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:

Sales and Use Taxes

Admissions
Milwaukee Symphony Orchestra Inc. 23

Computer software – taxability (canned vs. custom programs)
Menasha Corporation...23

Manufacturing exemption - snow-grooming equipment
James Engel D/B/A Sunburst Snowtubing and Recreation Park, LLC...26

Sales and Use Taxes, and Withholding of Taxes

Officer Liability
Christopher L. Field...26

SALES AND USE TAXES

Admissions. *Milwaukee Symphony Orchestra, Inc. vs. Wisconsin Department of Revenue* (Dane County Circuit Court, April 23, 2008). This is a judicial review of the Wisconsin Tax Appeals Commission decision dated December 15, 2006. See *Wisconsin Tax Bulletin* 150 (January 2007), pages 31-32, for a summary of the Wisconsin Tax Appeals Commission's decision.

The main issue in this case is whether revenues received by Milwaukee Symphony Orchestra Inc. ("MSO") from admissions to its concerts are subject to Wisconsin sales tax under sec. 77.52(2)(a)2., Wis. Stats., which imposes Wisconsin sales and use tax on the sale of admissions to amusement, athletic, entertainment, or recreational events or places.

The Department of Revenue conducted a field audit of MSO for September 1, 1992 through August 31, 1996. During the audit period, MSO paid sales taxes on its concert ticket sales. In July 1997, MSO filed amended sales tax returns for the audit period, claiming a refund of $719,456.69 in sales tax that it had previously paid on its sales, including all of its ticket sales. The department granted a portion of MSO's refund claim and denied the remainder of the claim, which denial MSO contests.

The Department of Revenue contends that MSO's performances are *primarily entertainment* in nature. It was the assertion of MSO that its purpose of performing is *primarily educational* in nature. The Wisconsin Tax Appeals Commission previously concluded that the concerts at issue are *not primarily educational* events and the receipts from its concerts are, therefore, subject to Wisconsin sales tax.

The Circuit Court determined that the Wisconsin Tax Appeals Commission's interpretation of sec. 77.52(2)(a)2., Wis. Stats., as establishing a test based on a distinction between educational and entertainment events, has no foundation in the statute. The Circuit Court stated that the educational value of an event is not an appropriate test to determine whether an event is "entertainment."

Therefore, the Circuit Court remanded the action back to the Wisconsin Tax Appeals Commission to develop a standard for determining whether an event is "entertainment" and then apply its standard to MSO's concert receipts. Although the Wisconsin Tax Appeals Commission is free to conclude that MSO's concerts are taxable entertainment events, the Circuit Court stated that the Wisconsin Tax Appeals Commission must anchor its determination on a statutorily-based standard.

It was not known at the time of publication whether this decision would be appealed.

Computer software – taxability (canned vs. custom programs). *Wisconsin Department of Revenue vs. Menasha Corporation* (Supreme Court of Wisconsin, July 11, 2008). On January 25, 2007, the Court of Appeals reversed the October 26, 2004 decision of the Circuit Court for Dane County, which had reversed the Wisconsin Tax Appeals Commission's December 1, 2003 decision. See *Wisconsin Tax Bulletin* 151 (April 2007), page 20, *Wisconsin Tax Bulletin* 141 (January 2005), page 25, and *Wisconsin Tax Bulletin* 137 (January 2004), page 29, respectively, for summaries of the Court of Appeals, Circuit Court, and Commission decisions.

Facts

The taxpayer is a Wisconsin corporation with headquarters in Neenah, Wisconsin. In 1993, the taxpayer hired an independent accounting firm to evaluate its business and accounting software systems. The firm recommended that the taxpayer standardize its systems by implementing a single business software environment. The independent accounting firm also recommended that another consulting firm conduct feasibility studies to determine if a software system could integrate all of the taxpayer's subsidiaries. With its consultants, the taxpayer concluded that a global application software system would be feasible, provided that the new system allowed custom modification to meet the taxpayer's unique business requirements.

The taxpayer purchased the software system ("R/3 System") in 1995 for $5.2 million. The initial R/3 System consisted of more than seventy software modules. Each module provided a rudimentary business and accounting software system for a segment of a client's business. The R/3 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 licensing agreement contained no provision for customization of the system by the vendor; however, the vendor advised the taxpayer that, because of the complexities of the system and substantial customization necessary to make the system usable, the taxpayer would be required to retain either the vendor's consultants or a consultant designated by the vendor. Since the vendor was unable to supply all of the necessary consultants for the installation and customization of the system, the taxpayer worked with one of the vendor's designated consultants. The taxpayer understood that the customization process could take years to complete and would cost tens of millions of dollars. The taxpayer's budget for purchasing the R/3 System included the costs that it expected to pay both the vendor and the vendor's designated consultants for the configuration, modification, and customization of the system.

Initial installation of the R/3 System began on March 25, 1996, and downloading was complete on March 27, 1996. The implementation and programming team members worked to customize the system for over nine months in order to meet the taxpayer's functional needs. The programming team created codes for hundreds of user exits to the R/3 System to integrate external programs with the R/3 System. In addition, the programming team created new subsystems to run parallel to the R/3 system for operations that were not available in the R/3 System, but were critical to the taxpayer's business. In total, more that 3,000 modifications were made to the R/3 System by the implementation and programming teams. The vendor also provided patches for the R/3 System to correct functional gaps. Some of these patches included new source code written specifically for the taxpayer's R/3 System to address the shortfalls of the R/3 System as it applied to the taxpayer's business.

Testing of the R/3 System lasted three to four months and included running real data through the system to determine whether it was operational in accordance with the taxpayer's required specifications. After testing was complete, all relevant employees from all of the taxpayer's subsidiaries were required to attend two-day to five-day classes provided by the consultants and the taxpayer's information support staff.

Customization and installation of the R/3 System cost the company more than $23 million, of which only $5.2 million was for the core R/3 System. To customize the system for the taxpayer's business, the taxpayer paid the vendor $2.5 million, the vendor's designated consultant approximately $13 million, and third-party consultants approximately $775,000.

In 1998, the Department of Revenue audited the vendor. In that audit, the department determined that the R/3 System was non-custom and thus taxable. The vendor did not dispute that determination. Separately, the vendor and the taxpayer entered into an agreement whereby the taxpayer would pay sales tax for the R/3 System but that the taxpayer would dispute that payment and file a claim for refund. The taxpayer filed a claim for refund with the Department of Revenue for tax paid on its purchase of the R/3 System. The department denied the taxpayer's refund claim and its petition for redetermination.

Case History

This case was previously heard by the Wisconsin Tax Appeals Commission, the Circuit Court for Dane County, and the Court of Appeals. Each of the courts decided the following:

> *Wisconsin Tax Appeals Commission* – On December 1, 2003, the Commission granted the taxpayer's motion for summary judgment. Using the factors for determining whether a program is a custom program under sec. Tax 11.71(1)(e), Wis. Adm. Code, the

Commission concluded the software was custom software, because: (1) significant presale consultation and analysis had occurred, (2) a former employee of the vendor loaded the software, and after installation and customization was complete, the R/3 System was tested for three to four months, (3) substantial training and written documentation was required, (4) the system needed enhancement and maintenance support, (5) the cost, when considering all the facts and circumstances, is a factor, but not determinative*, and (6) the software was not "prewritten" software because of the substantial amount of resources, time, and effort needed to make the R/3 System usable. The Commission determined that Factor 7 regarding significant modification to an existing program was not applicable, because the R/3 System was a custom program rather than an existing program. The Department of Revenue appealed this decision to the Circuit Court for Dane County.

> **The Commission concluded that Factor 5 regarding a rebuttable presumption that a program is not custom if it cost $10,000 or less, should not apply in this case, because the cost greatly exceeded $10,000, but the Commission reasonably concluded that cost could be considered when evaluating all the facts and circumstances. In the end, the Commission reasonably considered cost.*

Circuit Court for Dane County – The Circuit Court reversed the Commission on October 6, 2004. While the Circuit Court found no error with the Commission's interpretation of the rule's introduction, it disagreed with the Commission's interpretation and application of some factors. The Circuit Court concluded that the R/3 System was existing and prewritten when the vendor sold it to the taxpayer because (1) while there may have been significant presale consultation and analysis, and significant testing of the customized system, the fact that a former employee of the vendor installed it rather than the vendor weighs in favor of deeming the R/3 system prewritten; (2) while the Department of Revenue conceded the third, fourth, and fifth factors, the R/3 System fits the definition of a prewritten program because (a) it was already prepared and available for general consumption prior to the sale to the taxpayer, (b) it was held by the vendor to be licensed to thousands of world-wide customers as requested, and (c) it was not written solely for the taxpayer upon the taxpayer's request; therefore, (3) given that the R/3 System was an existing program, the seventh factor does apply, and the facts as set forth by the Commission do not show that the vendor performed the significant modification of the R/3 System that was required to make it useful to the taxpayer.

The Circuit Court stated that where the software selected for purchase is an already existing program available for general use, significant modification must be made by the vendor for the software to be deemed custom. Thus, the taxpayer's purchase of the R/3 System did not involve the purchase of custom software.

Court of Appeals - On January 25, 2007, 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 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 customized software. The Department of Revenue appealed this decision to the Supreme Court of Wisconsin.

Issues

The Supreme Court of Wisconsin addressed the following two issues:

1. What is the proper level of deference that it should give to the Commission's decision?
2. Did the Commission reasonably conclude that the R/3 System was a custom program and, therefore, not subject to sales and use tax?

The Supreme Court of Wisconsin's Decision

Issue 1 – In this case, the Supreme Court of Wisconsin reviewed the Commission's decision. While the Supreme Court of Wisconsin is not bound by an agency's (for example, the Commission's) conclusions of law, the Supreme Court of Wisconsin may defer to the Commission's legal conclusions. The specific characterization of deference given to an agency is dependent upon whether the agency is interpreting a statute or a regulation.

The Supreme Court of Wisconsin concluded that the Commission's interpretation of the statute (sec. 77.51(20), Wis. Stats.) is entitled to "due weight deference, while the Commission's interpretation of the regulation (sec. Tax 11.71(1)(e), Wis. Adm. Code) is entitled to "controlling weight deference."

Issue 2 – The Supreme Court of Wisconsin determined that the Commission reasonably concluded that all the facts and circumstances and all seven factors provided by regulation must be considered when determining whether a computer program is a custom program. Applying this construction to the particular facts of the case, the Supreme Court of Wisconsin determined that the Commission reasonably concluded that the R/3 System was a custom program.

Accordingly, the Supreme Court of Wisconsin affirmed the decision of the Court of Appeals.

Manufacturing exemption – snow-grooming equipment. *James Engel d/b/a Sunburst Snowtubing and Recreation Park, LLC vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, May 27, 2008).

The issue in this case is whether James Engel d/b/a Sunburst Snowtubing and Recreation Park, LLC and Summit Ski Corp. d/b/a Sunburst Ski Area (together, "taxpayer") uses snow-grooming tractors and related equipment exclusively and directly in its manufacture of snow, thus allowing the taxpayer an exemption from Wisconsin sales and use taxes on its purchase of such equipment. Section 77.54(6)(a), Wis. Stats., provides an exemption for machinery and specific processing equipment used exclusively and directly by a manufacturer in manufacturing tangible personal property.

The taxpayer owns and operates a winter recreational ski, snowboarding, and snowtubing area where the public can enter and participate for a fee. The taxpayer collects and remits sales taxes on its fees, which are taxable admissions.

In connection with its business, the taxpayer owns and operates certain snow-making and grooming equipment. The taxpayer uses its snow-grooming tractors and related equipment to spread and groom manufactured snow on the slopes of its facility. The snow-grooming tractors and related equipment are used to groom both manufactured snow and natural snow at its facility. The tractors are used by the taxpayer on a daily basis to refinish snow surfaces, regardless of new snow additions (natural or machine-made snow) and regardless of any snow-making process. On a daily or twice daily basis, the taxpayer uses the grooming tractors to create a "Corduroy Groomed Surface Condition" on the slopes of its facilities for use by its customers. Although the taxpayer does not manufacture snow for sale to its customers, the taxpayer asserts that it manufactures this "Corduroy Groomed Surface Condition" for sale to its customers that the customers purchase and consume through use on the slopes.

The Department of Revenue allowed the exemption for machinery and equipment that the taxpayer used in its snow-making operation. However, the department stated that the manufacturing process ends when the snow is deposited in piles on the slopes of the taxpayer's facilities. The taxpayer asserted that the end product of its manufacturing process is the "Corduroy Groomed Surface Condition" composed of natural and man-made snow and produced by the grooming tractors.

The Commission ruled that the snow-grooming equipment at issue did not qualify for exemption from Wisconsin sales and use taxes under sec. 77.54(6)(a), Wis. Stats. The taxpayer is not in the business of selling snow, including packed snow with a "Corduroy Groomed Surface Condition," to its customers. The taxpayer's customers do not come to its facilities to purchase snow. Rather, its customers come to ski, snowboard, or go snowtubing. The taxpayer sells taxable admissions. To the extent that the taxpayer sells any snow (including groomed snow) as tangible personal property in conjunction with its sales of admissions, such sales would be treated as incidental to its sales of services.

It was not known at the time of publication whether the taxpayer would appeal this decision.

SALES AND USE TAXES AND WITHHOLDING OF TAXES

Officer Liability. *Christopher L. Field vs. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Commission, March 19, 2008). The issue in this case is whether the taxpayer is a responsible person who is liable for the unpaid sales taxes of Next Generation Computers, LLC ("NGC") under sec. 77.60(9), Wis. Stats, for the period of July 1, 2001 through December 31, 2001.

NGC was organized effective June 21, 2001. NGC had a checking account that was active throughout and after the period at issue. The taxpayer was one of three individuals who signed a Bank Signature Card for the account and was authorized to act on NGC's behalf with respect to the account. The taxpayer signed checks from NGC's checking account during this period that were issued to various persons.

The taxpayer denied that he was a member and officer of NGC; however, the taxpayer stated that he was a member and officer of NGC in prior correspondence with the Wisconsin Department of Revenue. Additionally, on NGC's application for a Wisconsin Seller's Permit, the taxpayer is listed as an officer and 25% owner of NGC.

The Commission stated that the Department of Revenue presented clear and satisfactory evidence establishing that the taxpayer had the **authority** and **duty** to pay the taxes at issue and that he **intentionally breached that duty**. Therefore, the Commission concluded that the Department of Revenue was correct in determining that the taxpayer is a responsible person with respect to NGC and that the taxpayer is personally liable for the unpaid sales taxes at issue.

The taxpayer has appealed this decision to the Circuit Court.