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Tax Law Alert – Sales and Use Tax Exemption for Custom Computer Programs Expanded by Ruling of the Tax Appeals Commission

The Wisconsin Tax Appeals Commission recently determined that the sales and use tax exemption for custom computer programs applies to a wide range of software. It did so by rejecting the narrow interpretation previously used by the Wisconsin Department of Revenue. In Menasha Corp. v. WDOR, No. 01-S-72 (December 2003), the Commission ruled that a computer program was a custom program even though certain parts of the program existed prior to Menasha Corporation's purchase of the program. As a result, businesses may be able to go back up to four years to claim refunds for sales and use tax paid on certain computer programs.

Prior to the Menasha Corp. decision the Department of Revenue strictly applied the seven factors set forth in the administrative code for determining whether a program is custom. One factor that often made it difficult for a program to qualify as custom was the requirement that the program not be "prewritten" software.

Under the Department's approach a program was "prewritten" if the modules used as the building blocks for the program were in existence before the taxpayer contracted to have the program developed. The fact that substantial time and effort was needed to convert the modules into a useable program for the taxpayer did not affect its analysis that the program was "prewritten" and therefore ineligible for the exemption. In Menasha Corp., the Wisconsin Tax Appeals Commission rejected the Department's interpretation of when a program is "prewritten."

Menasha Corporation expended more than $23 million in installing and customizing a uniform information system to integrate its various business locations. The taxpayer contracted with a vendor who used a software system that consisted of more than 70 software modules as the starting point for developing the taxpayer's information system. Over 3,000 modifications to the vendor's software system were necessary to customize an information system to meet the taxpayer's needs. The development and implementation of the information system took several years and required a substantial amount of planning, testing, enhancement and training.

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The Department took the position that the computer program developed for the taxpayer was "prewritten" because the software modules used as the basis of the program existed prior to the development of the program. In rejecting the Department's position the Commission focused on the amount of time and effort necessary to convert the existing modules into a program that was usable by the taxpayer. The fact that the modules existed in advance of the sale did not necessarily make the program "prewritten." Rather, the Commission noted that the "distinction between custom and prewritten programs hinges on the amount of effort necessary to get the software operational for a particular customer's needs."

The Commission ruled that the program was not "prewritten." Since the taxpayer did not fail any of the other factors, the Commission ruled that the program qualified for the exemption. The Commission's interpretation marks a significant departure from the Department's approach to the sales and use tax exemption for custom programs. The effect of the Commission's ruling is that many programs that were once thought to be "prewritten" are, in fact, not "prewritten." This enhances the likelihood that a program can qualify as a custom program that is eligible for the exemption.

The Department has appealed the Menasha Corp. decision to the Dane County Circuit Court. However, in response to the decision, the Department is developing a procedure for taxpayers to extend the statute of limitations to apply for refunds of sales and use tax paid in connection with computer programs pending the final determination by the courts. We expect that the Department will finalize its application procedure in early 2004.

If you have any questions regarding the sales and use tax exemption for custom computer programs, please feel free to contact: John R. Austin ~ 414-298-8318
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