Report on Litigation

Summarized below are recent significant Wisconsin Tax Appeals Commission (WTAC) and Wisconsin Court decisions. The last paragraph of each decision indicates whether the case has been appealed to a higher Court.

The following decisions are included:

INDIVIDUAL INCOME TAXES

Earned income credit. *Tania Avila vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, November 6, 2006). The issue in this case is whether the department properly disallowed the earned income credits claimed by the taxpayer.

The taxpayer was a resident of Wisconsin during the years 2000 through 2003, and for each of these years filed a Wisconsin income tax return on which the earned income credit was claimed.

By notice dated February 28, 2005, the department issued an income tax assessment against the taxpayer. The assessment disallowed certain items on the 2000 through 2003 returns, including the earned income credits. The taxpayer filed a timely petition for redetermination of the department's assessment, which was denied by the department by notice dated July 18, 2005. The taxpayer filed a petition for review with the Commission on September 20, 2005.

By letter dated May 3, 2006, the department asked the taxpayer to provide documentation to substantiate the income reported on her 2000 through 2003 returns. In response, the taxpayer provided the department with handwritten notes recording various dates and amounts received during the years 2000 through 2003. Her notes were not made contemporaneously with the income and dates recorded therein, but rather were made in response to the department's letter.

At the hearing, the taxpayer testified that she had hired a professional preparer to prepare her 2000 through 2003 returns and that she had relied on her preparer's advice in preparing and filing the returns. Neither party was able to locate the preparer for a deposition, and the preparer did not testify at the hearing. The department contested only the taxpayer's eligibility for the earned income credits claimed on the 2000 through 2003 returns, and conceded the remaining issues.

Following the hearing, the department issued a revised assessment dated June 28, 2006 to the taxpayer consisting of the disallowed earned income credits and interest.

The Commission concluded that the taxpayer did not prove by clear and satisfactory evidence in what respects the department erred in its determination, and upheld the department's revised assessment.

The taxpayer has not appealed this decision.

SALES AND USE TAXES

Computer software – taxability (canned vs. custom programs). *Menasha Corporation vs. Wisconsin Department of Revenue* (Court of Appeals, District IV, January 25, 2007). On October 26, 2004, the Circuit Court for Dane County reversed the Wisconsin Tax Appeals Commission's December 1, 2003 decision. See *Wisconsin Tax Bulletin* 141 (January 2005), page 25, and *Wisconsin Tax Bulletin* 137 (January 2004), page 29, respectively, for summaries of the Circuit Court and Commission decisions.

The issue in this case is whether computer software purchased by the taxpayer is tangible personal property and subject to sales or use tax.

The taxpayer is a corporation, based in Wisconsin, that provides products to a variety of industries, including paperboard, packaging, plastics, material handling, promotions, and printing. In 1993, the taxpayer hired a consulting company who concluded that it would be feasible for the taxpayer to transition to a global applica-

tion software system, provided that the new system allowed custom modification to meet the taxpayer's unique business needs. The taxpayer consequently selected a vendor for its new system, due to the flexibility and customization which the taxpayer required and which the vendor could provide.

In 1995, the taxpayer's Board of Directors approved the license of the software. The taxpayer then entered into an agreement to license the software. The vendor's customers who license this software system "almost always retain either (the vendor) or (the vendor's) designated consultants" to help customize the software modules to their businesses.

When the vendor was demonstrating the software to the taxpayer, it advised the taxpayer that it would have to retain either the vendor's consultants or consultants listed by the vendor as vendor-certified consulting partners or "logo" partners to implement the software with the custom features that the taxpayer required. The vendor also advised the taxpayer that since it could not supply all the consultants needed to install and customize the taxpayer's software, the taxpayer would have to work with one of the vendor's logo partners. As advised, the taxpayer hired one of the vendor's logo partners.

The software system consists of more than seventy software modules. Each module can provide a rudimentary business and accounting software system for a different segment of a client's business. The system is not usable to a client as sold; it must be modified to fit a client's business operations. It becomes usable for serving a client's business and accounting needs only after the modifications are completed.

The customization and testing of the software was done by an implementation team and a programming team consisting of employees of the taxpayer as well as the software vendor's representatives, the vendor's logo partner's representatives, and third-party consultants. Customization and installation of the taxpayer's software cost the company more than $23 million, of which only $5.2 million was for the core software.

The taxpayer filed a claim for refund for use tax paid on its acquisition of the software from the vendor and for payment of maintenance fees. The department denied the taxpayer's refund claim and its petition for redetermination.

Using six of the seven factors for determining whether a program is a custom program listed under sec. Tax 11.71(1)(e), Wis. Adm. Code, the Wisconsin Tax Appeals Commission previously concluded the software was custom software, because there had been: (1) significant presale consultation, (2) extensive testing, (3) substantial training and written documentation, (4) enhancement and maintenance support, (5) a cost greater than $10,000, and (6) the software was not "prewritten" software because of the significant efforts required to bring it online for the taxpayer under factors 1 - 4. The Commission determined that Factor 7 (pre-existing programs which need to be significantly modified by the vendor to be usable) was not applicable here, as the Commission already had concluded that the software was custom.

The Dane County Circuit Court reversed the Commission's decision.

The Court of Appeals concluded that the Commission reasonably interpreted and applied sec. Tax 11.71(1)(e) and (k), Wis. Adm. Code, in determining that the software was custom software. The Court of Appeals reversed the Circuit Court's decision and affirmed the Commission's decision granting a refund to the taxpayer for taxes paid on the software.

The department has filed a petition with the Wisconsin Supreme Court asking it to review this decision.

Use tax – transfer of tangible personal property from related corporation. *Wisconsin Department of Revenue vs. River City Refuse Removal, Inc.* (Supreme Court of Wisconsin, March 8, 2007). On February 2, 2006, the Court of Appeals reversed the Circuit Court for Dane County's August 2, 2004 decision reversing the Wisconsin Tax Appeals Commission's August 19, 2003 decision. See *Wisconsin Tax Bulletin* 147 (April 2006), page 19, *Wisconsin Tax Bulletin* 140 (October 2004), page 23, and *Wisconsin Tax Bulletin* 136 (October 2003), page 19, for summaries of the Court of Appeals, Circuit Court, and Wisconsin Tax Appeals Commission decisions, respectively.

The issues in this case are:

A. Whether the fixed assets the taxpayer received through intercompany transfers with wholly-owned subsidiaries of its parent company are subject to Wisconsin use tax under sec. 77.53(1), Wis. Stats.

B. Whether the taxpayer satisfied its burden to show that its nonpayment of taxes was due to good cause and not due to neglect, pursuant to sec. 77.60(3), Wis. Stats.

The taxpayer was primarily engaged in the business of collecting refuse and recyclables from Wisconsin residences and businesses and hauling those materials to landfills or recycling centers. During the period from October 1, 1993 through September 30, 1997, the taxpayer was a separately incorporated Wisconsin corporation and wholly-owned subsidiary of its parent company.

Other subsidiaries of the parent company transferred to the taxpayer items of tangible personal property such as motor vehicles and related assets. The assets transferred were valued at net book value (original purchase price less accumulated depreciation), entered into the taxpayer's financial records at that value, and depreciated on the taxpayer's income or franchise tax returns. The taxpayer paid no sales or use tax on these intercompany transfers. No money was exchanged or expected between the parent's subsidiaries and the taxpayer for the intercompany transfers. The taxpayer received no invoice or other bill in connection with the receipt of intercompany assets.

The Wisconsin Tax Appeals Commission determined that (1) the intercompany transfers of tangible personal property to the taxpayer from the parent's subsidiaries were not subject to Wisconsin use tax because there was no transfer for remuneration or consideration, and (2) the negligence penalty did not apply as the taxpayer's failure to report the use tax was "due to good cause and not due to neglect."

The Circuit Court, in a de novo review (giving the Commission decision no weight), reversed the Commission on both issues.

The Court of Appeals subsequently reversed the Circuit Court's order and reinstated the Commission's ruling and order.

The Wisconsin Supreme Court found that the intercompany transfers that the taxpayer participated in do not fall within Wisconsin's use tax statute. The subsidiaries of the parent company did not constitute retailers pursuant to sec. 77.51(13), Wis. Stats. The requisite consideration did not exist for the transfers to be considered purchases under sec. 77.51(12)(a), Wis. Stats. Therefore, the Wisconsin Supreme Court affirmed the decision of the Court of Appeals.