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Subject:

WI Court of Appeals Reverses Menasha Case

State and Local Tax Alert

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On Jan 25th, 2007, the Wisconsin Court of Appeals reversed a Circuit Court's ruling and found that Menasha Corporation's ("Menasha") purchase from SAP of a "canned" mass marketed program was actually custom software and exempt from sales/use tax due to the significant amount of presale consultation, testing, training, documentation, enhancement and support. *Wisconsin Department of Revenue v. Menasha Corporation*, No. 2004AP3239, 2007 WL 189011 (Wis. Ct. App. Jan. 25, 2007).

Background

Menasha purchased an enterprise resource planning ("ERP") system ("the R/3 system") from SAP in September 1995. From September 1995 through March 1996, Menasha, SAP and outside consultants began the process of analyzing the overall system, preparing the hardware to run the system, and customizing the system. By the end of March 1996, the basic system modules had been prepared and loaded. From March 1996 through January 1997, the various programming teams made over 3,000 modifications. Full implementation of the system at all of Menasha's subsidiaries was ongoing for approximately seven years, and cost Menasha more than \$23 million, of which only \$5.2 million related to the cost of the base R/3 system.

Menasha proceeded to file a refund claim for the use tax it paid. However, the Wisconsin Department of Revenue ("Department") denied the refund claim on the presumption that the R/3 system was canned software subject to tax. That presumption was based upon the Department's audit of SAP's American subsidiary for sales and use tax liability. SAP agreed to the Department's assessment of the R/3 system's basic modules as non-custom software. Menasha appealed to the Wisconsin Tax Appeals Commission (the "Commission"), which concluded that the modules qualified for treatment as a custom program and therefore, was not subject to tax. The Circuit Court, Dane County, reversed the commission's ruling and instead found that the modules were subject to tax.

Wis. Admin. Code § 11.71(1)(e)(1) through (7) states that the determination of whether a program is a custom program shall be based upon all the facts and circumstances, including the following:

- The extent to which the vendor or independent consultant engages in significant presale consultation and analysis of the user's requirements and system;
- 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;
- The extent to which the use of the software requires substantial training of the customer's personnel and substantial written documentation;
- The extent to which the enhancement and maintenance support by the vendor is needed for continued usefulness;
- There is a rebuttable presumption that any program with a cost of \$10,000 or less is not a custom program;
- Custom programs do not include basic operational programs or prewritten programs; and
- 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.

The Department and Menasha presented opposing views as to how to interpret Wis. Admin. Code § 11.71(1)(e). Menasha argued that all seven factors should be considered, and, based on the amount of time and expense incurred to get the system ready for Menasha's use, the modules should be considered a nontaxable custom program. However, the Department argued that the last two factors above are controlling and, therefore, Menasha's system is non-custom and taxable.

The Court of Appeals agreed with Menasha and the Commission that all "facts and circumstances" contained in the rule should be considered in determining whether a computer program is a custom program. The Court of Appeals agreed with the Commission's assertion that the critical factor in determining whether a computer program is customized is the degree of difficulty in making it ready for use. The Commission noted that Menasha's R/3 system is considered a custom program due to the amount of pre-sale planning, testing, training, written documentation, enhancement, and maintenance, and the amount of resources, time, and effort needed to allow Menasha to use it properly. The Court of Appeals agreed with the Commission's conclusion and overturned the circuit court's decision.