

**STATE OF WISCONSIN**  
**TAX APPEALS COMMISSION**

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**FLOYD F. AND PATRICIA L. MARKLING,**

**DOCKET NO. 06-I-162**

Petitioners,

vs.

**RULING AND ORDER**

**WISCONSIN DEPARTMENT OF REVENUE,**

Respondent.

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**ROGER W. LEGRAND, COMMISSIONER:**

This matter comes before the Commission on cross-motions for summary judgment filed by petitioners and respondent. Petitioners, Floyd F. and Patricia L. Markling, appear by Attorney Edward J. Roepsch of Roepsch Law Offices. Respondent, the Wisconsin Department of Revenue (the "Department"), appears by Attorney Sheree Robertson.

Having considered the entire record before it, the Commission finds, concludes, rules and orders as follows:

**FINDINGS OF FACT**

1. By Notice of Amount Due dated April 12, 2004, the Department issued an assessment of additional income tax to Petitioners (the "assessment") that resulted from adjustments made to their reported income for the years 1999, 2000, 2001 and 2002 (collectively, the "period at issue" or "years at issue").

2. Among the adjustments made in the assessment, the Department added to Petitioners' previously taxed income certain interest income accrued by the Floyd F. Markling Revocable Trust (the "Trust") as a shareholder of Poly-Flex, Inc., a 100% Wisconsin S corporation ("Poly-Flex"), on certain loans that Poly-Flex made to and/or on behalf of Aluminum Extrusions, Inc., a Mississippi S corporation ("AEI"). (Dept. Exh. 23, Response Nos. 1(a) and 9; Robertson Affidavit ¶ 9; Buskager Affidavit ¶ 3.) With respect to that adjustment, the Department added the following amounts of interest income to Petitioners' income for the period at issue: (1) \$229,639 for tax year 1999;<sup>1</sup> (2) \$167,606 for tax year 2000; (3) \$172,486 for tax year 2001; and (4) \$173,432 for tax year 2002 (collectively herein, the "interest income"). (Dept. Exh. 8; Buskager Affidavit ¶ 12).

3. On or about June 9, 2004, Petitioners filed an objection to the assessment, which the Department considered their petition for redetermination. (Dept. Exh. 12; Henika Affidavit ¶ 3).

4. By Notice of Action letter dated May 1, 2006, the Department denied Petitioners' petition for redetermination. (Dept. Exh. 16; Henika Affidavit ¶ 8).

5. On June 13, 2006, Petitioners filed a petition for review of this matter with the Commission. With the Commission's permission, Petitioners subsequently amended their petition for review twice, and the Department filed answers to the respective amended petitions.

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<sup>1</sup> The Department has conceded the portion of the assessment related to the 1999 adjustment related to interest income from a personal loan(s) that Petitioner Floyd F. Markling made to Poly-Flex that is not related to the loans that Poly-Flex advanced to and/or on behalf of AEI.

6. Poly-Flex did business in the State of Wisconsin during each year of the period at issue. (Dept. Exh. 23, Response No. 2; Robertson Affidavit ¶ 9).

7. During the period at issue, the Trust was the sole shareholder of Poly-Flex. (Dept. Exhibit 23, Response No. 3; Robertson Affidavit ¶ 9).

8. During the period at issue, Petitioner Floyd F. Markling was the sole owner/grantor of the Trust. The Trust's income flows through to Mr. Markling as the owner/grantor of the Trust, which income is reported on Petitioners' individual income tax return. (Dept. Exh. 23, Response No. 4(a); Robertson Affidavit ¶ 9; Buskager Affidavit ¶ 9).

9. During the period at issue, Poly-Flex used the accrual method of accounting for reporting items of income and expenses for federal and Wisconsin income tax purposes. (Dept. Exh. 23, Response No. 7; Robertson Affidavit ¶ 9).

10. During the period at issue, Poly-Flex followed the calendar year for federal and Wisconsin income or franchise tax purposes. (Dept. Exh. 23, Response No. 8; Robertson Affidavit ¶ 9).

11. AEI did not do business in the State of Wisconsin during the period at issue and did not file Wisconsin Tax-Option (S) Corporation income or franchise tax returns for those years. (Dept. Exh. 23, Response No. 10; Robertson Affidavit ¶ 9; Buskager Affidavit ¶ 14).

12. According to AEI's Schedule K-1's for tax years 1999, 2000 and 2002, Petitioner Floyd F. Markling was the 100% shareholder of AEI. (Dept. Exh. 13).

According to AEI's Schedule K-1 for tax year 2001, the Trust was the 100% shareholder of AEI.<sup>2</sup> (*Id.*)

13. For the period at issue, AEI used the accrual method of accounting for federal and Mississippi income tax purposes. (Dept. Exh. 23, Response No. 12; Robertson Affidavit ¶ 9).

14. During the period at issue, AEI followed the calendar year for federal and Mississippi income tax purposes. (Dept. Exh. 23, Response No. 13; Robertson Affidavit ¶ 9).

15. For each year during the period at issue, AEI filed a federal Form 1120S U.S. Income Tax Return for an S Corporation and a Mississippi S-Corporation Income and Franchise Tax Return. (Dept. Exh. 10; Buskager Affidavit ¶ 13; Dept. Exh. 23, Response No. 14; Robertson Affidavit ¶ 9).

16. A copy of a Note<sup>3</sup> executed in connection with a loan in the amount of \$200,000 from Poly-Flex to AEI dated August 31, 1993, and signed by Petitioner Floyd F. Markling as President of AEI, provides as follows:

... Aluminum Extrusions, Inc., a Mississippi corporation ("Borrower") promises to pay to Poly-Flex, Inc. ("Lender") upon demand, the initial principal sum of Two Hundred Thousand and 00/100 Dollars (\$200,000), and such additional amounts as shall be advanced thereafter to Borrower, together with interest on the unpaid principal balance at an annual rate of the then existing Prime Rate of

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<sup>2</sup> Submitted to Department Resolution Officer Shirley Henika ("Ms. Henika") by Petitioners' former representative in this matter, Attorney Amy R. Seibel ("Ms. Seibel"), by letter dated November 4, 2005. On AEI's 2001 Schedule K-1, Mr. Markling's name was typed with the words "Revocable Trust" handwritten after his name.

<sup>3</sup> Enclosed with a letter dated May 3, 2006 from Ms. Seibel to Ms. Henika.

interest, which interest rate shall be changed throughout the term of the Note, until this Note is paid in full.

(Dept. Exh. 15; Henika Affidavit ¶ 9).

17. The initial amount of the Note was increased based on additional advances and accrued interest. For at least some of the years at issue, AEI maintained an Amortization Schedule for the loan.<sup>4</sup> (Dept. Exh. 15; Henika Affidavit ¶ 9).

18. For each tax year 2000, 2001 and 2002, Poly-Flex filed a Wisconsin Tax-Option (S) Corporation Franchise or Income Tax Return with an attached copy of its federal Form 1120S U.S. Income Tax Return for an S Corporation. (Dept. Exh.'s 1 through 3; Buskager Affidavit ¶ 5). On its Wisconsin Schedule 5K for each tax year 2000 through 2002, Poly-Flex reported as income the interest income accrued on the loans that it advanced to AEI in the following amounts: (1) \$167,606 for 2000; (2) \$172,486 for 2001; and (3) \$173,432 for 2002. However, on the respective Schedule 5K-1, the interest income accrued was subtracted from income. (Dept. Exh.'s 1 through 3). Poly-Flex also reported on its 2000 through 2002 federal Form 1120S income tax returns the interest income accrued on the loans that it advanced to AEI.

19. On Line 13 of its federal Form 1120S for each tax year 1999 through 2002, AEI claimed as a deduction interest in the amounts of \$318,085, \$370,629, \$370,629 and \$273,237, respectively. The interest accrued on the loans that Poly-Flex made to AEI was included in AEI's claimed interest deductions. (Dept. Exh. 10; Buskager Affidavit, ¶ 13).

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<sup>4</sup> By letter dated April 6, 2006 and attached to her May 3, 2006 letter to the Department, Ms. Seibel stated that the Amortization Schedule was maintained only for the earlier years of the period at issue. (Dept. Exh. 15; Henika Affidavit ¶ 9).

20. Poly-Flex and AEI are separate entities for state and federal income/franchise tax purposes. (Buskager Affidavit ¶ 15).

21. On or about October 17, 2001, Petitioners filed a 2000 Form 1NPR Wisconsin individual income tax return as residents of the State of Tennessee. Petitioners attached a copy of their 2000 Form 1040 federal income tax return to their 2000 Wisconsin individual income tax return. On Schedule B of their 2000 federal income tax return, Petitioners reported as income the \$167,606 of accrued interest income that Poly-Flex reported on its 2000 Schedule K-1. Petitioners did not report the \$167,606 of accrued interest income on their 2000 Wisconsin individual income tax return. (Dept. Exh. 4; Buskager Affidavit ¶ 10).

22. On or about October 18, 2002, Petitioners filed a 2001 Form 1NPR Wisconsin individual income tax return as residents of the State of Alaska. Petitioners attached a copy of their 2001 Form 1040 federal income tax return to their 2001 Wisconsin individual income tax return. On Schedule B of their 2001 federal income tax return, Petitioners reported as income the \$172,486 of accrued interest income that Poly-Flex reported on its 2001 federal Schedule K-1. Petitioners did not report the \$172,486 of accrued interest income on their 2001 1NPR Wisconsin individual income tax return. (Dept. Exh. 5; Buskager Affidavit ¶ 10).

23. On or about November 28, 2003, Petitioners filed a 2002 Form 1NPR Wisconsin individual income tax return as residents of the State of Alaska. Petitioners attached a copy of their 2002 Form 1040 federal income tax return to their 2002 Wisconsin individual income tax return. On Schedule B of their 2002 federal

income tax return, Petitioners reported as income the \$173,432 of accrued interest income that Poly-Flex reported on its 2002 Schedule K-1. Petitioners did not report the \$173,432 of accrued interest income on their 2002 Form 1NPR Wisconsin individual income tax return. On or about July 23, 2004, Petitioners filed an amended 2002 Form 1NPR Wisconsin individual income tax return, which also does not include the \$173,432 of accrued interest income. (Dept. Exh.'s 6 and 7; Buskager Affidavit ¶ 10).

24. On or about October 16, 2000, Petitioners filed a 1999 Form 1NPR Wisconsin individual income tax return, with a copy of their federal return attached, as residents of the State of Tennessee. (Dept. Exh. 11; Buskager Affidavit ¶ 16).

25. On Line 5 of Poly-Flex's 1999 federal Form 1120S,<sup>5</sup> Poly-Flex reported \$132,726 as "other income," and on Line 21, Poly-Flex reported \$1,934,948 as ordinary income (which included the \$132,726 as "other income"). The \$1,934,948 of ordinary income was also reported on Poly-Flex's 1999 Schedule K-1 showing the Trust as Poly-Flex's sole shareholder. (Dept. Exh. 13; Henika Affidavit ¶ 6).

### **RULING**

A summary judgment motion will be granted if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Wis. Stat. § 802.08(2). A party moving for summary judgment has the burden to establish the absence of a

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<sup>5</sup> Enclosed with Ms. Seibel's November 4, 2005 correspondence to the Department.

genuine, that is, disputed, issue as to any material fact. *Grams v. Boss*, 97 Wis.2d 332, 338-39, 294 N.W.2d 473 (1980). In this matter, both parties filed motions for summary judgment, with both stating that no material fact is in dispute.

The Department's assessments are presumptively correct and the burden is on the taxpayer to demonstrate the existence of any incorrectness. *Waller v. Dep't. of Taxation*, 35 Wis. 2d 227, 233, 151 N.W.2d 170 (1967). Petitioners have the burden to show by clear and convincing evidence that the Department's actions in making the assessment were incorrect. *Alan T. Zingelmin v. Wis. Dep't. of Revenue*, Docket No. 88-1-132 (WTAC April 26, 1989). In this matter, the Department issued the assessment and Petitioners bear the burden of proving that it is incorrect.

Wisconsin's income tax laws generally follow federal law, including tax laws governing S corporations and grantor trusts. Section 671 of the Internal Revenue Code of 1986, as amended (the "IRC"), provides in part:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust . . . .

Applicable regulations further provide that a grantor or other person who is regarded as the owner of any portion of a trust must include, in computing his or her taxable income and credits, those items of income, deductions and credits of the trust that are attributable to the portion of the trust that the grantor is regarded as owning. Treas.



Reg. § 1.671-2(a)-(c). Pursuant to § 71.01(6)(o), Stats., IRC § 671 and related regulations apply for Wisconsin income tax purposes.

Wisconsin imposes income tax on non-residents and non-resident trusts that derive their income from a tax-option Wisconsin corporation. § 71.04(9), Stats. In particular, “All tax-option items of nonresident individuals, nonresident estates and nonresident trusts derived from a tax-option corporation not requiring apportionment under sub. (2) shall follow the situs of the business of the corporation from which they are derived . . . .” § 71.362(1), Stats.

With regard to S corporations, Wisconsin law provides that “It is the intent of this section that shareholders of tax-option corporations include in their Wisconsin adjusted gross income their proportionate share of the corporation’s tax-option items unless the corporation elects under Section 71.365(4)(a) not to be a tax-option corporation.” § 71.36(1), Stats. “The tax treatment of all tax-option items shall be determined at the corporate level.” § 71.36(3)(a), Stats. “All shareholders of tax-option corporations shall treat tax-option items on their returns under this chapter in a manner consistent with the manner in which those tax-option items are treated on the corporation’s Wisconsin income or franchise tax return or shall notify the department of revenue of any inconsistency and the reason for it.” § 71.36(3)(b), Stats.

In this case, Poly-Flex, a Wisconsin S corporation, made the loans in question to AEI. Poly-Flex reported the interest accrued on the loans from 2000 through 2002 on IRS Form 1120S U.S. Tax Return for an S Corporation for each respective year and Wisconsin Schedule 5K. From 2000 through 2002, Poly-Flex was

100% owned by the Trust and elected to be taxed as a Wisconsin S corporation. All of Poly-Flex's interest income flowed to the Trust, and to Petitioner Floyd Markling as owner/grantor of the Trust.

The Department argues that it correctly required petitioners to report as income on their Wisconsin returns for 2000, 2001 and 2002 the interest income (1) accrued on the loans that Poly-Flex made to AEI, (2) that Poly-Flex reported as income on its federal returns and Wisconsin Schedule 5K for each year, and (3) that Petitioners reported as income on their own federal returns for those same years. However, Poly-Flex reported but also deducted the interest income on the Wisconsin Schedule 5K-1 that it issued to its sole shareholder, the Trust, for each year at issue.

Petitioners argue that the assessment was incorrect on the grounds that the Department should have audited Poly-Flex for the years 1999, 2000, 2001 and 2002. Petitioners allege that the Department was required to audit Poly-Flex under § 71.365(6), Stats. Petitioners contend that, if the Department had audited Poly-Flex, it would have found that Poly-Flex never received any interest from the loans it made to AEI. According to Petitioners, the interest at issue was only accrued on Poly-Flex's books and never paid to the Trust, and from there to Petitioners. According to Petitioners, the interest at issue therefore was not includable in their Wisconsin income.

Petitioners' arguments have no basis in Wisconsin law. Section 71.365(6), cited and quoted by Petitioners as requiring the Department to audit Poly-Flex, states:

**(6) Notice to shareholders of appeals and other proceedings.** Any notice of determination by the department of any tax-option item may be contested by a tax-option corporation under subch. XIV. A tax-option corporation shall timely notify all shareholders of any administrative or judicial proceeding about the determination of any tax-option item. Each shareholder may participate in any such proceeding and shall be bound by the final determination in that proceeding.

§ 71.365(6), Stats. On its face, this statute imposed no requirement on the Department to audit Poly-Flex; it merely allowed Poly-Flex to contest the Department's determinations regarding the interest income at issue. Here, the record provides no information as to whether Poly-Flex ever challenged the Department's actions in this matter. Finally, Petitioners cite no authority for the proposition that their actual receipt of the interest income at issue is required for it to be taxable in Wisconsin, and we are aware of none.

Under IRC § 671, Petitioners were required to report the interest income at issue on their 2000 through 2002 federal individual income tax returns, which they did. Furthermore, it is undisputed that Poly-Flex reported the interest income at issue on Wisconsin Schedule 5K during the period at issue. Petitioners were required to "treat tax-option items on their returns under this chapter in a manner consistent with the manner in which those tax-option items [were] treated on the corporation's Wisconsin income or franchise tax return" or "notify the [Department] of any inconsistency and the reason for it." § 71.36(3)(b), Stats. Petitioners thus were required to either report the interest income at issue on their Wisconsin individual income tax returns or notify the Department of the inconsistency and the reason for it.

However, the record shows that Petitioners did not report the income on their Wisconsin returns, and contains no evidence that they otherwise attempted to comply with § 71.36(3)(b).

The Commission concludes that there is no genuine issue of material fact in this case, and that the Department is entitled to summary judgment under Wis. Stat. § 802.08 as a matter of law, because Petitioners have failed to provide any evidence showing that the assessment is incorrect. Therefore,

**IT IS ORDERED**

1. Petitioners' motion for summary judgment is denied; and
2. Respondent's motion for summary judgment is granted, and its action on Petitioners' petition for redetermination is affirmed, as modified by its concession related to the 1999 adjustment.

Dated at Madison, Wisconsin, this 29<sup>th</sup> day of December, 2008.

**WISCONSIN TAX APPEALS COMMISSION**

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David C. Swanson, Chairperson

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Roger W. LeGrand, Commissioner

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Thomas J. McAdams, Commissioner

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