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:

CORPORATION FRANCHISE AND INCOME TAXES

Amended returns — interpretation of settlement stipulation. *Lyndon Insurance Company vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, April 24, 1995; revised decision July 6, 1995). Following are the issues presented in this case:

A. Whether refunds due to the taxpayer for the 1981, 1982, and 1983 taxable years to reflect certain Internal Revenue Service adjustments to federal taxable income should be calculated using the apportionment percentages disclosed in the amended returns filed by the taxpayer in May 1991, using a weighted average (60% for the taxpayer, 40% for the department) of the respective apportionment percentage positions of the parties during the first appeal, or whether the refund claims should be calculated in the manner detailed in the department's schedule supporting its July 25, 1991, notice of assessment.

B. Whether the department applied figures correctly reflecting "Tax Previously Assessed" in the schedule accompanying its assessment notice.

The issues in this case are based upon the taxpayer's filing of original Wisconsin Insurance Franchise Tax returns for 1981, 1982, and 1983, the taxpayer's subsequent filing of amended returns corresponding to those years, and the department's issuance of an assessment notice dated December 16, 1985, in which the department recalculated the tax impact of the Internal Revenue Service adjustments reported on the amended returns.

On each of its original 1981 through 1983 Wisconsin returns, the taxpayer reported an amount of 0% for "Percent of premiums outside of Wisconsin" and an amount of 100% for "Percent of payroll outside Wisconsin." The average of premiums and payroll indicated on each of the taxpayer's original 1981 through 1983 Wisconsin returns was 50%.

In a notice dated May 12, 1983, the department issued its first office audit adjustments to the taxpayer, which resulted in a net refund to the taxpayer. There were no adjustments made in the audit on the basis of error in the taxpayer's use of the 100% payroll factor, the 0% premiums factor, or the 50% average of premiums and payroll factor. There was no audit of the payroll, premiums, or average of payroll and premiums factors. The taxpayer did not appeal the department's May 12, 1983, office audit.

In a notice dated December 16, 1985, the department issued a second office audit assessment to the taxpayer for the years 1979 through 1984. In this second office audit, the department adjusted the taxpayer's previously reported payroll factor from 100% to 0% for the years 1981 through 1984, with the premiums factor remaining unadjusted at 0%.

On February 6, 1986, the taxpayer filed a petition for redetermination of the department's second office audit, objecting to specific adjustments therein and also including two general claims for refund.

The taxpayer's first general claim for refund was based on a deduction for

premium taxes and other state taxes which were omitted from its original returns for the years 1981 through 1983. These deductions were claimed as a result of adjustments made by the department in its first office audit, as set forth in the notice of refund dated May 12, 1983.

The taxpayer's second general claim for refund was based on a request that the 0% premiums factor used on its original returns for the years 1981 through 1983 be changed to include reinsurance premiums in the total premiums factor. The taxpayer did not specify the apportionment factor effect of this premiums factor change reflected in its claim for refund, but stated that it would "provide recomputed apportionment factors to include total premiums written on all property and risks, other than life insurance, for the years under audit by the Department."

On June 12, 1987, the department issued a notice of action in which it allowed the 100% payroll factor, with the average of premiums and payroll factors returning to 50% as originally reported by the taxpayer on its 1981 through 1983 returns. The result of the department's notice of action was a refund owing to the taxpayer.

Also on June 12, 1987, the department issued notices of action denying each of the taxpayer's claims for refund for various reasons, stating, "It is the department's position that under the provisions of Section 71.01(4)(a)6, Wis. Stats., premium taxes are not deductible. It is also the department's position that under the provisions of Section 71.01(4)(c)1 premiums written mean direct premiums written and not gross or net premiums."

The taxpayer appealed the department's three actions to the Tax Appeals Commission ("the first appeal"). On February 9, 1989, the Commission signed and filed a settlement stipulation disposing of the first appeal. Two schedules were attached to the settlement stipulation and are incorporated by reference into the language of the stipulation and order signed by the parties and approved by the Commission.

Schedule 1 incorporated in the settlement stipulation begins with "Adjusted Federal Taxable Income per Appellate Action Dated 6/12/87," and adjusts those figures for 1981 through 1983 to reflect amounts allowed by the department for each year for reverse fire department dues and premium taxes to reach an "Adjusted Federal Taxable Income — Amended" ("AFTI—Amended") figure for each year. Next in the Schedule 1 calculations, the product of the "AFTI—Amended" figure and the appropriate multiplier for "Net Gain From Operations, Other Than Life Insurance" produced "Total Income, Other Than Life Insurance." This total income figure was then multiplied by the apportionment percentages from Schedule 2 to produce "Total Income, Other Than Life Insurance, Outside Wisconsin" and, by subtraction, "Wisconsin Net Income." By applying the appropriate tax rates, the Schedule 1 calculations provided an adjusted tax liability for each year and compared this amount with the previously assessed amount per the action by the department's Appellate Bureau to generate an overpayment figure. Finally, the overpayment figure was multiplied by 60% to represent the amount of the claimed overpayment to be conceded by the department to the taxpayer to settle the first appeal. Interest calculated at 9% annually through February 10, 1989, was also applied to the agreed upon overpayment amount in the schedule.

Because of the settlement, the issue of the apportionment percentages was never litigated in a hearing before the Commission and was never the subject of any findings of fact or conclusions of law by the Commission. The settlement stipulation contains no language addressing how the terms of the settlement, whether incorporated in schedules or otherwise, were to be applied to any subsequent action affecting the tax liabilities of the taxpayer for the years covered by the settlement.

In May 1991, the taxpayer filed amended Wisconsin Insurance Franchise Tax returns for 1979 through 1983 to reflect adjustments made to federal taxable income by the Internal Revenue Service for those years. On the amended returns submitted by the taxpayer, the average of premiums and payroll factors used was 74.3648% for 1981, 74.4910% for 1982, and 77.5295% for 1983. These averages were derived by taking a weighted average of the department's and the taxpayer's positions concerning applicable apportionment percentages prior to settlement of the first appeal, according to a 60% for taxpayer, 40% for department weighting scheme.

The department did not accept the taxpayer's amended Wisconsin returns for 1981 through 1983, its position being that the settlement stipulation was not an agreement between the parties on the apportionment factors but was merely an agreement to refund 60% of the tax refund then in dispute based on the difference in opinion between the parties.

An assessment notice was issued, dated July 25, 1991, in which the department netted amounts of tax and interest due from the 1979 and 1980 taxable years (not at issue here) with amended refund amounts for the 1981 through 1983 taxable years, resulting in an assessment due. In making its calculations, the department applied the same line-by-line analysis detailed

in Schedule 1 attached to the settlement stipulation from the first appeal. As with the first appeal, the calculations began with adjusted federal taxable income, incorporated the taxpayer's adjustments to this figure as reported in the amended returns, and then applied the same multipliers and apportionment percentages used in the settlement schedules to arrive at an adjusted Wisconsin net income and adjusted Wisconsin tax liability for 1981 through 1983. The adjusted Wisconsin tax liability for each year was then compared with the adjusted tax liability previously determined for each year in the settlement schedule from the first appeal to arrive at new figures for overpayment. The revised overpayment figures for each year were multiplied by the 60% compromise factor used in the settlement schedules from the first appeal to arrive at refunds due to the taxpayer, once again applying interest due on the overpayment.

The taxpayer filed a petition for redetermination dated October 3, 1991, which took the position that the settlement stipulation was an agreement between the parties on the apportionment factors to be used for each of the years under review. It was the taxpayer's view that the apportionment figures themselves were to have been weighted by the 60%-40% compromise which it contended was derivative from the settlement schedules incorporated in the stipulation and order from the first appeal.

The Commission reached the following conclusions:

A. There is no basis for concluding that an agreement or consent of the parties to a weighted average apportionment may be found or derived from the settlement stipulation entered into in the first appeal, because this alleged agreement or consent is not set forth in the written terms of the settlement agreement or its accompanying schedules as required under sec. 807.05, Wis. Stats., and adequate support for inferring such an agreement has not been provided by the taxpayer. The Commission concluded, however, that the parties did agree upon a methodology for making refund calculations for the 1981 through 1983 taxable years, as set forth in the settlement agreement from the first appeal and as applied by the department in the schedule accompanying its assessment notice dated July 25, 1991.

B. The taxpayer has failed to show by clear and satisfactory evidence that the department improperly used the "Adjusted Tax Liability" figures from the 1989 settlement stipulation as "Tax Previously Assessed" in the schedule accompanying its assessment notice under review herein.

Therefore, the Commission affirmed the department's action denying the taxpayer's petition for redetermination.

The taxpayer has not appealed this decision. □

SALES AND USE TAXES

Claims for refund — time limitation for filing. *D&S Dental Laboratory, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, June 14, 1995). The issue in this case is whether the taxpayer's refund claim was timely filed.

By notice from the department dated August 1, 1991, a field audit assessment of sales tax was issued against the taxpayer. The taxpayer paid the field audit assessment by its check dated August 6, 1991, which was received by the department on August 7, 1991.

On August 6, 1993, the department received a refund claim from the taxpayer for the amount of the field audit assessment. The department rejected the taxpayer's refund claim because the refund claim was not received by the department within two years of the field audit assessment issued August 1, 1991.

The taxpayer argues that sec. 77.59(4)(a), Wis. Stats., allows a refund claim to be filed within 2 years after the tax payment date. The department maintains that the refund claim must be filed within 2 years after the assessment date.

The Commission concluded that the taxpayer's refund claim was not timely filed. Because the taxpayer missed the deadline imposed by sec. 77.59(4)(a), Wis. Stats., for filing a claim for refund, neither the department nor the Commission has jurisdiction to consider the taxpayer's claim on its merits.

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

Computer software — tangible vs. intangible. *Wisconsin Department of Revenue vs. Manpower International, Inc.* (Circuit Court for Dane County, June 15, 1995). This is a review of the August 15, 1994 decision of the Wisconsin Tax Appeals Commission. For a summary of that decision, see *Wisconsin Tax Bulletin* 89 (October 1994), page 13. The issues in this case are:

A. Whether "canned" or "pre-written" software leased by the taxpayer is tangible personal property and subject to sales or use tax.

B. Whether "canned" or "pre-written" software leased by the taxpayer is an accessory, component, attachment or part to tangible personal property in the form of computer hardware and subject to sales or use tax.

C. Whether the taxpayer's lease of "canned" or "pre-written" software is a purchase of a taxable service.

Software, also referred to as a "computer program" or "program," is any set of specific instructions in a machine-readable form that the computer uses to perform a task. The "instructions" are in machine language, in the form of encoded magnetic impulses, which the computer "reads" electronically in order to enable it to accomplish a specific task.

All the software at issue here is non-custom software, also referred to as "canned" or "pre-written" software. This is in contrast to "custom" software, which 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 its needs, is generally usable by the customer as written, and is "loaded" into the computer memory by the customer.

Usually when the taxpayer utilizes a new program it is received at the taxpayer's location on magnetic tape or diskettes and then loaded onto the taxpayer's computer. The process of "copying" a new program into the computer's memory unit requires a rearrangement of the memory unit at the molecular level so that the computer's memory media contains a reproduction of the new program. Memory units in computers are tangible personal property. However, although the taxpayer received canned software in this manner, it would have been possible to obtain the programs at issue in another form, such as transmitting the programs over telephone lines. Once copied onto the taxpayer's disk drive, the program can continue being used without ever having to go back to the original tape or diskette (which retains the program unless it is recorded over or magnetically erased). A copy of the tape or diskette is often retained by the taxpayer for "archive" or backup purposes.

With each purchase of software the taxpayer received one or more magnetic tapes or diskettes, along with written manuals. The cost of the blank tape used to transmit the copy of the program is minimal in comparison to the total charge for the program: approximately $1.00 per blank diskette, and about $5.00 per blank magnetic tape. The taxpayer cannot 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 loading the programs, or whether any such tapes or diskettes were in fact returned, retained, or destroyed.

The Court concluded that the taxpayer's lease of "canned" or "pre-written" software is not subject to sales or use tax.

The answers to the three issues of this case depend on the question of whether "canned" or "pre-written" software is tangible personal property. The Court concluded that canned computer software programs, existing as encoded magnetic impulses, are intangible property.

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

SALES TAXES AND WITHHOLDING TAXES

Personal liability. *Wisconsin Department of Revenue vs. William Drilias* (Circuit Court for Dane County, June 12, 1995).

The department appeals the Wisconsin Tax Appeals Commission (Commission) decision of August 15, 1994, which cancelled a tax penalty assessment against the taxpayer. The issues are:

A. Did the Commission correctly conclude that the taxpayer's failure to pay sales and withholding taxes was neither "willful" nor "intentional," as defined by the applicable statutes?

B. Did the Commission erroneously place the burden of proof upon the department to establish that the taxpayer's failure to pay sales and withholding taxes was "willful" or "intentional"?

C. Did the Commission's decision constitute an unexplained deviation from its existing policy of making responsible corporate officers personally liable for intentionally failing to pay corporate sales and withholding taxes?

The taxpayer was an officer of Suburpia Submarine Shoppes, Inc. (the corporation) during the period covered by the assessment, having become the president of the corporation in August of 1982. He had authority over the corporation business affairs until January 31, 1985. On that date, a Bankruptcy Court granted a motion from a Creditors Committee requesting that the corporation be liquidated under Chapter 7, ending the taxpayer's control over the company.

Tax deficiencies had accumulated during the period from August 1982 through August 1984, when sales and withholding taxes were not paid to the department. An installment agreement was entered into regarding the payment of these deficiencies on August 31, 1984. The terms of the agreement, and the statute granting the department the authority to enter into such agreements, provided that in the event of default, the total unpaid portion of the delinquent accounts would be due and the agreement would be revoked. The taxpayer made weekly payments of $2,500 on the *past due* withholding taxes, as required by the installment agreement. The assessment includes the past due withholding tax which remained on the installment agreement at the time the taxpayer lost control of the corporation.

In October 1984, the taxpayer filed a late return and payment on *current* taxes. In January 1985, just prior to the Chapter 7 liquidation, the taxpayer failed to pay over *currently* due sales and withholding taxes that had been collected in December 1984 and January 1985.

The Circuit Court remanded the case to the Commission, concluding:

A. The Commission's legal conclusion that the taxpayer did not willfully or intentionally fail to pay sales and withholding taxes is based upon factual findings that are not supported by substantial evidence in the record. On remand, the Commission is instructed to make explicit what evidence supports its factual findings that the taxpayer complied with the entire installment agreement until he lost control and authority of the corporation, and that there was not time in which to take care of late arising liabilities of the corporation.

B. The Commission is instructed, on remand, to make explicit which party must bear the burden of proof and by which standard the evidence is to be judged.

C. The Commission must also decide whether the installment agreement changed the corporation's obligation to prefer the state to other creditors, and if so, whether the department is estopped from asserting liability against the taxpayer. Legal conclusions must be made regarding the effect of the department's collection efforts upon the taxpayer's duty to pay (1) the withholding taxes covered by the installment agreement, (2) the withholding taxes not covered by the installment agreement, and (3) the sales taxes. Should these conclusions be a deviation from previous policies, they should be adequately explained in the record.

The taxpayer has not appealed this decision. □

TEMPORARY RECYCLING SURCHARGE

Temporary recycling surcharge — constitutionality. *Love, Voss & Murray vs. Wisconsin Department of Revenue* (Court of Appeals, District II, June 7, 1995).

The partnership appeals from an order of the Circuit Court for Waukesha County in favor of the Wisconsin Department of Revenue wherein the Circuit Court affirmed the Wisconsin Tax Appeals Commission's decision and held that the Wisconsin recycling surcharge tax for 1991 was constitutional. For summaries of the prior decisions, see *Wisconsin Tax Bulletins* 86 (April 1994), page 20, and 90 (January 1995), page 25.

The partnership is a law practice located in Waukesha, Wisconsin. For 1991, it filed a Form 3S Wisconsin Partnership Temporary Surcharge return. The partnership refused to pay the tax, claiming it was unconstitutional. The department denied the partnership's claim by notice of adjustment.

The partnership challenges, among other things, the constitutionality of sec. 71.94, Wis. Stats. (1991-92), which calculates the surcharge. The partnership argues that "those who get taxed 'for the privilege of doing business in this state' get taxed in a substantially disparate fashion, solely on the basis of whether they are or are not a noncorporate entity engaged in farming."

The Court of Appeals began its analysis with the familiar proposition that "constitutional challenges to a statute must overcome a strong presumption of constitutionality." A party attacking the statute on constitutional grounds has the burden of proving that the statute is unconstitutional beyond a reasonable doubt.

The Circuit Court agreed with the Commission, stating that "the Wisconsin temporary recycling surcharge tax, provided by subch. VII of ch. 77, Stats., is constitutional as it rationally furthers a legitimate state interest."

The Court of Appeals concluded that there is a rational relationship between the classification and a legitimate government purpose; therefore, the statutory sections at issue do not violate the Equal Protection Clause. The Court of Appeals agreed with the Commission that farmers, unlike other businesses, cannot necessarily absorb the recycling surcharge tax

through increasing the prices of their product because of the "vagaries of the commodity marketplace." Additionally, this classification serves a legitimate state interest by giving a partial exemption to a valuable part of Wisconsin's economy which has seen a decrease in numbers.

The partnership also argues that the disparate treatment of noncorporate farmers under the recycling surcharge is not a reasonable exemption under §1 of Article VIII of the Wisconsin Constitution. Because Wisconsin farmers serve a vital function in this state as well as throughout the country, because they cannot necessarily recoup the tax through raising the prices on their products, and because farm numbers have dropped, the Court of Appeals concluded that the partial exemption of farmers from the recycling surcharge tax is reasonable.

The Court of Appeals affirmed the Circuit Court's order because it concluded that the tax is not violative of the Equal Protection Clause of the United States Constitution and is a reasonable exemption under §1 of Article VIII of the Wisconsin Constitution.

The partnership has not appealed this decision. □

Tax Releases

"Tax releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. In situations where the facts vary from those given herein, the answers may not apply. 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.

The following tax releases are included:

INDIVIDUAL INCOME TAXES

1 Adjustments to Interest for Underpayment of Estimated Tax

Statutes: Sections 71.09(1)(am), 71.29(1)(a), 71.84 and 77.947, Wis. Stats. (1993-94)

Note: This tax release applies only with respect to taxable years beginning on or after January 1, 1994.

Background: Individuals, estates, and trusts generally must make estimated tax payments if they expect a tax due (tax, alternative minimum tax, and temporary recycling surcharge, minus credits and withholding) on their return of $200 or more. Partnerships that expect to owe temporary recycling surcharge of $200 or more must make estimated surcharge payments. Corporations, including exempt organizations subject to tax on unrelated business taxable income, that expect the sum of their net tax (tax minus credits) and temporary recycling surcharge to be $500 or more generally must make estimated tax payments. Taxpayers who do not