STATE OF WISCONSIN

TAX APPEALS COMMISSION

FRANK D. AND BILLIE J. LEACH DOCKET NO. 02-I-320
814 Elm Court
Marco Island, FL 34145,

Petitioners,

vs. **DECISION AND ORDER**

WISCONSIN DEPARTMENT OF REVENUE
P.O. Box 8907
Madison, WI 53708-8907,

Respondent.

DON M. MILLIS, COMMISSION CHAIRPERSON:

This matter comes before the Commission on stipulated facts. Both parties have submitted briefs. Petitioners represent themselves. Respondent is represented by Attorney Donald J. Goldsworthy.

Based upon the stipulation of the parties, the submissions of the parties, and the entire record in this matter, the Commission finds, concludes, and orders as follows:

FINDINGS OF FACT

As and for its Findings of Fact, the Commission adopts the Stipulation of Facts, omitting references to exhibits, making non-substantive alterations for form and relevancy, and incorporating facts from exhibits to the Stipulation of Facts:

1. Petitioners were full-year residents of Wisconsin prior to September 1998, and filed Wisconsin Form 1 income tax returns for each year through and including 1997.

2. Petitioners have been residents of the state of Florida since September 15, 1998. Petitioners filed in 1998 a Wisconsin Form 1 NPR as part-year residents of Wisconsin from January 1, 1998 to September 11, 1998.

3. Petitioner Frank D. Leach individually, Greenbriar Products, Inc., a Wisconsin manufacturing company located in Spring Green, Wisconsin ("Greenbriar"), and N.G.P., Inc. ("N.G.P."), entered into an asset purchase agreement dated April 16, 1999. Under the agreement, Greenbriar sold the business and substantially all the assets used by Greenbriar to N.G.P. N.G.P. also purchased from Mr. Leach certain real property which was part of the facilities used by Greenbrier but which was owned individually by Mr. Leach.

4. As part of the agreement, Mr. Leach entered into a covenant not to compete with N.G.P. for five years for the sum of $1 million in cash paid to Mr. Leach at closing, which occurred on April 16, 1999. The covenant not to compete applied to the entire United States and all foreign nations.

5. Petitioners filed a 1999 Wisconsin Form 1 NPR, indicating that they were nonresidents of Wisconsin and residents of Florida for calendar year 1999, and on which petitioners did not report the $1 million payment for the covenant not to compete.

6. Under the date of December 24, 2001, respondent issued an income tax assessment against petitioners in the amount of $82,338.73. Respondent's assessment

adjusted petitioners' 1999 return to include the $1 million payment pursuant to the covenant not to compete.

7. Petitioners filed a timely petition for redetermination of respondent's assessment. Petitioners' petition for redetermination was denied, in part, by respondent's notice of action dated August 12, 2002.

8. In its notice of action, respondent adjusted petitioners' taxable income by prorating the income from the covenant not to compete based on the use of a three-factor formula. The proration generated a percentage of 39.31 percent, which was applied to the payment under the covenant not to compete, generating additional net income of $339,100 beyond the amount that was originally reported. In the notice of action, respondent adjusted the assessment to $26,445.81 in tax and $7,929.40 in interest.

9. The three-factor formula used by respondent was based upon sales, payroll, and property from Greenbriar. Amounts for the sales factor were double-weighted and included Greenbriar's sales in Wisconsin in the numerator and Greenbriar's gross receipts for sales everywhere in the denominator. Since all of Greenbriar's payroll and property are located in Wisconsin, the ratio for these two factors was each 100 percent. The data for the sales and property factors applied to Greenbriar's fiscal year ending August 31, 1999.

10. Mr. Leach owned no property used in the production of apportionable income in 1999, did not pay compensation in the production of apportionable income in 1999, and had no sales in Wisconsin in the production of apportionable income in 1999.

11. For more than ten years prior to the sale of Greenbriar, Mr. Leach was employed as the corporate president of Greenbriar. During Greenbriar's 1998 fiscal year ending on August 31, 1999, Mr. Leach was president of Greenbriar, devoted 100 percent of his time to the corporate business, and owned 100 percent of the corporate stock of Greenbriar.

APPLICABLE LAW

Statutes

> **71.02 Imposition of tax.**
> **(1)** For the purpose of raising revenue for the state and the counties, cities, villages and towns, there shall be assessed, levied, collected and paid a tax on all net incomes of individuals … by every nonresident natural person and trust of this state, upon such income as is derived from property located or business transacted within the state including, but not limited by enumeration, income derived from a limited partner's distributive share of partnership income, income derived from a limited liability company member's distributive share of limited liability company income, … and also by every nonresident natural person upon such income as is derived from the performance of personal services within the state, except as exempted under s. 71.05 (1) to (3). …

> **71.04 Situs of income; allocation and apportionment.**
> **(1)** SITUS. (a) All income or loss of resident individuals and resident estates and trusts shall follow the residence of the individual, estate or trust. Income or loss of nonresident individuals and nonresident estates and trusts from business, not requiring apportionment under sub. (4), (10) or (11), shall follow the situs of the business from which derived, … Income or loss of nonresident individuals and nonresident estates and trusts derived from rentals and royalties from real estate or tangible personal property, or from the operation of any farm, mine or quarry, or from the sale of real property or tangible personal property shall follow the situs of the property from which derived. … A nonresident limited liability company member's distributive share of limited liability company income shall follow the situs of the business, … All other income or loss of

> nonresident individuals and nonresident estates and trusts, including income or loss derived from land contracts, mortgages, stocks, bonds and securities or from the sale of similar intangible personal property, shall follow the residence of such persons, except as provided in par. (b) and sub. (9), …

CONCLUSION OF LAW

The Wisconsin income tax is not imposed on the $1 million payment received by Mr. Leach under the covenant not to compete because the applicable provision of section 71.02(1) of the Statutes imposes the income tax on income derived from tangible property, not from intangible property rights.

OPINION

The parties have stipulated that the sole issue for the Commission to decide is whether Mr. Leach can meet his burden of proof that respondent's notice of action incorrectly apportioned to Wisconsin a part of Mr. Leach's 1999 income from the $1 million that he was paid under the covenant not to compete. Petitioners do not challenge the methodology of the apportionment, but rather respondent's right in the first place to consider any portion of the $1 million payment Wisconsin income.

Petitioners bear the burden to show that respondent's assessment is incorrect. *Woller v. Dep't of Taxation*, 35 Wis. 2d 227, 232 (1967). Because this case involves an imposition statute—section 71.02 of the Statutes—the tax cannot be imposed without clear and express language, with all doubts or ambiguities being resolved against taxability. *Kearney & Trecker Corp. v. Dep't of Revenue*, 91 Wis. 2d 746, 753 (1979); *Department of Revenue v. Milwaukee Refining Corp.*, 80 Wis. 2d 44, 48-49 (1977).

It is undisputed that petitioners were residents of Florida at the time the covenant not to compete was signed and the payment received. Section 71.02(1) of the Statutes imposes the income tax on income received by "every nonresident natural person … upon such income as is derived from property located or business transacted within the state … ." Respondent contends that Mr. Leach's right to compete which he forfeited by signing the covenant not to compete was a "property right with situs where the competition would occur in the absence of the covenant." *Respondent's Brief*, at 7. We cannot agree.

Our conclusion rests upon our construction of the term "property" in section 71.02. In order for respondent's position to prevail, we must conclude that the payment under the covenant not to compete was "income … derived from property located" in Wisconsin.[1] "Property" is not defined with respect to section 71.02.[2] There are, however, numerous definitions of property in tax statutes. For example, for purposes of section 70.105 of the statutes, "property" means real estate and fixtures and does not include intangible property. Wis. Stat. § 70.105(2)(d). On the other hand, for purposes of section 71.91, "property" includes real property, personal property, tangible property, and intangible property. Wis. Stat. § 71.91(6)(a)3.

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[1] Respondent does not argue that the payment under the covenant not to compete was derived from "business transacted" in Wisconsin—the other prong of section 71.02(1) excerpted above. It does not appear to the Commission that entering into the covenant not to compete falls within the definition of "business transacted."

[2] The default definition of "property" is found in section 990.01(31) and includes "real and personal property." The default definition of "personal property" includes "money, goods, chattels, things in action, evidences of debt and energy." Wis. Stat. § 990.01(27). We do not read this definition of personal property to include the intangible right to compete. However, even if it

It is unclear whether the term "property" in section 71.02(1) includes intangible property. We construe "property" in section 71.02(1) as not including intangible property for two reasons. First, when an imposition statute is ambiguous, all doubts are resolved against taxability. Limiting "property" to tangible property certainly augurs against taxability in all cases.

Second, context mandates that we conclude that "property" in section 71.02 does not include intangible property. In order for income to be taxable to nonresidents, it must be "derived from property *located*" in Wisconsin. [Emphasis supplied.] By its very nature, intangible property cannot be *located* anywhere. It is clear from this context that the legislature intended "property" to be limited to tangible property located within Wisconsin.

Respondent relies upon *In re Appeals of Milhous*, Cal. Tax Rptr. (CCH) ¶ 403-116 (Cal. St. Bd. Of Equal. 2000). In *Milhous*, the taxpayers were residents of Florida when they received a payment under a covenant not to compete that was entered into with a Delaware corporation that had its headquarters in California. *Id.*at 2. Based on prior California administrative cases, the California State Board of Equalization concluded that a right to compete is an intangible right, with situs in any location where such competition would occur in the absence of such a covenant. *Id.* One of these prior decisions relied upon a 1943 Tax Court decision, *The Korfund Company, Inc. v. Commissioner*, 1 T.C. 1180, (CCH) Dec. 13,210 (1943).

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did, for the reasons explained below, we would disregard the definition as producing a "result inconsistent with the manifest intent of the legislature." *See*, Wis. Stat. § 990.01(Intro).

We are unpersuaded by *Milhous*, *Korfund*, and the other California cases. First and foremost, we have already concluded that in section 71.02(1) the phrase "income derived from property located" in Wisconsin refers only to tangible personal property.

Second, *Milhous* was based on entirely different legal authorities. Section 17952 of the California Revenue and Taxation Code explicitly provides that certain intangible personal property may obtain situs in California. Section 179529(c) of Title 18 of the California Code of Regulations sets forth the conditions under which intangible personal property has a business situs in California. It may be that California's tradition of treating intangible personal property having a situs in that state derives from the fact that California's income tax was a substitute for that state's ad valorem tax on intangible personal property. *Weber v. Santa Barbara County*, 98 P.2d 492, 493 (Cal. 1940). Wisconsin's law is simply different.[3]

Finally, application of *Milhous* leads to absurd results. If the right to compete is an intangible right, with situs in any location where such competition is barred by the covenant not to compete, then petitioners are susceptible to income tax liability in

[3] While section 71.04(7)(d) of the Statutes arguably includes the sale of intangible personal property into the sales factor of the apportionment formula, these are limited to those sales associated with an income producing activity within Wisconsin.

every state (and possibly every foreign country) that has an income tax since the covenant not to compete extends to the entire world. It stretches the limits of reasonableness to conclude that payments under the covenant not to compete have situs in states and nations where N.G.P. has no business dealings and where petitioners have no connection.

The California Board of Equalization may have recognized this absurdity when it admitted that the law provided no clear guidance on how to apportion such a payment but, nevertheless, decided to apply a three-factor formula applicable to the corporation that made the payment under the covenant not to compete. *Milhous*, at 2 (deciding that it was "comfortable" with the three-factor formula approach). (Respondent applied the same approach in its action on the petition for redetermination.) While this apportionment approach eliminates the possibility that a state where no situs exists over the corporation making payments under a covenant not to compete could tax those payments, it belies the theoretical underpinnings of respondent's argument that situs exists wherever a person relinquished the right to compete.

We note that the New York Tax Appeals Tribunal rejected a similar argument and rejected the applicability of *Korfund* to this issue. *In re Albanese*, NY Tax Rptr. (CCH) ¶ 402-775 at 13 (Tax. App. Trib. 1997).

Because we conclude that the $1 million payment is not subject to Wisconsin's income tax, we need not consider the applicability of the apportionment formula employed by respondent.

ORDER

The action of respondent on the petition for redetermination is reversed.

Dated at Madison, Wisconsin, this 29th day of March, 2004.

WISCONSIN TAX APPEALS COMMISSION

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Don M. Millis, Commission Chairperson

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Thomas M. Boykoff, Commissioner

ATTACHMENT: "**NOTICE OF APPEAL INFORMATION**"