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Refund Opportunity: Wisconsin Supreme Court Rules SAP Is Custom Software For Sales and Use Tax Purposes

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In *Wisconsin Department of Revenue v. Menasha Corporation*,[1] the Wisconsin Supreme Court ruled that the Wisconsin Department of Revenue (the "DOR") erroneously collected sales tax on the sale of customized software. The decision upholds a Wisconsin Tax Appeals Commission (the "Commission") ruling that Menasha Corporation ("Menasha") was improperly charged excess sales tax on its purchase of software from SAP. The decision represents a significant taxpayer victory, as some estimates indicate approximately $265 million of previously collected Wisconsin sales and use taxes will need to be refunded.

Background

During the period at issue, Menasha was a Wisconsin corporation with its headquarters in Neenah, Wisconsin. It maintained sixty-three business locations in twenty states and eight countries. In 1993, Menasha hired an independent accounting firm to evaluate its business and accounting software to address shortcomings in its then current system. In tandem with its consultants, Menasha concluded that one global application software system would fit Menasha's needs but that the system would need to allow custom modification to meet Menasha's unique business requirements. In April of 1995, Menasha began discussions with SAP regarding its R/3 System, making it clear that the critical factor in the selection of that system was its ability to allow customization. After several years of analyzing Menasha's computing needs and evaluation of the R/3 System, Menasha licensed the R/3 System from SAP on September 27, 1995 for $5.2 million. At the time of the purchase, Menasha understood that the customization process would take years to complete and would cost tens of millions of dollars. Menasha's budget for purchasing the R/3 System included the costs that it expected to pay both SAP as well as SAP's designated consultants for the configuration, modification and customization of the R/3 System. Menasha's Board of Directors approved the licensing of the R/3 System acknowledging that the projected cost of implementation would be approximately $46.5 million.

[1] *Wisconsin Department of Revenue v. Menasha Corporation*, No. 2004AP3239, (Wisc., July 11, 2008)

Menasha paid Wisconsin sales and use tax on the $5.2 million purchase price it paid for the R/3 System. On June 30, 1998, Menasha filed a refund claim with the DOR for the sales and use taxes that it had paid on the purchase price of that system. The DOR denied the claim. Menasha then petitioned the DOR for a redetermination of the denial of its refund claim which was also denied by the DOR. Menasha then requested that the Commission review the DOR's determination. On December 1, 2003, the Commission granted Menasha's motion for summary judgment and directed the DOR to return the funds to Menasha. The Commission concluded that the R/3 System was custom software and not subject to the Wisconsin sales tax. The DOR petitioned the Dane County Circuit Court for review of the Commission's determination. The Dane County Circuit Court vacated the Commission's decision and reinstated the DOR's determination that the refund claim should be denied because the R/3 System was not custom software. Menasha appealed the Circuit Court's decision to the Wisconsin Court of Appeals which reversed the Circuit Court's decision and affirmed the Commission's decision. Thereafter, the DOR petitioned the Wisconsin Supreme Court to review the decision of the Court of Appeals.

Factors Distinguishing Custom versus Canned Software

The Wisconsin sales and use tax applies to the sale or use of tangible personal property and certain specified services that are not at issue. During the period at issue, tangible personal property was defined for Wisconsin sales and use tax purposes as all tangible personal property of every kind and description including computer programs, except for custom computer programs. Section 11.71(1)(e) of the Wisconsin Administrative Code (sections 11.71(1)(e) and (k) of the Wisconsin Administrative Code are hereafter collectively referred to as the "Regulation") defined a custom program as utility and application software which accommodate the special processing needs of the customer. The determination of whether a program is a custom program is based upon all the facts and circumstances, including the following:

1. the extent to which the vendor or independent consultant engaged in significant presale consultation and analysis of the user's requirements and system;

2. whether the program is loaded into the customer's computer by the vendor and the extent to which the installed program must be tested against the program's specifications;

3. the extent to which use of the software requires substantial training of the customer's personnel and substantial written documentation;

4. the extent to which enhancement and maintenance support by the vendor is needed for continued usefulness;

5. there is a rebuttable presumption that any program with a cost of $10,000 or less is not a custom program;

6. custom programs do not include basic operational programs or prewritten programs; and

7. if an existing program is selected for modification, there must be a significant modification of that program by the vendor so that it may be used in the customer's specific hardware and software environment.

As to the sixth element listed above, Regulation 11.71(1)(k) states that prewritten programs are often referred to as canned programs, which are programs prepared, held, or existing for general use normally for more than one customer, including programs developed for in-house or custom program use which are substantially held or offered for sale or lease.

The Supreme Court began its analysis noting that this case required the application of the Wisconsin tax law to the facts of Menasha and that the Wisconsin legislature had designated the Commission as the final authority on all tax questions. Thus, it was the Commission's decision and not the decisions of the DOR, the Circuit Court or the Court of Appeals which must be given deference. As long as the Commission's interpretation of the statute and Regulation are reasonable and consistent with the meaning and purpose of the Regulation, the Supreme Court will uphold the Commission's decision rather than substitute its own judgment.

The DOR had argued that the Supreme Court was bound to follow the DOR's interpretation of the Regulation since it was that agency that promulgated the Regulation. The Supreme Court noted, however, that the legislature designated the Commission as the final authority on all tax questions. By virtue of creating the Commission and identifying it as the agency charged with interpreting questions that arise under the tax code, the legislature had divided the agencies' duties with regard to the tax code. The DOR may promulgate regulations and even issue private letter rulings or interpretations that give guidance to taxpayers, but the Commission is the final authority on interpreting tax regulations. Accordingly, the Supreme Court held that no authority requires the Commission to defer to the DOR's construction of the Regulation.

The Commission had concluded that the Regulation instructs one to consider all of the facts and circumstances, including the seven factors listed in the Regulation. The factors, the Commission concluded, are not elements that must be met for a program to be deemed custom, but rather factors to be weighed along with other facts and circumstances. When considering all seven factors and all of the facts and circumstances, the Commission concluded that the R/3 System was a custom program because of the significant investment Menasha made in presale consultation and analysis, testing, training, written documentation, enhancement and maintenance and support. The Commission also determined that the R/3 System was not a prewritten program. Under the standard of review employed by the Supreme Court, the Court determined that the Commission's interpretation was reasonable and consistent with the Regulation's language and purpose and upheld the Commission's determination. As support for this conclusion, the Supreme Court then reviewed the Commission's analysis of the seven factors listed in the Regulation.

Under the first factor, regarding presale consultation, the Commission found that the DOR had conceded in its pleadings that significant presale consultation and analysis had taken place. As to the second factor, regarding loading and testing of the R/3 System, the Commission found that, even though the vendor did not load the software, a former SAP employee who was retained by Menasha for providing support during the installation loaded the software and that this factor appeared to favor the software's treatment as custom. The second factor also requires consideration of whether the newly installed software program must be tested against the program's specifications. The Commission again found that the DOR had conceded in its pleadings that after installation and customization was complete, the R/3 System was tested for three to four months.

Under the third factor, regarding whether substantial training and written documentation was required to use the software, the Commission ruled that the DOR had conceded that substantial training and written documentation was needed. All employees of Menasha were required to attend two-day to five-day classes. In addition, extensive written materials were prepared by third-party consultants and Menasha's support staff. Factor four, which requires an examination regarding the extent to which the software requires enhancement and maintenance support by the vendor, was found by the Commission to exist due to the fact that Menasha continued to contact SAP on a weekly basis for assistance and support after implementation. In addition, SAP provided Menasha with upgrades, new releases, and patches to the R/3 System on at least a quarterly basis. As to the fifth factor, the Commission concluded that this factor did not warrant special attention because the cost of the R/3 System greatly exceeded $10,000. The Supreme Court noted that the Commission did partially take into account the cost of the R/3 System when evaluating all of the facts and circumstances surrounding the customization of the software. The Supreme Court, in supporting the conclusion of the Commission, noted that cost may be a factor in determining whether software is custom but that cost alone is not dispositive.

The DOR focused its arguments on factors six and seven. Under factor six, distinguishing basic operational or prewritten programs, the DOR argued that the R/3 System can be sold to anyone in the same form (on a series of diskettes) and recipients may choose which specific modules and changes they would like to make to the software to fit their needs. In essence, the DOR argued that the basic R/3 System was previously existing and not created at the time of its sale and that the initial program should be deemed non-custom and thereby taxable on the basis of its $5.2 million purchase price. The Supreme Court rejected this argument noting that the initial or basic R/3 System was *useless* until it was modified, and that modification required a time consuming and expensive process. Given these facts, the Supreme Court concluded that the R/3 System was not a prewritten program as defined under the sixth factor of the Regulation.

Under the seventh factor, regarding an existing program selected for modification, the Commission concluded that the R/3 System was not prewritten as defined in the Regulation and, consequently, could not be an existing program. The Supreme Court noted that the only way to interpret this factor as being in harmony with the other

provisions of the Regulation was to interpret an existing program as one that was available for general use. Given the specialized nature of the R/3 System and the amount of effort necessary to make it useable by any recipient, the Supreme Court concluded that the program could not be one that was available for general use.

How to Obtain Your Refund?

All taxpayers who have integrated software packages into their current systems in Wisconsin should promptly review this matter to determine whether claims for refunds of Wisconsin sales and use taxes should be filed. Buyers or sellers of computer software and/or related services that should not have been taxable based on the *Menasha* decision may file a claim of refund with the Wisconsin Department of Revenue for the periods open under the statute of limitations. Taxpayers who filed extensions solely for the *Menasha* issue have until January 11, 2009 to file their claims.

The Wisconsin Department of Revenue has posted detailed information for obtaining *Menasha* refunds at: http://www.revenue.wi.gov/faqs/ise/menasha.html. Claims should be mailed (not faxed or e-mailed). Refunds may take one year from the date of the refund request, but the refunded amount will bear interest at 9%.

Sellers may claim a refund by (i) filing an amended return on Form ST-12, Wisconsin Sales and Use Tax Return (see page 6 of the instructions); or (ii) a letter to the Department of Revenue indicating the claimant's name, address, tax account number, amount of the claim for refund, reporting periods for the overpayment, and reason for the claim of refund. Sellers must return the refunded tax to the buyer within 90 days after the tax is refunded.

Buyers are required to use Form S-220, Buyer's Claim for Refund of Wisconsin State, County, and Stadium Sales Taxes and Form S-220a, Schedule P, Attachment to Buyer's Claim for Refund. A separate Schedule P must be submitted for each seller to whom the buyer paid sales or use tax in error.

Many states, similar to Wisconsin, provide some type of sales or use tax exemption for custom software while taxing canned or prewritten programs. Companies that have recently implemented new software systems should take a close look at the laws of the states where the implementation took place to confirm that they are not paying sales and/or use taxes to jurisdictions that exempt custom software similar to Wisconsin.

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