

2007 DRAFTING REQUEST

Bill

Received: **11/17/2006**

Received By: **mshovers**

Wanted: **As time permits**

Identical to LRB:

For: **Administration-Budget 6-7597**

By/Representing: **Easton**

This file may be shown to any legislator: **NO**

Drafter: **mshovers**

May Contact:

Addl. Drafters:

Subject: **Tax, Individual - income**

Extra Copies:

Submit via email: **NO**

Pre Topic:

DOA:.....Easton, BB0152 -

Topic:

Provide that a covenant not to compete is taxable income for nonresidents

Instructions:

See Attached

Drafting History:

<u>Vers.</u>	<u>Drafted</u>	<u>Reviewed</u>	<u>Typed</u>	<u>Proofed</u>	<u>Submitted</u>	<u>Jacketed</u>	<u>Required</u>
/?	mshovers 11/17/2006	wjackson 11/17/2006		_____			State
/1			jfrantze 11/20/2006	_____	sbasford 11/20/2006		

FE Sent For:

<END>

2007 DRAFTING REQUEST

Bill

Received: 11/17/2006

Received By: **mshovers**

Wanted: **As time permits**

Identical to LRB:

For: **Administration-Budget 6-7597**

By/Representing: **Easton**

This file may be shown to any legislator: **NO**

Drafter: **mshovers**

May Contact:

Addl. Drafters:

Subject: **Tax, Individual - income**

Extra Copies:

Submit via email: **NO**

Pre Topic:

DOA:.....Easton, BB0152 -

Topic:

Provide that a covenant not to compete is taxable income for nonresidents

Instructions:

See Attached

Drafting History:

<u>Vers.</u>	<u>Drafted</u>	<u>Reviewed</u>	<u>Typed</u>	<u>Proofed</u>	<u>Submitted</u>	<u>Jacketed</u>	<u>Required</u>
/?	mshovers	1 wj 11/17		<i>J. Self</i> 11/20			
<i>11 MES 11/17/06</i>							

FE Sent For:

<END>

2007-09 Budget Bill Statutory Language Drafting Request

- Topic: Covenant Not To Compete
- Tracking Code: BB0152
- SBO team: Tax and Local Government
- SBO analyst: Easton
 - Phone: 6-7597
 - Email: Darren.easton@wisconsin.gov
- Agency acronym: DOR
- Agency number: 566
- Priority (Low, Medium, High): Low

**Legislative Proposal Summary
Wisconsin Department of Revenue
IS & E Division**

August 18, 2006

TITLE: PROVIDE THAT A COVENANT- NOT-TO- COMPETE IS TAXABLE INCOME WHEN RECEIVED BY A NONRESIDENT OF WISCONSIN

DESCRIPTION OF CURRENT LAW AND PROBLEM

Section 71.02(1), Wis. Stats., provides for the imposition of tax. In the case of nonresident natural persons and trusts of this state, the tax is imposed upon "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 by every nonresident natural person upon such income as is derived from the performance of personal services within the state...".

Section 71.04(1)(a), Wis. Stats., provides the situs of income for nonresidents. This section in part provides that income or loss from business, not requiring apportionment, shall follow the situs of the business from which derived. Income or loss of nonresident individuals 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. Income from personal services of nonresident individuals shall follow the situs of the services. All other income or loss of nonresident individuals, 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.

The problem arises with the tax treatment of a covenant not to compete. When a taxpayer sells a business, the purchase agreement, under which the business and substantially all of its assets are sold, may provide for a payment under a covenant not to compete. Under a covenant not to compete, the purchaser provides a payment to the seller for an agreement not to compete for a specified number of years. In other cases, a payment under a covenant not to compete may be made by an employer to a former employee.

In a recent case before the Tax Appeals Commission (*Frank D. and Billie J. Leach vs. Wisconsin Department of Revenue*), the taxpayer owned and sold 100% of the shares of a Wisconsin corporation. Under the purchase agreement, the taxpayer entered into a covenant not to compete for five years for the sum of \$1 million. The taxpayers were residents of Florida at the time the covenant was signed and the payment received. The Tax Appeals Commission ruled that 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 sec. 71.02(1) of the Statutes imposes the income tax on income derived from tangible property, not from intangible property rights.

Example: The taxpayer, a Wisconsin resident, started a business in Wisconsin. The business was very successful. Several years later the taxpayer sold the business for \$10,000,000 of which \$2,000,000 was allocated to a covenant not to compete for 10 years. The taxpayer would be paid \$8,000,000 in the year of the sale plus \$200,000 in each of the next ten years for the

covenant not to compete. If the taxpayer remains a Wisconsin resident, the payments for the covenant not to compete are taxable to Wisconsin. If the taxpayer becomes a resident of another state, payments received while a nonresident of Wisconsin for the covenant not to compete are not taxable to Wisconsin, even though they were related to the sale of the Wisconsin business.

RECOMMENDATION FOR ACTION

Provide that amounts received by a nonresident of Wisconsin under a covenant not to compete is income from property located or business transacted in Wisconsin to the extent the covenant was based on a Wisconsin-based activity.

ADMINISTRATIVE IMPACT

This proposal would clarify the treatment of a covenant not to compete.

FAIRNESS/TAX EQUITY

Sellers of a business located in Wisconsin can escape Wisconsin taxation on any portion of gain allocated to a covenant not to compete if the seller is a nonresident when payments are received. This proposal would mean that gain is taxable to Wisconsin regardless of whether it was allocated to the sale of tangible business assets or to a sale of a covenant not to compete.

IMPACT ON ECONOMIC DEVELOPMENT

This proposal would increase efficiency of the department by clarifying the treatment of a covenant not to compete.

FISCAL EFFECT

Unknown, but will increase revenue.

DRAFTING INSTRUCTIONS

Amend secs. 71.02(1) and 71.04(1)(a) to provide that a covenant not to compete is income from property located or business transacted in Wisconsin to the extent the covenant was based on a Wisconsin-based activity.

EFFECTIVE DATE AND/OR INITIAL APPLICATION

Taxable years beginning on or after January 1, 2007.

INTERESTED/AFFECTED PARTIES

Nonresidents and part-year residents who have income from a covenant not to compete.

DOR CONTACT PERSON

Diane Hardt, 266-6798
Dhardt@dor.state.wi.us

PREPARED BY Marcy Stock
August 18, 2006

E:marcy/legislative proposal-covenant



State of Wisconsin
2007 - 2008 LEGISLATURE

LRB-0839/1

MES.....j:....

Wij
MNR

DOA:.....Easton, BB0152 - Provide that a covenant not to compete is taxable income for nonresidents

FOR 2007-09 BUDGET -- NOT READY FOR INTRODUCTION

do not
gen

1 AN ACT ...; relating to: imposing income tax on a covenant not to compete for
2 certain nonresidents of this state.

Analysis by the Legislative Reference Bureau

TAXATION

* INCOME TAXATION

* This bill specifies that amounts received by a nonresident of this state under a covenant not to compete is taxable by this state to the extent that the covenant was based on a Wisconsin-based activity.

For further information see the *state* fiscal estimate, which will be printed as an appendix to this bill.

The people of the state of Wisconsin, represented in senate and assembly, do enact as follows:

3 SECTION 1. 71.02 (1) of the statutes is amended to read:

4 71.02 (1) For the purpose of raising revenue for the state and the counties,
5 cities, villages and towns, there shall be assessed, levied, collected and paid a tax on

1 all net incomes of individuals and fiduciaries, except fiduciaries of nuclear
2 decommissioning trust or reserve funds subject to the tax under s. 71.23 (2), by every
3 natural person residing within the state or by his or her personal representative in
4 case of death, and trusts resident within the state; by every nonresident natural
5 person and trust of this state, upon such income as is derived from property located
6 or business transacted within the state including, but not limited by enumeration,
7 income derived from a limited partner's distributive share of partnership income,
8 income derived from a limited liability company member's distributive share of
9 limited liability company income, income derived from a covenant not to compete to
10 the extent that the covenant was based on a Wisconsin-based activity, the state
11 lottery under ch. 565, any multijurisdictional lottery under ch. 565 if the winning
12 lottery ticket or lottery share was purchased from a retailer, as defined in s. 565.01
13 (6), located in this state or from the department, winnings from a casino or bingo hall
14 that is located in this state and that is operated by a Native American tribe or band
15 and pari-mutuel wager winnings or purses under ch. 562, and also by every
16 nonresident natural person upon such income as is derived from the performance of
17 personal services within the state, except as exempted under s. 71.05 (1) to (3). Every
18 natural person domiciled in the state shall be deemed to be residing within the state
19 for the purposes of determining liability for income taxes and surtaxes. A
20 single-owner entity that is disregarded as a separate entity under section 7701 of the
21 Internal Revenue Code is disregarded as a separate entity under this chapter, and
22 its owner is subject to the tax on the entity's income.

History: 1987 a. 312; 1989 a. 31; 1991 a. 39, 269; 1993 a. 112; 1995 a. 27; 1997 a. 27, 237, 297; 1999 a. 9.

23 **SECTION 2.** 71.04 (1) (a) of the statutes is amended to read:

1 71.04 (1) (a) All income or loss of resident individuals and resident estates and
2 trusts shall follow the residence of the individual, estate or trust. Income or loss of
3 nonresident individuals and nonresident estates and trusts from business, not
4 requiring apportionment under sub. (4), (10) or (11), shall follow the situs of the
5 business from which derived, except that all income that is realized from the sale of
6 or purchase and subsequent sale or redemption of lottery prizes if the winning tickets
7 were originally bought in this state shall be allocated to this state. All items of
8 income, loss and deductions of nonresident individuals and nonresident estates and
9 trusts derived from a tax-option corporation not requiring apportionment under
10 sub. (9) shall follow the situs of the business of the corporation from which derived,
11 except that all income that is realized from the sale of or purchase and subsequent
12 sale or redemption of lottery prizes if the winning tickets were originally bought in
13 this state shall be allocated to this state. Income or loss of nonresident individuals
14 and nonresident estates and trusts derived from rentals and royalties from real
15 estate or tangible personal property, or from the operation of any farm, mine or
16 quarry, or from the sale of real property or tangible personal property shall follow the
17 situs of the property from which derived. Income from personal services of
18 nonresident individuals, including income from professions, shall follow the situs of
19 the services. A nonresident limited partner's distributive share of partnership
20 income shall follow the situs of the business, except that all income that is realized
21 from the sale of or purchase and subsequent sale or redemption of lottery prizes if
22 the winning tickets were originally bought in this state shall be allocated to this
23 state. A nonresident limited liability company member's distributive share of
24 limited liability company income shall follow the situs of the business, except that
25 all income that is realized from the sale of or purchase and subsequent sale or

1 redemption of lottery prizes if the winning tickets were originally bought in this state
 2 shall be allocated to this state. Income of nonresident individuals, estates and trusts
 3 from the state lottery under ch. 565 is taxable by this state. Income of nonresident
 4 individuals, estates and trusts from any multijurisdictional lottery under ch. 565 is
 5 taxable by this state, but only if the winning lottery ticket or lottery share was
 6 purchased from a retailer, as defined in s. 565.01 (6), located in this state or from the
 7 department. Income of nonresident individuals, nonresident trusts and nonresident
 8 estates from pari-mutuel winnings or purses under ch. 562 is taxable by this state.
 9 Income of nonresident individuals, estates and trusts from winnings from a casino
 10 or bingo hall that is located in this state and that is operated by a Native American
 11 tribe or band shall follow the situs of the casino or bingo hall. Income derived by a
 12 nonresident individual from a covenant not to compete is taxable by this state to the
 13 extent that the covenant was based on a Wisconsin-based activity. All other income
 14 or loss of nonresident individuals and nonresident estates and trusts, including
 15 income or loss derived from land contracts, mortgages, stocks, bonds and securities
 16 or from the sale of similar intangible personal property, shall follow the residence of
 17 such persons, except as provided in par. (b) and sub. (9), except that all income that
 18 is realized from the sale of or purchase and subsequent sale or redemption of lottery
 19 prizes if the winning tickets were originally bought in this state shall be allocated
 20 to this state.

21 **Cross Reference:** Cross Reference: Cross Reference: See also s. Tax 3.085, Wis. adm. code. **Cross Reference:**

History: 1987 a. 312; 1987 a. 411 ss. 34 to 40, 61; 1989 a. 31; 1989 a. 56 s. 259; 1991 a. 39, 189, 269; 1993 a. 112, 204, 491; 1995 a. 27; 1997 a. 27, 237; 1999 a. 9; 2003 a. 37; 2005 a. 25.

22 **SECTION 9341. Initial applicability; Revenue.**

23 (1) COVENANT NOT TO COMPETE. The treatment of sections 71.02 (1) and 71.04 (1)

24 (a) of the statutes first applies to taxable years beginning on January 1, 2007.

25 (END)



State of Wisconsin
2007 - 2008 LEGISLATURE

LRB-0839/1
MES:wlj:jf

DOA:.....Easton, BB0152 - Provide that a covenant not to compete is taxable income for nonresidents

FOR 2007-09 BUDGET -- NOT READY FOR INTRODUCTION

1 **AN ACT** ...; **relating to:** imposing income tax on a covenant not to compete for
2 certain nonresidents of this state.

Analysis by the Legislative Reference Bureau

TAXATION

INCOME TAXATION

This bill specifies that amounts received by a nonresident of this state under a covenant not to compete is taxable by this state to the extent that the covenant was based on a Wisconsin-based activity.

For further information see the *state* fiscal estimate, which will be printed as an appendix to this bill.

The people of the state of Wisconsin, represented in senate and assembly, do enact as follows:

3 **SECTION 1.** 71.02 (1) of the statutes is amended to read:

4 71.02 (1) For the purpose of raising revenue for the state and the counties,
5 cities, villages and towns, there shall be assessed, levied, collected and paid a tax on

1 all net incomes of individuals and fiduciaries, except fiduciaries of nuclear
2 decommissioning trust or reserve funds subject to the tax under s. 71.23 (2), by every
3 natural person residing within the state or by his or her personal representative in
4 case of death, and trusts resident within the state; by every nonresident natural
5 person and trust of this state, upon such income as is derived from property located
6 or business transacted within the state including, but not limited by enumeration,
7 income derived from a limited partner's distributive share of partnership income,
8 income derived from a limited liability company member's distributive share of
9 limited liability company income, income derived from a covenant not to compete to
10 the extent that the covenant was based on a Wisconsin-based activity, the state
11 lottery under ch. 565, any multijurisdictional lottery under ch. 565 if the winning
12 lottery ticket or lottery share was purchased from a retailer, as defined in s. 565.01
13 (6), located in this state or from the department, winnings from a casino or bingo hall
14 that is located in this state and that is operated by a Native American tribe or band
15 and pari-mutuel wager winnings or purses under ch. 562, and also by every
16 nonresident natural person upon such income as is derived from the performance of
17 personal services within the state, except as exempted under s. 71.05 (1) to (3). Every
18 natural person domiciled in the state shall be deemed to be residing within the state
19 for the purposes of determining liability for income taxes and surtaxes. A
20 single-owner entity that is disregarded as a separate entity under section 7701 of the
21 Internal Revenue Code is disregarded as a separate entity under this chapter, and
22 its owner is subject to the tax on the entity's income.

23 **SECTION 2.** 71.04 (1) (a) of the statutes is amended to read:

24 71.04 (1) (a) All income or loss of resident individuals and resident estates and
25 trusts shall follow the residence of the individual, estate or trust. Income or loss of

1 nonresident individuals and nonresident estates and trusts from business, not
2 requiring apportionment under sub. (4), (10) or (11), shall follow the situs of the
3 business from which derived, except that all income that is realized from the sale of
4 or purchase and subsequent sale or redemption of lottery prizes if the winning tickets
5 were originally bought in this state shall be allocated to this state. All items of
6 income, loss and deductions of nonresident individuals and nonresident estates and
7 trusts derived from a tax-option corporation not requiring apportionment under
8 sub. (9) shall follow the situs of the business of the corporation from which derived,
9 except that all income that is realized from the sale of or purchase and subsequent
10 sale or redemption of lottery prizes if the winning tickets were originally bought in
11 this state shall be allocated to this state. Income or loss of nonresident individuals
12 and nonresident estates and trusts derived from rentals and royalties from real
13 estate or tangible personal property, or from the operation of any farm, mine or
14 quarry, or from the sale of real property or tangible personal property shall follow the
15 situs of the property from which derived. Income from personal services of
16 nonresident individuals, including income from professions, shall follow the situs of
17 the services. A nonresident limited partner's distributive share of partnership
18 income shall follow the situs of the business, except that all income that is realized
19 from the sale of or purchase and subsequent sale or redemption of lottery prizes if
20 the winning tickets were originally bought in this state shall be allocated to this
21 state. A nonresident limited liability company member's distributive share of
22 limited liability company income shall follow the situs of the business, except that
23 all income that is realized from the sale of or purchase and subsequent sale or
24 redemption of lottery prizes if the winning tickets were originally bought in this state
25 shall be allocated to this state. Income of nonresident individuals, estates and trusts

1 from the state lottery under ch. 565 is taxable by this state. Income of nonresident
2 individuals, estates and trusts from any multijurisdictional lottery under ch. 565 is
3 taxable by this state, but only if the winning lottery ticket or lottery share was
4 purchased from a retailer, as defined in s. 565.01 (6), located in this state or from the
5 department. Income of nonresident individuals, nonresident trusts and nonresident
6 estates from pari-mutuel winnings or purses under ch. 562 is taxable by this state.
7 Income of nonresident individuals, estates and trusts from winnings from a casino
8 or bingo hall that is located in this state and that is operated by a Native American
9 tribe or band shall follow the situs of the casino or bingo hall. Income derived by a
10 nonresident individual from a covenant not to compete is taxable by this state to the
11 extent that the covenant was based on a Wisconsin-based activity. All other income
12 or loss of nonresident individuals and nonresident estates and trusts, including
13 income or loss derived from land contracts, mortgages, stocks, bonds and securities
14 or from the sale of similar intangible personal property, shall follow the residence of
15 such persons, except as provided in par. (b) and sub. (9), except that all income that
16 is realized from the sale of or purchase and subsequent sale or redemption of lottery
17 prizes if the winning tickets were originally bought in this state shall be allocated
18 to this state.

19 **SECTION 9341. Initial applicability; Revenue.**

20 (1) COVENANT NOT TO COMPETE. The treatment of sections 71.02 (1) and 71.04
21 (1) (a) of the statutes first applies to taxable years beginning on January 1, 2007.

22 (END)