

STATE OF WISCONSIN
TAX APPEALS COMMISSION

LINDA FOSCOLO-LANIGAN,

DOCKET NO. 05-I-130

and

PETER LANIGAN AND LINDA FOSCOLO-LANIGAN,

DOCKET NO. 05-I-131

Petitioners,

vs.

DECISION AND ORDER

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

DAVID C. SWANSON, COMMISSIONER:

These matters come before the Commission following a hearing initially convened and adjourned on August 2, 2006, then reconvened and completed on August 1, 2007 before the undersigned Commissioner. In this matter, William J. Kirchen, CPA, represents petitioners Linda Foscolo-Lanigan and Peter Lanigan, and respondent, the Wisconsin Department of Revenue (the "Department"), is represented by Attorney Lisa A. Gilmore. At the hearing, the Commission received and entered into evidence petitioners' exhibits A through I and the Department's exhibits 1 through 21, and petitioner Linda Foscolo-Lanigan and William J. Kirchen, CPA, provided sworn testimony. Petitioner Peter Lanigan and Department Resolution Officer Shirley Henika were present at the hearing, but did not testify. Upon the conclusion of the hearing, the parties agreed to file briefs. Prior to the hearing, petitioners filed a brief on January 17,

2007. After the hearing, respondent filed its brief on February 19, 2008, and petitioners filed a reply brief on April 30, 2008. Having considered the sworn testimony and the parties' exhibits and briefs, the Commission finds, concludes, decides and orders as follows:

FINDINGS OF FACT

1. By a Notice of Amount Due dated October 18, 2004, the Department issued an income tax assessment to petitioners for the years 2001 and 2002 in the total amount of \$19,925.88, including tax and interest (the "2001-2002 assessment"). (Dept. Ex. 2.) According to the Department's Office Audit Worksheet also dated October 18, 2004, the 2001-2002 assessment is based primarily on the Department's disallowance of (1) the ordinary loss from Crane Lithography claimed by petitioner Linda Foscolo-Lanigan for 2001 and (2) the Wisconsin net operating loss carryover for 2001 and 2002 claimed by both petitioners. (Dept. Ex. 6.)

2. By letter dated December 15, 2004, petitioners' representative filed with the Department a petition for redetermination of the 2001-2002 assessment. (Dept. Ex. 3.)

3. By Notice of Action dated June 13, 2005, the Department denied petitioners' petition for redetermination of the 2001-2002 assessment, and updated the 2001-2002 assessment by a Notice of Amount Due also dated June 13, 2005 in the total amount of \$21,098.95, including tax and interest. (Dept. Ex. 4 and 5.)

4. By a Notice of Amount Due dated October 18, 2004, the

Department issued an income tax assessment to petitioner Linda Foscolo-Lanigan¹ for the year 2000 in the total amount of \$7,604.02, including tax and interest (the “2000 assessment”). (Dept. Ex. 7.) According to the Department’s Office Audit Worksheet also dated October 18, 2004, the 2000 assessment is based primarily on the Department’s disallowance of the Wisconsin net operating loss carryover deducted from petitioner’s Wisconsin income for 2000. (Dept. Ex. 10.) (The 2000 assessment and the 2001-2002 assessment are referred to herein collectively as the “assessments,” and the years 2000, 2001 and 2002 as the “period at issue.”)

5. By letter dated December 15, 2004, petitioners’ representative filed with the Department a petition for redetermination of the 2000 assessment. (Dept. Ex. 3.)

6. By Notice of Action dated June 13, 2005, the Department denied petitioner’s petition for redetermination of the 2000 assessment, and updated the 2000 assessment by a Notice of Amount Due also dated June 13, 2005 in the total amount of \$7,997.09, including tax and interest. (Dept. Ex. 8 and 9.)

7. On August 15, 2005, petitioners filed a petition for review with the Commission of the Department’s respective denials of their petition(s) for redetermination of the assessments. The Commission assigned Docket No. 05-I-130 to its review of the 2000 assessment and Docket No. 05-I-131 to its review of the 2001-2002 assessment.

¹ For 2000, petitioner Linda Foscolo-Lanigan filed individual income tax returns, and for 2001-2002, petitioners filed joint returns. Because they involve the same issues, these matters have been consolidated for hearing before the Commission.

8. During the period at issue, petitioner Linda Foscolo-Lanigan was President, Secretary and part owner of Crane Lithography, Inc. (n/k/a Display Promotions) (“Crane”), a Wisconsin corporation treated as an “S corporation” for federal and Wisconsin income tax purposes. (Tr. at 11.)

9. In 1999, Mrs. Foscolo-Lanigan owned 50% of the stock of Crane. In 2000, Mrs. Foscolo-Lanigan owned approximately 77% of the stock of Crane, and in 2001 she owned 75% of the stock of Crane. In 1999 and 2000, Crane had one additional shareholder, Craig Zander. During 2000, Crane repurchased Mr. Zander’s shares. In 2001, Mark Heimerl joined Crane as its Chief Operating Officer and became Crane’s only other shareholder, in addition to Mrs. Foscolo-Lanigan. (Pet. Ex. B, C, D; Dept. Ex. 14.)

10. On September 29, 1998, petitioners executed a term note in the amount of \$1.65 million and a demand line of credit note in the amount of \$800,000 with Firststar Bank (n/k/a U.S. Bank, and herein, the “Bank”) for the benefit of Crane (the “Notes”). (Pet. Ex. A.) The Notes were secured by a personal guaranty executed by petitioners dated September 29, 1998 (the “Guaranty”), which was secured by a mortgage also dated September 29, 1998 (the “Mortgage”). *Id.*

11. In 2001, Crane voluntarily surrendered its assets to the Bank pursuant to a receivership proceeding under Chapter 128 of the Wisconsin Statutes in Ozaukee County Circuit Court. (Tr. at 20; Dept. Ex. 12.) On February 20, 2002, the receivership was closed and the receiver discharged by court order. (Dept. Ex. 12.)

12. In correspondence dated February 18, 2005, Firststar’s representative,

Attorney Emory Ireland, informed petitioners' representative, Attorney Catherine A. La Fleur, that the proceeds of the receivership "were insufficient to satisfy Crane's obligations to the Bank, and interest has continued to accrue." (Pet. Ex. A, p. 2.) Furthermore, "[t]he Chapter 128 proceeding did not discharge the obligations of Linda Foscolo-Lanigan under either the Guaranty or the Mortgage." *Id.* In that letter, the Bank's attorney offered to release petitioners from the Guaranty and Mortgage in exchange for their execution of a "New Note" in the amount of \$350,000, subject to certain additional enumerated terms, by March 15, 2005. *Id.*

13. Crane was never dissolved, but its name was later changed to Display Promotions. (Tr. at 20-21.) Petitioners still control Display Promotions. *Id.*

14. Debts totaling approximately \$1.8 million remained payable by Crane at the time of its insolvency and the Chapter 128 receivership, of which just over \$1.5 million was owed to the Bank. (Pet. Ex. E.)

15. On or about September 13, 2006, Crane and petitioners filed amended Wisconsin income tax returns (Crane for 2001 and petitioners for 2000-2002) claiming the carryover losses disallowed by the Department. (Pet. Ex. F, G, H and I.)

16. Except for the Notes, petitioners have conceded the Department's disallowance of the other claimed deductions at issue in the assessments. (Tr. at 13.)

17. On the returns at issue, petitioners claimed the entire amounts of the unpaid Notes as additional basis in their shares of Crane. In their reply brief, petitioners conceded that they should have claimed only the pro rata share allocable to their percentage ownership of the outstanding shares of Crane for each year at issue

(i.e., 75% in 2001), as argued by the Department. (Pet. reply brief dated April 30, 2008, p. 1.)²

CONCLUSIONS OF LAW

1. Petitioners have failed to satisfy their burden of proof in these matters.

2. Crane's indebtedness under the Notes was not discharged through Crane's receivership under Chapter 128 of the Wisconsin Statutes during 2001-2002.

DECISION

Assessments made by the Department are presumed to be correct, and the burden is on the petitioners to prove by clear and satisfactory evidence in what respects the Department erred in its determination. *Edwin J. Puissant, Jr. v. Wis. Dep't of Revenue*, Wis. Tax Rptr. (CCH) ¶ 202-401 (WTAC 1984); Wis. Stat. § 77.59(1). Tax exemptions, deductions, and privileges are matters of legislative grace and will be strictly construed against the taxpayer. *Fall River Canning Co. v. Dep't of Taxation*, 3 Wis. 2d 632, 637, 89 N.W.2d 203 (1958).

The dispute in these matters stems from the Department's disallowance of petitioners' deductions of ordinary losses from Crane and related Wisconsin net operating loss carryovers for the years at issue. Petitioners based these claimed losses on their position that all of Crane's debts were discharged through Crane's insolvency and receivership filing under Wis. Ch. 128 in 2001.³ According to petitioners' analysis,

² Specifically, petitioners "agree that of the \$1,812,882 of debt that was forgiven, only \$1,359,662 of that debt should apply to Linda Foscolo-Lanigan." (Pet. reply brief dated April 30, 2008, p. 1.)

³ However, petitioners now claim only the discharge of the Notes, Guaranty and Mortgage.

Crane's discharge of indebtedness income during the period at issue passed through to the shareholders in the same manner as any other item of income under the general rule of Section 1366(a)(1)(A) of the Internal Revenue Code of 1986, as amended (the "Code"⁴), applicable to S corporations, thus increasing their basis in their shares of Crane by the same amounts. However, petitioners argue that the discharged amounts also were excluded from their gross income under Code § 108(a) due to Crane's insolvency at the time of discharge. In support of their position, petitioners cite *Gitlitz v. Comm'r*, 531 U.S. 206 (2001).⁵

The Department raises a number of arguments against petitioners' position, but its most persuasive point is that Crane's debts were not discharged during the period at issue. We agree.⁶

In general, a discharge of indebtedness is included in income under Code § 61(a)(12). For example, a debt is discharged when it is cancelled or forgiven. Treas. Reg. § 1.61-12(a). Here, Crane's remaining debts were never discharged during the period at issue. The fact that a Chapter 128 proceeding provides for a distribution of assets of an insolvent corporation among its creditors is not the same as a discharge of

⁴ Wisconsin's income tax is federalized and Wisconsin income tax law generally follows federal law. While there are some differences between Wisconsin and federal income tax law with respect to S corporations, those differences are not relevant to this decision and therefore are not discussed herein.

⁵ Congress legislatively overturned the holding reached in *Gitlitz* through the enactment of Code § 108(d)(7)(A) in the Job Creation and Worker Assistance Act of 2002. P.L. 107-147. However, this change was not retroactive to the decision date of *Gitlitz*. The *Gitlitz* rule still applies to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001. P.L. 107-47, § 402(b). Under the current rule of Code § 108(d)(7)(A), a discharge of indebtedness is excluded as an item of income of an S corporation under Code § 108(a), but is not taken into account as an item of income that flows through to any shareholder under Code § 1366(a), thus providing no increase in basis for the shareholders.

⁶ Because we find that that was no discharge of indebtedness that would create the increased basis claimed by petitioners in their shares of Crane during the years at issue, we do not reach the other arguments raised by the Department in these matters.

indebtedness.

For petitioners to prevail in these matters, they must prove that Crane's indebtedness to the Bank was discharged during the period at issue. Petitioners maintain that the discharge occurred during Crane's Chapter 128 proceeding in Ozaukee County Circuit Court, but the evidence shows that no such discharge occurred. The Court order closing the receivership and releasing the receiver does not release Crane from any unpaid obligation. Petitioners provided no evidence that the Bank ever released Crane or petitioners from their obligations under the Notes, the Guaranty or the Mortgage, except for the letter sent by the Bank's attorney in 2005. However, that letter indicates that the Bank had not released Crane or petitioners from these obligations, and in fact was still pursuing collection in 2005. The letter does offer to settle the obligations owed by petitioners under the Guaranty and Mortgage, but this offer was made in 2005, well after the end of the period at issue. Moreover, the letter provides no relief to Crane with respect to the Notes and states that interest was continuing to accrue on those debts.

Without a discharge of indebtedness, petitioners cannot obtain the tax result they seek. Code §§ 61(a)(12), 108(a) and 1366(a) do not apply, which prevents the application of *Gitlitz*. Petitioners provide no legal precedent for their argument that completing a receivership under Wis. Stats. Ch. 128 results in a discharge of indebtedness. Indeed, the Wisconsin Supreme Court has held that Chapter 128 does not encroach upon the field occupied by federal bankruptcy law in part because Chapter 128 does not permit the discharge of a debtor. *In re Mader's Store for Men, Inc.*, 77 Wis. 2d 578, 254 N.W.2d 171 (1977) (also cited as *Gelatt v. DeDakis*). "It is settled in this regard that state statutes providing for the discharge of a debtor, or exacting from

creditors a stipulation of discharge as a condition of participating in the distribution of the debtor's assets, are invalid so long as national legislation is in effect." *Id.*, 77 Wis. 2d at 593, citing *Int'l Shoe Co. v. Pinkus*, 278 U.S. 261 (1929) and *In re Tarnowski*, 191 Wis. 279, 210 N.W. 836 (1926).⁷

In these cases, petitioners have provided no evidence documenting any discharge of indebtedness that would give rise to the increased basis and loss deductions disallowed by the Department. In addition, petitioners' legal theory that Crane's receivership under Chapter 128, Wis. Stats., resulted in a discharge of indebtedness is inconsistent with existing law and the evidence presented in these matters. Therefore,

IT IS ORDERED

The Department's actions on the petitioners' petition(s) for redetermination in these matters are affirmed.

Dated at Madison, Wisconsin, this 27th day of October, 2008.

WISCONSIN TAX APPEALS COMMISSION

David C. Swanson, Chairperson

Roger W. Le Grand, Commissioner

Thomas J. McAdams, Commissioner

ATTACHMENT: "NOTICE OF APPEAL INFORMATION"

⁷ The Court further noted that the U.S. Supreme Court upheld the result in another case involving Wis. Stats. Ch. 128 partly on the grounds that the case did not involve the discharge of a debtor. *Mader's Store*, 77 Wis. 2d at 585-86, citing *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 525 (1933); see, also, *In re Wisconsin Builders Supply Co.*, 239 F.2d 649 (7th Cir. 1956).