

petition for writ of certiorari with the United States Supreme Court. At the time of publication of this Bulletin, it was unknown whether the United States Supreme Court would hear the case. □

## CORPORATION FRANCHISE AND INCOME TAXES

**— Bad debts; Statute of limitations — 6-year.** *The Capital Group, Inc. vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, January 3, 1996). The issues in this case are as follows:

- A. Whether the department correctly adjusted the taxpayer's 1985 loss carryforward of \$25,000 as that carryforward reflected a bad debt deduction to be used in years subsequent to 1985, or whether the department was barred from making such an adjustment by the 6-year statute of limitations found in sec. 71.77(7)(a), Wis. Stats.
- B. Whether the department correctly disallowed the taxpayer's \$84,000 Seattle First National Bank bad debt carryforward originating in 1986, on the alternative grounds that reserve bad debt deductions were not allowed by law in 1986 or that the deduction was not adequately substantiated by the taxpayer under sec. 166 of the Internal Revenue Code (IRC) and applicable treasury regulations or sec. Tax 3.14 of the Wisconsin Administrative Code.
- C. Whether the department correctly disallowed the taxpayer's \$76,150 Custardo bad debt claimed during 1987, on the alternative grounds that reserve bad debt deductions were not allowed by law in 1987 or that

the deduction was not adequately substantiated by the taxpayer under IRC sec. 166 and applicable treasury regulations.

The taxpayer in this matter was, during the period under review, from 1985 through 1987, a Wisconsin corporation specializing in corporation finance and litigation support consulting activities. For each of the years during the period under review, the taxpayer filed federal and state income tax returns on an accrual basis.

The taxpayer filed its 1985 Wisconsin franchise or income tax return on or around April 22, 1986, and included with the state return a copy of its corresponding 1985 federal corporation income tax return. On its federal return for 1985, the taxpayer claimed a Schedule F bad debt deduction of \$25,000 as an increase in the corresponding bad debt reserve for the year ended December 31, 1985. This particular debt or uncollectible receivable was associated with services which the taxpayer alleged to have performed for an entity known as Wykoff Farms.

The existence of the federal Schedule F \$25,000 bad debt deduction gave rise to a reported 1985 taxable loss of \$40,670, which formed part of a loss balance of \$47,153.09 that the taxpayer carried over in a schedule accompanying its 1986 Wisconsin franchise or income tax return.

No addition or subtraction modifications to federal income were made by the taxpayer in its 1985 Wisconsin franchise or income tax return.

The taxpayer filed its 1986 Wisconsin franchise or income tax return on or around November 25, 1987, and once again included a copy of its 1986 federal income tax return, along with typed supporting schedules detailing its income statement

and loss carryforwards as of the close of 1986. The taxpayer claimed a bad debt deduction for 1986 of \$154,511.75, resulting in a taxable loss for the year of \$20,962. The full amount of the 1986 bad debt deduction was reported on the taxpayer's federal income tax return, thus increasing the taxpayer's bad debt reserve as of the close of 1986.

The income statement prepared by the taxpayer and submitted with its 1986 income tax returns indicated that the bad debt deduction was comprised of 3 separately written off debts, as follows:

Seattle First National Bank	\$84,000
Patrick Custardo	\$50,000
	(Streamwood)
J.E. Burkhardt	\$20,000
	(expenses)

The statement of the components of the taxpayer's 1986 bad debt deduction was followed with the statement "Bad debts may be recovered as a result of legal action now in progress. Earnings will be booked in 1988 if recovered."

Also included with the taxpayer's 1986 Wisconsin franchise or income tax return was a typed schedule summing up a net loss balance of \$47,153.09 carried forward from prior years with the 1986 net loss of \$20,962.61, resulting in a total available carryforward of \$68,115.70.

The taxpayer made no addition or subtraction modifications to federal income in its 1986 Wisconsin franchise or income tax return.

The taxpayer filed its 1987 Wisconsin franchise or income tax return on June 9, 1988. The taxpayer's 1987 federal income tax return indicated taxable income before net operating loss deduction and special deductions

of \$146,680. From this figure, the taxpayer deducted its deemed carry-over losses of \$68,115.70 and a "special reserve for bad and doubtful debt" of \$76,150, to arrive at federal taxable income of \$2,414.30.

In a typed schedule accompanying its 1987 profit and loss statement for the year ended December 31, 1987, the taxpayer included a note indicating, with respect to the special reserve for bad and doubtful debt, that "reserves are for Patrick Custardo d/b/a/ Streamwood who has judgments against him 5/88 in excess of \$4 million. Recovery prospects are nil. Reserve is for legal costs plus accrued portion of fee." The \$76,150 associated with the so-called Custardo loan was added to the taxpayer's allowance for bad debts as disclosed in the balance sheet disclosures in its 1987 federal income tax return.

The taxpayer made no addition or subtraction modifications to federal taxable income on its 1987 Wisconsin franchise or income tax return.

On April 9, 1990, the department assessed the taxpayer for additional taxes and interest due for the 1987 taxable year. In calculating its adjustment to the 1987 income reported by the taxpayer, the department began with the taxpayer's pre-loss offset federal taxable income as reported of \$146,680. The department then allowed in its calculation the net business losses carried forward from 1985 of \$40,671 and from 1986 of \$20,962, resulting in allowed deductions to 1987 income of \$61,633. The adjustment created a taxable income for the taxpayer of \$85,047, rather than the \$2,414.30 previously reported. The department's adjustment resulted in the effective denial of the 1987 so-called Custardo bad debt addition to reserve of \$76,150, for the stated reason that bad debts are not allowed

by law to be deducted based upon the reserve method.

The taxpayer filed its petition for redetermination with the department in a letter dated April 18, 1990, in which it re-asserted the deductibility of the Custardo bad debt, arguing that it reported its income on the cash basis and that the IRS had previously allowed the Custardo deduction in full.

The department attempted to obtain substantiation of the taxpayer's bad debt deductions for the years 1984 through 1987 by soliciting financial accounting data detailing the specific receivables of the taxpayer relating to each debt written off for each year the write-offs gave rise to an income tax deduction by the taxpayer. Not having received the requested substantiation, the department issued its letter of action denying the taxpayer's petition for redetermination on April 6, 1992.

On November 22, 1993, the department issued a second assessment against the taxpayer for additional taxes and interest for the years 1986 and 1987. The department's adjustments in the second assessment were based upon a removal of the carryforward effect of the bad debt deductions associated with the taxpayer's Wykoff Farms write-off originating in 1985 of \$25,000 and the effect of the bad debt associated with the Seattle First National Bank write-off originating in 1986 of \$84,000. The adjustments decreased available carryforwards and, accordingly, increased Wisconsin taxable income and interest for the years 1986 and 1987. The audit worksheet accompanying the assessment indicated that the adjustments were based upon the taxpayer's failure to substantiate the debts in question and also cited sec. 71.77(7)(a), Wis. Stats., the 6-year statute of limitations for adjustments to income for

what the department deemed in its second assessment to be a material understatement of income on the part of the taxpayer.

The Commission reached the following conclusions:

- A. The department correctly adjusted the taxpayer's 1985 loss carryforward of \$25,000 as that carryforward reflected a bad debt deduction to be used in years subsequent to 1985, because the department was not barred from making such an adjustment by the 6-year statute of limitations found in sec. 71.77(7)(a), Wis. Stats., where the adjustment did not involve an assessment of additional tax liability for 1985 but only reflected the propriety of deductions carried forward for tax effect in subsequent years.
- B. The department correctly disallowed the taxpayer's \$84,000 Seattle First National Bank bad debt carryforward originating in 1986, on the alternative grounds that reserve bad debt deductions were not allowed by law in 1986 and that the deduction was not adequately substantiated by any direct proof offered by the taxpayer as required under IRC sec. 166 and applicable treasury regulations or sec. Tax 3.14, Wis. Adm. Code.
- C. The department correctly disallowed the taxpayer's \$76,150 Custardo bad debt claimed during 1987, on the alternative grounds that reserve bad debt deductions were not allowed by law in 1987 and that the deduction was not adequately substantiated by the taxpayer as required under IRC sec. 166 and applicable treasury regulations.

The taxpayer has not appealed this decision.

**Insurance companies — addback of exempt or excluded interest and dividends received deduction; Interest from United States government obligations; Loss carryovers.** *American Family Mutual Insurance Company vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, April 11, 1996). The issues in this case are as follows:

- A. *Add Modifications for Federally Nontaxable Interest and Dividends.* Did the department properly determine that the taxpayer was required, for Wisconsin income tax purposes, pursuant to secs. 71.01(4)(a)4 and 5, Wis. Stats. (1985-86), 71.45(2)(a)3 and 4, Wis. Stats. (1987-88), and 71.45(2)(a)3, Wis. Stats. (1989-90), to increase its income by those 15% increments of interest and dividends which were subject to an addback under sec. 832(b)(5) of the Internal Revenue Code (IRC) in calculating federal taxable income?
- B. *Taxation of U.S. Interest.* Did the department properly determine, pursuant to secs. 71.01(2), Wis. Stats. (1985-86), and 71.43(2), Wis. Stats. (1987-88), that the taxpayer must include interest from federal obligations in the measure of income subject to the Wisconsin corporate franchise tax?
- C. *Loss Carryforward.* Did the department properly reduce the taxpayer's net business loss carryforward by the dividends received deduction?
- D. *Dividends Received Deduction.* Did the department properly determine that the taxpayer was not entitled to deduct dividends received by it from various

corporations which did not use 50% or more of their net income or loss in computing taxable Wisconsin income within the meaning of sec. 71.26(3)(j), Wis. Stats. (1987-88) [formerly sec. 71.04(4), Wis. Stats. (1985-86)]?

The taxpayer and the department agree to hold open the dividends received deduction issue, based upon the eventual outcome in the *NCR* case (*NCR Corporation v. Wis. Dept. of Revenue*, WTAC Docket Nos. I-8669 and 87-I-359 [February 10, 1992]), which is currently pending at the Wisconsin Court of Appeals. The "eventual outcome" of the case includes any final determination by the highest court to which it is appealed.

The taxpayer is organized as a mutual insurance company under ch. 611, Wis. Stats., and is engaged in the business of selling automobile, homeowner, health, and business insurance coverage. The taxpayer is subject to federal income tax under IRC secs. 831-848 and to Wisconsin franchise tax under secs. 71.42-71.49, Wis. Stats. [formerly sec. 71.01(4), Wis. Stats. (1985-86)].

American Family Mutual Insurance Company (AFMIC) is a mutual non-stock insurance company with the following subsidiaries: AmFam, Inc.; American Family Brokerage, Inc.; American Standard Insurance Company of Wisconsin; American Family Life Insurance Company; and American Family Financial Services, Inc.

The taxpayer timely filed Forms 41, Wisconsin Insurance Franchise Tax Return, for the calendar years 1984 through and including 1991. On or about February 24, 1994, after a field audit of the years 1984 through

1991 ("the years at issue"), the department issued an assessment notice.

- A. *Add Modifications for Federally Nontaxable Interest and Dividends*

During the years at issue, the taxpayer received interest income on state and local bonds, which interest was excludable from federal taxable income under secs. 832(c)(7) and 103, IRC. During the years at issue, the taxpayer received dividend payments which were deductible from federal taxable income under secs. 832(c)(12) and 243, IRC.

In preparing its 1987-1991 Wisconsin franchise tax returns, the taxpayer calculated its interest income "add modification" to federal taxable income under sec. 71.01(4)(a)4, Wis. Stats. (1985-86), renumbered as sec. 71.45(2)(a)3, Wis. Stats. (1987-88), and amended commencing with the taxpayer's year 1989, as follows: The taxpayer added to its federal taxable income for the year 100% of the interest income excludable from federal taxable income under secs. 832(c)(7) and 103, IRC, less the amount of such interest income that was used on its federal tax return to reduce its deduction for losses on insurance contracts under sec. 832(b)(5)(B), IRC, as amended by the Tax Reform Act of 1986.

In preparing its 1987-1990 Wisconsin franchise tax returns, the taxpayer calculated its dividend income "add modification" to federal taxable income under sec. 71.01(4)(a)5, Wis. Stats. (1985-86), renumbered as sec. 71.45(2)(a)4, Wis. Stats. (1987-

88), as follows: The taxpayer added to its federal taxable income for the year 100% of its dividend income deductible from federal taxable income under secs. 832(c)(12) and 243, IRC, less the amount of such dividend income that was used on its federal income tax return to reduce its deduction for losses on insurance contracts under sec. 832(b)(5), IRC, as amended by the Tax Reform Act of 1986. In preparing its 1991 Wisconsin franchise tax return, the taxpayer followed the same procedure, except that it added 100% of its federally deductible dividend income without reduction for the amount thereof used to reduce its federal loss under sec. 832(b)(5), IRC.

The department determined that the taxpayer was not entitled to reduce its interest income add modification or its dividend income add modification by the amounts of interest and dividend income used to reduce its federal deduction for losses on insurance contracts under sec. 832(b)(5), IRC. The department's position is that because the federal reduction in the taxpayer's interest and dividends deduction occurs as the result of a reduction in the taxpayer's federal loss reserve deduction, which is computed separately on the federal form, it is "separate" and therefore not subject to Wisconsin's addition modification exception language under sec. 71.45(2), Wis. Stats.

#### B. Taxation of U.S. Interest

During the years at issue, the taxpayer received interest on obligations of the United States government. The taxpayer, in preparing its 1984-1989 Wisconsin franchise tax returns, subtracted such interest on United

States obligations from its federal taxable income for each year. In its original 1990-1991 Wisconsin franchise tax returns, which are involved in this case, the taxpayer subtracted a portion of such interest on United States obligations. The department determined that the amounts were not properly subtracted from federal taxable income in determining the taxpayer's net Wisconsin income.

The taxpayer contends that the department may not tax federal obligations because Wisconsin's franchise tax is not "a nondiscriminatory franchise tax" within the meaning of 31 USC sec. 3124(a). The taxpayer argues that because part of the language in sec. 71.43(2), Wis. Stats., provides that a corporation is subject to the "special franchise tax" in the year it is dissolved or ceases doing business, according to or measured by its entire Wisconsin taxable income for the year of business cessation or dissolution, the entire scheme of sec. 71.43(2), Wis. Stats., is rendered an income tax rather than a franchise tax.

The taxpayer also attacks the franchise tax as discriminatory because it includes income from federal obligations while exempting interest on certain state, local, and corporate obligations from the tax. In particular, the taxpayer points to statutory sections which exempt certain state and local bonds "from all taxes" and other sections which allow a subtraction for certain corporate dividends received.

#### C. Loss Carryforward

The taxpayer incurred a Wisconsin net business loss in 1985 and 1990. In preparing its Wisconsin

franchise tax returns, the taxpayer carried this loss forward and subtracted it from 1986 and 1991 income, respectively, under sec. 71.06, Wis. Stats. (1985-86), and sec. 71.45(4), Wis. Stats. (1991-92), respectively.

In calculating its Wisconsin net business loss carryforward, the taxpayer included the deduction for dividends received to which it was entitled under sec. 71.01(4)(a)7, Wis. Stats. (1985-86), and sec. 71.45(2)(a)8, Wis. Stats. (1991-92), respectively, and did not add such dividends back into income. Thus, the taxpayer carried forward to 1986 and 1991 the amount of loss reported in 1985 and 1990, respectively. The department reduced the taxpayer's loss carryforwards by adding back into income for the taxpayer's years 1986 and 1991 the amount of the taxpayer's dividend deductions (as determined by the department) in 1985 and 1990.

The loss carryforward statute applicable for 1986, sec. 71.06(3), Wis. Stats. (1985-86), provides in part that the "Wisconsin net business loss shall be determined under s. 71.01(4), except that s. 71.01(4)(a)7 ... may not apply." At issue is the meaning of the words "may not apply," which the department interprets as mandatory and which the taxpayer insists has no plain meaning, is therefore ambiguous, and produces an absurd result.

The loss carryforward statute applicable for 1991, sec. 71.45(4), Wis. Stats. (1991-92), states in part that insurers may subtract from Wisconsin net income "any Wisconsin net business loss sustained in any of

the next preceding taxable years to the extent not offset by Wisconsin net business income of any year between the loss year and the taxable year for which an offset is claimed and computed without regard to sub. (2)(a)8 and 9 of this subsection ...”

The taxpayer also challenged the constitutionality of the loss carryforward statutes under the Equal Protection Clause of the United States and Wisconsin Constitutions. The taxpayer’s challenge is grounded on the proposition that there is no rational basis either for the legislature’s disparate tax treatment of insurance companies compared to other business corporations or for its discriminating against insurance companies who receive dividends in net loss years.

The Commission reached the following conclusions:

- A. The department did not properly determine that the taxpayer was required, for Wisconsin income tax purposes, to increase its income by those 15% increments of interest and dividends which were subject to an addback under sec. 832(b)(5), IRC, in calculating federal taxable income. Wherever placed on the federal tax form or however characterized by the department, the amounts at issue were plainly not “used as a deduction in determining federal taxable income” and therefore fall squarely within the exception to addition modifications required to arrive at Wisconsin taxable income.
- B. The department properly determined that the taxpayer must include interest from federal obligations in the measure of

income subject to the Wisconsin corporate franchise tax. The “franchise tax” which was assessed here by the department against the taxpayer is a true franchise tax and not an income tax, notwithstanding the “special franchise tax” language in the same statutory subsection. In addition, the taxpayer has not shown by evidence in the record or otherwise that the department has ever applied the franchise tax in a manner which discriminates in favor of state and local obligations, including during the period under review.

- C. The department properly reduced the taxpayer’s net business loss carryforward by the dividends received deduction. The language of sec. 71.06(3), Wis. Stats. (1985-86), is mandatory. The plain meaning of sec. 71.45(4), Wis. Stats. (1991-92), which uses “without regard to” the dividends received deduction rather than the earlier “may not apply,” makes it even clearer that the department properly excluded the deduction for dividends received in auditing the taxpayer’s 1991 claimed loss carryforward. The taxpayer’s arguments challenging the constitutionality of the loss carryforward statutes are insufficient to overcome the strong presumption of constitutionality attached to taxation statutes.

The department has appealed this decision to the Circuit Court. □

■ **Insurance companies — addback of exempt or excluded interest and dividends received deduction; Interest from United States government obligations.** *American Standard Insurance Company of Wisconsin vs. Wisconsin Department of Revenue* (Wisconsin

Tax Appeals Commission, April 11, 1996). The two issues in this case are identical to issues A and B in *American Family Mutual Insurance Company vs. Wisconsin Department of Revenue*, which are described above.

The taxpayer is a Wisconsin corporation engaged in the business of writing high-risk coverage for individuals who are unable to qualify for select risk coverage offered by the taxpayer’s parent, American Family Mutual Insurance Company (AFMIC). The taxpayer reinsures all of its coverage with its parent company.

American Standard Insurance Company of Wisconsin (ASIC) was organized in 1961 under the laws of Wisconsin. On October 1, 1982, ASIC transferred its unpaid losses, loss expenses, and unearned premium reserves to AFMIC. All business written by ASIC subsequent to September 30, 1982, is reinsured 100% by AFMIC. ASIC is a wholly-owned subsidiary of AmFam, Inc. (a holding company), which in turn is owned 100% by AFMIC.

The Commission’s conclusions of Law and Opinion on the issues are identical to conclusions A and B in the *AFMIC* case above.

The department has appealed this decision to the Circuit Court. □

■ **Leases — 1986 and prior — safe harbor rules.** *Northern States Power Company vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, May 30, 1996). The issue in this case is whether the taxpayer’s cash purchases of tax benefits can be amortized and deducted under the Wisconsin franchise tax law.