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Testing the Validity of a Wisconsin Income Tax Rule Through a Declaratory Judgment Action

George J. Maly Jr.

TESTING THE VALIDITY OF A WISCONSIN INCOME TAX RULE THROUGH A DECLARATORY JUDGMENT ACTION

The 1955 session of the Wisconsin Legislature revised and expanded the procedure for the making, promulgating, and validating of rules by administrative agencies. In providing for determination of the validity of a rule the legislature expanded and clarified the provisions for declaratory judgment actions.

Under the Revised Statutes the means of judicial determination of the validity of a rule of any administrative agency is an action for declaratory judgment in the Circuit Court for Dane County.[1] This court is to render a judgment determining the validity or invalidity of a rule when it appears ". . . that the rule or its threatened application interferes with or impairs, or threatens to interfere with or impair, the legal rights and privileges of the plaintiff."[2] This procedure is limited to a certain extent, however, in that a rule can be declared invalid in such an action only if the rule violates a constitutional provision, exceeds the sattutory authority of the agency making it, or was adopted without adherence to statutory rule making procedure.[3]

When the declaratory judgment provisions are applied to rules issued by the Wisconsin Department of Taxation several perplexing questions of statutory interpretation arise. This is particularly true when the new statutes are considered in conjunction with pre-existing statutes providing for assessments of income taxes by the Department of Taxation and judicial review of such assessments.

In the first place, it would seem that the taxpayer may, in some instances, challenge the validity of a rule in a declaratory judgment action prior to the time an assessment is made by the Department of Taxation based on such rule. The Legislative Committee on Administrative Rule Making, in considering the value of the declaratory judgment action, stated:

> ". . . it enables disputes to be determined in their incipiency, . . . a decision as to the validity of a rule can be obtained without first taking a chance on having violated the rule. . . ."[4]

The question is: in what type of situation does the taxpayer have standing to challenge the validity of a rule? Must he wait until he files

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[1] WIS. STATS. §227.05(1) (1955).

[2] *Ibid.*

[3] WIS. STATS. §227.05(5) (1955); 227.014(2)(a) grants administrative agencies power to make rules to "effectuate the purpose of the statutes." Such rules are not valid if they "exceed the bounds of correct interpretation" of the statutes, however. Thus it would seem that an interpretative rule might be declared invalid in a declaratory judgment action if it "exceeds the bounds of correct interpretation." For the distinction between interpretative and legislative rules see Comment, 40 MARQ. L. REV. 414, at 416 (1957).

[4] II Wis. Legis. Council Report, Part II, at 117 (1955).

an income tax return which includes a transaction to which the rule would apply? May he challenge it on the basis of a transaction entered into which will be taxed under the rule in the future? Is the fact that he is contemplating entering into a transaction which will be taxed under the rule adequate to give him such standing? Clearly much of the usefulness of declaratory judgment actions is dependent upon the answer to these questions.[5]

The Legislative Committee declined to specify the factual situation which would give a taxpayer standing to challenge the validity of a rule. They stated:

> "Judicial review sometimes may be denied on the ground that the person requesting the review has no standing to challenge the rule or the action in question. Such decisions usually speak in terms of the absence of 'legal right' and occasionally in terms of absence of 'case or controversy.' The concept of 'legal right' defies exact definition. . . . The basic question is whether or not the petitioner asserts an interest which under the circumstances is deserving of legal protection. The way the question is answered varies from case to care."[6]
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> "227.05 provides that the court shall render a declaratory judgment as to the validity of a rule when the rule interferes or threatens to interfere with or impair the 'legal rights and privileges of the petitioner' . . . While the court is apt to speak in terms of such statutory language when deciding questions of standing to challenge, the basic problem of who has standing to challenge an administrative rule is not altered by such general language."[7]
>
> "The law pertaining to who has the right to challenge the validity of an administrative rule is largely court law. Probably little could be done in an administrative procedure act to improve the 'legal rights' formula."[8]

There are no Wisconsin cases which indicate what circumstances give a taxpayer a "legal right" to challenge a rule of the Department of Taxation in a declaratory judgment action and thus in any particular case the taxpayer can only initiate the action and await the court's decision as to whether or not he has the requisite standing to challenge the rule. There seems to be no valid reason why the courts should not be liberal in allowing a taxpayer to challenge the validity of a rule as it would seem all parties concerned would benefit from the early determination of such validity.

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[5] It is interesting to note that the possibility of using declaratory judgment actions to test the validity of tax regulaions on the federal level is currently being considered. See American Bar Association Section of Taxation, Program and Committee Reports to be Presented at the Eighteenth Annual Meeting of the Section, at 75 (1957).

[6] II Wis. Legis. Council Report, Part II, at 125 (1955).

[7] *Id.* at 126.

[8] *Id.* at 128

If a taxpayer is allowed to initiate a declaratory judgment action to test the validity of a rule which will effect a contemplated transaction no difficulty arises as the Department of Taxation will clearly take no action prior to the rendering of such judgment. Likewise, if the taxpayer is allowed to initiate a declaratory judgment action on a rule applicable to a transaction entered into and the judgment is rendered prior to the time for filing income tax returns covering such transaction there is no problem. If a taxpayer initiates a declaratory judgment action and the judgment is not rendered prior to the time for filing returns on transactions which the challenged rule will effect the taxpayer may file his return and pay the tax as though the rule were valid. This likewise presents no problem as the taxpayer may, upon determination of the invalidity of the rule by the circuit court, apply to the Department of Taxation for a refund. In applying for such a refund the taxpayer must show the reason for the claim (in this case the invalidity of the rule under which the tax was paid) and the determination of this claim is subject to judicial review.[9] Normally, the Department of Taxation should allow such refunds as a matter of course without a second judicial test through the review procedure.

Once an additional assessment is made by the Department of Taxation, numerous difficulties arise. In Wisconsin, an initial assessment is made on the basis of the income tax return, such return being presumed to be correct.[10] An additional assessment is made by the Department of Taxation whenever a field of office audit indicates the initial assessment was for a lesser amount of tax than that actually owed.[11] Once such an additional assessment becomes final the taxpayer may not recover a refund or be allowed a credit: (1) on any item so assessed if the assessment was based on an office audit; (2) on any year so assessed if the assessment was based on a field audit.[12] The statutes denying such refund or credit are clear and unambiguous and there are no provisions for exceptions; thus it would seem there are no circumstances under which such a refund or credit will be allowed. It is thus apparent that any relief afforded a taxpayer by a declaratory judgment rendered after an additional assessment has become final is illusory only, as the taxpayer still must pay the tax and will be barred from recovery by refund. This is true even though the rule under which the tax was assessed is declared invalid in the declaratory judgment action.

An additional assessment becomes final unless the taxpayer files an application for abatement with the department of taxation within thirty days after notification of such assessment. If this application is denied

[9] WIS. STATS. §71.10 (10) (f) (1955).
[10] *Id.* at 71.11 (13).
[11] *Id.* at 71.11(16), 71.11(20), 71.11(21).
[12] *Id.* at 71.10(10)(d).

the assessment becomes final unless the taxpayer files a petition for review with the Board of Tax Appeals within thirty days.[13] When the Board of Tax Appeals renders a decision in such a review the decision and the assessment becomes final unless the taxpayer appeals to the Circuit Court within thirty days.[14] Finally, the judgment by the Circuit Court is final unless the taxpayer takes an appeal to the Supreme Court of the State of Wisconsin within thirty days.[15]

Thus, if a declaratory judgment action to determine the validity of a rule is to be of any value the taxpayer must prevent any additional assessment based on such rule from becoming final.

THE DEPARTMENT OF TAXATION AND DECLARATORY JUDGMENTS

In considering the Department of Taxation and declaratory judgment actions the first question that arises is whether or not a declaratory judgment action can be initiated after an additional assessment is made by the Department. Sec. 71.12 (3) provides that no party shall be allowed in any action to question an assessment unless an application for abatement has been filed with the Department of Taxation, such application has been denied, and a petition for review has been filed with the Board of Tax Appeals. However, sec. 227.05 (1) provides:

> "Declaratory judgments may be rendered *whether or not* the plaintiff has first requested the agency to pass upon the validity of the rule in question." [emphasis supplied]

Perusal of the report of the Legislative Committee on Administrative Rule Making indicates the legislature intended this section to allow actions for declaratory judgment to be initiated after action was commenced by the administrative agency. After an extensive discussion of the doctrine that no resort may be had to the courts until all administrative remedies have exhausted, the committee stated:

> ". . . . The Wisconsin Administrative Procedures Act contains provisions dealing expressly with the exhaustion doctrine. Sec. 227.05 (1) provides that a declaratory judgment may be rendered whether or not the petitioner has first requested the agency to pass on the validity of the rule in question."[16]

and later:

> "The exhaustion of remedies doctrine frequently has been applied by the Wisconsin courts but apparently not arbitrarily. The doctrine has been abolished with respect to declaratory judgment proceeding."[17]

This would seem to indicate that the declaratory judgment procedure may be resorted to after assessment by the Department of Taxation.

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[13] *Id.* at 71.12(1).
[14] *Id.* at 73.01(5)(e), 73.015(2), 227.16(1).
[15] *Id.* at 227.21.
[16] II Wis. Legis. Council Report, Part II, at 125 (1955).
[17] *Id.* at 128.

In both cases the taxpayer must prevent the assessment from becoming final or the declaratory judgment will be of little avail. Clearly, this may be done by filing an application for abatement with the Department of Taxation and, if this is denied, appealing to the Board of Tax Appeals.[18] However, this necessitates maintaining two actions at one time with the attendant expense. A more desirable method would be to file the application in abatement and then obtain a stay of the proceedings on this application until the declaratory judgment is rendered.

One possible method of accomplishing this would be to obtian an order for a temporary stay of proceedings (injunction) from the Circuit Court for Dane County. Historically, Wisconsin courts have been reluctant to enjoin administrative agencies.

In *Wagner v. Leenhouts*[19] the plaintiff asked an injunction restraining the assessor from assessing his income and auditing his books until such time as it could be judicially determined if his income was eligible for taxation. The court held that: "Equity will not enjoin an apprehended illegal assessment" on the basis that it is to be assumed that the assessor will act legally in performing his duties. It is thus clear that no injunctive relief could be obtained prior to an assessment.

Dictum in the *Wagner* case held that equity will not enjoin an illegal assessment when there is an adequate legal remedy, no extraordinary facts being shown. Moreover, the party against whom an assessment has been made has an adequate remedy through statutory provisions for the appeal of administrative decisions.

The above case, however, is not a situation in which the court in which the injunction was requested has been specifically granted primary jurisdiction over the question of law involved in the issue, as is the case in declaratory judgment actions. Sec. 227.05 (1) gives primary jurisdiction on the question of the validity of a rule of an administrative agency to the Circuit Court for Dane County whether or not petitioner has exhausted the administrative remedies.[20] It would seem that this court, having primary jurisdiction, would not be prevented from ordering a stay of administrative proceedings to insure the effectiveness of its judgments. The rule in the *Wagner* case was devised to facilitate expeditious handling of appeals of administrative decisions by confining them to statutorily designated channels. Certainly the intent of the rule would be violated by compelling a party to conduct parallel actions in a court of primary jurisdiction and an administrative agency on the basis that adequate legal review may be obtained on appeal from the decision of the administrative agency.

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[18] See note 13 *supra.*
[19] 208 Wis. 292, 242 N.W. 144 (1932), *appeal dismissed* 287 U.S. 571 (1932).
[20] See note 16 and note 17 *supra.*

Thus there would seem to be no valid reason why the Circuit Court for Dane County should not enjoin the proceedings of the Department of Taxation until such court has determined the validity of the rule in question.

THE BOARD OF TAX APPEALS AND DECLARATORY JUDGMENTS

When a decision of the Department of Taxation is appealed to the Board of Tax Appeals and the validity of a rule pertinent to a decision is challenged, the question arises as to whether the B.T.A. may determine the validity of such rule. Sec. 73.01 (5) (a) sets forth the powers of the B.T.A.:

> "Subject to the provisions of judicial review contained in the Statutes, the board shall be the final authority for the hearing and determination of all questions of law and fact arising under the tax laws of the state, except such as may be otherwise expressly designated."

This would seem to give broad powers to the B.T.A. However, Sec. 227.05 (1) provides declaratory judgment actions shall be "the exclusive means of *judicial* review of the validity of a rule" with four specific exceptions which do not include the B.T.A.[21] Thus the determining of the validity of a rule could be a power not granted to the B.T.A. as one "otherwise expressly designated" under 73.01 (5) (a). The problem hinges on the question of the nature of review by the B.T.A.: is such review judicial?

In *Kaukauna v. Department of Taxation*[22] it was held that:

> "Prior to the enactment of ch. 412, Laws of 1939, the Wisconsin tax commission exercised administrative powers and exercised quasi-judicial functions by holding hearings for review as provided by law. In 1939 the legislature created two separate and distinct departments. The administrative work was placed in the Wisconsin Department of Taxation, and the quasi-judicial functions were transferred to the Wisconsin Board of Tax Appeals. Thus the taxpayer was afforded a review of quasi-judicial questions before an independent tribunal."

It is thus clear that review by the B.T.A. is quasi-judicial review.

The report of the Legislative Committee on Administrative Rule Making would seem to indicate legislative intent to embrace quasi-judicial review within the "judicial review" provisions of the statutes. The recommendations of the committee were that the exclusiveness of declaratory judgment proceedings in determining the validity of an administrative rule should be clarified; "either by specifying the forms of proceedings in which review of rules may be had or by providing that review may be had in any type of proceedings where

[21] WIS. STATS. §227.05(3) (1955).
[22] 250 Wis. 196, 26 N.W.2d 637 (1947).

the issue of the rule is a material one."[23] The legislature adopted the former method in sec. 227.05 (3). The use of the term "proceedings" by the committee seem to indicate that all proceedings which are not granted specific authority to determine validity of a rule may not do so. This language is clearly broad enough to include quasi-judicial proceedings. Thus legislative intent would seem to indicate that "judicial review" as used in 227.05 (1) would include quasi-judicial review and thus the B.T.A. would be excluded from determining the validity of a rule of the Department of Taxation.

If this interpretation is correct the procedure to be followed is clear. Sec. 227.05 (4) provides that if the validity of a rule is challenged in judicial proceeding other than one in which its validity may be determined, the party so challenging shall move for a stay of proceedings and institute a declaratory judgment action. When this judgment is rendered it shall be binding upon the court in which the validity of the rule was challenged (in this case, the Board of Tax Appeals).

Thus a taxpayer who had instituted a declaratory judgment action prior to an additional assessment by the Department of Taxation would not attempt to enjoin proceedings by the Department of Taxation but would file his application for abatement and if it were denied, appeal to the B.T.A. As soon as the B.T.A. assumed jurisdiction he would move for a stay of proceedings, and initiate the declaratory judgment action.

One factor would indicate that the legislature intended the B.T.A. to be able to determine, for purposes of B.T.A. proceedings, the validity of a contested rule. If a taxpayer is an individual his appeal from a decision of the B.T.A. will go to the circuit court for the county in which he resided where judicial review of the decision will be afforded.[24] Sec. 227.05 (3) (e) provides that this court may determine the validity of a rule when such is challenged in an appeal from a decision of an administrative agency, this being one of the specific exceptions to the exclusive determination of rule validity by declaratory judgment action. If the taxpayer is a corporation his appeal from the B.T.A. goes to the Circuit Court for Dane County[25] which clearly can determine the validity of rules.[26] It would thus seem that the legislature would not intend the proceedings of the B.T.A. to be interrupted and a declaratory judgment initiated to determine the validity of a rule when the validity of the rule may be determined upon appeal from the B.T.A. The incongruous result of such interpretation in the

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[23] II Wis. Legis. Council Report, Part II, at 127 (1955).
[24] See note 14 *supra.*
[25] *Ibid.*
[26] See notes 1 and 14 *supra.*

case of a corporate taxpayer would be the suspending of the proceedings of the B.T.A. while the Circuit Court for Dane County determined the validity of a rule. Upon such determination the B.T.A. would render a decision and such decision could be appealed back to the Circuit Court for Dane County for review. It might be argued that, in the case of an individual taxpayer, the legislature intended such a course of action in that, through handling numerous declaratory judgment actions, the Circuit Court for Dane County would become an "expert" court on the matter of administrative rules. The report of the Legislative Committee on Administrative Rule Making indicated no legislative intent to create such an "expert" court, however.

If the B.T.A. can make a limited determination of the validity of a rule the taxpayer can still initiate a declaratory judgment action after the B.T.A. assumed jurisdiction or continue one previously initiated. Sec. 73.015 (1) provides:

> ". . . no person shall contest, in any action or proceeding, any matter reviewable by the board unless such person shall first have availed himself of a hearing before the board. . . ."

However, sec. 227.05 (1) abolishes the doctrine that administrative remedies must be exhausted before applying to the courts in respect to declaratory judgment actions. If the quasi-judicial determination by the B.T.A. is not judicial and thus the B.T.A. can determine the validity of a rule, such determination would seem to be administrative in its nature. Thus the abolition of the exhaustion of administrative remedies doctrine would negate the effect of 73.015 (1) on declaratory judgment actions.

As a practical matter the taxpayer would probably not initiate a declaratory judgment action after an appeal to the B.T.A. as it would be more economical and convenient to wait for a determination of the validity of a rule until appeal from the B.T.A. to the circuit court.

If an appeal is taken to the B.T.A. and a declaratory judgment action is pending in the Circuit Court for Dane County the taxpayer must still prevent the assessment from becoming final to obtain actual relief. Assessments become final when a decision is handed down by the B.T.A. and not appealed to the circuit court within thirty days.[27]

As in the case of actions by the Department of Taxation, actions by the B.T.A. might be suspended by temporary injunctions issued by the Circuit Court for Dane County. The reasoning applicable to enjoining the Department of Taxation would apply to the B.T.A. by analogy although no actual cases of injunction of the B.T.A. have

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[27] WIS. STATS. §73.01(5)(e) (1955).

been decided in Wisconsin. In fact, it would seem there might be an even more valid reason for the granting of injunctive relief in the case of the B.T.A. Art. VII, Sec. 8 of the Constitution of the State of Wisconsin provides:

> "The circuit court shall have power to issue injunctions and other writs necessary to carry into effect their judgments, orders, and decrees and give them general control over inferior jurisdictions."

In *Ballard v. Goodland*[28] it was held that: ". . . all tribunals . . . acting in a quasi-judicial capacity are subject to the jurisdiction of the circuit court." This clearly indicates that the B.T.A. falls under the control of the circuit court as an inferior jurisdiction. There would seem to be no reason why a superior court having primary jurisdiction in a matter could not temporarily enjoin the proceedings of an inferior quasi-judicial body under its control in order to prevent duplicity of actions.

If the taxpayer cannot obtain an injunction aganist the B.T.A. and the board holds the contested rule valid the taxpayer would have to appeal to the circuit court to obtain relief. The incongrous result would be that the taxpayer, if an individual, would be challenging the validity of the same rule in an appeal before the circuit court in the county in which he resides and in a declaratory judgment action in the Circuit Court for Dane County. It is clear that one circuit court could not enjoin the other as, under the doctrine of *Stahl v. Broeskert*,[29] injunctive relief is not available when courts of equal dignity claim jurisdiction as to the same issue. Thus it would seem the taxpayer must carry on two actions simultaneously and plead the first decision handed down as res judicata to the other action. In the case of a corporate taxpayer the appeal and declaratory judgment action would merge in the Circuit Court for Dane County. It is hardly probable that the legislature intended this result.

CONCLUSION

This is an area in which existing statutes and decisions leave many important questions unanswered. The taxpayer has no way of knowing when he has the requisite degree of standing to challenge a rule through a declaratory judgment action. The legislature has declined to set forth what factual situations give a taxpayer such standnig and thus the question will only be determined by future judicial decisions. Clearly, much of the value of the declaratory judgment action as a method of tax relief will hinge on such decisions. At best, the determining of a workable standard by this method will take time.

Many of the other ambiguities can be settled by legislative clarifi-

[28] 159 Wis. 393, 150 N.W. 488 (1915).
[29] 167 Wis. 113, 166 N.W. 653 (1918).

cation. First, there should be clarification as to the procedure to follow when the Department of Taxation assesses a taxpayer under a rule the validity of which the taxpayer is challenging in a pending declaratory judgment action. Secondly, there should be clarification of the procedure to be followed when an additional assessment is made and the taxpayer desires to challenge the validity of the rule under which it was made. Thirdly, the legislature should indicate the scope of the power of the Board of Tax Appeals to determine the validity of a rule. It would be especially helpful to know if the procedure of the B.T.A. must be suspended and a declaratory judgment sought whenever the validity of a rule is challenged in a B.T.A. proceeding.

Until there is such clarification the value of the declaratory judgment action as a means of determining the validity of a rule of the Department of Taxation is seriously hampered by uncertainty and ambiguity.

GEORGE J. MALY, JR.