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Malcolm K. Whyte

IMPORTANT CHANGES IN THE WISCONSIN INCOME TAX LAW

MALCOLM K. WHYTE*

THE 1927 legislature enacted a revision of Wisconsin's Income Tax Law which was beyond doubt the most far-reaching since the enactment of the law itself in 1911. The purpose of this article is merely to point out the more important changes, and to suggest some of the problems which may arise in the interpretation of the new law, rather than to attempt a complete exposition of the revision or to urge any particular interpretation of the various new clauses.

The first change that the taxpayer will notice will be the time of payment. Under the former law the taxpayer submitted his return of March 15 for the preceding year and paid it the following January. Under the new law the taxpayer will submit his return on March 15, as formerly, but will pay it on June 1, or seven months earlier than under the old law.[1] The return has been made self-assessing to the extent that the return as submitted will be presumed to be correct for the purpose of entering the tax on the assessment rolls.[2] Corrections as to computation and verification of entries will be done afterward and incorporated in additional assessment rolls.

The most interesting of the changes is the adoption of the averaging system of computing taxable income. Under this method the taxable income of any year is to be determined by averaging the gain or loss for the particular year with the gain or loss of the preceding two years.[3] For the tax to be assessed in 1928, however, the average income of 1927 and 1926 only are to be used. This system was used in Great Britain for several years, but has been recently discontinued.

There are certainly definite advantages in this method of computation, but the scheme does seem to raise some rather difficult questions and in some instances to inflict hardship. Let us assume, for instance, that A Company had a net income of $45,000 in 1927, $30,000 in 1928 and a loss of $15,000 in 1929. Its taxable income for the year 1929, under the new law, would thus be $20,000 on which an income tax of approximately $1,000 would have to be paid. In such a case it will

* Member of the Milwaukee Bar.

[1] 71.10 (4) (a)

[2] 71.10 (2)

[3] 71.10 (1) (a)

be very difficult to convince the management that it is fair to tax the company on an assumed income of $20,000 in 1929 when it actually lost $15,000.

The case may be easily conceived of where the $15,000 loss just cited might mean that the entire capital of A Company was thereby extinguished. It might be a very interesting constitutional question as to whether A Company, which had an actual loss of $15,000 and, had its entire capital wiped out with nothing left in its coffers to pay taxes with, can be assessed any tax at all for the particular year assessed as an *income* tax.

Using the average of 1926 and 1927 to determine the 1927 taxable income, while using a three year average thereafter brings some strange results. Let us assume that A Company's income was actually as follows:

1926	*1927*	*1928*	*1929*	*Total*
None	$90,000	None	None	$90,000

This would result in taxable income as follows:

1926	*1927*	*1928*	*1929*	*Total*
None	$45,000	$30,000	$30,000	$105,000

In other words, A Company, under the statute, will be taxed on $15,000 more than it made. If the $90,000 had been earned in 1928, and nothing earned before or after, the total taxable income would be only the $90,000. In case the constitutionality of the averaging system is tested, no doubt variations such as the above will be made a basis of attack. Similar instances of variation can be easily multiplied.[4]

There are several other points of difficulty which arise through the vagueness of the statute. One of these is the method of computing the income for a dissolved corporation. Let us assume that A Company, having earned $10,000 each year, decides to liquidate and dissolve on December 31, 1931, and does so. Its taxable income for each year up to and including 1931 is $10,000, but the question arises at once, does it have a taxable income of $6,666.67 in 1931, made up of the $10,000 earned in 1929 and 1930 each and zero in 1931, and does it have a taxable income of $3,333.33 in 1932, being the aver-

[4] Since the above article was written the Legislature at a Special Session (Chapt. 4, Laws of Special Session, signed Feb. 3, 1928) amended the law by providing that 1927 taxable income should be determined by taking the 1926 income twice and the 1927 income once for the averaging. This throws the weight on the 1926 income, and gives even more strange results. For instance a company makes $15,000 in 1926 and loses $18,000 in 1927. Under the amendment its 1927 taxable income will be $4,000, although it actually lost $18,000 in 1927, and lost a net of $3,000 over the two year period.

age of the 1930 $10,000 income and no income for the two succeeding years? The statute gives little light. Section 71.10 (1) (c) provides that if a subsequent year must be used to the last year in which a person received income in order to compute taxable income, then for such subsequent years it will be assumed that no income or loss was received. This would indicate that the above method of computation would be applicable.

On the other hand, when a corporation is dissolved and completely liquidated, and its stockholders are reporting and paying tax on the profit growing out of the liquidation, it may surely be argued that the corporation is non-existent for the purpose of earning, computing and returning any taxable income. If this view be taken we might have this situation, however, which seems almost as strange as the one just discussed. A Company actually earns:

1928	*1929*	*1930*
0	0	$90,000

and immediately liquidates. Its total taxable income then would be only $30,000 and $60,000 would have escaped taxation.

The income of estates presents a similar problem. The statute[5] does not even by definite language direct that the income of the executor be averaged with income of the deceased in the preceding two years. It is fair, however, to assume that was the intent of the statute or otherwise an estate could use zero income for the two preceding years and thus pay on only one-third of its actual income. But it is in closing an estate that the more serious difficulty arises. Section 71.095(6) requires that before an executor can be discharged, he must submit returns up to date of his petition, and pay such tax as is determined on them by the assessor of incomes. It does not state whether the income of an executor in the year the estate is closed is to be used as an element in computing the taxable income for the two years following such close.

For instance, let us assume, as often happens, that a person dies who has had substantially no income, but owned a large and valuable tract of land which his executor sells in 1930 at a profit of $90,000. We then have this result if it be assumed that the executor closes the estate December 31, 1930, and it be the correct view that no tax is owed after the close:

	1928	*1929*	*1930*
Actual income	0	0	$90,000
Taxable income	0	0	$30,000

[5] 71.095 (6)

If it be the correct interpretation of the law that the income for 1930 must be used in computing the tax for 1931 and 1932, and it must be immediately paid prior to the closing of the estate, we get this result:

	1928	*1929*	*1930*	*1931*	*1932*
Actual income	0	0	$90,000	0	0
Taxable income	0	0	$30,000	$30,000	$30,000

On the latter view the estate apparently would pay on the full $90,000, which would seem fair but it would have to pay the tax for 1931 and 1932 two years before due, and there is no provision for a discount. The present payment of a tax not due for two years of course puts a burden of two years' interest on the estate, as compared with an individual who does not need to anticipate his taxes. This discrimination might seem to raise a constitutional question.

A third situation on which the statute is equally vague is the one where a taxpayer, after a prosperous year leaves the state. Is the state going to contend that the taxpayer will have taxable income in Wisconsin for two years after he has left the state? If it does, serious constitutional questions would seem to arise, as well as difficulties of enforcement, and, if not, the taxpayer seems to have escaped his just share of taxation.

A decided improvement found in the new law is the elimination of stock dividends as income,[6] thus at last bringing Wisconsin in line with the Federal rule. Every intelligent business man, accountant and lawyer has long realized that a stock dividend was not only not income, but almost the reverse as it in fact constitutes a declaration by the corporation that it is retaining its earnings to be used as *capital,* and that they are no longer available for distribution as *income* for the stockholders.

Another improvement in the new law is the adoption of the federal "reorganization" section.[7]

It is rather difficult to completely summarize these sections in the limited scope required by this article. It will probably suffice to say that under these sections the following are now tax-free transactions: (a) the transfer of property for stock by individuals in organizing a corporation, (b) the breaking up of a corporation into two or more corporations, (c) the consolidation or merger of cor-

[6] 71.02 (2) (b) 3

[7] 71.02 (1), i, 1-8

porations, the latter of which includes (d) the acquisition by one corporation of the majority of the stock of another corporation. These sections eliminate a good many of the absurdities found in our tax law as it had heretofore existed, including, for example, the taxing of one who had transferred his real estate to a corporation in which he held all the stock, on a claimed profit based on increases in value of the land just as if he had sold it.

Another change of major importance is found in Section 71.03(5) which makes dividends tax free to stockholders from corporations where 50 per cent of the income in the previous year was Wisconsin income. The old law had exempted dividends only to the same extent that the income of the corporation had been assessed in Wisconsin, for example, if a corporation reported 75 per cent of its income as Wisconsin income and 25 per cent as earned outside of Wisconsin, the stockholders could claim an exemption as to 75 per cent of the dividend received.

The new law can be made clear by this illustration:

A and B Company report in 1927 income as follows:

	A. Company	*B. Company*
Earned in Wisconsin	$25,001.00	$24,999.00
Earned in Illinois	24,999.00	25,001.00
	$50,000.00	$50,000.00

Each then pays in 1928 a dividend of $50,000 to A and B, respectively, each being the sole stockholder of the respective company.

A Company will pay to Wisconsin about ten cents more tax than B Company which is fair enough, but because of the $2.00 difference in Wisconsin income and ten cents difference in tax, B must pay full taxes on his entire dividend of $50,000 or about $3,000, as compared to A who gets his dividend of $50,000 tax free. This presents an interesting constitutional question as to whether dividing all corporations into only two classes, namely those whose income is 50 per cent or more in Wisconsin and those whose income is less than 50 per cent in Wisconsin, is a reasonable classification.

There are a number of other changes for which space will not permit discussion, such as the reduction of the interest rate on additional assessments from 10 per cent to 6 per cent, and the allowing of interest to the taxpayer at 6 per cent on overpayments made by him.[8]

Many of the administrative features of the law have been simplified, and the arrangement of the various subjects has been tremendously improved.

[8] 71.06 (3)

On the whole the new revision marks a real advance in our income tax law, notwithstanding the serious problems suggested above. The two greatest gains discernible are, first, the progress made in making our state law more like the Federal law, and secondly, the apparent recognition in the new revision that the state should play fairly with its taxpayers with respect to interest charges, refunds and simplicity of procedure. This will do much in allaying the not unfounded feeling of resentment against our tax laws and tax officials, which many of our taxpayers have held for many years.