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.

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INDIVIDUAL INCOME TAXES

Retirement benefits exempt. *Donald and Janet Groschel vs. Wisconsin Department of Revenue* (Circuit Court for Waukesha County, November 25, 1996). The issue in this case is whether annuity payments received by Donald Groschel are exempt from Wisconsin income taxation.

The Wisconsin Tax Appeals Commission concluded that the payments are not exempt, and the taxpayers appealed the decision to the Circuit Court. See *Wisconsin Tax Bulletin* 100 (January 1997), page 21, for a summary of the Commission's decision.

The Circuit Court dismissed the case, based on a stipulation and agreement entered into by both the taxpayers and the department. The case is closed. □

Retirement funds exempt — constitutionality. *John D. and Jane A. Hennick vs. Wisconsin Department of Revenue* (Court of Appeals, District I, November 5, 1996). The taxpayers appeal from a judgment of the Circuit Court for Milwaukee County, affirming the Wisconsin Tax Appeals Commission's decision that denied their claim for an income tax refund for taxes paid on income from a private pension. See *Wisconsin Tax Bulletin* 95 (January 1996), page 23, for a summary of the Circuit Court decision.

The taxpayers argue that sec. 71.05(1)(a), Wis. Stats. (1989-90), which exempts certain public employe pension income from taxation, violates the uniformity clause of the Wisconsin Constitution and the equal protection clauses of the United States and Wisconsin Constitutions.

Mr. Hennick receives pension income due to his employment from 1956 through 1983 with a private entity, the Public Expenditure Survey of Wisconsin. In 1993, the Hennicks filed amended tax returns for the years 1989 through 1992 seeking a refund, and the department denied their claim for refund.

The Court of Appeals concluded that sec. 71.05(1)(a), Wis. Stats., does not violate the uniformity clause of the Wisconsin Constitution, because that clause applies only to taxation of property, not income.

The Court also concluded that sec. 71.05(1)(a), Wis. Stats., does not violate the equal protection clauses of the Wisconsin and United States Constitutions. When dealing with equal protection challenges, legislation is presumed to be valid and will be sustained if the classification drawn by the statute is rationally related to a legitimate state interest. When no suspect classifications are present, that presumption is even greater. Further, where a tax measure is involved, the presumption of constitutionality is strongest. The burden is upon the challenger to prove abuse of legislative discretion beyond a reasonable doubt. The standard used for determining whether the Legislature has abused its discretion is not whether some inequality results from the classification, but whether there exists any reasonable basis to justify the classification.

First, there are no "inherently suspect distinctions" involved in sec. 71.05(1)(a), Wis. Stats. Second, the statute is not without a reasonable basis, namely, that the exclusion was thought by its framers as desirable to correct or ameliorate pay inequities for Milwaukee municipal employes. Finally, the taxpayers only demonstrated that Mr. Hennick's pension income was taxed differently. As the Commission accurately explained, "the mere establishment of a difference in the taxation treatment accorded certain types of incomes does not *per se* indicate that those differences result from distinctions made through legislative enactments which are not reasonable."

The taxpayers have not appealed this decision. □

Tax Appeals Commission — class action claims. *Wisconsin Department of Revenue vs. J. Gerard and Delores M. Hogan, et al.* (Circuit Court for Dane County, February 11, 1997).

The Circuit Court, having been advised that the Wisconsin Tax Appeals Commission (Commission) had entered an order effectuating a February 7, 1997 stipulation of the parties before that body, reversed those portions of the Commission's oral decisions dated May 24, 1994 and June 24, 1994 which are inconsistent with the court of Appeals' decision dated December 21, 1995. See *Wisconsin Tax Bulletin* 96, (April 1996), page 15, for a summary of the Court of Appeals decision.

The Circuit Court also remanded the record in this case to the Commission for such further proceedings as it may deem appropriate. □

CORPORATION FRANCHISE AND INCOME TAXES

Extension of time — filing franchise or income tax return. *Huebsch Chevrolet, Inc., vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, December 18, 1996). The issue in this case is whether the taxpayer is liable for the late filing fee and negligence penalty because it failed to file with its 1993 Wisconsin return a copy of the Form 7004 it filed with the Internal Revenue Service ("IRS") for the same year, as required by sec. 71.24(7), Wis. Stats. (1993-94).

On April 17, 1995, the taxpayer mailed to the department its 1993 corporate franchise or income tax return for its fiscal year ending July 31, 1994 ("1993 return"). In waiting to file until April 17, 1995, the taxpayer relied on a federal Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax, that it filed with the IRS and that it claims it filed with the department in a timely manner. On its 1993 return, the taxpayer reported an amount due of $3,886 and paid the same.

When it filed its 1993 return, the taxpayer did not include a copy of the Form 7004 it had filed with the IRS for the same tax year.

Under the date of July 1, 1995, the department assessed the taxpayer $280.69 in underpayment interest, $401.04 in delinquent interest, a $30 late filing fee, and a $930.69 negligence penalty. The taxpayer filed a petition for redetermination challenging the delinquent interest, negligence penalty, and late filing fee. The department denied the petition for redetermination, and the taxpayer appealed the denial to the Wisconsin Tax Appeals Commission with

regard only to the negligence penalty and the late filing fee.

Even though the taxpayer had a copy of the requested Form 7004 at all relevant times, neither the taxpayer nor its representative produced a copy of the requested Form 7004 until the hearing in this matter.

The Commission concluded that the taxpayer is liable for the late filing fee and the negligence penalty because the taxpayer failed to file with its 1993 Wisconsin return a copy of the Form 7004 it filed with the IRS for the same year, as required by sec. 71.24(7), Wis. Stats. (1993-94).

The taxpayer has not appealed this decision.

Caution: This is a small claims decision of the Wisconsin Tax Appeals Commission and may not be used as a precedent. This decision is provided for informational purposes only. □

Leases – 1986 and prior – safe harbor rules. *Wisconsin Department of Revenue vs. Northern States Power Company* (Circuit Court for Eau Claire County, November 15, 1996). The department appealed the Wisconsin Tax Appeals Commission's decision that allowed Northern States Power Company (NSP) to deduct from its gross income transactional costs related to its acquiring of safe harbor leases in 1982. See *Wisconsin Tax Bulletin* 98 (July 1996), page 23, for a summary of the Commission's decision.

During 1982, the federal Internal Revenue Code (IRC) sec. 168(f)(8) allowed leases, which would not have otherwise qualified as leases for federal income tax purposes, to be treated as leases to permit the seller/lessee of property to transfer to a buyer/lessor the benefits of federal depreciation deductions and federal investment tax credits. Wisconsin, however, does not allow the deductions. Sec. 71.04(15)(b), Wis. Stats. (1981-82).

Safe harbor leases allow a company needing new equipment to reduce its cost for the equipment by effectively selling its federal tax consequences of equipment ownership to another company which can use those benefits. The sale of the tax consequences is accomplished by safe harbor leases, under which ownership is treated as being sold and the equipment is treated as being leased back. The transaction is essentially on paper only since the ownership and possession of the equipment remains with the original company. For federal tax purposes, however, the other company is treated as the owner and obtains the federal depreciation deductions and investment tax credits related to the equipment. Under Wisconsin law, the company is not entitled to these deductions and credits.

In 1982, NSP, based on Wisconsin law, did not claim any of the federal depreciation deductions and investment tax credits related to its safe harbor leases. It did, however, claim $212,762 for transactional costs (for example, legal fees) related to securing the safe harbor leases. The department disallowed all but $3,520 of the deduction. The amount allowed represented amortization of legal fees. The Commission reversed the department.

The Circuit Court concluded that the Commission's decision is supportable by the Wisconsin Statutes and the Internal Revenue Code. Because the transactional costs are deductible under IRC sec. 167, they are similarly allowable as a deduction under sec. 71.04(15)(a), Wis. Stats. (1981-82).

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

Refunds – claims after field audit refund. *National Presto Industries, Inc., vs. Wisconsin Department of Justice* (Circuit Court for Eau Claire County, January 16, 1997). National Presto Industries, Inc. (Presto) filed a petition with the Circuit Court for review of the Wisconsin Tax Appeals Commission's dismissal of its petition for a refund for 1985.

The Commission decision to dismiss Presto's petition was based on its finding that sec. 71.75(4), Wis. Stats., was applicable to the facts of this case. The Commission concluded Presto could not seek a refund for 1985 because the field audit of 1985, 1986, and 1987 produced a refund. The Commission also held that the law did not require the department to advise Presto of appeal rights because in essence it had already done so as part of the audit process.

Presto is a Wisconsin corporation with its principal place of business located in Eau Claire, Wisconsin. Presto is subject to Wisconsin franchise and income taxes and was so at the times material to this dispute.

In 1992, a field audit of Presto's taxable years 1985, 1986, and 1987 was conducted by the Wisconsin Department of Revenue (department). On November 4, 1992, the department issued a notice of field audit action which reported the three years separately but which combined them for the purposes of computing a net figure. Specifically, Presto was found to have underpaid taxes for 1985 and 1986, and interest at the rate of 12% was assessed against Presto separately on the amounts owed each year. The department determined that Presto substantially overpaid taxes in year 1987, and

interest was computed in favor of Presto at the rate of 9% against that amount. The department issued Presto a refund check for the 1987 overpayment plus interest owed, less Presto's computed underpayments for 1985 and 1986 plus interest Presto owed.

During September 1994, Presto concluded the department erred on its calculation and determination of Presto's taxes for 1985 only, and Presto on September 13, 1994, notified the department it was claiming a refund for the year 1985.

On November 10, 1994, the department responded to the refund claim by denying it on the basis that under sec. 71.75(4), Wis. Stats., no refund shall be made for "... any year that has been the subject of a field audit if the audit resulted in a refund or no change to the tax owed or resulted in an assessment that is final." The letter went on to state that because the audit report of November 4, 1992, resulted in Presto's receipt of a refund, there was no assessment and sec. 71.75(5), Wis. Stats., was inapplicable. The letter contained no other information with regard to any rights Presto had to appeals or further review of this decision.

Presto did nothing in response to this letter from the department until June 13, 1995, when it wrote a letter taking issue with the department's conclusions as set forth in its November 10, 1994, denial.

From June 13, 1995, through July 17, 1995, Presto and the department exchanged letters which essentially claimed the other was incorrect in its interpretation of Wisconsin tax law. Presto ultimately filed a petition with the Wisconsin Tax Appeals Commission. The department moved to dismiss Presto's petition which was granted. Presto thereafter filed a petition with the Circuit Court for review of the dismissal.

The Circuit Court, after a complete review of the file, concluded that the Commission's interpretation of secs. 71.75(4) and 71.75(5), Wis. Stats., is plainly incorrect. Presto seeks a refund for the tax year 1985 only. The field audit conducted by the department for that year found Presto underpaid $33,919.02 and assessed Presto the amount of the underpayment and on top of that assessed Presto $27,231.86 in interest. The plain language of sec. 71.75(4), Wis. Stats., states that no refund shall be allowed if, after a field audit, there is no change in the tax owed or if a refund is issued. The field audit for 1985 imposed a significant change in Presto's tax liability for that year.

The fact that the department elected to conduct a field audit for three years and issue a net check after concluding that Presto substantially overpaid its taxes for 1987 does not alter the fact that for the year 1985 Presto was assessed more tax and interest.

The Circuit Court reversed the Commission's decision granting the department's motion to dismiss and remanded the case back to the Commission for a decision on its merits.

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

Transition rules — federalization. *Lincoln Savings Bank, S.A., f/k/a Lincoln Savings and Loan Association vs. Wisconsin Department of Revenue* (Court of Appeals, District I, December 10, 1996). The department appealed from the Circuit Court's reversing an order by the Wisconsin Tax Appeals Commission that assessed additional franchise taxes against the taxpayer for the years 1987-1990. For summaries of the prior decisions, see *Wisconsin Tax Bulletins* 91 (April 1995), page 13, and 95 (January 1996), page 27.

The only dispute between the parties is whether Lincoln Savings Bank (Lincoln) may subtract its pre-1962 balance of bad debt reserves for federal tax purposes, which accumulated *before* it was subject to the Wisconsin franchise tax. The Commission held that it could not; the Circuit Court held that it could.

Lincoln was first subjected to franchise tax liability in 1962. Both Wisconsin and federal tax law permit institutions like Lincoln to deduct reserves set aside to cover bad debts from their tax liability. Prior to 1987, Wisconsin tax law established a specific mechanism for this deduction in sec. 71.04(9)(b), Wis. Stats. (1985-86). This section was repealed effective for the "taxable year 1987" as part of the legislature's federalization of Wisconsin's tax law. In its place, the legislature defined corporate "net income" for Wisconsin tax purposes, with provisos not pertinent here, as "gross income, as computed under the internal revenue code."

The federalization of Wisconsin's tax law changed the amount of bad debt reserves that institutions like Lincoln could deduct from their income in order to arrive at their taxable income. For the years 1962 through 1986, Lincoln's federal bad debt reserve balance equaled $3,375,023; Lincoln's Wisconsin bad debt reserve balance for that period was $2,608,622.

Federalization of the corporate tax liability in Wisconsin resulted in changes in the tax treatment of myriad items for all corporations, and the legislature enacted a transition mechanism to equalize the