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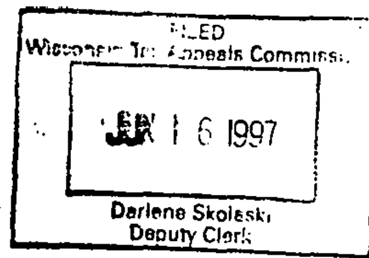
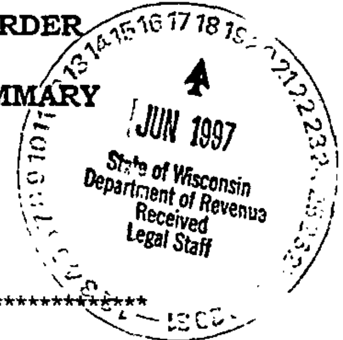


STATE OF WISCONSIN

TAX APPEALS COMMISSION

DELCO ELECTRONICS CORPORATION 3044 W. Grand Boulevard Detroit, MI 48202 Petitioner,	*	DOCKET NO. 95-I-112
vs.	*	**RULING AND ORDER GRANTING SUMMARY JUDGMENT**
WISCONSIN DEPARTMENT OF REVENUE P.O. Box 8933 Madison, WI 53708 Respondent.	*	



DAVID PROSSER, JR., COMMISSIONER,[1] JOINED BY MARK E. MUSOLF, COMMISSION CHAIRPERSON, AND DON M. MILLIS, COMMISSIONER:

The above-entitled matter comes before the Commission, with both parties having moved for summary judgment. Both parties have filed briefs and supporting papers in behalf of their respective motions. The petitioner is represented by Quarles & Brady, by Attorney David D. Wilmoth. The respondent is represented by Attorney Veronica Folstad.

Based upon the entire record in this matter, the Commission finds, rules, and orders as follows:

SUMMARY OF UNDISPUTED FACTS

1. The petitioner, Delco Electronics Corporation ("Delco"), is a corporation organized and existing under the laws of the State of Delaware, with

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[1] Dissenting in part.

its principal offices in Kokomo, Indiana. Delco is a second-tier subsidiary of General Motors Corporation ("GM").

2. Delco is the world's largest supplier of automotive electronics. Delco produces entertainment systems for GM vehicles, as well as anti-lock braking controllers, suspension and steering controllers, remote keyless entry systems, and computer products that include engine, transmission, power train, and vehicle control modules.

3. During the years 1986 through 1989 ("the period under review"), Delco had manufacturing facilities in Indiana, Michigan, and Wisconsin, and was engaged in business both inside and outside these states.

4. During the period under review, Delco incurred a liability for the Michigan Single Business Tax ("MSBT") by reason of the business activities it conducted in the state of Michigan.

5. Delco is part of a consolidated group, the common parent of which is GM. During the period under review, Delco did not file a separate MSBT return but was included in GM's consolidated MSBT return.

6. During the period under review, Delco claimed a deduction on its federal corporate income tax return for its accrued, estimated liability for the MSBT. Because the MSBT liability for the consolidated group had not been finally determined at the time Delco filed its federal income tax returns for each of the years under review, the amounts claimed represented accruals of Delco's estimated MSBT liability.

7. In determining its MSBT liability, Delco calculated its Michigan adjusted tax base pursuant to Michigan Compiled Laws § 208.9 — by a

modified addition method — as opposed to the optional gross receipts method provided for in Michigan Compiled Laws § 208.31(2).

8. Delco timely filed Wisconsin franchise tax returns on a calendar year basis during the period under review. In doing so, Delco claimed an MSBT deduction in an amount equal to the deduction claimed on each of its federal corporate income tax returns.

9. The respondent, Wisconsin Department of Revenue, denied each MSBT deduction.

10. By Notice of Amount Due dated October 29, 1993, the Department of Revenue issued an assessment of additional Wisconsin franchise tax against Delco for the period under review in the amount of $1,049,887, along with interest in the amount of $591,578, for a total of $1,641,465. A portion of the additional assessment was a result of denial of the four MSBT deductions.

11. By letter dated December 6, 1993, Delco filed with the Department of Revenue a timely petition for redetermination objecting to certain of the adjustments proposed in the Notice of Amount Due.

12. By Notice of Action dated November 28, 1994, the Department of Revenue granted in part and denied in part Delco's petition for redetermination. The Notice of Action denied that portion of Delco's petition for redetermination which objected to the disallowance of the claimed MSBT deduction. For this, the Department assessed Delco $912,222.93 in additional franchise tax, along with $513,384.83 in interest, for a total of $1,425,607.76.

13. On January 20, 1995, Delco filed with the Commission a timely Petition for Review.

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APPLICABLE WISCONSIN STATUTES

(1985-86)

Section 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:

* * *

(3) Taxes other than special improvement taxes paid during the year upon the business or property from which the income tax is derived, including therein taxes imposed by this state as income taxes, and taxes on all real property which is owned and held for business purposes whether income producing or not. . . . Taxes imposed by this or any other state or the District of Columbia on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible. However, gross receipts taxes assessed in lieu of property taxes, the license fee imposed under s. 76.28 and the tax imposed under s. 70.375 are deductible from gross income. [Emphasis supplied]

(1987-88)

Section 71.26 Income computation.

* * *

(3) MODIFICATIONS. The income of a corporation shall be computed under the internal revenue code, except a corporation under sub. (2)(b), as modified in the following ways:

* * *

(g) Section 164(a)(3) is modified so that state taxes and taxes of the District of Columbia on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible.

APPLICABLE INTERNAL REVENUE CODE

§ 164. Taxes

(a) General rule

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

* * *

> (3) State and local, and foreign, income, war profits, and excess profits taxes.
>
> * * *
>
> In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).
> . . .

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CONCLUSIONS OF LAW

1. There is no genuine issue of material fact, and this matter is appropriate for summary judgment.

2. Delco Electronics Corporation was not entitled to deduct the Michigan Single Business Tax from its gross income under Wis. Stats. § 71.04(3) (1985-86) or § 71.26(3)(g) (1989-90) during the period under review because the MSBT is a state tax on or measured by all or a portion of Delco's net income.

3. Delco Electronics Corporation was not entitled to deduct the Michigan Single Business Tax from its gross income under Wis. Stats. § 71.04(3) (1985-86) or § 71.26(3)(g) (1989-90) during the period under review because the MSBT is a state tax on or measured by all or a portion of Delco's gross receipts.

RULING

This case comes before the Commission on cross-motions for summary judgment. When both parties move by cross-motions for summary judgment, it is equivalent to a stipulation of facts and permits a court, or the Commission, to decide the case on legal issues. *Miller v. Thomas*, 201 Wis.2d 673, 680-81 (1995); *Friendship Village, Inc. v. City of Milwaukee*, 181 Wis.2d 207, 219 (Ct. App. 1993). We conclude that, inasmuch as there is no issue of material

fact and that one of the moving parties is entitled to judgment as a matter of law, this case is appropriate for summary judgment. *See*, Wis. Stats. § 802.08(2).

In the matter before us, Delco Electronics, a Delaware corporation doing business in Wisconsin, Michigan, Indiana, and other states, deducted a Michigan tax — the Michigan Single Business Tax — from its "gross income" in determining its Wisconsin franchise tax liability. The deductions at issue were made in calendar years 1986, 1987, 1988, and 1989. The deductions were disallowed. After the usual procedural steps, Delco filed with the Commission a timely petition for review.

The issue to be decided is whether, during the period under review, the Michigan Single Business Tax was deductible by a corporation from its gross income in calculating its liability under the Wisconsin franchise tax.

Wisconsin Statutory Background

Wisconsin enacted a corporate income tax in 1911. In the mid-1960s, the State also adopted a franchise tax, which imposed a tax on most corporations for the privilege of exercising their franchise or doing business in Wisconsin in a corporate capacity. The relevant statutes have been revised many times.

Under the law as it existed in the period under review, a corporation which exercised its franchise in this state was required to pay a tax "according to or measured by its entire Wisconsin net income" in the taxable year. Wis. Stats. § 71.01(2) (1985-86), § 71.23(2) (1987-88). "Wisconsin net income" is calculated by making adjustments to gross income, including the deduction of certain taxes. The statute covering such deductions in 1986 was Wis. Stats. § 71.04(3).

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Prior to the 1981 biennial budget, Wisconsin law provided in § 71.04:

> Deductions from income of corporations. Every corporation, joint stock company or association shall be allowed to make from its gross income the following deductions:
>
> * * *
>
> **(3)** Taxes other than special improvement taxes paid during the year upon the business or property from which the income taxed is derived, including therein taxes imposed by this state as income taxes, and taxes on all real property which is owned and held for business purposes whether income producing or not. Income taxes imposed by this state shall accrue for the purpose of this subsection only in the year in which such taxes are assessed. Sales and use taxes paid during the taxable year which under s. 71.043(2) and (3) may be used to reduce a corporation's income or franchise tax shall not be deductible from gross income. [Emphasis supplied]

Under this language, the taxes of other states upon a corporation, including income taxes, gross receipts taxes, and taxes on capital stock, were deductible from gross income. The MSBT was clearly deductible, irrespective of how the tax was characterized, because it was a tax upon business.

As part of the 1981 state budget, Chapter 20, Laws of 1981, § 71.04(3) was amended to read:

> **(3)** Taxes other than special improvement taxes paid during the year upon the business or property from which the income taxed is derived, including therein taxes imposed by this state as income taxes, and taxes on all real property which is owned and held for business purposes whether income producing or not. Income taxes imposed by this state shall accrue for the purposes of this subsection only in the year in which such taxes are assessed. Sales and use taxes paid during the taxable year which under s. 71.043(2) and (3) may be used to reduce a corporation's income or franchise tax shall not be deductible from gross income. *Income, excess profits, war profits and capital*

stock taxes imposed by the federal government are not deductible from gross income. For taxable year 1981 and thereafter, real property taxes that are related to a definite period of time may be accrued ratably over that period by accrual basis taxpayers, and the windfall profit tax under section 4986 of the internal revenue code is not deductible from gross income. For the taxable year 1981 and thereafter, taxes imposed by this or any other state or the District of Columbia on or measured by net income, gross income, gross receipts or capital stock are not deductible. *However, gross receipts taxes assessed in lieu of property taxes and the tax imposed under s. 70.375 are deductible from gross income.* [Emphasis supplied][2]

The change represented by the underlined language was not included in the original budget submitted by the governor. It was part of a series of changes to tax law proposed by the legislature's Joint Committee on Finance, following a memorandum of "suggested revenue sources" from the Legislative Fiscal Bureau. See Fiscal Bureau Paper of May 6, 1981, entitled General Fund Revenue Sources, from Bob Lang, Director, Legislative Fiscal Bureau, to Members of the Joint Committee on Finance. On page 2 of the memorandum, Mr. Lang wrote:

> Under current law, a deduction for state and foreign income taxes is allowed for corporations. Repealing this deduction would generate an additional $19.2 million in fiscal year 1981-82 and $23.2 million in fiscal year 1982-83, or a biennial revenue increase of $42.4 million.

The committee accepted this option and broadened it to include gross receipts and capital stock taxes, estimating substantial additional revenue for the biennial budget.[3]

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[2] The italicized language represents other changes narrowing the deduction in § 71.04(3) which were included in the same biennial budget bill.

[3] The governor subsequently vetoed the elimination of foreign income taxes as a deduction.

The Wisconsin Department of Revenue was thereafter called upon to administer the new law. On November 19, 1981, Department Attorney Allan Hubbard prepared an internal legal opinion, which dates the Department's determination that the MSBT was no longer deductible from gross income.

In 1986, Section 71.04(3) was amended again, so that it read:

> **(3)** Taxes other than special improvement taxes paid during the year upon the business or property from which the income taxed is derived, including therein taxes imposed by this state as income taxes, and taxes on all real property which is owned and held for business purposes whether income producing or not. . . . Taxes imposed by this or any other state or the District of Columbia on or measured by <u>all or a portion of</u> net income, gross income, gross receipts or capital stock are not deductible. . . . [Emphasis supplied].

This 1986 amendment produced the statutory language in place for calendar year 1986.

The 1987 legislature "federalized" the corporate tax structure and significantly rewrote Chapter 71 of the Statutes. *See*, Act 27, Laws of 1987, and Act 312, Laws of 1987. These changes produced § 71.26(3)(g):

> **(3)** MODIFICATIONS. The income of a corporation shall be computed under the internal revenue code . . . as modified in the following ways:
>
> * * *
>
> (g) Section 164(a)(3) is modified so that state taxes and taxes of the District of Columbia on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible.

This language set out the law for calendar years 1987, 1988, and 1989.

During the whole period under review, these Wisconsin Statutes were substantially different from parallel statutes in most other states because

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the Wisconsin deduction excluded taxes on or measured by both "net income" and "gross income," as well as "gross receipts" and "capital stock," and any "portion" of any of them. In short, Wisconsin authorized one of the narrowest deductions for state taxes of any state.

MSBT Statutory Background

The Michigan Single Business Tax was enacted in 1975, effective January 1, 1976. 1975 Mich. Pub. Acts 228. By this enactment, Michigan continued a tradition of experimenting with value added taxes. Between 1953 and 1967, Michigan had utilized a Business Activity Tax (BAT) similar to the MSBT. *Trinova Corp. v. Michigan Treasury Dept.*, 498 U.S. 358, 366, n.4 (1991). Because of its novelty and complexity, the MSBT has been the subject of extensive commentary and frequent litigation.

In the *Trinova* case, the United States Supreme Court provided a simplified example of how value added is determined (498 U.S. at 464-465):

> . . . Assume a bakery's sole revenue comes from the sale of bread. The bakery's costs consist of materials (flour, sugar, spices, utilities), labor (baker, sales clerk), capital (building, mixer, utensils, oven), and credit (interest paid on loans). Any excess of revenues over costs represents profit. Thus:
>
> Revenue = Cost of Labor + Cost of Materials + Depreciation + Interest + Profit.
>
> Because value added is defined as the difference between the value of products sold (revenues), and the cost of materials going into the products, we can represent value added (for the entire firm) by a second simple equation:
>
> Value added = Revenues – Cost of Materials.
>
> The same result is reached by another common method. If we subtract Cost of Materials from each side of the first equation above, we have:

Revenues – Cost of Materials = Cost of Labor + Depreciation + Interest + Profit.

So in practice value added can be calculated as *either* Revenues – Cost of Materials; *or* Cost of Labor + Depreciation + Interest + Profit. Not surprisingly, these are referred to as the "subtraction" and the "addition" methods. Each provides an identical measurement of a taxpayer's value added. Once value added is determined, the VAT is assessed as a percentage of the value added for the relevant fiscal period.

The Court described the MSBT as "an addition method VAT, although it inevitably permits various exclusions, exemptions, and adjustments that depart from the simple value added example described above." *Trinova*, 498 U.S. at 367. The Michigan Supreme Court has said of the MSBT: "The act employs a modified additive method of value added computation." *Trinova Corporation v. Department of Treasury*, 433 Mich. 141, 149 (1989). The Michigan court also said (433 Mich. at 150):

> The computation of the tax involves several steps beginning with the calculation of the taxpayer's tax base. Under the act, "tax base" is defined as business income (or loss) before apportionment subject to certain adjustments. M.C.L. § 208.9; M.S.A. § 7.558(9). "Business income" is essentially federal taxable income. M.C.L. § 208.3(3); M.S.A. § 7.558(3)(3). Common adjustments to business income include additions to reflect the business consumption of labor and capital. Those include adding back compensation, depreciation, dividends, and interest *paid* by the taxpayer to the extent deducted from federal taxable income. Common deductions from business income include dividends, interest, and royalties *received* by the taxpayer to the extent included in federal taxable income. This income is deducted for the purpose of value added computation because it does not result from capital expenditure by the taxpayer. . . .

Using the modified addition method set out in Mich. Compiled

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Laws, § 208.9, a corporation with taxable business activity in Michigan starts with "federal taxable income" and then makes a series of additions and subtractions. The additions include items often considered income, e.g., certain "gross interest income and dividends," other "interest," and certain "royalties," as well as items normally deducted from gross income such as "all taxes on or measured by net income and the tax imposed by this act to the extent the taxes were deducted in arriving at federal taxable income." Also added are such items as compensation, depreciation, certain rents, certain interest and dividends paid — items traditionally viewed as either pre-tax or post-tax costs of doing business. Certain items included in "federal taxable income," such as certain dividends, interest, royalties, and rent, are then subtracted. This creates the corporation's Michigan tax base.

The MSBT also establishes an alternative method of calculation:

> Any taxpayer can . . . calculate its adjusted tax base as total gross receipts multiplied by the apportionment figure . . . divided by 2. This figure is then multiplied by the 2.35% tax rate to give actual tax liability. § 208.31(2). Under this alternative calculation, no firm's Michigan SBT will ever exceed 1.175% of apportioned gross receipts.

Trinova, supra, 498 U.S. at 369.

Against this background, we must decide whether the MSBT, when calculated by the modified addition method, is a state tax "on or measured by all or a portion of net income, gross income, gross receipts or capital stock."

Application of Wisconsin Statutes

In the period under review, the broad, general language contained in § 71.04(3) and then in § 71.26(3)(g), established 16 categories of taxes which are not deductible from Wisconsin gross income:

1. Taxes on net income
2. Taxes on gross income
3. Taxes on gross receipts
4. Taxes on capital stock
5. Taxes measured by net income
6. Taxes measured by gross income
7. Taxes measured by gross receipts
8. Taxes measured by capital stock
9. Taxes on a portion of net income
10. Taxes on a portion of gross income
11. Taxes on a portion of gross receipts
12. Taxes on a portion of capital stock
13. Taxes measured by a portion of net income
14. Taxes measured by a portion of gross income
15. Taxes measured by a portion of gross receipts
16. Taxes measured by a portion of capital stock

Taxes on or measured by all or a portion of capital stock are not involved in this dispute. But the 12 other categories of taxes must be systematically eliminated before the petitioner is entitled to prevail in its deduction.

In an appeal to the Tax Appeals Commission, the petitioner generally has the burden of showing that the Department's determination is incorrect. *Laabs v. Tax Commission*, 218 Wis. 414, 424 (1935); *Department of Taxation v. O.H. Kindt Mfg. Co.*, 13 Wis. 2d 258, 268 (1961); and *Woller v. Department of Taxation*, 35 Wis. 2d 227, 232 (1967). This burden can be heavy when the petitioner is challenging the Department's determination on a tax exemption, a tax deduction, or a tax credit. Tax exemptions and deductions are matters purely of legislative grace. Tax statutes are to be strictly construed against granting exemptions and deductions. A petitioner must bring itself clearly within the terms of the deduction. *Comet Co. v. Department of Taxation*, 243 Wis. 117, 123 (1943); *Fall River Canning Co. v. Department of Taxation*, 3 Wis. 2d 632, 637 (1958); *Ramrod, Inc. v. Department of Revenue*, 64 Wis. 2d 499, 504

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(1974); and *Revenue Department v. Greiling*, 112 Wis. 2d 602, 605 (1983).

Petitioner argues that there are significant differences between a value added tax and an income tax. It quotes the United States Supreme Court to the effect that:

> A VAT differs in important respects from a corporate income tax. The corporate income tax is based on the philosophy of ability to pay, as it consists of some portion of the profit remaining after a company has provided for its workers, suppliers, and other creditors. A VAT, on the other hand, is a much broader measure of a firm's total business activity. Even if a business entity is unprofitable, under normal circumstances it adds value to its products and, as a consequence, will owe some VAT. Because value added is a measure of actual business activity, a VAT correlates more closely to the volume of governmental services received by the taxpayer than does an income tax.

Trinova, 498 U.S. at 364.

But the fact that major differences exist between a value added tax, including the MSBT, and an income tax is not inherently dispositive because of the unique features of. § 71.04(3) and § 71.26(3)(g).

Net Income

Petitioner cites a number of decisions from other jurisdictions to argue that the MSBT is not a tax "on or measured by" net income. None of these decisions is mandatory authority upon the Commission or Wisconsin courts. We are not persuaded that the rationale of these decisions should be applied in Wisconsin, where our statute is unique in its language and evolution.

Petitioner's reliance on *In re Appeal of Dayton Hudson Corp.*, Cal. Bd. of Equalization, No. 94-SBE-003, CCH CA-Tax Rptr. ¶ 402-678 (Feb. 3, 1994), is misplaced in two respects. First, the issue in *Dayton Hudson* was

whether the MSBT was tax measured by gross income, not net income. *Id.* Second, in *Dayton Hudson*, the California Board of Equalization performed a functional analysis of the MSBT, determining the "true nature" of the MSBT. *Id.* (*citing Beamer v. Franchise Tax Board*, 19 Cal. 3d 467, 475 (1977)).

Even if *Dayton Hudson* involved the question of whether the MSBT was a tax *measured by* net income, the result would not be persuasive because the issue before this commission is not the "true nature" of the MSBT, but simply whether it is a tax "on or measured by" net income under Wis. Stats. § 71.04(3) (1985-86) and § 71.26(3)(g) (1989-90).

Similarly, the decisions in *Revenue Cabinet v. General Motors Corp.*, 794 S.W. 2d 178 (Ky. Ct. App. 1990), and *Kellogg Sales Company v. Dept. of Revenue*, 10 Ore. Tax 480, 1987 WL 18468 (1987), are not persuasive because these decisions relied upon a functional analysis. In *General Motors*, the court indicated that if the statute was read literally, it would conclude that the MSBT is a tax on net income. *General Motors*, 794 S.W.2d at 179. However, the court was obligated to engage in a "functional analysis" in which the "[c]haracter of any tax must be determined by its operation and effect." *Id.* Because we are not required to use a functional analysis, the reasoning of *General Motors* actually supports respondent's contention that the MSBT is a tax on net income.

In *Ardire v. Tracy*, 674 N.E.2d 1155 (Ohio 1997), the Supreme Court of Ohio, relying on *Gillette Co. v. Michigan Dept. of Treasury*, 198 Mich. App. 303, 309-11 (Ct. App. 1993), determined that the MSBT was not a tax "measured by" net income for purposes of eligibility for Ohio's resident tax credit. The *Ardire* court noted that the starting point was federal taxable income (i.e., net

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income) with several addition adjustments. The *Ardire* court deferred to the Michigan court's view in *Gillette* that, even though federal taxable income (profit) was the starting point for computation of the MSBT, the many addition adjustments prevented a conclusion that the MSBT is a tax "measured by" net income.

We disagree with the conclusion in *Ardire* because we are not persuaded by the reasoning in *Gillette* to the effect that net income, which we regard as an essential and clearly defined component of the total tax measure, loses its identity as a "measure" of the MSBT. Indeed, the U.S. Supreme Court in *Trinova* recognized net income/profit as a defined and distinct component in the MSBT base used to measure tax liability:

> The total tax base consists of the taxpayer's value added, calculated by the addition method: Cost of Labor + Depreciation + Interest + Profit. . .[T]he taxpayer begins with federal taxable income (representing profit). . .

498 U.S. at 367 (Emphasis supplied).

We therefore conclude that the MSBT was "measured by net income" within the unambiguous meaning of Wis. Stats. § 71.04(3) during the entire period under review because net income is a clearly defined, distinct, and essential component of the MSBT total tax base in the addition method utilized by petitioner. If our statute applied only to taxes measured "solely or exclusively" by net income, petitioner's argument would prevail. The fact is that few if any taxes are taxes purely on net income. (The same holds true for taxes on gross income and gross receipts.) There are generally additions and deductions that must be made and which, to varying degrees, have a basis in economic reality. At what point, under petitioner's analysis, do the additions or subtractions

become so great that a tax is no longer a tax measured by net income? We do not believe it is necessary to address this question.

Gross Income

"Gross income" is a more expansive term than "net income." Conceptually, it includes all "income" from whatever source derived. See § 61, Internal Revenue Code.

U.S. Treasury Regulation § 1.61-3(a) has defined gross income in a manufacturing business, in part, as follows:

> **[¶551]** § 1.61-3. **Gross income derived from business.**—(a) *In general.* In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of . . . selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446-1(c)(1)(ii).

The CCH Standard Federal Tax Reporter explains the regulation as follows:

> For a business entity, the term "gross income" is not synonymous with "gross sales" or "gross receipts." Gross sales or gross receipts generally refers to the total amount received from sales of goods or services prior to any reductions for costs or expenditures. Gross income generally refers to gross sales or gross receipts, <u>less the cost of goods sold</u>, plus income from investments and other sources. [Emphasis supplied].

971 CCH Standard Federal Tax Reports, ¶ 5600.014, p. 18,201. In *Appeal of*

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Kelly Services, Inc., No. 94R-0909 (May 8, 1997), the California Board of Equalization said simply: "Gross income for federal tax purposes in a manufacturing . . . business is defined as gross receipts less cost of goods sold."

California has determined in *Appeal of Dayton Hudson Corporation, supra*, and *Appeal of Kelly Services, Inc., supra*, that the MSBT is measured by something other than gross income. The Ohio Supreme Court reached the same conclusion in *Ardire v. Tracy, supra*.

We do not believe it is necessary here to define the outer limits of "gross income" and then analyze whether the MSBT is a tax on or measured by all or a portion of gross income, because the issue can be resolved on other grounds.

Gross Receipts

"Gross receipts" can be more expansive than "gross income." The concept embraces virtually all revenue that a business takes in during a tax year. It would be difficult to find a term more comprehensive than "gross receipts" to describe a corporation's total revenues.

Is the MSBT a tax on or measured by all or a portion of gross receipts?

There are two options for calculating the MSBT. One option, under § 208.31(2), Mich. Compiled Laws, is to take "total gross receipts multiplied by the apportionment figure . . . divided by 2." *Trinova, supra*, 498 U.S. at 369. In this option, the statute explicitly calls for the MSBT to be measured by all or a portion of gross receipts.

The other option, under Mich. Compiled Laws, § 208.9, uses a modified addition method of calculating value added. In essence, a corporate

taxpayer adds PROFIT + COST OF LABOR + DEPRECIATION + INTEREST. This calculation produces a tax base which is a portion of the corporation's gross receipts.

This conclusion would be easier to follow if Michigan employed the subtraction method of value added, namely "Revenues - Cost of Materials = Cost of Labor + Depreciation + Interest + Profit." *Trinova*, 498 U.S. at 365. "Revenues" are equivalent to gross receipts. *Trinova Corporation v. Department of Treasury*, 433 Mich. 141, 149 (1989). Using this method, a taxpayer would begin with "gross receipts," then subtract the cost of materials to obtain value added. Hence, value added — the difference between the value of products sold (revenues) and the cost of materials going into the products — would be a portion of gross receipts. A tax on value added is measured by a portion of gross receipts.

Whether the corporate taxpayer uses the modified addition method or the subtraction method, the result (a value added tax base) is a portion of the corporation's gross receipts. As the United States Supreme Court said in *Trinova* (498 U.S. at 365), each method of calculation "provides an identical measurement of a taxpayer's value added." According to the Michigan Supreme Court: "Value added, a business activity, is subject to calculation by two equivalent methods." *Trinova Corporation,* 433 Mich. at 149.

The 1986 amendment to § 71.04(3) was designed expressly to apply to a tax measured by a portion of gross receipts. In 1985, the Tax Appeals Commission had issued a decision in *Cedarburg Mutual Insurance Company v. Wisconsin Department of Revenue*, CCH ¶ 202-616 WI Tax Rptr., 11 WTAC 751 (November 1, 1985). The Commission ruled that "fire insurance dues" were not required to be added back to "net income" under § 71.01(4)(a)6 — a subsection

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virtually identical to the key sentence in § 71.04(3) — because they were <u>not</u> taxes "on or measured by net income, gross income, gross receipts or capital stock. . . ." Rather, fire dues were taxes measured by the amount of net fire insurance premiums less dividends — "a component" of gross income or gross receipts. 11 WTAC at 753. The legislature responded immediately — adding the phrase "all or a portion of" to § 71.01(4)(a)6 and § 71.04(3). The governor vetoed the amendment to § 71.01(4)(a)6 but not the amendment in point here.

Hence, the legislature made certain that taxes imposed on all or a portion of a corporation's gross receipts are not deductible.[4] Conceptually, value added as a portion of gross receipts is like $250,000 as part of $350,000. See, *Citizens Utility Board v. Klauser*, 194 Wis. 2d 484, 504-505 (1995).

In *Trinova*, the Supreme Court said that "we recognize that the [MSBT] bears some similarities to a gross receipts tax." 498 U.S. at 384, n. 10. In *Revenue Cabinet, Commonwealth of Kentucky v. General Motors Corporation*, 794 S.W. 2d at 179, the Court observed:

> . . . [A] practical functional analysis of the tax is necessary to determine if it is deductible. . . . In performing the functional analysis, the "[c]haracter of any tax must be determined by its operation and effect." . . . . Several experts described the MSBT as a value-added tax, <u>very similar to</u> . . . <u>gross receipts taxes</u>. [Emphasis supplied].

The Court footnoted this statement, citing Richard A. Musgrave and Peggy B. Musgrave, <u>Public Finance in Theory and Practice</u> (4th ed. 1984). "Testimony by Professor Fisher at trial also supports this proposition." *Id.*

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[4] The Legislative Fiscal Bureau analysis of the tax changes in Act 120, Laws of 1985, includes this statement: "Act 120 . . . clarifies that taxes imposed on all or a portion of the corporation's gross receipts are not deductible under the state corporate income tax." See, January 1986 Special Session Senate Bill 1, Summary of Provisions of 1985 Wisconsin Act 120, Legislative Fiscal Bureau, February 12, 1986, at 7.

In *Ardire v. Tracy*, Ohio Bd. of Tax Appeals, No. 94-K-347 (June 30, 1995), the Board stated in footnote 5: "The Tax Commissioner has suggested that the SBT is a gross receipts tax. See Brief of Appellee at 7-9. We find it unnecessary to make this specific determination as the language of R.C. 5747.05 (B)(1) in the context of this case requires only that we decide whether the SBT is a tax on income or a tax measured by income." By contrast, it was the taxpayer in *Appeal of Dayton Hudson Corporation*, Cal. Bd. of Equalization, No. 94-SBE-003 (Feb. 3, 1994), who suggested that the MSBT was a gross receipts tax, because in California, as the Board said, "A tax on or measured by gross receipts is deductible; a tax on or measured by gross income is not deductible." This is exactly opposite the law in Ohio.

We find that the MSBT is a tax on or measured by all or a portion of gross receipts. Hence, it is not deductible from gross income by a corporation under Wisconsin law.

Effect of 1994 Amendment

In 1994, the legislature amended Wis. Stats. § 71.26(3)(g) by adding the underlined language:

> (g) Section 164(a)(3) is modified so that state taxes and taxes of the District of Columbia that are value-added taxes, single business taxes or taxes on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible.

Petitioner argues that this change, which was effected after the respondent had made its assessment in this case, "clearly demonstrates that § 71.26(3)(g), as it existed prior to the change, did not apply to value-added taxes generally or the MSBT specifically." Petitioner's Brief, at 18 (Feb. 29, 1996).

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We disagree. Inasmuch as we have concluded that the statutes in place during the period under review already excluded the deduction of the MSBT, we believe the 1994 amendment should be viewed as a clarification which provides guidance to taxpayers and removes all uncertainty about the law. The amendment did not change the law retroactively. Respondent could not rely on the change to strengthen its position in this case. Conversely, the respondent's position is not undermined by efforts to make the statute as clear as possible.

Petitioner points to the word "or" in the amendment as implying a contrast or distinction between "value-added taxes" and "single business taxes," on the one hand, and income taxes, gross receipts taxes, and capital stock taxes, on the other. But the word "or" does not always imply the disjunctive, as can be seen in the preceding sentence ("a contrast or distinction"). Moreover, subsection (g) would not make sense if the word "and" had been substituted for the word "or" in the new text. Nor would it make sense if the subsection referred to "state taxes . . . on or measured by all or a portion of net income, gross income, gross receipts, capital stock, value added, or single business [or single business taxes]. . . ." The term "single business taxes" does not fit into this formulation.

Petitioner cites *In Re Marriage of Lang v. Lang*, 161 Wis. 2d 210 (1991), for the proposition that "the legislature is presumed to have intended a change in the law when it amends a statute." Petitioner's Brief, at 18 (Feb. 29, 1996). However, the petitioner has extended the legal proposition well beyond the narrow language of that case. In *Lang*, the Court said "there is a presumption that the legislature intended to change the law <u>by creating a new right or withdrawing an existing right</u> when it amends a statute." [Emphasis

supplied] 161 Wis. 2d at 220. The language in *Lang* creates conditions for the presumption. The petitioner neglected to include these conditions. Surely, the legislature is empowered to clarify the law without making any substantive change in it. The Law Revisions Committee, a permanent committee of the Wisconsin Legislative Council, exists primarily to act on minor remedial measures, proposed by state agencies or the Revisor of the Statutes, to <u>clarify</u> the law. Wis. Stats. § 13.83(1)(a)2 and 4 and § 13.93(2)(j).

The 1994 amendment to § 71.26(3)(g) does not demonstrate that the previous language allowed a corporate taxpayer to deduct the MSBT from its gross income.

1987 Federalization Amendment

Section 164 of the Internal Revenue Code allows the deduction of certain taxes in determining federal taxable income. Among the deductions allowed are:

> (3) State and local, and foreign, income, war profits, and excess profits taxes.
>
> * * *
>
> In addition, there shall be allowed as a deduction state and local, and foreign, taxes not described in the preceding sentence, which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). . . .

For federal income tax purposes, the MSBT is deductible under the unenumerated provision at the bottom of the subsection because it is not a state income tax but is a state tax incurred in carrying on a trade or business.

In 1987, Wisconsin "federalized" its corporate taxes, so that corporate income is computed in accordance with the Internal Revenue Code.

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But the State modified this "federalization" in § 71.26(3), which provides:

> (g) Section 164(a)(3) is modified so that state taxes and taxes of the District of Columbia on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible.

Petitioner argues that for tax years 1987, 1988, and 1989, Wisconsin did not modify § 164 to disallow deductions of the MSBT. It asserts: "Because § 71.26(3)(g) applies by its express terms, only to those taxes described in IRC § 164(a)(3), i.e., income, war profits and excess profits taxes, the modification does not apply to the MSBT." [Emphasis in original]. Petitioner's Brief, at 21 (Feb. 29, 1996).

We are unable to embrace this thesis. The 1987 legislature used virtually the same words in its amendments as appeared in the 1985-86 Statutes. The words "state taxes" in the amendments are substituted for the phrase "Taxes imposed by this or any other state" in the previous statute, and the phrase "the District of Columbia on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible" is exactly the same before and after. This was not a coincidence. If petitioner's thesis were adopted, the legislature would have made gross receipts taxes deductible, which is entirely inconsistent with its modification in § 71.26(3)(f), which mentions gross receipts taxes. It would have made taxes on capital stock deductible. And the 1994 amendment, which adds language about value-added taxes and single business taxes, would not have had even a clarifying purpose because it also applies to § 164(a)(3). In short, the evidence does not support such a sea change in legislative intention.

The federal statute, § 164, is badly drafted. It poses a challenge to other drafters on how to refer to the unenumerated paragraph. The legislature

may not have responded perfectly, but it gave a very clear directive to taxpayers and to the respondent that the Internal Revenue Code is modified for corporations so that "state taxes . . . on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible." [Emphasis supplied]. The legislature's specific directive in § 71.26(3)(g) supercedes federal language and federal policy for Wisconsin corporate tax purposes.

We conclude that the MSBT is not deductible from Delco's gross income for the reasons given.

Therefore,

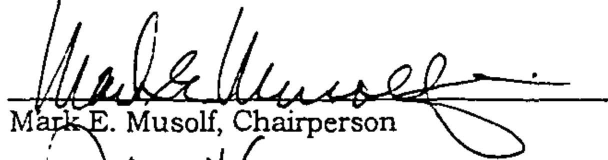
IT IS ORDERED

That petitioner's motion for summary judgment is denied; and

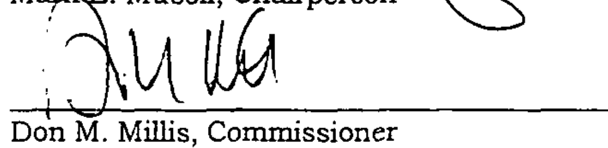
That respondent's motion for summary judgment is granted, and its action on petitioner's petition for redetermination is affirmed.

Dated at Madison, Wisconsin, this 16th day of June, 1997.

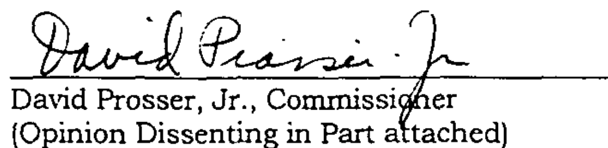
WISCONSIN TAX APPEALS COMMISSION



Mark E. Musolf, Chairperson



Don M. Millis, Commissioner



David Prosser, Jr., Commissioner
(Opinion Dissenting in Part attached)

ATTACHMENT: "**Notice of Appeal Information**"

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DAVID PROSSER, JR., DISSENTING IN PART:

The Commission is unanimous in its conclusion that the Michigan Single Business Tax is not deductible by Delco Electronics from the corporation's Wisconsin gross income. We all conclude that the MSBT is a tax on or measured by all or a portion of a corporation's gross receipts. But we have different views on whether the MSBT is a tax on or measured by all or a portion of net income.

The term "net income" is manifestly designed to be broad and generic. The term is not tied to a specific definition in our state statutes, for it is intended to apply to income taxes in all states and the District of Columbia. These income taxes may use a variety of different labels and allow a multitude of different adjustments. Nonetheless, the term "net income," as the Supreme Court said in *Trinova Corp. v. Michigan Treasury Dept.*, 498 U.S. 358, 364 (1991), is "based on the philosophy of ability to pay, as it consists of some portion of the profit. . . ." Net income embodies a notion of gain realized after payment of the expenses necessary to earn the income.

The MSBT is quite different.

One reason why the *Trinova* case was a good vehicle for courts to examine the MSBT was that the Trinova Corporation suffered a net loss in 1980, the tax year in question. *Trinova*, 498 U.S. at 369. This factor helped to distinguish the MSBT from an income tax. As the Court explained, "Even if a business entity is unprofitable, under normal circumstances it adds value to its products and, as a consequence, will owe some VAT." 498 U.S. at 364.

The *Trinova* case perfectly illustrates why the MSBT is not a tax on or measured by all or a portion of net income. In the Supreme Court decision, the Court set out a chart showing Trinova Corporation's 1980 income

(-$42,466,114) in relation to its total value added tax base ($221,125,319), before other adjustments:

U.S. taxable income (loss)		($42,466,114)
Add:		
Compensation		$226,356,271
Depreciation		$23,262,909
Dividends, interest, and royalties paid		$22,908,950
Other		$549,526
	Subtotal	$230,611,542
Subtract:		
Dividends, interest, and royalties received		($9,486,223)
Total Tax Base		$221,125,319
Apportionment		
Payroll Factor		0.2328%
Property Factor		0.0930%
Sales Factor		26.5892%
Average Factor		8.9717%
Apportioned Tax Base:		$221,125,319
		X 8.9717%
		= $19,838,700

498 U.S. at 369.

The $19,838,700 in apportioned tax base was thereafter adjusted by subtracting a capital acquisition deduction ($9,063) and by taking the maximum (37%) reduction for labor-intensive taxpayers. These adjustments resulted in a 1980 adjusted tax base of $12,492,671. When the adjusted tax base was subjected to a tax of 2.35%, the result was a tax liability of $293,578. *Id.*

Taking these facts and applying them hypothetically to a corporation doing business in Wisconsin in any of the years between 1986 and 1989, we would ask: May the hypothetical corporation deduct the $293,578 it paid in MSBT from its Wisconsin gross income? If Wisconsin law denied a

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deduction only for state taxes on or measured by all or a portion of "net income," the answer would be "yes." Why? Because the $293,578 in tax is not "on" the corporation's net income, which was a loss of $42,466,114; because the $293,578 is not a "portion" of the net loss; and because the $293,578 was not "measured" by all or a portion of the net loss. "Net income" was only one of many factors in obtaining a pre-adjustment tax base of $19,838,700 or a post-adjustment tax base of $12,492,671.

Most written decisions in other states rule that the MSBT is not a tax on net income. In *Gillette Co. v. Dept. of Treasury*, 198 Mich. App. 299, 303, 497 N.W. 2d 595, 598 (1993), the Michigan Court of Appeals said: "The appellate courts of this state have rejected the theory that the single business tax is a tax upon income. . . . We conclude that the single business tax is not a tax 'imposed on' net income." The court cited *Trinova Corp. v. Dept. of Treasury*, 433 Mich. 141, 149 (1989); *Mobil Oil Corp. v. Dept. of Treasury*, 422 Mich. 473, 493 (1985); *Town & Country Dodge, Inc. v. Dept. of Treasury*, 152 Mich. App. 748, 755 (1986); *Wismer & Becker Contracting Engineers v. Dept. of Treasury*, 146 Mich. App. 690, 696 (1985). See also *Ardire v. Tracy*, 77 Ohio St. 3d 409, 674 N.E. 2d 1155 (1997); *Revenue Cabinet, Commonwealth of Kentucky v. General Motors Corp.*, (Ky. App.) 794 S.W. 2d 178 (1990); *In re Appeal of Dayton Hudson Corp.*, Cal. Bd. of Equalization, No. 94-SBE-003, CCH CA-Tax Rptr. ¶ 402-678 (Feb. 3, 1994); *In the Matter of the Appeal of Kelly Services, Inc.*, Cal. Bd. of Equalization, No. 94R-0909 (May 8, 1997); *Kellogg Sales Company v. Dept. of Revenue*, 10 Ore. Tax 480, 1987 WL 18468 (1987); In re Ruling Request (Oct. 17, 1994), Va. Dept. of Tax No. P.D. 94-313, unreported.

The decisions also hold that the MSBT is not a tax "measured by

net income." *Ardire v. Tracy, supra. In re Appeal of Dayton Hudson, supra. Kellogg Sales Company v. Dept. of Revenue, supra.*

It is hard to overlook the fact that Michigan taxpayers who do not choose the gross receipts method of calculation under Mich. Compiled Laws, § 208.31(2), begin their calculations under § 208.9 with "federal taxable income," which is encompassed within any reasonable reading of "net income." There is no doubt that federal taxable income or "business income" is a critical component of the MSBT.

Franchise and corporate income taxes paid to the State of Wisconsin and other states are another component of the MSBT because they are added to "federal taxable income" in establishing the Michigan tax base. Consequently, the petitioner is seeking to deduct from its Wisconsin gross income a tax which includes in its calculation income taxes paid to Wisconsin and other states.

However, our statute disallows the deduction of taxes on or measured by a portion of net income as opposed to taxes of which net income is a portion. Profit is a portion of value added, as is compensation; but the MSBT is not really a tax on or measured by the profit portion of value added any more than it is a tax on or measured by the compensation portion. Measuring value added by net income is like measuring a baseball game by the score in the first inning.

In *Revenue Cabinet, Commonwealth of Kentucky v. General Motors Corporation*, (Ky. App). 794 S.W.2d 178 (1990), the court ruled that the MSBT was not functionally equivalent to an income tax. It therefore allowed deduction of all parts of the MSBT except that part of the tax that was computed, in whole

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or in part, by reference to the corporation's net income. This decision was based on the specific language of Kentucky's statute which disallowed "Any deduction for a state tax which is computed in whole or in part, by reference to gross or net income and which is paid or accrued to any state of the United States. . . ." KRS 141.0101(a), and by Kentucky court decisions which required a functional analysis of the tax. The Kentucky statute appears to permit focus on the components of the MSBT; our statute focuses on portions of net income. If Wisconsin had the Kentucky statute, my views on the point at issue would be different.

Respectfully submitted,

David Prosser, Jr., Commissioner