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Article 8

Taxation

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water from the land and uses it for a beneficial purpose is not subject to liability for interference with the use of water by another, unless

(a) The withdrawal of water causes unreasonable harm through lowering the water table or reducing artesian pressure,

(b) The ground water forms an underground stream, in which case the rules stated in sec. 850A to 857 are applicable, or

(c) The withdrawal of water has a direct and substantial effect upon the water of a watercourse or lake, in which case the rules stated in secs. 850A to 857 are applicable.

Thus, the Restatement rule continues to recognize the right of a property owner to utilize ground water without incurring liability, but imposes certain limitations which appear enforceable, yet flexible enough to apply fairly in a wide variety of circumstances.

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TAXATION

I. TAXATION AND THE MARITAL RELATIONSHIP

After.only a very few years experience with the federal income tax as originally enacted, legislators were made acutely aware of the different tax results between married individuals living in separate property states and those living in community property states. Under the community property theory, all income earned by married couples was split equally between them. Naturally the tax burden was considerably lower than that sustained in separate property states where one party earned all or substantially more of the income than the other. The remedy for such unequal taxation was to adopt income splitting in the form of the joint return as part of the Internal Revenue Code.[1] The joint return affords similar treatment to married individuals respective of state law.[2]

A. Income Splitting

Prior to 1965, income taxation in Wisconsin made no reference to the federal tax base. The Wisconsin Legislature enacted an income tax "simplification law"[3] in July of 1965 which provided

1. INT. REV. CODE OF 1954, § 6013.
2. McClure v. United States, 228 F.2d 322 (4th Cir. 1955).
3. Wis. Laws 1965, ch. 163.

that Wisconsin income tax would be calculated using federal taxable income as a basis, with some modifications. The legislature, holding firmly to separate property principles, did not extend the advantages of income splitting to married individuals for Wisconsin income tax purposes.

One obvious way to obtain the same advantages as those provided by a joint return was to form a husband-wife partnership. In *Skaar v. Department of Revenue*[4] and *Stern v. Department of Revenue*,[5] the taxpayers tried unsuccessfully to argue for the existence of such a partnership. The two cases were factually similar. In *Skaar*, the parties operated a farm which they held in joint ownership. The husband had a salaried job in addition to his farm duties. The wife kept all the financial records for both the farm and nonfarm operations, in addition to performing her half of the farm duties. The taxpayers contended they had an oral partnership agreement to share all profits and losses equally. However, some of the personal property was registered in the husband's name, and the insurance had also been taken out in his name only. They did not file partnership tax returns nor did they pay social security taxes for Mrs. Skaar. In *Stern*, the situation was similar. There was joint ownership of the business property and the business liabilities, and each party had made a capital contribution out of their own separate property. Both parties shared the work and felt justified in sharing the income. However, there was no formal partnership agreement, no partnership tax return filed, and no social security payments made in Mrs. Stern's name. In both cases the supreme court held that the arrangements were based on the sharing inherent in the marital relationship, rather than upon any formal partnership relationship.

While the supreme court indicated that it would prefer the federal system as it applies to married individuals, a change to such a system was considered a matter for the legislature. At the same time the court noted that it had ruled in *Amerpohl v. Tax Commission*[6] that Wisconsin's income tax provisions regarding joint returns were unconstitutional as written. Since 1937, the legislature has failed to enact a constitutional provision for filing joint returns. As a result of *Skaar* and *Stein*, it would appear that tax-

4. 61 Wis. 2d 93, 211 N.W.2d 642 (1973), *cert. denied*, ___ U.S. ___, 94 S. Ct. 1611 (1974).

5. 63 Wis. 2d 506, 217 N.W.2d 326 (1974).

6. 225 Wis. 62, 272 N.W. 472 (1937).

payers, as well as tax advisors, should argue the equities of joint returns in the legislature and not the courts.

The federal system still has the problem faced by the court in the instant cases because many individuals are aware of the advantages of family partnerships which allow splitting income with children and other relatives in lower tax brackets. The United States Supreme Court has established the *Culbertson*[7] test, where the determinative factor is a bona fide intent to establish a partnership by the family members, either because of services to be performed or because of contributions of capital of which they are the true owners. Using that test, the Internal Revenue Service has been successful in challenging family partnerships even though no reliable criteria have yet been developed for predictive purposes. Based on the way the bona fide intent test has been applied under the federal law, it is probably that the result in *Skaar* and *Stern* would remain unchanged. This is true even though each party performed significant services and, at least in *Stern*, each party made a capital contribution from separate property. The lack of bona fide intent could be found from inconsistent positions taken by the taxpayers, *i.e.*, partnership treatment on state returns to save tax dollars but individual attribution for social security tax purposes.

Left unanswered by the Wisconsin court is the question of what total evidence is required to establish a husband-wife partnership for Wisconsin income tax purposes. The decision clearly infers that a combination of the following would be sufficient: (a) the existence of formal partnership agreement; (b) the filing of partnership information returns; (c) the paying of social security taxes for both husband and wife; (d) sharing the actual work. This places a duty on tax advisors to be aware of the possibility for tax savings by using the husband-wife partnership form where it is appropriate.

It appears from the facts in both cases that the inequities in the social security laws were the impetus for taking inconsistent positions on the partnership form of business. Tax reform in this area is long overdue, but in the meantime every tax advisor must understand the obligations imposed by these laws and must explain the alternatives to his clients considering them both as a couple and as individuals. The client's individual best interests will at times be in direct conflict with their interests as a family.

7. Commissioner v. Culbertson, 337 U.S. 733 (1949).

was divided into two factions, the Soref group wanting to make innovative changes in the conduct of the business and the Stahl group being content with the status quo. With the death of one of the directors, the board was evenly divided and deadlocked. As a result, it was determined that the corporate taxpayer would purchase the stock of the Stahl group, leaving the Soref group in control. To effect the purchase, the Sorefs hired legal counsel to draw up the agreements and caused the corporate taxpayer to borrow money for the impending purchase. In its tax returns for 1964, the year of the purchase, the corporation deducted the interest payments and the legal expenses. Likewise in the years following, the corporation deducted interest payments on the loan. The Department of Revenue contended that the expenditures were not deductible under Wisconsin Statute section 71.04(2)[12] and section Tax 3.20 of the Wisconsin Administrative Code.[13]

Two rules of law had application to the facts of the case. First, if the purchase is equivalent to no more than a readjustment of internal affairs, *i.e.*, a realignment of the interests of the individual stockholders, the interest on the debt is not deductible because it does not relate to the operations of the business from which the corporate income is derived.[14] Second, if the stock purchase is related to the income production of a corporation, the interest is

12. WIS. STAT. § 71.04:

Deductions from gross income of corporations. Every corporation, joint stock company or association shall be allowed to make from its gross income the following deductions:

(2) Other ordinary and necessary expenses actually paid within the year out of the income in the maintenance and operation of its business and property, including with respect to the calendar year 1963 and corresponding fiscal years and prior calendar and fiscal years, but not thereafter a reasonable allowance for depreciation by use, wear and tear of property from which the income is derived; and in the cases of mines and quarries an allowance for depletion of ores and other natural deposits on the basis of their actual original cost in cash or the equivalent of cash; and including also interest and rent paid during the year in the operation of the business from which its income is derived; provided, the payor reports the amount so paid, together with the names and addresses of the parties to whom interest or rent was paid as provided in s. 71.10(1).

13. 8 WIS. ADM. CODE, Rule Tax 3.20:

Interest paid by corporations. (Section 71.04(2), Wis. Stats.) Interest paid on money borrowed by a corporation to purchase its own capital stock is not deductible.

14. Basic Products Corp. v. Department of Taxation, 19 Wis. 2d 183, 186, 120 N.W.2d 161 (1963); Pelton Steel Casting Co. v. Department of Taxation, 268 Wis. 271, 276, 67 N.W.2d 294 (1954); and Wisconsin Ornamental Iron & Bronze Co. v. Wisconsin Tax Comm., 202 Wis. 355, 363, 229 N.W. 646, 233 N.W. 72 (1930).

deductible.[15] Factually, *Master Lock* fits within both rules, because the stockholder interests were realigned and the company operations significantly improved. While the court did not cite the figures set forth in the appellant's brief,[16] it stated that:

> The true interest of the state of Wisconsin is served by permitting deductions from gross income when those deductions serve the purpose of preserving the corporate entity in such a manner that it may in the future continue to produce income that will be taxable by the state of Wisconsin.[16.1]

Determining deductibility is complicated because there are no precise guidelines to follow. Hopefully the test in *Master Lock* will be helpful since it incorporates both of the previously exclusive concepts. In the future, "a deduction will be allowed where a stock realignment is effected by a corporate purchase of its own stock when it is for the purpose of preserving the income producing capacity of the corporation."[17] The supreme court looked to federal law and found the rationale in *Mountain State Steel Foundries, Inc. v. Commissioner*[18] persuasive.[19] There it was stated:

> When the stockholders have such conflicting interests, the corporation and its future are necessarily affected. When the situation results in demands that the business be sold or liquidated, as it did here, the impact of the conflict upon the corporation is direct and immediate. . . . The resolution of such a conflict, so that the need of the corporation may govern managerial decision, is plainly a corporate purpose.

Thus the treatment of the cost of purchases of the corporation's own stock will be similarly treated under federal and Wisconsin tax laws.

15. Hoffman Co. v. Department of Revenue, 51 Wis. 2d 220, 229, 186 N.W.2d 228 (1971).

16. In the three-year period immediately following the elimination of the controversy, the unimpeded management of the Sorefs increased the profit of the taxpayer from $3,590,896 in 1964 (the year of the controversy), to $5,219,671 or by approximately fifty per cent notwithstanding the substantial additional interest costs here disputed, greatly increased marketing and advertising expenses, and a substantial capital expansion program. Appellant's Reply Brief, page 7.

16.1. 62 Wis. 2d at 727.

17. *Id.*

18. 284 F.2d 737, 745 (4th Cir. 1960).

19. The Wisconsin Corporate Franchise Tax was not "federalized" and respondent argued against using federal law as a basis for the decision.

III. APPORTIONMENT OF INCOME IN MULTISTATE OPERATIONS

Apportionment of income commonly refers to an apportionment formula developed for income taxation[20] of multistate operations of "unitary" businesses.[21] However, multistate operations of unitary businesses can create apportionment difficulties where other types of taxes are levied on the basis of income, for example, a gross premium tax levied on insurance companies' income.

It is axiomatic that Wisconsin has the power to tax income received or derived within the state, but generally has no power to tax income received or derived outside the state. Naturally each state involved in the multistate operations of a company wants to claim its share of the taxable income. Theoretically, the "unitary" business should have its income apportioned among the states in such a manner that only 100 per cent of the total income is taxed, just as though a separate entity was operating in each state. While constitutional protections are available to stop gross inequities, each state generally has its own apportionment formula which it may apply when it has a sufficient nexus to satisfy due process.[22] Until there is a uniform apportionment formula among the states,[23] unitary businesses will continue to pay local income taxes on more or less than 100 per cent of total income.

In *National Liberty Life Insurance Co. v. State*,[24] Wisconsin imposed a gross premiums tax[25] on an unlicensed foreign "mail-

20. WIS. STAT. § 71.07(2) (1969) supplied the apportionment formula used in this case. A new formula was subsequently substituted by Wis. Laws 1971, ch. 125, § 373.

21. A "unitary" business is one which functions as a single unit; *i.e.*, it is not divided into a separate entity for each of the states in which it operates. *See* W. R. Authur & Co. v. Department of Taxation, 18 Wis. 2d 225, 118 N.W.2d 168 (1962).

22. Note, *Constitutional Law - Taxation - Sufficient Nexus to Satisfy Due Process of Law*, 1962 WIS. L. REV. 378.

23. *See*, *Interstate Taxation Bill Goes to House Floor*, 47 TAXES 400 (1969) for the development of a uniform federal law.

24. 62 Wis. 2d 347, 215 N.W.2d 26 (1974).

25. WIS. STAT. § 201.42(11)(a) (1969):

> (11) UNAUTHORIZED INSURANCE PREMIUM TAX. (a) Except as to premiums on lawfully procured surplus lines insurance and premiums on independently procured insurance on which a tax has been paid pursuant to sub (12), every unauthorized insurer shall pay to the commissioner before March 1 next succeeding the calendar year in which the insurance was so effectuated, continued or renewed a premium receipts tax of 3 per cent of gross premiums charged for such insurance other than marine insurance and a premium receipts tax of one-half of one per cent of gross premiums charged for such marine insurance on subjects resident, located or to be performed in this state. Such insurance on subjects resident, located or to be performed in this state procured through negotiations or an application, in whole or in part occurring or made within or from within or outside of this state or for which

order" insurance company. The company paid the tax in order to prevent additional penalties and in order to become licensed. The taxpayer brought this action to recover the taxes paid on the basis that the taxes imposed an unconstitutional burden upon interstate commerce and deprived the taxpayer of property without due process of law.

The taxpayer relied on a long line of cases ending with *National Bellas Hess v. Department of Revenue*[26] to establish an insufficient nexus with Wisconsin. In *National Bellas Hess* sales were made in Illinois through the use of catalogues. There were no agents or sales outlets in Illinois; the only connection with customers was by mail or common carrier. The United States Supreme Court held that *National Bellas Hess* had no physical presence within Illinois sufficient to establish a nexus for imposing a use tax.[27] However, making sales of personal property through the mails rests on a substantially different state interest test than selling insurance. The Supreme Court made this clear in *McGee v. International Life Insurance Co.*,[28] where it upheld jurisdiction asserted by California over an insurance company which had done no business in California except for the one policy involved in the case. Thus, it is not surprising that the Wisconsin Supreme Court found the necessary minimum contacts to establish jurisdiction where National had written substantial amounts of "mail-order" insurance with Wisconsin residents. The traditional test has been whether a state has provided benefits for which it can expect a contribution for a share of the costs. Since Wisconsin provides a comprehensive regulatory program enacted to protect all insurance companies—both licensed and unlicensed—conducting business within the state, as

premiums in whole or in part are remitted directly or indirectly from within or outside of this state, shall be deemed to be insurance procured, or continued or renewed in this state. The term 'premium' includes all premiums, membership fees, assessments, dues and any other consideration for insurance. Such tax shall be in lieu of all taxes and fire department dues. On default of any such unauthorized insurer in the payment of such tax the insured shall pay the tax. If the tax prescribed by this subsection is not paid within the time stated, the tax shall be increased by a penalty of 25 per cent and by the amount of an additional penalty computed at the rate of one per cent per month or any part thereof from the date such payment was due to the date paid.

26. 386 U.S. 753 (1967).

27. A use tax is generally imposed as a complement to the sales tax. Such tax is imposed on any purchaser who consumes, stores or uses the property but must be collected by the seller. The use tax applies where the sale is consummated outside the state and the sales tax is not applicable. WIS. STAT. § 77.53.

28. 355 U.S. 220 (1957).

well as to protect Wisconsin citizens, there is a sufficient basis for Wisconsin to exact a tax on a "mail-order" insurer.

The constitutional issue of the case was decided in accordance with the general rule that where a tax is not apportioned, it violates the due process clause and is unconstitutional. Hence in National Liberty Life Insurance Co. it was held that where Wisconsin applied the gross premium tax on the total premiums collected whether from Wisconsin residents or not, the state went beyond the limits of due process, even though it had jurisdiction over the taxpayer.[29]

IV. STATUTE OF LIMITATIONS

American Motors Corp. v. Department of Revenue[30] was an apportionment case, but the main issue has been mooted by subsequent revision of the apportionment formula.[31] The case is worthy of note, however, because of the collateral issue decided by the supreme court as a matter of first impression.

American Motors Corporation sold all of its automobiles to a subsidiary, American Motors Sales Corporation. The main offices of American Motors and its subsidiary are in Detroit, Michigan, and the contract was negotiated there incorporating historically accepted prices and terms. The manufacturing is performed by American Motors in Wisconsin and the automobiles are shipped from Wisconsin on the directions of the Sales Corporation. The Wisconsin Department of Revenue determined the income from the overriding sales contract was derived in Wisconsin and taxable here even though executed in Michigan. American Motors paid the taxes when due and later filed refund claims. The supreme court held that the sale was completed in Michigan and the income was not taxable by Wisconsin. The claims for refund were granted. However, the Department of Revenue had also made an assessment against American Motors which could not be asserted because of the four-year statute of limitations. The state contended that this amount could be set off against the refund due for the barred year. The supreme court agreed.

Setoffs have long been recognized under the federal system where the statute of limitations has otherwise barred assessment. The United States Supreme Court in *Lewis v. Reynolds*[32] stated:

29. *See generally*, Patty, *State Premium Taxes on Mail Order Insurance Under the Due Process Clause*, 22 TAX LAWYER 363 (1969).

30. 64 Wis. 2d 337, 219 N.W.2d 300 (1974).

31. Wis. Laws 1971, ch. 125, § 373.

32. 284 U.S. 281, 283 (1932).

> Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

The Wisconsin court did not address itself to the policy argument that the statute of limitations was enacted to provide a definite time after which a taxpayer need not be prepared to prove that his tax returns were proper. The court in its decision has even adopted the broadest possible definition of "transaction" which opens the entire year when a refund claim is filed rather than resticting the Department of Revenue to the narrow area covered by the refund claim.

This decision brings the Wisconsin and federal views in line with each other. This seems to be a desirable result from the standpoint of tax advisors as well as taxpayers. In addition, where setoff and recoupment[33] are both given similar treatment, it does not matter whether the government or the taxpayer is the first to sue.

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TORTS

I. NEGLIGENT LIABILITY

A. Architects' Negligence

In *A.E. Investment Corp. v. Link Builders, Inc.*[1] and *Rosenthal v. Kurtz*[2] the supreme court this term furnished a restatement of the law of architects' tort liability.

A.E. Investment Corp. involved a claim by a sublessee seeking damages for loss of past and future profits, loss of fixtures and merchandise, and loss of goodwill, all resulting from defendant architects' alleged negligence in designing and supervising construction of a commercial building. Defendants argued that plain-

33. In the event the government has made an assessment for a year which is now barred by the statute of limitations, the taxpayer can raise his claim for refund under the recoupment theory. Thus the theory is the "mirror-image" of setoff. *See*, Rothensies v. Electric Storage Battery Co., 329 U.S. 296 (1946).

1. 62 Wis. 2d 479, 214 N.W.2d 764 (1974).
2. 62 Wis. 2d 1, 213 N.W.2d 741 (1974).