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STATE OF WISCONSIN CIRCUIT COURT Branch 6 DANE COUNTY

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DELCO ELECTRONICS CORPORATION,

Petitioner,

vs.

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

MEMORANDUM DECISION AND ORDER (Admin. Review)

Case No. 97-CV-1908

This is a judicial review of a decision by the Tax Appeals Commission denying Plaintiff corporation a deduction of its Michigan Single Business Tax, a form of value added tax, from the calculation of its Wisconsin franchise income taxes. Because a value added tax is not a tax on or measured by all or a portion of income or gross receipts, the Court reverses TAC's decision.

REVIEW OF RECORD

The facts are not disputed. Petitioner Delco Electronics Corporation is a subsidiary of General Motors and is engaged in the business of manufacturing automotive electronics. It has plants in Wisconsin, Michigan and Indiana and engages in business in those and other states. During the years under review, 1986 through 1989, Delco incurred a liability for the Michigan Single Business Tax (MSBT or SBT), a form of value added tax (VAT). Delco's Michigan tax was included in the returns of its parent, General Motors, as provided by Michigan law. For the period under review, Delco claimed its estimated MSBT as a deduction on its federal corporate income tax returns.

Delco timely filed Wisconsin franchise tax returns, claiming in them a deduction for the MSBT equal to the amounts claimed in its federal returns. Respondent, the Wisconsin Department of Revenue, denied the deduction for the MSBT. Delco petitioned the Department for a redetermination. The Department rejected that part of the petition which objected to the disallowance of the MSBT deduction.[1]

On January 20, 1995, Delco petitioned for review by the Tax Appeals Commission (TAC). Following cross motions for summary judgment, TAC upheld the Department's disallowance of the MSBT deduction on the grounds that the MSBT was a tax on or measured by all or a portion of either Delco's net income or its gross receipts. Delco now seeks review of that determination.

CONCLUSIONS OF LAW

The question presented on this review is whether Delco's Michigan Single Business Tax liability may be deducted from its Wisconsin franchise tax base for the years 1986 through 1989. The material facts are undisputed and this review presents only questions of law. Under sec. 73.015(2), Stats., TAC's determinations are reviewed under ch. 227, Stats. The Court shall

[1]According to TAC's findings, the Department assessed Delco's franchise tax liability attributable to the disallowance of the MSBT deduction at $912,222.93 in additional tax plus $513,384.83 in then accrued interest. Finding # 12. Delco contends that the figure attributable to the MSBT was much lower, $110,409 in additional tax plus $65,800 in interest. The amount of the tax is not germane to this review and TAC may address the issue, to the extent disputed, on remand.

set aside or modify agency actions, as required, resulting from material errors of law. Sec. 227.57(5), Stats.

A. DEFERENCE.

The parties disagree as to the degree of deference to be accorded TAC's analysis of the law. Depending on such factors as whether the legislature has charged an agency with administering or interpreting a statute, the agency's experience and use of its expertise in interpreting a statute, and its consistency in interpreting the statute, reviewing courts will give the agency's interpretation great, due or no particular weight. See Zignego Co., Inc. v. Dept. of Revenue, 211 Wis.2d 817, 820-24 (Ct. App. 1997).

"A de novo standard of review is only applicable when the issue before the agency is clearly one of first impression . . . or when an agency's position on an issue has been so inconsistent as to provide no real guidance. . . ." UFE Inc. v. LIRC, 201 Wis.2d 274, 285 (1996). Due weight deference is accorded when the agency has some expertise but not necessarily more than that of a court. Zignego, 211 Wis.2d at 821. Under a due deference test, a reasonable agency interpretation of a statute will be upheld unless there is a more reasonable interpretation available. Id. Great weight deference, under which any reasonable agency position is accepted, will be given when an agency has a long standing and consistent history of interpretation of a matter within its expertise. Id..

While TAC is charged with administering and interpreting the corporate and franchise tax statutes, it has no demonstrated record of applying value added taxes to them. In the United States, value added taxes are "much studied but little used," Trinova Corp. v. Michigan Dept. of Treasury, 498 U.S. 358, 362 (1991), so TAC has apparently not previously been called upon to interpret or understand taxes of that nature.

The Department asserts that deference is not accorded as to whether TAC has been faced with a particular set of facts but according to TAC's experience in administering a particular legislative scheme. See Barron Elec. Cooperative v. PSC, 212 Wis.2d 752, 764 (Ct. App. 1997). However, as discussed more fully in Part E., below, TAC's record in applying the statutory scheme at issue in this case has been spotty. In Cedarburg Mut. Ins. Co. v. Dept. of Revenue, ¶202-616 at 12,700 (CCH Wis. Tax Rptr. Nov. 1, 1985), and Cumis Insurance Society, Inc. v. Dept. of Revenue, ¶202-908 at 13,590 (CCH Wis. Tax Rptr. Sep. 30, 1987), TAC gave what was regarded by the Department to be excessively cramped readings to the language denying deductions (or requiring add-ons) for the payment of taxes "on or measured by net income, gross income, gross receipts or capitol stock." This led directly to the amendment of the statutes in 1986 to make taxes based on "a portion" of such measures non-deductible as well. TAC Decision at 9, 19-20.

The risk in according great deference here is that TAC may have learned its lesson too well and now reads the exception to the deduction more broadly than the legislature intended. This fear is

especially borne out by one of TAC's conclusions here, that the MSBT is measured by net income, a determination that, as discussed below, not only "directly contravenes the clear meaning of the statute," UFE, 201 Wis.2d at 282 n. 2., but also flies in the face of the decisions of every other tribunal considering the question. The combination of the newness of the issue and TAC's track record with the statutory scheme leads the Court to conclude that it is entitled to no more than due deference here.

B. WISCONSIN'S CORPORATE AND FRANCHISE INCOME TAXING SCHEME.

Wisconsin assesses corporate income or franchise taxes based on a corporation's Wisconsin net income. Secs. 71.23(1), (2), Stats. Delco was subject to the franchise tax for the period under review, calendar years 1986 through 1989.

For 1986, sec. 71.04(3), Stats., permitted businesses to deduct from its tax base certain other taxes paid by the business except that "[t]axes 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."[2]

[2]As the Court understands it, a tax "on" something, taxes the specified thing. By contrast, a tax "measured" by something, taxes a certain privilege, to conduct business for example, while the tax is measured by some scale of economic activity. For example, the corporate income tax is a tax "on all Wisconsin net income" while the franchise tax is for the privilege of exercising franchise and doing business but "measured by [the taxpayer's] entire Wisconsin net income. . . ." Secs. 71.23(1), (2), Stats.

Commencing with tax year 1987, the legislature "federalized" the state corporate tax scheme so that, in general, the corporate and franchise income tax calculation would track the federal corporate income tax scheme. However, Wisconsin adopted several substantial modifications to the federal scheme. Among these was sec. 71.26(3)(g), Stats., which stated that "Section 164(a)(3) [of the Internal Revenue Code, 26 USC §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." For the purposes of this decision, the Court assumes, without deciding, that the legislature did not intend any substantive change in the former sec. 71.04(3) by the adoption of sec. 71.26(3)(g). Compare State v. Wachsmuth, 73 Wis.2d 318, 329 (1976) (court may reject words in a statute which are inadvertently used or retained "in order to bring meaning to what is manifestly intended."), with Wis. Tax. Bull. 99 at 26 (Dept. of Revenue Oct. 1996) (sec. 71.26(3), Stats., only modifies provisions of sec. 164(a)(3) of the IRC).

In 1994, sec. 71.26(3)(g), Stats., was amended to expressly identify value added and single business taxes as also non-deductible.

C. THE MICHIGAN SINGLE BUSINESS TAX.

TAC concluded that the Michigan Single Business Tax was excepted from deduction under both the pre-federalized and post-federalized schemes. This requires an analysis of the MSBT.

The MSBT is a form of value added tax or VAT. "Value added is defined as the increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale." Trinova, 498 U.S. at 362 (quoting James W. Haughey, The Economic Logic of the Single Business Tax, 22 Wayne L. Rev. 1017, 1018 (1976)).

> For an individual business there are two equivalent methods to calculate value added. The first is to subtract from total sales all of the purchases made from other businesses. The result is the increase in value brought about by the internal operations of the business. The second method is to add up all of the payments paid internally to the owners of the labor and capital used to bring about the added value of the materials or services initially purchased. The results of either method are necessarily identical since subtracting purchased goods and services from total sales leaves labor cost, profit or loss, interest paid and depreciation charges--the internal payments to the factors of production that create the added value.

Haughey, 22 Wayne L. Rev. at 1018-19.

> 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.

Trinova, 498 U.S. at 365 (emphasis in original) (footnotes omitted).

> The MSBT essentially taxes according to the addition method.
>
> In order to calculate the amount of a taxpayer's SBT the taxpayer must, first, determine its total tax base. The total tax base consists of the taxpayer's value added, calculated by the addition method: Cost of Labor + Depreciation + Interest + Profit. Under §208.9 [Mich. Comp. Laws (1979)], the taxpayer begins with federal taxable income (representing profit), adds other elements that reflect consumption of labor and capital including

> compensation, depreciation, dividends, and interest paid by the taxpayer, and makes other detailed adjustments.

Trinova, 498 U.S. at 367. The result has been characterized as "a modified additive method for value added computation." Trinova Corp. v. Dept. of Treasury, 445 NW2d 428, 432 (Mich. 1989), aff'd, 498 US 358 (1991). For multi-state operations, the tax base is apportioned according to how much of the total value added is attributable to its efforts in Michigan. Trinova, 498 US at 367-68.[3]

Virtually every tax contains exemptions, exclusions and adjustments that are motivated by political and social considerations so that almost no tax will be "pure" in terms of what it purports to tax. The MSBT is no exception. Trinova, 498 U.S. at 367. Lobbying pressures from special interests resulted in departures from the economist's notion of a "pure" value added tax. See Alan Schenk, The Michigan Single Business Tax: A State Value Added Tax, 58 Mich. Bar J. 392, 394 (Jul. 1979).

Among these adjustments,

> the computation process involves provisions designed to give relief to businesses with a high labor cost or a high tax base in relation to gross receipts. The taxpayer has the option to take advantage of the most favorable elective adjustment. The taxpayer may elect to reduce the adjusted tax base either to 50 percent of

[3]In Trinova, the Michigan Supreme Court, 445 NW2d at 440, and the United States Supreme Court, 498 US at 387, in turn, upheld the constitutionality of the tax's multi-state apportionment scheme, as applied to Trinova.

gross receipts, or by the percentage that compensation exceeds 65 percent of the total tax base.[4]

Louis W. Kasischke, Computation of the Michigan Single Business Tax: Theory and Mechanics, 22 Wayne L. Rev. 1069, 1070 (1976). These elections, a taxpayer may choose only one, in effect set ceilings on the tax base in relation to gross receipts or compensation. Trinova, 498 U.S. at 368 and n. 6.

D. MSBT AS TAX MEASURED BY NET INCOME.

TAC's conclusion that the MSBT as described above constitutes a tax on or measured by net income is plainly erroneous. While "pure" taxes on net income are rare, this does not justify TAC's conclusion that any tax base which has income as a component thereby leads to a tax "measured by all or a portion of net income. . . ." Such language clearly does include taxes which are measured only in part by income. Taken to its logical extreme, which TAC's decision nearly does, almost any tax on the economic process or business activity could be classified as a tax measured by income, because income (or profit), which is the primary goal of a business enterprise in a free market system, is inextricably linked with nearly every other variable which might form a measure of taxable business activities. See Trinova, 498 US at 376 ("In a unitary enterprise, compensation, depreciation, and profit are not

[4]By the time of the Trinova case, involving tax year 1980, the scheme had been amended to reduce the compensation ceiling to 63%. Trinova, 445 NW2d at 433 n. 13.

independent variables to be adjusted without reference to each other.").[5]

While Wisconsin's tax scheme denies deductions for taxes that go beyond "pure" measures of net income, the legislature was equally obvious in expressing its intention that not all taxes on business activities were to be non-deductible. Thus, in 1986, sec. 71.04(3) provided that "[t]axes other than special improvement taxes upon the business or property from which the income is derived," including, but not limited to, property taxes and Wisconsin income taxes, were deductible, while state taxes "on or measured by all or a portion of net income, gross income, gross receipts or capital stock" were non-deductible. In 1987, 1988 and 1989, the federalized Wisconsin tax scheme started with Section 164(a) of the Internal Revenue Code which permitted deductions for state income taxes, other taxes expressly enumerated in that section, and other unspecified taxes imposed on the carrying on of a business. From this starting point, under sec. 71.26(3)(g), Stats., the legislature expressly specified the taxes it wanted to exclude from the deduction, those taxes "on or measured by all or a portion of net income, gross income, gross receipts or capital stock. . . ." It is hard to believe that the legislature, which expressly limited non-deductibility to four specifically enumerated

[5]For the purposes of this litigation, the parties appear to agree that there is no material distinction between net income and profit. See Trinova, 498 US at 367. In reality, however, net income includes income from sources other than profit created by generating value added and under the MSBT such income is deducted from the tax base. Trinova, 445 NW2d at 432.

types of taxes, including reasonable variations on such taxes, by cagey extension also intended non-deductibility of taxes which, in their essence, quality and scope, are substantially different from those specifically enumerated. It is also hard to believe that the legislature intended by the term "on or measured by . . . net income" to include any tax which had somewhere in it income as a component, regardless of the nature and function of the tax as a whole.

As a value added tax, Michigan's Single Business Tax is conceptually entirely different from a tax on or measured by income.

> A VAT differs in important respects from a corporate income tax. A 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. Further, because value added does not fluctuate as widely as net income, a VAT provides a more stable source of revenue than the corporate income tax. . . . "'The logic or rationale of the [VAT] rests squarely on the benefits received principle of taxation--government services are essential to the operation of any business enterprise ... and a part of these public service costs should properly be included in the cost of doing business.'"

Trinova, 498 US at 363-64 (citation omitted).

To be sure, Michigan's tax scheme uses federal taxable income as its starting point but that does not make the tax one measured by income.

> For ease of administration . . . , the SBTA [Single Business Tax Act] uses the federal income tax system as a reference and starting point and, through various required additions and subtractions, converts the federal tax base into a consumption-type VAT base.

Mobil Oil Corp. v. Dept. of Treasury, 373 NW2d 730, 741-42 (Mich. 1985) (emphasis added). The MSBT "is not a tax upon income." Trinova, 445 NW2d at 432. "[T]he single business tax is not a tax 'measured by net income.'" Gillette Co. v. Dept. of Treasury, 497 NW2d 595, 598 (Mich. Ct. App. 1993). As the Ohio Tax Commissioner expressed in a determination upheld by the Supreme Court of his state:

> "[a]lthough the MSBT starts its calculation with federal taxable income, numerous adjustments are made to that amount in order to derive the Michigan tax base. Among those adjustments are additions of salary, depreciation, rent, interest, and other expenses that were deducted by the corporation for purposes of computing its federal taxable income. Those adjustments are so significant that any relationship that the starting point for the MSBT may have had to 'income' was lost on the way to computing the MSBT base."

Ardire v. Tracy, 674 NE2d 1155, 1157-58 (Ohio 1997) (emphasis added).

Under a subtraction method of value added, Revenues - Cost of Materials, Trinova, 498 US at 365, net income does not figure in the calculation at all. Thus, according to the United States Court of Appeals for the Sixth Circuit, "[b]ecause . . . the result for taxpayers is the same regardless of which way the value added tax is written, the additive method of computing value added taxes does not truly tax the individual components that go into the calculation of value added." Thiokol Corp. v. Roberts, 76 F3d 751, 756 (6th Cir. 1996) (footnote omitted).

Putting the income component of the MSBT in its proper context demonstrates why the tax cannot be regarded as measured by income. Because of the additions of such expenses as labor, depreciation and interest, the taxpayer may owe a MSBT even if it has negative income, that is even if it is unprofitable. See Trinova, 498 US at 375; Kasischke, 22 Wayne L. Rev. at 1071. As the Michigan Court of Appeals observed,

> We do not perceive the SBT as an income tax. Although Federal taxable income is used as the starting point in computing the tax base, it is possible that a taxpayer may have no income and still be subject to payment of the SBT. Other components of the tax base, e.g., wages, include expenses incurred, a theory not synonymous with income taxes."

Stockler v. Dept. of Treasury, 255 NW2d 718, 723-24 (Mich. Ct. App. 1977).

Indeed, the dissent in Trinova remarked that "[p]ayroll and depreciation represent over 90 percent of the SBT base," 498 US at 388 (Stevens, J., dissenting), which means that income must be a part of the remaining 10%. According to one scholarly analysis, "[c]ompensation alone is expected to constitute about 75 to 80 percent of the base." Kasischke, 22 Wayne L. Rev. at 1072. Even after a special interest tax break for labor intensive firms, labor costs, on average, still should be the predominant component of value added. See Id., at 1093. Keeping in mind that "Gross National Product is virtually equivalent to national value added," Haughey, 22 Wayne L. Rev. at 1017, the Statistical Abstract of the United States, Table 691 at 448 (U.S. Dept. of Commerce, 116th ed.

1996), reveals that corporate profits are consistently less than 10% of annual gross national product.

As far as the Court is aware, TAC's determination that the MSBT is on or measured by net income is novel among all the administrative or judicial tribunals to consider the issue. See Ardire, 674 NE2d at 1158 (collecting cases); TAC Decision at 28 (Prosser, Comm., dissenting in part).[6] TAC's assertion that Wisconsin law supplies a unique definition to the term is purely conclusory and is supported neither by the history nor the language of Wisconsin's statutes.[7] Its assertion that Wisconsin law precludes a functional analysis of the tax sought to be deducted is puzzling because it is impossible to know whether a tax is measured by all or a portion of net income or any of the other specified categories without examining how the tax under scrutiny operates. Taxes are analyzed according to their substance, not their shadow. Stewart Dry Goods Co. v. Lewis, 294 US 550, 555 (1935); Ed Schuster

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[6]The one partial exception is Kentucky which allows for partial deduction of taxes. In Revenue Cabinet v. General Motors Corp., 794 SW2d 178, 179-80 (Ky. Ct. App. 1990), a Kentucky court determined that the part of the value added tax attributable to income was non-deductible while the other parts were deductible. Neither the parties nor TAC have suggested that Wisconsin allows partial deductions under the statutes involved here.

[7]According to TAC, Decision at 9, what makes Wisconsin's exceptions from deduction of other taxes different from those of other states is simply that the Wisconsin statutes name more non-deductible categories of taxes than the laws of other states. It does not follow from this that the categories named are more broadly defined in Wisconsin than in other states. Contrary to the Department's stance, the language identifying tax bases measured by "a portion" of net income as non-deductible does not include tax bases of which net income may be a component. See Decision at 29 (Prosser, Comm., dissenting in part).

& Co. v. Henry, 218 Wis. 506, 510 (1935). Accord, Thiokol, 76 F3d at 756. TAC's analysis itself cannot be construed as anything but a functional analysis, albeit an erroneous one.

Given the small size of corporate profits in relation to the MSBT base, corporate income is a poor predictor of the tax owed. When 90% of a tax base consists of something other than net income, it cannot under any reasonable reading of the words be a tax "on or measured by all or a portion of net income. . . ." As a result, TAC's conclusion to the contrary "directly contravenes the clear meaning of the statute." UFE, 201 Wis.2d at 282 n. 2.

E. MSBT AS TAX ON A PORTION OF GROSS RECEIPTS.

TAC's determination that the Michigan tax is on or measured by a "portion" of gross receipts presents a more difficult question. Formalistically, a value added tax base might arguably be characterized as a "portion" of gross receipts, that portion which excludes the cost of materials. See Trinova, 498 US at 464-65. However, while tax exemption statutes are to be strictly construed, they must also be reasonably construed. Columbia Hospital Ass'n v. City of Milwaukee, 35 Wis.2d 660, 668 (1967).[8] "[A] requirement of strict construction does not mean that the court is not to search for and ascertain such legislative intent." Heidersdorf v.

[8]This case adds a twist to the burden because it involves exceptions to an exemption. For the purposes of this discussion, the Court accepts TAC's implicit corollary to the general rule and assumes that exceptions to exemptions should be construed broadly to limit applicability of the exemption. However, the construction must still be reasonable.

State, 5 Wis.2d 120, 123 (1958). Even statutes which require strict construction do "not require a narrow technical meaning be given words in question in such blatant disregard of their context as to frustrate the obvious intent of the legislature." State v. Wachsmuth, 73 Wis.2d 318, 330 (1976).

Words and phrases in a statute are to be construed according to common and approved usage. State v. Brulport, 202 Wis.2d 505, 522 (Ct. App. 1996). A "portion" is essentially defined as a part or a share of a whole. See Webster's Third New International Dictionary, at 1768 (1986). Black's Law Dictionary, at 1162 (6th ed. 1990), defines "portion" as "[a]n allotted part; a share, a parcel; a division in a distribution; a share of an estate or the like, received by gift or inheritance." A restaurant patron requesting a portion of pumpkin pie will be justifiably irked if served a piece of bare crust. Nobody would refer to a slice of ham as a portion of a ham and cheese omelette. "Portion" connotes a division of a whole in which the parts maintain the identity of or reference to the whole. The term generally does not apply to ingredients of the whole in their separately identifiable states.

For example, under TAC's standard, net income is that "portion" of gross receipts left when expenses are subtracted. But, most people would regard the term "a portion . . . of gross receipts" as a convoluted, perhaps even devious, way of identifying an income tax. Indeed, according to the United States Supreme Court, "'[t]he difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our

decisions, is manifest and substantial. . . .'" Stewart Dry Goods Co., 294 US at 558.[9] Statutory interpretation ought to presume a certain degree of straightforwardness on the part of the legislature which means here that the legislature will not be presumed to have intended to define and identify some taxes in terms of taxes that are "manifest[ly] and substantial[ly]" different. As the income tax example demonstrates, the trouble with TAC's definition of "portion" is that it allows some taxes to be identified and defined for purposes of the exception to deduction by other taxes that are completely different in their essence, quality and scope.

The Court's understanding of the Wisconsin legislature's intent is reinforced by a history of the statutory terminology which was amended in order to identify as non-deductible taxes which were quite different from the MSBT. Until 1986, the corporate and franchise income tax exception to the deduction of other taxes contained no reference to "all or a portion" of the taxes excepted. Only taxes "on or measured by net income, gross income, gross receipts or capitol stock" were excepted. In Cedarburg Mut. Ins. Co. v. Dept. of Revenue, ¶202-616 at 12,700 (CCH Wis. Tax Rptr. Nov. 1, 1985), a taxpaying insurer sold five lines of insurance, one of which covered fires. The Department of

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[9]In Stewart, 294 US at 566, the United States Supreme Court held that the Constitution prohibited graduated gross receipts taxes even though graduated income taxes are permitted. The Wisconsin Supreme Court followed Stewart in striking down a graduated Wisconsin gross receipts tax in Ed Schuster & Co. v. Henry, 218 Wis. 506, 510 (1935).

Revenue denied a deduction for a fire insurance dues tax measured by the gross receipts of fire insurance sales with adjustments. The taxpaying insurer asserted that the tax was deductible because fire insurance sales represented only part of its gross receipts. TAC upheld the deduction, concluding, among other things that "'[g]ross income' and 'gross receipts' as those terms are used in Section 71.01(4)(a)6 of the Wisconsin Statutes is the total of all income and receipts of an insurer." Cedarburg, at 12,701.[10]

The Department points out that in Cedarburg, at 12,701, the fire insurance dues were based on the amount of fire insurance premiums minus returns to policyholders such as dividends. However, there is no suggestion that TAC's decision in any way rested on this aspect of the dues calculation. Thus, in Cumis Ins. Soc., Inc. v. Dept. of Revenue, ¶202-908 at 13,590 (CCH Wis. Tax Rptr. Sep. 30, 1987), TAC upheld an insurer's deduction of out of state taxes based on premiums themselves. Regarding Cedarburg as dispositive of the issue, TAC again concluded the deduction could not be disallowed because the insurer had other sources of gross receipts. Cumis, at 13,592.

The Department beseeched the legislature to add the language "all or a portion of" in order to overcome TAC's conclusion in Cedarburg. The taxes sought by the Department to be included in the insurers' income in both Cedarburg and Cumis used as their base

[10]The insurer took the deduction according to the tax calculation statutes applicable to insurers under which the dues were simply not added back onto the insurer's federal taxable income. The terminology interpreted in Cedarburg was not materially different from that applicable to other corporations.

a certain class of gross receipts, derived from the sale of certain lines of insurance, but because those gross receipts were not all of the insurers' gross receipts--the insurers sold other insurance or had other sources of receipts--TAC ruled that the statutory language permitted the deduction. In effect, TAC was saying that only taxes on whole pumpkin pies mattered, not taxes on individual slices. The purpose of amending then sec. 71.04(3), Stats., so that taxes "on or measured by all or a portion of net income, gross income, gross receipts or capital stock are not deductible," (emphasis added) was to extend non-deductibility to taxes measured by such divisions of gross receipts, that is taxes using as their base certain types or classes of gross receipts which do not add up to a taxpayer's total gross receipts. Such taxes are gross receipts taxes, just not, under Cedarburg, at 12,702, "the total" of gross receipts. The amendment was to correct this problem, not to extend non-deductibility to taxes measured by the product of gross receipts minus some substantial element because such taxes are not measured by gross receipts at all.[11]

This view is further reinforced by the legislature's amendment to sec. 71.26(3), Stats., in 1994, after the years involved in this case, which expressly added "value-added taxes" and "single business taxes" to the list of non-deductible taxes. "[T]here is a presumption that the legislature intends to change the law by creating a new right or withdrawing an existing right when it

[11]Interestingly, then Governor Earl vetoed the amendment of the statute applicable to insurers which was the original source of the issue.

amends a statute." In re Marriage of Lang v. Lang, 161 Wis.2d 210, 220 (1991). TAC, Decision at 22-23, reads Lang tautologically, asserting essentially that the presumption operates to change the law only when rights are changed. However, "'. . . [i]f any presumption applies, it is that the legislature by reason of the amending enactment sought to change the existing law.'" Estate of Nottingham, 46 Wis.2d 580, 590 (1970) (emphasis added). It is the fact of the amendment itself that creates the presumption of an intention to change the law.

The Department contends that the amendment was intended to clarify and make express what the previous language implied, that value added and single business taxes were not deductible. That may have been its stance before the legislature. However, the legislative history of the amendment must be regarded as inconclusive. While the Department's Fiscal Estimate characterized the amendment as "clarifying," the Legislative Reference Bureau analysis which accompanied the original bill characterized the bill as "expand[ing]" the categories of non-deduction. See 1993 AB 1234; sec. 134, 93 Wis. Act 437. Moreover, the fact that the Department supported the amendment indicates that it saw grounds to hedge its position. Thus, the Court regards the presumption of change as unrebutted.[12]

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[12]The record contains other documents explaining the Department's position to the legislature and the LRB. Resp. App. 10. Interestingly, the Department's stance in these documents was only that the SBT and value added taxes were non-deductible because they were measured in part by net income. The Department did not assert in them that the taxes were measured by a portion of gross income.

That a tax on value added is manifestly and substantially different from a tax on gross receipts requires some explanation. It is undisputed that gross receipts are essentially the taxpayer's sales revenues. For instance, Wisconsin's sales tax is imposed on retailers and measured by the gross receipts from individual taxable transactions and gross receipts are defined essentially as the sale price of the goods and services sold at the retail level. Secs. 77.52(1), (2), 77.51(4)(a), Stats.[13] Conversely, even though Wisconsin's use tax system is designed to complement and supplement the sales tax system, use taxes cannot be regarded as a tax on all or a portion of gross receipts because they are imposed on the consumer who buys and uses a product or service with the tax measured by the price paid by the taxpayer. Sec. 77.53(1), Stats. Sales and use taxes "cover different taxable events involving the same kinds of tangible personal property." Dept. of Revenue v. Moebius Printing Co., 89 Wis.2d 610, 622 (1979).

Whether retail level or not, sales taxes based on gross receipts reflect the total value added to the economy of every entity which had a hand in the production and distribution process up to the point of the taxable transaction.

> [T]he sale price of any good or service is identically its total value added. The value added of a loaf of bread is the sum of the value contributed at each stage of the production and distribution process. Among

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[13]Michigan has a retail sales tax as well as its Single Business Tax. Schenk, 58 Mich. Bar J. at 396 n. 2. Apparently, the Department would allow a deduction for this tax even though it may be a tax on a portion of gross receipts. Wis. Tax Bull. 99 at 26 (Oct. 1996).

> others, it includes the contribution of the farmer, miller, baker, wholesaler and retailer.

Haughey, 22 Wayne L. Rev. at 1019. The major distinction between a value added tax and a tax on gross receipts is that with the latter, the taxpayer is assessed a tax not only according to its own value added but according to the value added of all the other entities preceding it in the stream of commerce.

The significance of the distinction between a tax on gross receipts and a tax on value added is readily apparent even by examining the subtraction method of value added whereby the taxpayer's cost of materials is actually subtracted from its gross receipts. See Trinova, 498 US at 364-65.

> The payments made to purchase intermediate goods must be subtracted from the taxpayer's base in order to avoid the multiple taxation of intermediate goods, which are goods which go through several production stages before becoming a final good. In the absence of special treatment for intermediate goods, a tax of fifty percent would, for example, take half the wheat produced by the farmer, half the flour produced by the miller, and half the loaves of bread produced by the baker. As a result, wheat would be taxed at a rate of 87-1/2 percent, while apples sold by the farmer directly to a consumer would [be] taxed only at a rate of fifty percent. Therefore, the tax base of every entrepreneur must include only the value the enterprise has added to the intermediate good, and not the cost of acquiring the intermediate good itself.[14]
>
> Thus, the farmer would be taxed on the wheat he produces at the full rate--for him, the wheat is a raw

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[14] A tax imposed only on goods at the retail level might provide the special treatment on intermediate goods to which the Michigan Court refers and avoids double taxation, although creating its own problem which is, as discussed, that the retailer pays the tax for the value added by other entities which might distort the economic process.

> material, not an intermediate good.[15] The miller, however, would be taxed only on the value added to the wheat by grinding it into flour. The miller would subtract what was paid to the farmer in order to acquire the wheat; the remaining tax base, consisting of labor, land, capital, and profits, would equal the value added by making it into flour. Similarly, the baker would subtract the cost of acquiring the flour, and the remaining sum, consisting of labor, land, capital, and profits, would equal the value added by baking the flour into bread.

Mobil Oil, 373 NW2d at 741 n. 13.

In sum, the difference between a value added tax and a gross receipts tax is that a value added tax is a function of the value added to the economy by the taxpayer's actual efforts while a gross receipts tax is more dependent on the value of the products sold regardless of the taxpayer's contribution to that value.

The same distinction is seen when analyzing the European Economic Community's value added tax system which is essentially a modification of the subtraction method in which taxes are assessed or credited with each of the taxpayer's transactions.

> Under the EEC system, the bakery in our example would be taxed on each sale of bread, and would receive a credit for each purchase of materials going into the production of bread. Similarly, at each other link in the chain of production and distribution, tax is assessed on sales, but credit is provided on purchases.

Trinova, 498 US at 365 n. 3. As noted by the Supreme Court in another case, "[f]or purposes of calculation and assessment, the European VAT system is by no means equivalent to a sales tax."

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[15]The reference to the farmer's wheat as "a raw material" is somewhat misleading since, under the subtraction method, it is the cost of materials which is subtracted from revenues to obtain value added. The example is correct in the sense that the farmer adds value to the economy by turning seed (which would be a deductible raw material if purchased from an outside source) into wheat.

Itel Containers International Corp. v. Huddleston, 507 US 60, 67-68 (1993).[16] With a tax truly based on gross receipts, there would be no credit for purchases. As noted by one scholarly authority, although the SBT is not a pure value added tax, "it has less deviations than the European taxes." Haughey, 22 Wayne L. Rev. at 1026.

The Michigan tax was designed not to be a tax on gross receipts.

> It attempts to avoid the cascade effect of a gross receipts or turnover tax by eliminating from the tax base the cost of purchases and the cost of services provided by independent contractors.

Schenk, 58 Mich. Bar. J. at 395. It is also not analogous to a retail level sales tax because every entity in the chain of production and distribution is responsible for paying the tax as measured by its own work product or value added.

With the addition method of value added taxing, a version of which is employed in Michigan's SBT, the distinction between a VAT and a gross receipts tax is most clear. Under the addition method, value added is calculated by adding "Cost of Labor + Depreciation + Interest + Profit," Trinova, 498 US at 365. "Gross receipts" ordinarily does not even figure into the calculation. Just as the SBT cannot be regarded as a tax measured by net income, though net

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[16] In Itel, the distinction between the VAT and the sales tax at issue in that case was immaterial to the Court's decision because the case involved a challenge to application of a state sales tax based on the grounds that this was prohibited by international trade conventions. The Court determined that the conventions only prohibited taxes on the act of importation, which neither sales nor VAT taxes are.

income is one of its components under one formula of calculation, see Thiokol, 76 F3d at 756, as discussed in Part. D, above, so too, the SBT cannot be considered a tax on a portion of gross receipts, because under the addition method, the method employed by Michigan here, gross receipts is not even an element in the calculation.

For that reason, even if a VAT using the subtraction method or the EEC method could be regarded as a tax measured by a portion of gross receipts, an addition method VAT cannot be so regarded. Apart from the profit element, which, as discussed in Part D, above, comprises only a small component of the tax base, the MSBT is measured by consumption, not receipts. See Trinova, 498 US at 367. "A base consisting of profits will be adjusted to measure the use of labor and capital." Kasischke, 22 Wayne L. Rev. at 1071 (emphasis added). Thus, the MSBT "taxes the user, and not the supplier, of capital." Mobil Oil, 373 NW2d at 742 n. 15. Just as Wisconsin regards sales and use taxes to be separate taxes "covering different events," sales and consumption, Moebius Printing, 89 Wis.2d at 622, so to Michigan's addition based value added tax, which is measured mostly by expenses and consumption of labor and capital used in production must be distinguished from a tax which uses gross receipts, or even a fraction of gross receipts, as a base. A tax measured by use and consumption expenses cannot be measured by "all or a portion of. . . gross receipts."

To be sure, there are similarities between a gross receipts tax and a value added tax. See Revenue Cabinet v. Gen'l Motors

Corp., 794 SW2d 178, 179 (Ky. Ct. App. 1990), just as there are similarities between an income tax and a value added tax. See Haughey, 22 Wayne L. Rev. at 1026. All are taxes on what the Michigan Supreme Court characterized as "the economic process." Mobil Oil, 373 NW2d at 739. They differ, for example, from property taxes or flat fee taxes in that they are measured by some element or fruit of the generation of product or services.[17] They are assessed by comparing various elements of the economic process. Id.. These elements are not independent variables. See Trinova, 498 US at 376.

However, to say that these elements are not independent variables is not to say that the different taxes derived from them do not measure substantially different aspects of the economic process. Just as the United States Supreme Court has recognized that income taxes and gross receipts taxes are manifestly and substantially different even though income itself is the remainder of gross receipts after all expenses are subtracted, Stewart Dry Goods, 294 US at 558-60, so too value added taxes measure something manifestly and substantially different from gross receipts taxes even when the subtraction method is used and value added is the remainder after the expenses for obtaining materials are subtracted from gross receipts. "The SBT cannot readily be identified as an

[17]The distinction between taxes on the economic process and other taxes is not perfect. Income taxes, for example, may include taxes on the proceeds of sales of property or capital, which do not generate product or services. See n. 5, above.

income tax, a gross receipts tax, or a property tax." Schenk, 58 Mich. Bar J. at 392.

As further support for its conclusion, TAC noted that under the MSBT, an entity has the option of calculating its tax as a percentage of gross receipts as a whole. That option has been criticized as the result of special interests lobbying to reduce the economic purity of the value added nature of Michigan's tax. Schenk, 58 Mich. Bar J. at 394, 395. However, an examination of the gross receipts "option" reveals that employing it carries serious tax consequences which restricts its use and availability.

Under Mich. Comp. Laws, sec. 208.31(2), "if" the Single Business Tax Base exceeds 50% of the sum of gross receipts plus certain adjustments, then the taxpayer may use that 50% figure as its tax base in calculating the tax due. The "elective" would generally not be relevant to a taxpayer whose value added does not approach 50% of gross receipts, at least so long as that taxpayer's goal is minimizing tax exposure.[18] The election feature of the provision most frequently comes into play if the taxpayer, in addition to qualifying for the gross receipts ceiling, also qualifies for the independent ceiling set under Mich. Comp. Laws, sec. 208.31(5) [now sub. (4)], which allows the taxpayer "to reduce the adjusted tax base by the percentage that compensation exceeds

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[18]The Court in Trinova, 498 US at 369 n. 7, suggested that the gross receipts calculation option might also be available to taxpayers who are willing to accept increased tax liability in order to avoid purported extra labor of calculating the tax according to the value added method. There is no indication, however, that this is commonly done.

65% [now 63%][19] of the total tax base." See Kasischke, 22 Wayne L. Rev. at 1093. Under Mich. Comp. Laws., sec. 208.31(2), a taxpayer eligible for both ceilings may choose either but not both. Business entities operating on the principle of tax minimization will choose the option resulting in a lower tax liability. See Revenue Cabinet, 794 SW2d at 179. This is exactly what the taxpayer did in Trinova, 498 US at 369 and n. 7. Electing the gross receipts measure might have other serious tax consequences. For example, "[t]he SBT credit against the Michigan Income Tax is unavailable to any Michigan income taxpayer electing the gross receipts limitation." Kasischke, 22 Wayne L. Rev. at 1092. While the parties have offered no figures as to the frequency with which these options are used, according to the Michigan Supreme Court, they are available only "under limited circumstances." Trinova, 445 NW2d at 433. According to a scholarly source, it is the compensation cap which predominates, being employed by almost one-half of MSBT taxpayers. Schenk, 58 Mich. Bar. J. at 394.

Even were the Court to agree with TAC that a taxpayer should not be able to avoid Wisconsin's exception to the deduction by its choice in calculating the out of state tax sought to be deducted, it does not follow that the MSBT's gross receipts based ceiling which is realistically available only to some taxpayers and useful only to some to whom it is available, should dictate the characterization of the tax as to all taxpayers. Under the MSBT, the gross receipts option has serious tax consequences which should

[19]See n. 4, above.

not extend to those who do not choose it. To extend the analogy introduced earlier, what TAC is saying is that if some customers get pieces of pumpkin pie which actually have pumpkin filling, all those who get pieces of crust are deemed to have received pie as well. The legislature could not have intended such an inequitable interpretation of the statutory exceptions to the deduction. Here, it is undisputed that Delco did not calculate its tax according to the gross receipts alternative and though it is not clear whether that option was available to it, it cannot be inferred that the method chosen was employed for any purpose other than the lawful minimization of tax exposure to the MSBT provided by and in full accordance with Michigan's statutory tax scheme.[20]

F. MSBT AS A TAX ON GROSS INCOME.

The Department asserted before TAC that the Single Business Tax was also on or measured by all or a portion of gross income, an issue on which TAC passed. Decision at 17-18. At least since 1987, Wisconsin has used the federal definition of "gross income." Sec. 71.26(2), Stats. The pertinent federal regulation states in part:

> 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.

26 CFR §1.61-3(a).

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[20]The Court is without opinion as to whether the pre-1994 Wisconsin statutes disallowed deductions to taxpayers who used the gross receipts cap.

The difficulty with identifying the MSBT as a tax on or measured by all or a portion of a taxpayer's gross income, is demonstrated in the function of labor costs in relation to the "cost of goods sold" element of gross income. For manufacturing and mining businesses, i.e. producers of goods, the labor costs of turning raw materials into finished salable products is part of the cost of goods sold, hence not part of gross income. For merchandisers, labor costs are part of gross income, but deductible expenses from it. See 1997 Ed. Tax Return Manual at §3.400 (Form 1120, Sch. A), §3.563 and §3.700 (CCH Fed. Tax. Serv.).[21] Since, as discussed earlier, labor costs occupy the lion's share of value added in the economy, for manufacturing entities at least, gross income excludes the single biggest component of value added, making gross income no better a predictor of value added than net income. That the taxpayer's labor cost, the largest element of value added, sometimes is and sometimes is not part of its gross income means that the MSBT cannot be defined in relation to gross income.

G. CONCLUSION

As emphasized by the United States Supreme Court, the MSBT is unique in this country as an attempt to measure a taxpayer's taxable contribution to the economic process in terms of value added. Trinova, 498 US at 362. It should come as no surprise then that until Wisconsin's corporate and franchise income tax laws were

[21] If an entity produces and sells its own goods, some of its labor costs may count as gross income while some may not.

amended in 1994, value added taxes did not fit into the definitions of taxes expressly designated for non-deduction by sec. 71.26(3)(g), Stats., and its predecessors. This statutory scheme was based on traditional notions of tax accounting under which gross receipts are used as the base then costs of goods sold are subtracted to arrive at gross income then other deductible expenses are subtracted to arrive at net income. By contrast, a value added tax scheme such as the MSBT makes substantial modifications to the tax accountant's traditional ledger so that the tax cannot fairly be characterized in terms of the taxes identified in the old Wisconsin statutes. Because the Michigan Single Business Tax is manifestly and substantially different from income and gross receipts taxes, they cannot be on or measured by income or on or measured by all or a portion of gross receipts in the sense intended by those statutes.

Accordingly,

O R D E R

IT IS HEREBY ORDERED that the decision of the Tax Appeals Commission in the above captioned matter is REVERSED and the matter is REMANDED for further proceedings consistent with this decision.

Dated, at Madison, Wisconsin, this 20th day of March, 1998.

BY THE COURT

Richard J. Callaway, Judge
Circuit Court, Branch 6

cc: Attorney David D. Wilmoth
Assistant Attorney General F. Thomas Creeron III
Tax Appeals Commission