

nation does not reflect economic reality within the meaning of Department of Revenue v. Sterling Custom Homes, 91 Wis. 2d 675, 679 (1979). The fact that Kohler referred to the display materials as "free" or "no charge" is irrelevant to the economic realities of the taxed transactions. The department and the Commission have confused the concepts of cost and price. Given this standard and the evidence of record, the Court of Appeals concluded that reasonable minds could not have made the same determination as the Commission. Because the record showed that Kohler recouped the costs of all included decorative items, the Court of Appeals concluded those items were resold and were not gifts. Kohler is therefore not liable for a use tax on the items.

The department has appealed this decision to the Supreme Court.

**Schuster Construction Company vs. Wisconsin Department of Revenue** (Court of Appeals, District IV, July 11, 1985). Schuster Construction Company appealed a Circuit Court order which affirmed an order of the Wisconsin Tax Appeals Commission. The taxpayer contended the Commission erred in limiting its jurisdiction to issues raised in the petition for redetermination, and in concluding that the taxpayer failed to show good cause which would abate the penalty imposed on a sales and use tax deficiency. (See WTB #38 for a summary of the Circuit Court's decision.)

The Department of Revenue notified the taxpayer of a sales and use tax deficiency determination including

interest and a penalty. The taxpayer filed a petition for redetermination which stated in part: "[W]e are requesting partial abatement of the proposed addition to the Sales Taxes for the periods 1974, 1975, 1976, 1977, and January 1, to August 31, 1978. We do not object to the measure of the tax; however, the objection is to the penalty as proposed in the amount of \$23,049.53."

The department denied the petition for redetermination. The taxpayer filed a petition for review of the department's decision, and at the hearing on the petition, the taxpayer contended it was appealing the assessment plus interest, as well as the penalty. The Commission ruled that it lacked jurisdiction to decide issues not raised in the petition for redetermination and upheld imposition of the penalty. The Circuit Court affirmed.

While the statutes governing petitions for redetermination are silent as to the contents of a petition, the administrative rules are not. Wis. Adm. Code section Tax 3.91 provides that "[t]he petition for redetermination specified in sections 71.12(1), . . . and 77.59(6), Wis. Stats., shall . . . set forth clearly and concisely the specific grievances to the assessment or to parts thereof, including a statement of the relevant facts and propositions of law upon which the grievance is based". The failure to set forth all grievances precludes their consideration as would failure to specify an issue in a petition for review before the Commission.

The record does not contain a closing stipulation indicating that the

parties agreed on different issues at an informal conference (Wis. Adm. Code section Tax 3.93). In the absence of such a stipulation, the Court is bound by the issues alleged in the petition.

The taxpayer challenged the Commission's finding that it failed to show good cause which would abate the penalty. A court must uphold an administrative agency's factual finding if, "upon an examination of the entire record, the evidence, including the inferences therefrom, is found to be such that a reasonable man, acting reasonably, *might* have reached the decision. . . ."

A field auditor for the department testified that he recommended imposition of a penalty because the taxpayer had previously been penalized and had made very few changes in its procedures. The taxpayer did not ask how to compute the use tax. The method used in the prior audit was employed because proper records were not kept. The taxpayer offered no evidence of the reasonableness of its reliance on other companies' representations that purchases were exempt, or that there was good cause for its accounting error.

A reasonable person could have found that the taxpayer did not meet its burden of proving there was good cause for the error. Substantial evidence supports the finding.

The Court of Appeals affirmed the Circuit Court order.

The Supreme Court denied the taxpayer's petition for review.

## TAX RELEASES

*("Tax Releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. However, the answer may not apply to all questions of a similar nature. In situations where the facts vary from those given herein, it is recommended that advice be sought from the Department. Unless otherwise indicated, Tax Releases apply for all periods open to adjustment. All references to section numbers are to the Wisconsin Statutes unless otherwise noted.)*

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**INDIVIDUAL INCOME TAXES**

**1. Gain on Installment Sales—Persons Moving Into or Out of Wisconsin**

Statutes: sections 71.07(1) and 71.05(1)(a)5, 1983 Wis. Stats.

Wis. Adm. Code: section Tax 2.30 and 2.95, September 1983 Register

Facts and Question: Sales of tangible property (e.g., land, buildings, machinery) or intangible property (e.g., stocks, bonds) may be made under installment arrangements that provide for a part or all of the sales price to be paid after the year in which the sales are made. If these sales result in gains and qualify for Wisconsin tax purposes under the installment method of reporting income, the gross profit may be prorated over the period in which payments under the installment arrangement are received.

For individuals moving into or out of Wisconsin, how are these installment payments (gross profit and interest) taxed for Wisconsin income tax purposes?

Answer: For both residents and nonresidents for taxable years prior to 1975, gain or loss derived from the sale of real property or tangible personal property followed the situs of the property. Gain or loss from the sale of intangible personal property followed the residence of the individual.

Beginning with the 1975 taxable year and thereafter, all gain or loss realized or incurred while a Wisconsin resident from the sale of real property, tangible personal property, and intangible personal property is taxable by Wisconsin, regardless of where the property is located. However, the amount of gain which is includable in Wisconsin taxable income from the sale of property located outside Wisconsin is limited to the gain portion of the installment payments received while a Wisconsin resident. The gain from the sale of such out-of-state property sold while the individual is a nonresident is not taxable for Wisconsin purposes (s. 71.07(1), 1983 Wis. Stats., and Wis. Adm. Code section Tax 2.30 and 2.95).

**A. Persons Moving Into Wisconsin**

For sales of property reported under the installment method by individuals who move into Wisconsin, the gain portion of each installment payment received after Wisconsin residence is established is treated as follows:

- (1) The gain is taxable by Wisconsin for sales of
  - (a) Tangible property (e.g., land, buildings, machinery) located in Wisconsin.
  - (b) Tangible property located outside Wisconsin if the sale occurred in 1975 or later and the seller was a Wisconsin resident at the date of sale (see

Wis. Adm. Code section Tax 2.30 for computation of gain).

- (c) Intangible property (e.g., stocks, bonds) if the seller was a Wisconsin resident at the date of sale.
- (2) The gain is not taxable by Wisconsin for sales of
  - (a) Tangible property located outside Wisconsin if the sale occurred prior to 1975 or if the seller was a nonresident at the date of sale of the tangible property.
  - (b) Intangible property if the seller was a nonresident at the date of sale.

The interest portions of installment payments received by Wisconsin residents are taxable by Wisconsin, regardless of whether the taxpayer was a resident or nonresident at the time of sale.

Example 1: A taxpayer moved from Arkansas and became a Wisconsin resident on July 1, 1984. On January 3, 1984, while an Arkansas resident, he sold his Arkansas building in an installment sale. The gross profit percentage for the sale was 60% and interest was charged at the rate of 10%. On November 15, 1984, he sold business equipment located in Arkansas in an installment sale with a gross profit percentage of 40% and interest at a rate of 10%. He received the following installment payments in 1984:

Sale of Building

| State of Residence on Date of Payment | Date of Payment | Total Payment   | Principal       | Gain Portion (60% of Principal) | Interest       |
|---------------------------------------|-----------------|-----------------|-----------------|---------------------------------|----------------|
| Ark.                                  | 6/30/84         | \$13,000        | \$ 8,000        | \$4,800                         | \$5,000        |
| Wis.                                  | 12/31/84        | 9,100           | 4,500           | 2,700                           | 4,600          |
| Total                                 |                 | <u>\$22,100</u> | <u>\$12,500</u> | <u>\$7,500</u>                  | <u>\$9,600</u> |

Sale of Equipment

| State of Residence on Date of Payment | Date of Payment | Total Payment   | Principal       | Gain Portion (40% of Principal) | Interest     |
|---------------------------------------|-----------------|-----------------|-----------------|---------------------------------|--------------|
| Wis.                                  | 11/15/84        | \$ 2,000        | \$ 2,000        | \$ 800                          | \$ 0         |
| Wis.                                  | 12/15/84        | 585             | 500             | 200                             | 85           |
| Total                                 |                 | <u>\$ 2,585</u> | <u>\$ 2,500</u> | <u>\$1,000</u>                  | <u>\$ 85</u> |

Building: None of the \$7,500 gain on the sale of the building is taxable by Wisconsin because the building was sold while the taxpayer was an Arkansas resident. Interest income of \$4,600 (12/31/84 interest) is taxable by Wisconsin.

Equipment: The total gain of \$1,000 is taxable by Wisconsin because the taxpayer was a Wisconsin resident on the date of sale. Interest income of \$85 is also taxable on his 1984 Wisconsin return.

Example 2: A taxpayer moved into Wisconsin and became a Wisconsin resident on November 10, 1978. Prior to her move, she sold her interest in a partnership (intangible asset) at a gain and elected to report the proceeds under the installment method.

The gain from the sale of the partnership interest is not taxable by Wisconsin, but any interest income received after Wisconsin residence was established must be reported to Wisconsin.

**B. Persons Moving Out of Wisconsin**

When a Wisconsin resident sells property under the installment method and later moves out of the state, the gain portion of the installment payments received after Wisconsin residence is terminated may be taxable to Wisconsin, depending on the type of property (tangible or intangible), the property's location at the date of sale, and the date the installment payments are received.

For years prior to 1982, gain realized on the sale of a Wisconsin residence was taxable if the replacement residence was not located in Wisconsin (s. 71.05(1)(a)5, 1983 Wis. Stats.). Beginning with the 1982 taxable year, gain realized on the sale of a Wisconsin residence may be deferred in accordance with Section 1034(a) of the Internal Revenue Code even though the replacement residence is outside Wisconsin. Since no gain is realized under the installment method until payment is received, if a residence was sold prior to 1982 and an out-of-state replacement residence was acquired, installment payments received in 1982 and subsequent years are not taxable by Wisconsin provided the individual qualifies for deferral of gain under Section 1034(a) of the Internal Revenue Code.

For property sold while a Wisconsin resident and reported under the installment method by individuals who move out of Wisconsin, the gain portion of each installment payment received after the individual's Wisconsin residence is terminated is treated as follows:

(1) The gain is taxable by Wisconsin for sales of

- (a) Tangible property other than a principal residence (e.g., land, buildings, machinery) located in Wisconsin.
- (b) A principal residence located in Wisconsin if the gain may not be deferred or excluded from income under the Internal Revenue Code (e.g., a more expensive residence is not purchased or the taxpayer does not qualify for the age 55 and over exclusion).
- (c) A principal residence located in Wisconsin if the replacement residence is outside Wisconsin and the sale occurred prior to 1982, for payments received prior to 1982. (For payments received in 1982 and subsequent years, gain is not taxable by Wisconsin provided the individual qualifies for deferral of gain under Section 1034(a) of the Internal Revenue Code.)

(2) The gain is not taxable by Wisconsin for sales of

- (a) Tangible property located outside Wisconsin.
- (b) A principal residence located in Wisconsin if the replacement residence is outside Wisconsin and the sale occurred prior to 1982, for payments received in 1982 and subsequent years, provided the individual qualifies for deferral of gain under Section 1034(a) of the Internal Revenue Code.
- (c) A principal residence located in Wisconsin if the replacement residence is outside Wisconsin and

the sale occurs in 1982 or thereafter, provided the individual qualifies for deferral of gain under Section 1034(a) of the Internal Revenue Code.

- (d) Intangible property, regardless of where the property is located.

The interest income portions of installment payments received by an individual after his or her Wisconsin residence is terminated (i.e., while a nonresident) are not taxable by Wisconsin.

**Example 1:** A taxpayer moved from Wisconsin and became a Florida resident on October 15, 1984. On January 20, 1984 she sold her Wisconsin summer cottage in an installment sale. The gross profit percentage for the sale was 32% and the interest rate was 12%. She received the following installment payments in 1984:

| State of Residence on Date of Payment | Date of Payment | Total Payment   | Principal       | Gain Portion (32% of Principal) | Interest       |
|---------------------------------------|-----------------|-----------------|-----------------|---------------------------------|----------------|
| Wis.                                  | 4/20/84         | \$ 4,700        | \$ 3,500        | \$1,120                         | \$1,200        |
| Wis.                                  | 7/20/84         | 4,595           | 3,500           | 1,120                           | 1,095          |
| Florida                               | 10/20/84        | 4,490           | 3,500           | 1,120                           | 990            |
| <b>Total</b>                          |                 | <b>\$13,785</b> | <b>\$10,500</b> | <b>\$3,360</b>                  | <b>\$3,285</b> |

The taxpayer must report a gain of \$3,360 and interest income of \$2,295 (\$1,200 and \$1,095) on her 1984 Wisconsin return. The interest income of \$990 received while a Florida resident is not taxable by Wisconsin.

**Example 2:** A taxpayer moved out of Wisconsin and became an Iowa resident on February 15, 1984. Prior to moving out he sold shares of stock (intangible asset) at a gain which he is reporting under the installment method. The gross profit percentage was 20% and he received interest at a rate of 8%. He received the following installment payments in 1984:

| State of Residence on Date of Payment | Date of Payment | Total Payment | Principal | Gain Portion (20% of Principal) | Interest |
|---------------------------------------|-----------------|---------------|-----------|---------------------------------|----------|
| Wis.                                  | 1/30/84         | \$500         | \$340     | \$68                            | \$160    |
| Iowa                                  | 5/30/84         | 500           | 350       | 70                              | 150      |
| Iowa                                  | 9/30/84         | 500           | 360       | 72                              | 140      |

The taxpayer must report a gain of \$68 (1/30/84 gain) and interest of \$160 (1/30/84 interest) on his 1984 Wisconsin return. If the taxpayer had sold the stock on or after February 15, 1984 (i.e., while an Iowa resident), no portion of the installment payments would be taxable by Wisconsin.

**Example 3:** On July 1, 1980, a taxpayer sold his Wisconsin residence for \$100,000 on a land contract. The contract provided for a \$25,000 down payment and principal payments of \$15,000 on July 1, 1981, 1982, 1983, 1984 and 1985. The taxpayer realized a \$35,000 gain on the sale. He purchased a new residence outside Wisconsin for \$125,000. For federal purposes, he must defer the \$35,000 gain. He elected to report the gain under the installment method for Wisconsin. Under the installment method, the following amounts of gain would be realized each year:

| Year | Principal Payment | Gain Portion    |
|------|-------------------|-----------------|
| 1980 | \$ 25,000         | \$ 8,750        |
| 1981 | 15,000            | 5,250           |
| 1982 | 15,000            | 5,250           |
| 1983 | 15,000            | 5,250           |
| 1984 | 15,000            | 5,250           |
| 1985 | 15,000            | 5,250           |
|      | <u>\$100,000</u>  | <u>\$35,000</u> |

The taxpayer is required to report \$8,750 of gain as an addition modification on his 1980 return and \$5,250 of gain in 1981. Since no gain is realized under the installment method until the taxpayer has received payment, the gains on the installment payments received in 1982 and subsequent years are not taxable by Wisconsin.

## 2. Land Contract as "Security" in Corporate Liquidation

Statutes: section 71.333(4), 1983 Wis. Stats.

Facts and Question: Under s. 71.333(4), 1983 Wis. Stats., the gain to be recognized by a shareholder for the year of corporate liquidation is limited to the greater of

- The portion of assets received by the shareholder which consists of money, or of stock or securities acquired by the liquidating corporation after January 1, 1955, or
- The shareholder's ratable share of the earnings or profits of the liquidating corporation accumulated after January 1, 1911.

A corporation has the following net assets to distribute in liquidation:

|                                 |                  |
|---------------------------------|------------------|
| Cash                            | \$ 5,000         |
| Land contract receivable        | 30,000           |
| Equipment and real estate       | 500,000          |
| Less: Liability owing           | (435,000)        |
| Net fair market value of assets | <u>\$100,000</u> |

Does the \$30,000 land contract receivable constitute a "security" within the meaning of s. 71.333, 1983 Wis. Stats., and accordingly subject the taxpayer to recognition of gain on that asset in the year of liquidation?

Answer: No. "Securities" is a term which may acquire different meanings depending upon the circumstances and context with which the term is used. For this purpose, the term should take on a meaning which contemplates the use of one's money by another as an investment in a business enterprise. The nature of the debt should evidence a continuing interest in the affairs of the corporation. In addition to stocks, "securities" would include bonds and notes, usually of a long-term duration. Although "securities" would not have to possess all of the attributes of stock, the phrase "stock or securities" as used in s. 71.333, 1983 Wis. Stats., should take on a meaning similar to stock. When viewed in this context, a land contract would not be a security. In the instant case, the land contract simply represents the balance due the seller under the terms of a standard land contract.

## CORPORATION FRANCHISE/INCOME TAXES

### 1. Expenses Related to Wholly Exempt Income

Statutes: section 71.04(2)(b)9, (4)(b) and (7m), 1983 Wis. Stats.

Note: This Tax Release is a corrected version of the Tax Release which originally was published in Wisconsin Tax Bulletin #44. This Tax Release applies to taxable years 1983 and thereafter, as well as retroactively to the earliest taxable year in which additional assessments or refunds may be made as of July 2, 1983.

Facts: Section 71.04(2)(b)9 and (7m), 1983 Wis. Stats., effective for the taxable year 1983 and thereafter and effective retroactively to the earliest taxable year in which additional assessments or refunds may be made as of July 2, 1983, does not allow deductions related to "wholly exempt income". Wholly exempt income for corporations subject to Wisconsin franchise or income tax includes amounts received from affiliated or subsidiary corporations for interest, dividends or capital gains that, because of the degree of common ownership, control or management between the payor and payee, are not subject to taxation under Chapter 71. Interest on obligations of the United States is included in "wholly exempt income" for a corporation subject to the income tax.

In 1983, Corporation X received \$1,000 in dividends from Corporation Y, a nonunitary subsidiary, and \$5,000 in dividends from Corporation Z, a unitary subsidiary. Both Corporation Y and Corporation Z are wholly owned subsidiaries of Corporation X. Because Corporation Y is a nonunitary subsidiary of Corporation X, the \$1,000 in dividends Corporation X received from Corporation Y is exempt from taxation under Chapter 71. The \$5,000 in dividends Corporation X received from Corporation Z is not exempt under Chapter 71 but would be deductible to the extent of \$2,500 under s. 71.04(4)(b), 1983 Wis. Stats.

Question 1: Does "wholly exempt income" for Corporation X include the \$2,500 in deductible dividends under s. 71.04(4)(b), 1983 Wis. Stats., received from Corporation Z in addition to the \$1,000 in dividends received from the nonunitary subsidiary Corporation Y?

Answer 1: Section 71.04(2)(b)9, 1983 Wis. Stats., does not apply to the \$2,500 in dividends deductible under s. 71.04(4)(b) because of the definition of "wholly exempt income". Section 71.04(2)(b)9, 1983 Wis. Stats., states that wholly exempt income does not include income excludable, exempt or deductible under specific provisions of Chapter 71. In this case, only the \$1,000 would be considered "wholly exempt income".

Question 2: What types of expenses would be included as nondeductible under s. 71.04(2)(b)9, 1983 Wis. Stats.?

Answer 2: Section 71.04(2)(b)9, 1983 Wis. Stats., specifies any amount directly or indirectly related to producing wholly exempt income is not deductible. Examples of such expenses would be taxes, interest, and administrative fees related to the production of this wholly exempt income.

### 2. Declaration Requirements of Surviving Corporation After Merger

Statutes: section 71.22(10)(a), 1983 Wis. Stats.

Facts and Question: Corporation A merges into Corporation B on July 31, 1984. A's net tax liability for 1983 was