible property cannot be *located* anywhere. It is clear from this context that the legislature intended "property" to be limited to tangible property located within Wisconsin.

The department has not appealed but has adopted a position of nonacquiescence in regard to this decision. The effect of this action is that, although the decision is binding on the parties in this case, the Commission's conclusions of law, the rationale and construction of statutes in this case are not binding upon or required to be followed by the department in other cases.

Retirement funds exempt. *Paul and Barbara Weprinsky vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, April 6, 2004). The issue in this case is whether retirement benefits paid to Paul Weprinsky ("the taxpayer") are exempt from Wisconsin's income tax under sec. 71.05(1)(a), Wis. Stats.

Note: The Commission's decision in this case pertained to four dockets that were at issue (Docket Nos. 94-I-257, 95-I-04, 02-I-231-SC, and 02-I-232-SC). This summary pertains only to the Commission's decision regarding Docket No. 94-I-257.

The taxpayer commenced his military service with the federal government in 1955. His military service included active service. The department's action does not involve the taxpayer's income from his military pension, and it is not at issue here.

The taxpayer became a National Guard technician no earlier than September 14, 1965. His service as a National Guard technician ended on October 31, 1987. Upon his retirement, he began to collect a federal Civil Service Retirement System ("CSRS") pension based on his service as a National Guard technician.

The taxpayers reported the income from the CSRS pension on their 1987 and 1988 Wisconsin income tax returns. At some point prior to August 8, 1994, they filed a claim for refund of income tax they paid in 1987 and 1988 on the CSRS pension income. The department denied the claim for refund, and under the date of March 13, 1990, the taxpayers filed a petition for redetermination objecting to the denial. Under the date of August 8, 1994, the department denied the petition for redetermination. The taxpayers filed a petition for review with the Commission on August 15, 1994.

The taxpayer's assertion appeared to be that the CSRS gives him credit in its benefits calculation for service in the military or under the military retirement program, and, therefore, this makes him a constructive member of the CSRS on December 31, 1963. In support of this argument, he provided one page from the Commission's decision in *Hafner vs. Dep't of Revenue*. That portion of *Hafner* recounted the procedural history of *Department of Revenue v. Hogan* (*Hogan II*). As the Commission noted in *Hafner*, the Commission in *Hogan II* adopted the notion that sec. 71.05(1)(a), Wis. Stats., applied to members who had a "constructive" date of employment or service on December 31, 1963. The taxpayer's argument appeared to be that because he may be able to enhance his CSRS pension based on his military service, and because he was in the military on December 31, 1963, that this gives him a constructive membership in the CSRS on December 31, 1963.

The Commission concluded that the taxpayer's CSRS payments are not exempt from Wisconsin's income tax under sec. 71.05(1)(a), Wis. Stats., because he was not a member of the CSRS as a matter of historical fact on December 31, 1963.

Section 71.05(1)(a), Wis. Stats., provides that payments "which are paid on the account of any person who was a member of [an eligible retirement] system or fund as of December 31, 1963" are exempt from Wisconsin's income tax. Pension payments to the taxpayer based on his military service are exempt from Wisconsin's income tax. However, because the taxpayer did not become a member of the CSRS until 1965 at the earliest, his pension income from this system is not exempt under sec. 71.05(1)(a), Wis. Stats.

The taxpayer failed to note in his arguments that the Commission's decision in *Hogan II* was reversed by the Court of Appeals. The Court of Appeals did not address the issue of constructive membership. However in *Hafner*, the Commission rejected the notion of constructive membership and held that in order to qualify for the exemption under sec. 71.05(1)(a), Wis. Stats., a retiree must be a member "as a historical fact." This conclusion was explicitly affirmed by the Court of Appeals:

> The commission concluded that the statutory language was unambiguous – that when it talks about "membership" in the CSRS on the stated date, it means "membership as a historical fact, not membership that is constructive or purchased at a later date."
>
> …We consider this interpretation of the statute to be reasonable – both on its face and in light of prior decisions of the commission. …Indeed, … we consider the commission's interpretation to be not only the most reasonable, but quite possibly the *only* reasonable interpretation of WIS. STAT. § 71.05(1)(a).

Hogan II, 239 Wis. 2d at 224-26 (emphasis in original).

The taxpayers have not appealed this decision.

SALES AND USE TAXES

Admissions - hunting fees. *Granite Ridge Ranch, LLC vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, April 7, 2004). The issues in this case are:

A. Whether the trophy fees and wounded animal fees the taxpayer charged in relation to animal hunts conducted at its game ranch were subject to sales tax.

B. Whether the department's assessment of sales tax is barred by the doctrine of "laches."

The taxpayer is a Wisconsin limited liability company that operates a game ranch in Wisconsin. During the period under review, the taxpayer held game hunts at its ranch, charging two types of fees. One type of fee charged was a "hunt fee," which, prior to 1997, was based on a daily rate of $150 for a one-day hunt, $175 for two days, and $200 for three days. Also, until the fall of 1997, the taxpayer charged a "trophy fee," which, until the fall of 1996, was based on the number of animals taken and, from the fall of 1996 through the spring of 1997, was based on the weight of the animal taken. The trophy status of an animal is directly related to the weight of the animal. The primary motivation of hunters at the taxpayer's ranch is to obtain trophy animals. Trophy fees ranged from $225 per animal in 1995 to $275 per animal in 1996 and, from the fall of 1996 through the spring of 1997, $240 for an animal weighing less than 200 pounds to $550 for an animal weighing 400 pounds or more.

Beginning in the fall of 1997, hunt fees were based on a one-day or two-day hunt fee if no animal was taken, and a fee that varied based on the weight of an animal that was taken. Examples of the fees based on animal weight beginning in the fall of 1997 are $350 for an animal weighing less than 200 pounds, and $650 for an animal weighing 400 pounds or more. At times, the taxpayer charged more for animals that displayed enhanced trophy status, beyond the animal's weight. For example, a nine-point buck would result in a fee of $1,800. The hunt fees charged by the taxpayer included the hunt, meals and lodging during the hunt, field dressing animals taken, and the animals taken. The taxpayer also charged a fee if an animal was wounded, which charge was refunded if the animal survived.

Although the taxpayer paid sales tax on the "hunt fees," it contended the "trophy fees" and fees for wounded animals were not subject to tax because they were payments for food for human consumption. The taxpayer also contended that because the department possessed the taxpayer's income tax return but did not notify the taxpayer of its requirement to charge sales tax, the department's assessment of sales tax on the trophy and wounded animal fees was barred by the doctrine of "laches." Laches is a defense to an action based upon an unreasonable delay by a plaintiff, and an equitable remedy in which the party seeking the remedy must come to the court with clean hands, not seeking relief from a predicament of its own making.

The Commission concluded that the trophy and wounded animal fees were subject to sales tax. The trophy fees are actually fees for the trophy status of the animals taken. The animals are not food for human consumption because they are only field dressed, and the meat of some of the animals taken is available commercially for substantially less cost. The primary intention of hunters at the taxpayer's ranch is to obtain trophy animals rather than meat.

The Commission also concluded that the department's assessment of sales tax on the trophy and wounded animal fees was not barred by the doctrine of laches because the taxpayer had failed to comply with the sales tax law, and thus did not come to the Commission with clean hands. Also, the department's action was reasonable because it was within the statute of limitations.

The taxpayer has not appealed this decision.

Appeals - attorney fees and costs. *Plaza Publications, Inc.. vs. Wisconsin Department of* Revenue (Wisconsin Tax Appeals Commission, April 6, 2004). The issues in this case is whether the taxpayer should be awarded attorney fees and costs related to the Commission's decision of January 31, 2003. See *Wisconsin Tax Bulletin* 134 (April 2003), page 25, for a summary of the Commission's decision.

On October 6, 2003, the Dane County Circuit Court issued a decision reversing the conclusion reached by the Commission in the January 31, 2003 decision. See *Wisconsin Tax Bulletin* 138 (April 2004), page 23, for a summary of the Circuit Court's decision. The taxpayer has not appealed the Circuit Court's decision.

Under sec. 227.485, Wis. Stats. (2001-02), attorney fees and costs may be awarded to a taxpayer litigating against the State if the taxpayer, along with other requirements, prevails in its appeal.

Because the taxpayer did not prevail in the Circuit Court decision, and has not appealed the Circuit Court's decision, the Commission concluded that the taxpayer's request for attorney fees and costs is denied.

The taxpayer has not appealed this decision.

Services subject to tax - pet cremation service. *Thompson Animal Medical Center, Ltd. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, February 27, 2004). The issue in this case is whether the animal cremation service provided by the taxpayer is subject to tax when the animal remains are returned to the customer.

The taxpayer is a Wisconsin corporation engaged in the business of providing veterinary services. During the period under review, the taxpayer offered animal cremation services to its customers for a fee. The taxpayer did not perform the cremations, but contracted with a third party to perform the actual cremations. In one-third of the cases, the remains of the cremated animal were returned to the customer by the taxpayer, and the department assessed the taxpayer sales tax on these cremations. In the other two-thirds of the cremations, the remains were disposed of by the third party crematory.

The Commission concluded that the animal cremation service provided by the taxpayer that was assessed by the department is subject to tax. One of the facts agreed to by the taxpayer and the department is that "a cremation service is not classified as a veterinary service." Because of this stipulation, the cremation service is not an exempt service under sec. 77.52(2)(a)10, Wis. Stats., which provides in part that "'Service' does not include services performed by veterinarians." The alteration of tangible personal property is subject to sales tax under sec. 77.52(2)(a)10, Wis. Stats., and the cremation service in this case involves the alteration of tangible personal property (animals).

The taxpayer has not appealed this decision.