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

Native Americans – reservation of another tribe. *Edward and Margaret Snow vs. Wisconsin Department of Revenue* (Circuit Court for Dane County, January 6, 2006). This is a judicial review of a March 31, 2005, decision of the Wisconsin Tax Appeals Commission. See *Wisconsin Tax Bulletin* 143 (July 2005), page 14, for a summary of the Commission's decision. The issue in this case is whether a member of one tribe who is living and working on the reservation of another tribe is subject to the Wisconsin income tax.

The taxpayer, Edward Snow, is an enrolled member of the Lac du Flambeau Band of Lake Superior Chippewa Indians. The taxpayer's spouse, Margaret Snow, is an enrolled member of the Menominee Tribe of Indians of Wisconsin (the Menominee Tribe). The taxpayers reside together within the Menominee Indian Reservation Boundaries.

The taxpayers filed Wisconsin income tax returns for the years at issue, claiming a deduction for all earned income. The deduction for the taxpayer's income was based on his status as an enrolled member of a federally recognized Indian tribe who lived and worked on a federally recognized Indian reservation.

The Commission concluded that the issue in this case is identical to the issue decided in *Joan La Rock vs. Wisconsin Department of Revenue* (see *Wisconsin Tax Bulletin* 110 [July 1998], page 14, 111 [October 1998], page 12, 119 [April 2000], page 15, and 125 [July 2001], page 14 for summaries of the decisions in this case), and that Wisconsin may impose an income tax on the taxpayer, an Indian who is an enrolled member of the Lac du Flambeau Band of Lake Superior Chippewa Indians but who lives and works on the Menominee Indian Reservation, because he is not a member of the Menominee Tribe.

The taxpayers sought to distinguish their case from *La Rock* based on several factors:

1. The Snows remain married, unlike the La Rocks. Joan La Rock, a Menominee Tribe member, was divorced from her husband, an Oneida Tribe member, at the time she earned the income in question. Thus, Joan La Rock's connection to the Oneida Tribe and its lands was somewhat more tenuous, even though all her children were Oneida Tribe members and all her income was earned from Oneida Tribe employment at a job site on the Oneida Reservation.
2. Mr. Snow's status, specifically as a Menominee Tribe non-member "citizen resident," was not explicitly considered in *La Rock*. Oneida Tribe status was at issue in *La Rock*. The Oneida and Menominee Tribes should be distinguished based on various legislation, specifically the exemption of the Menominee Tribe from Public Law 280. The Oneida Tribe is subject to Public Law 280, which confers on Wisconsin certain types of civil and criminal jurisdiction over it.
3. All of Mr. Snow's income is from federal sources or unemployment compensation from his job with the Tribe in providing security services to the Tribe. In *La Rock*, the wife's income was earned for work on the Oneida Reservation at the Oneida's casino, wholly owned and operated by the Oneida Tribe.

The Court found these arguments to be unpersuasive, and accepted and applied *La Rock* as controlling in this case.

The Court affirmed the Commission's decision, concluding that it is bound by the *La Rock* decision and its reasoning: inherent tribal sovereignty does not come into play except as to its own members.

The taxpayers have not appealed this decision.

SALES AND USE TAXES

Bad debts. *DaimlerChrysler Services North America LLC vs. Wisconsin Department of Revenue* (Dane County Circuit Court, December 21, 2005). This is a judicial review of the Wisconsin Tax Appeals Commission decision dated September 7, 2004. See *Wisconsin Tax Bulletin* 141 (January 2005), page 25, for a summary of the Commission's decision. The issue in this case is whether the taxpayer may claim a refund for bad debts resulting from installment contracts assigned to the taxpayer by motor vehicle dealers and later found to be worthless.

During the years 1997, 1998, and 1999, Wisconsin motor vehicle dealers entered into retail installment contracts with motor vehicle purchasers. The dealer then paid the sales tax to the Department of Revenue. The amount financed under each contract consisted of the purchase price of the motor vehicle and the sales tax that was charged on the vehicle.

The retail installment contracts were then assigned to the taxpayer. The taxpayer did not pay the sales tax due on each contract to the Department of Revenue. The taxpayer paid the full amount financed, including the sales tax, to the dealer when the contract was assigned to the taxpayer. After the taxpayer purchased the contracts from the dealers, the vehicle purchasers owed the amount financed to the taxpayer.

When a vehicle purchaser went into default on a contract purchased by the taxpayer, the taxpayer repossessed the vehicle and sold it at auction to a third party. The taxpayer then applied the auction proceeds to the amount due from the purchaser, leaving an unpaid balance due. The taxpayer determined the unpaid balances on the default contracts were worthless and bad debts, and charged the unpaid balances off for income tax purposes, including a proportional share of the sales tax paid to the dealer when the contract was assigned to the taxpayer. The taxpayer held a Wisconsin seller's permit because it sold and leased motor vehicles in addition to financing dealer sales of motor vehicles. The taxpayer did not take a bad debt deduction on its sales and use tax return for any of the bad debts resulting from the default contracts.

The Circuit Court concluded that the Commission was correct in its decision that the taxpayer was not entitled to a Wisconsin sales tax bad debt deduction for the default contracts because the taxpayer was not the retailer that previously paid the sales tax to the Department of Revenue as required by secs. 77.51(4)(b)4 and 77.52(6), Wis. Stats. The Court stated that Wisconsin case law supports the requirement that only those who are responsible for and who actually remit the sales tax are eligible for a refund under the bad debt statutes. Therefore, the Commission was correct in its decision that the Department of Revenue properly denied the taxpayer's claim for refund.

The taxpayer has appealed this decision to the Court of Appeals.

Real Property Construction Activities Versus Manufacturing. *Visu-Sewer Clean & Seal, Inc. vs. Wisconsin Department of Revenue* (Dane County Circuit Court, June 12, 2006). This is a review of the Wisconsin Tax Appeals Commission decision dated October 6, 2005. See *Wisconsin Tax Bulletin* 146 (February 2006), page 37, for a summary of the Commission's decision.

The taxpayer is a Wisconsin corporation engaged in various lines of business, including sewer cleaning and inspecting and re-lining underground sewer pipes that are in disrepair. All of the taxpayer's sewer re-lining work is for underground sewer pipes made of such materials as clay, reinforced concrete, non-reinforced concrete, case iron, steel, and transite. Sewer pipes have a design life of 50 years. The liners at issue that the taxpayer used have a design life of 50 years.

The issues addressed by the Wisconsin Tax Appeals Commission were whether Visu-Sewer Clean & Seal, Inc. ("taxpayer") was (1) engaged in real property construction activities when it installed sewer liners, and (2) whether royalties paid by the taxpayer for its purchases of U-Liners are subject to Wisconsin use tax. The issue relating to royalties was not under review by the Circuit Court.

The taxpayer contended that its installation of the National Liners and U-Liners into a customer's host sewer pipes is a manufacturing process, and that the raw materials, equipment, and equipment repair and maintenance were exempt from Wisconsin sales and use tax.

The Commission previously determined that the installation of sewer liners by the taxpayer was a real property construction activity. The taxpayer's purchase of the materials, machinery, and equipment used to install the sewer liners were not exempt from Wisconsin use tax under sec. 77.53, Wis. Stats. The sewer liners were physically annexed to the real estate when they were installed into the host pipes and were clearly adapted to

the use of those pipes. The sewer pipe lines were intended to be a permanent accession to the realty.

The Commission also ruled that the taxpayer is liable for sales or use tax on its purchase of the materials that it used in the real property construction activity of the sewer liner installation, stating that "(the taxpayer) is a real property construction contractor, and the activities in question are real property construction activities. Thus, (the taxpayer's) activities are not eligible for the manufacturing exemption."

In making its determination, the Commission relied on the three-part test for determining when an item becomes a fixture or real property, as set forth by the Wisconsin Supreme Court in *Department of Revenue v. Smith Harvestore Products* 72 Wis.2d 60, 240 N.W.2d 357 (1976). The elements of this test are "(1) Actual physical annexation to the real estate; (2) application or adaptation to the use or purpose to which the realty is devoted; and (3) an intention on the part of the person making the annexation to make a permanent accession to the freehold." The *Harvestore* test has been codified in sec. 77.51(2), Wis. Stats., as part of the definition of "real property construction activities."

The Circuit Court determined that the Commission correctly applied the *Harvestore* test in its determination that the pipe liners are real property, and thus, that the taxpayer was engaged in real property construction. The Circuit Court affirmed the Commission's decision that the taxpayer is not entitled to a tax exemption under sec. 77.54(2), Wis. Stats., on its purchases of the materials that it used in the real property construction activity of the sewer liner installation. The Commission was also correct in its conclusion that the exemption under sec. 77.54(6)(a), Wis. Stats., does not apply, because the subject machines and equipment are not used in the manufacture of tangible personal property, as required by the exemption. Rather, the items are used or consumed by the contractor and, therefore, the contractor must pay tax on purchases of such property.

It was not known at the time of publication whether the taxpayer would appeal this decision.