

*Legal
Division*

STATE OF WISCONSIN

TAX APPEALS COMMISSION

HEALTH MICRO DATA SYSTEMS, INC.
583 D'Onofrio Drive
Madison, WI 53719

Petitioner,

vs.

WISCONSIN DEPARTMENT OF REVENUE
P.O. Box 8933
Madison, WI 53708

Respondent.

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* DOCKET NO. 87-S-418
* DECISION AND ORDER
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STATE OF WISCONSIN
DEPARTMENT OF REVENUE

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KEVIN C. POTTER, CHAIRPERSON:

An evidentiary hearing was held before this Commission on November 8, 1988, in Madison, Wisconsin. Appearing for the petitioner was Frank Poggio, its president, and Keith R. Clifford, Attorney, Clifford & Relles, S.C., Madison, Wisconsin; appearing for respondent was Allyn Lepeska, Attorney, Office of Legal Counsel, Madison, Wisconsin.

Based on the evidence presented, the post-hearing briefs, and the record herein, this Commission makes the following:

FINDINGS OF FACT

1. The petitioner, Health Micro Data Systems, Inc. (HMDS), is, and at all times relevant hereto was, a corporation doing business in the state of Wisconsin, and as such is subject to the sales and use tax provisions of Chapter 77 of the Wisconsin Statutes.

2. During the period under review, HMDS developed, produced, and marketed microcomputer financial-based management information programs for a limited class of health care organizations. In particular, petitioner's market consisted of small hospitals with less than 15 beds, nursing homes with less than 400 beds, and clinics with less than 25 doctors.

3. HMDS marketed its programs nationally by means of advertising in trade journals, a bi-monthly newsletter to potential customers, presentations at trade shows, and through telemarketing and sales calls by sales representatives staffing regional offices in San Francisco, California; Austin, Texas; and Madison, Wisconsin. Petitioner did not wholesale its programs.

4. Computer programs generally fall into one of three categories: 1) Custom, 2) Feature, or 3) Standard, a/k/a canned or pre-written.

5. Custom programs are uniquely created for an individual user and an individual system. Virtually 100% of a custom program is written for the user.

6. Feature programs are basic programs which have been extensively modified to meet the unique needs of individual users, and have been adapted for use on the user's own equipment. Approximately 50-80% of a feature program is specifically written for a particular user. Due to the uniqueness of the programs and systems involved, both custom and feature programs normally require specialized training for individual users, as well as significant manufacturer involvement after installation. Custom

and feature programs are normally created for and run on mainframe and minicomputers. Custom programs are not portable from one computer to another. Feature programs are rarely portable, and then only with significant adjustments.

7. Standard programs are produced for a general class of users. Unlike custom and feature programs, they are not created to meet the specific needs of an individual customer, nor are they tailored to any one customer's system or equipment. Rather, they are pre-written programs which may be transferable to other users, need little if any modification to be implemented by any user in the class, and may be run on any compatible line of microcomputers. In addition, little or no manufacturer assistance or training is necessary after installation. Due to the uniformity of the respective programs, any training deemed necessary may be conducted in group sessions.

8. There are generally three categories of computers: microcomputers, minicomputers, and mainframes. A microcomputer is a machine that is designed for exclusive use in that it can only be used by one person at a time. Minicomputers and mainframes are shared devices where several users may be performing different activities at the same time. Minicomputers and mainframes generally require customized or feature programs, while microcomputers normally use standard programs.

9. HMDS produces programs for microcomputers. It does not produce any programs for minicomputers or mainframes.

10. All HMDS programs can be run on any IBM-PC

compatible microcomputer, of which there are 3-4,000,000 in use at this time. HMDS does not modify its standard programs to meet a user's particular computer environment. The customer's hardware must meet HMDS requirements.

11. Customers must determine whether the HMDS programs fulfill their needs. HMDS does not modify its programs for specific users nor does it build programs to order. All of its programs are pre-written and need little or no manufacturer assistance after installation.

12. HMDS holds group training sessions for its customers two to three times a year.

13. The programs produced by HMDS are standard programs. HMDS does not produce custom or feature programs.

14. HMDS produces new programs and updates existing programs when the company determines there is a mass market for the contemplated product. HMDS also provides a subscription service at additional cost which provides the customer with the periodic updates it produces. Updated programs are produced and distributed in the same manner as new programs.

15. The steps involved in developing new HMDS programs are as follows:

- a) The company identifies a need in the marketplace;
- b) The program concept is discussed, criteria and specifications are established, the program is designed and reduced to flow charts, screen layouts and written instructions.

c) After the program design is documented, a programmer types the instructions into a computer where the data is encoded onto a master diskette. The Computers used in this process are the same as those used to produce HMDS' programs.

17. Depending on its complexity, it may take HMDS 2-3 months to develop a program. HMDS did not develop all of the programs which it produces and sells.

18. HMDS provides a standard written instruction manual with each of their manufactured programs. The same standard manual is provided to every customer that purchases the standard program it describes. They are not user specific.

19. HMDS programs can be purchased as a package or separately to run as stand-alone systems.

20. At least some of HMDS's standard programs have optional add-on components available. These add-on components are also pre-written.

21. The steps in producing and distributing HMDS standard programs are as follows:

- a) The customer selects the HMDS program(s) and add-on components it wishes to purchase. The HMDS salesperson obtains a purchase contract and forwards an order sheet to the Madison office;
- b) The programmer prepares the order by first formatting a blank 5¼" diskette, and then assembling and transferring from the master

diskette(s) to the blank diskette the program(s) and components ordered by the customer;

c) The new diskette is then sent to the quality assurance department where it is checked for defects and proper components;

d) The diskette is then sent to the shipping department where it is packaged with its manual and shipped to the customer. Each standard program has a standard checklist which is reviewed prior to shipping. HMDS usually ships a program within one to four weeks of the order.

22. HMDS maintains separate departments for production, customer support, clerical/administrative, quality assurance, and shipping.

23. None of HMDS' salespersons are involved in the production process. HMDS' programmers are not involved in public relations or marketing.

24. Presently, HMDS has 33 microcomputers which are used in the production of its programs. Of these, four or five are used in the quality assurance process. None of the computers used in the production process is used for administrative or clerical purposes. These computers are operated 8 - 10 hours per day and sometimes on weekends as well.

25. The number of computers used by HMDS was less at the time of its incorporation in 1982. Since that time, as the business has expanded, the number of people employed, and

computers used, has steadily increased. (HMDS had approximately 2-3 employees in 1982, 4 - 5 employees in 1983, 10 - 12 employees by 1984, and 20 employees by 1985.)

26. After stipulations between and concessions by the parties at the time of hearing, the only items which remain at issue are the following computers and accessories which are listed on the last page of petitioner's Exhibit D:

IPC PRINTER	COMPUTER
SPRINT PRINTER	PRINTER
SYSTEM E 3005	SENSOR - 5Y2BASES
SYSTEM A 2600	3 IBM AT MICROCMPTRS
IBM PC	SURFACE AND JACKS
VECOM	2 ETHERLINK CARDS
IBM XT	32MEG INTERNAL IB
MEC	2 TURBO 186 BOARDS
VECTOR 3032	ADIC MODEL 552-NOVEL
IBM XT	MULTITECH 700 CMPTR
T6 DISC DRIVE	MULTITECH 700 CMPTR
2 COMPUTERS	COMPUTER ACCESSORIES
2 CMPTRS-RMDR84	COMPUTER

(Respondent has conceded that petitioner paid sales tax on the RS COMPUTER, the 232 INTERFACE, the DISC DRIVE, and the TRS 80 listed on the last page of petitioner's Exhibit D.)

27. The only other items in dispute are three Medifile IBM systems which petitioner purchased from Sensor-Based Systems in 1984 for \$2,044.80 (listed on the fourth from the last page of petitioner's Exhibit D). These were basic operational programs purchased in diskette form which petitioner incorporated into and used as the base for its own programs. The three systems in question may have been resold to petitioner's customers or used by petitioner for its own internal purposes.

28. With the exception of the three Medifile IBM

systems from Sensor-Based Systems, the aforementioned computers and accessories at issue in this case are used directly and exclusively in the production of HMDS' standard programs. Their use in the developmental process is merely incidental to their primary function which is the production of new and updated programs.

29. HMDS' president Frank Poggio has worked as an operations research analyst with the General Electric Company, as a project engineer for the Hospital Association of New York State (where he was involved with a number of computer projects using mini and mainframe computers), and as a consultant with the national consulting firm of Peat, Marwick and Mitchell, where he specialized in systems consulting for hospitals. In 1975, Mr. Poggio became director of computer systems and finance for the University of Wisconsin Hospitals and Clinics where he remained until starting with HMDS in 1980. At HMDS he has been involved in every facet of the business, including management, marketing and operations. Mr. Poggio also teaches classes at the University of Wisconsin and does general consulting work in relationship with HMDS. Mr. Poggio's background, together with the knowledge and experience he has acquired during his tenure with HMDS, have made him "conversant" not only with the production process at HMDS, but the computer software production industry in general.

30. The standard programs produced by HMDS' computers are new articles with forms, uses, and names different from those

articles from which they were produced. The process employed by HMDS in producing its programs is one, popularly regarded as manufacturing.

31. The process by which HMDS produced standard computer programs constituted manufacturing as defined in Sec. 77.51(27), Wis. Stats.

32. The standard programs manufactured by HMDS were tangible personal property.

33. On March 25, 1987, respondent issued to petitioner a field audit notice of amount due for additional sales and use tax in the amount of \$13,994.62, including interest, for the period of January 1, 1982 through December 31, 1987. This assessment related in part to the computers and accessories at issue in this case due to petitioner's failure to show that a sales/use tax was paid on those items when purchased.

34. Under date of April 15, 1987, petitioner filed a timely petition for redetermination of respondent's assessment.

35. Petitioner objected to the assessment on the grounds that the computers and accessories in question were used in the production of its standard computer programs and were, therefore, exempt from Wisconsin use tax under Sec. 77.54(6)(a), Wis. Stats.

36. Petitioner's petition for redetermination was denied by respondent's notice of action letter dated September 9, 1987.

WISCONSIN STATUTES INVOLVED

Sec. 77.54 General Exemptions. There are exempted from the taxes imposed by this subchapter:

* * *

"(6) The gross receipts from the sale and the storage, use or other consumption of:

(a) Machines and specific processing equipment and repair parts or replacements thereof, exclusively and directly used by a manufacturer in manufacturing tangible personal property."

Sec. 77.51 Definitions. Except where the context requires otherwise, the definitions given in this section govern the construction of terms in this subchapter.

* * *

"(27) For purposes of s. 77.54(6)(a) 'manufacturing' is the production by machinery of a new article with a different form, use and name from existing materials by a process popularly regarded as manufacturing."

CONCLUSIONS OF LAW

1. With the exception of the 3 Medifile IBM Systems purchased by HMDS from Sensor Based Systems, the computer equipment used by HMDS in the production of its standard computer programs constituted machinery exclusively and directly used by a manufacturer in manufacturing tangible personal property so as to be exempt from the state's use tax under Sec. 77.54(6)(a), Wis. Stats.

2. Petitioner failed to meet its burden of showing that the Sensor Based Systems programs were machines used exclusively in the manufacturing process.


Therefore,

IT IS ORDERED

That respondent's action on petitioner's petition for redetermination is affirmed with regard to the Sensor Based Systems programs, and reversed as to the remaining computers and accessories in dispute.

Dated at Madison, Wisconsin, this 23rd day of May, 1989.

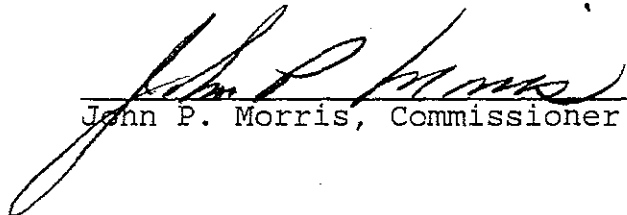
WISCONSIN TAX APPEALS COMMISSION



Kevin C. Potter, Chairperson



Thomas R. Timken, Commissioner



John P. Morris, Commissioner

(Dissenting)

Robert C. Junceau, Commissioner



Douglass H. Bartley, Commissioner

ATTACHMENT:

"Notice of Appeal Information"

O P I N I O N

The issue presented in this case is whether or not the computer equipment used by petitioner in the production of its software programs was exclusively and directly used by a manufacturer in manufacturing tangible personal property so as to be exempt from the state's use tax under Sec. 77.54(6)(a), Wis. Stats.

I.

The Wisconsin sales and use tax is a general taxing plan under which everything is taxable at the retail level unless specifically exempted. Department of Revenue v. Milwaukee Refining Corp., 80 Wis. 2d 44, 245 N.W. 2d 885 (1977). It is a long-established rule of statutory construction in this state that tax exemptions are purely matters of legislative grace and the statutes granting them are to be given a strict but reasonable construction against taxpayers who claim under them. One who claims such an exemption must point to an express provision granting it, and bring himself clearly within the terms of the exemption. Midcontinent Broadcasting Co. v. Dept. of Revenue, 64 Wis. 2d 449, 219 N.W. 2d 604 (1974). This strict statutory construction however is applicable only where the meaning of the language expressing the objective intent of the legislature is doubtful. Dept. of Revenue v. Bailey Bohrman Steel Corp., 93 Wis 2d 602, 287 N.W. 2d 715 (1980).

Here, petitioner has claimed that the computers and equipment in question are exempt under Sec. 77.54(6)(a),

Wis. Stats. as machines used in the manufacturing of tangible personal property. To be entitled to this exemption, petitioner must first show that it was involved in "manufacturing" as that term is defined in Sec. 77.51(27), Wis. Stats. Whether the language in Sec. 77.51(27) should be given a strict construction has already been decided in Dept. of Revenue v. Bailey-Bohrman, supra. There the court stated,

"In this case, the objective intent of the language is clear. Sec. 77.51(27), Stats., demonstrates the objective intent of the legislature to grant an exemption to those who use machinery in the course of manufacturing. A strict construction is inappropriate in the present case." Id at 607.

Adopting the court's rationale in Bailey-Bohrman, we also decline to give Sec. 77.51(27) a strict construction.

While this Commission has never directly construed the term "manufacturing" in the context of creating computer software, we have determined on at least one occasion that a process used to produce computer programs constituted manufacturing. In International Business Machine Corp. v. Wisconsin Department of Revenue, 2 CCH State Tax Rptr. (Wis.) par. 202-854 (1987), aff'd. Dane County Cir. Ct. Oct. 2, 1987, aff'd. Ct. App. Dist. IV June 23, 1988, pet. for review denied Wis. Sup. Ct. August 23, 1988, we found that IBM was,

"engaged in the manufacture of computer programs. It manufactures two general classes of programs: standard programs (also called 'build to plan') and nonstandard programs (also called 'build to order')." (Emphasis added.)

Unfortunately, this finding is of little precedential value for purposes of this case. There, the substantive issue was whether the licensing of feature programs was exempt under Sec. 77.54, Wis. Stats. The question of whether the process used by IBM to produce its computer programs met the statutory definition of manufacturing was neither raised nor contested by the parties, and so it was unnecessary for the Commission to specifically address that point. In addition, the facts in IBM do not disclose the process by which IBM produced its computer software. Therefore, even if it had been found that IBM's operation fell within the 77.51(27) definition of manufacturing, we would be unable to determine whether that process was analogous to the one used by petitioner in producing its programs.

Manufacturing as defined in Sec. 77.51(27) may be broken down into "six objective elements." 1) The production by machinery, 2) of a new article, 3) with a different form, 4) use and, 5) name, 6) by a process popularly regarded as manufacturing. We believe that the process used by petitioner to produce its programs meets these standards. Respondent does not dispute the fact that the computers and accessories used to produce the programs constitute machinery, or that the articles produced had a different use and name. Respondent does object to the programs being characterized as new articles with a different form. These elements were discussed in Department of Revenue v. Bailey Bohrman, 92 Wis. 2d 602, 287 N.W. 2d 715 (1980), where the court held that the process whereby the taxpayer cut large rolls

of hot rolled, coiled steel into narrower widths constituted manufacturing under Sec. 77.51(27). In reaching that conclusion, the court recognized that the taxpayer's process effectively converted a roll of steel which was essentially unusable by its customers, into a new article which they could utilize for their own purposes. The same can be said for the process used by petitioner in this case.

HMDS starts with concepts and ideas which it develops into programs designed to meet the needs of its potential customers. For all practical purposes, however, these programs are in and of themselves unusable unless petitioner can market them to those customers. By transferring the data it has developed onto diskettes, petitioner has created a new and usable article that did not exist before, i.e. a computer program in tangible form which can be purchased, shipped, implemented, and used by any of its customers. The fact that this new article looks, for all outward appearances, the same as one of the components (the diskette) from which it was created is immaterial. See Bailey Bohrman, supra.

This rationale applies equally to the question of whether the programs produced by petitioner are articles with a different form. In Department of Revenue v. Bailey Bohrman, 92 Wis. 2d 602, 487 N.W. 2d 715 (1980), the court defined "form" as follows,

"'Form' refers to contours and dimensions and is not, properly speaking, a characteristic of the material of which an object is composed. Nor is form necessarily related to

physical or chemical composition." Id at 609.

Again, HMDS produces computer programs by encoding data onto previously blank diskettes. While there may be no visible physical change in the diskettes themselves, the transfer of the data onto the diskettes creates programs which had not otherwise existed in that tangible form.

Finally, petitioner has the burden of showing that the article produced was the result of a "process popularly regarded as manufacturing." Respondent contends that petitioner did not meet this burden due to its failure to present any testimony on that point from an expert witness familiar with the industry. Contrary to respondent's argument, expert testimony of that nature is not necessary to prove this particular element. The phrase "a process popularly regarded as manufacturing" need only "be applied with reference to the opinions of those conversant with the subject matter involved." H. Samuels Co. v. Department of Revenue, 70 Wis. 2d 1076, 1085-86, 236 N.W. 2d 250 (1975). The only evidence presented by petitioner to prove this element was the testimony of its president Frank Poggio. Mr. Poggio testified that the process used by petitioner to produce its programs was considered to be manufacturing within the industry. Prior to starting HMDS, Mr. Poggio held a number of positions which dealt with or were related to computers or the computer industry. (See finding of fact #26.) This background, when coupled with the experience he has acquired during his tenure at HMDS, certainly makes him "conversant" with the computer software

industry. This conclusion is further borne out by the breadth of knowledge exhibited by Mr. Poggio as he testified about not only HMDS' business, but the industry in general. While we recognize that as president and principal stockholder of HMDS, Mr. Poggio admittedly has an interest in the outcome of this action, we see no need to discount the weight given to his testimony. Respondent did not challenge Mr. Poggio's credentials, veracity, or knowledge of the computer software industry. Respondent also failed to present any evidence to refute Mr. Poggio's testimony. Therefore, as a person found to be "conversant with the subject matter involved" Mr. Poggio is qualified to give, and we accept, his uncontroverted testimony that HMDS' computer production process is considered manufacturing within the industry.¹

II.

Having determined that petitioner is involved in manufacturing, we must next examine whether the programs produced are "tangible personal property". This question poses an interesting problem. On the one hand, the diskettes upon which the data is encoded are clearly tangible personal property. On the other hand, the data itself may be considered intangible.² In Janesville Data Center Inc. v. Wisconsin Department of Revenue, 84 Wis. 2d 341, 267 N.W. 2d 656 (1978), our Supreme Court had the opportunity to address the question of tangibility in relation to computer coded information. There the taxpayer was engaged in the business of encoding data provided by its customers onto keypunch cards and magnetic tapes, which allowed

the data to be read, utilized, and retained by its customer's computers. The court held that although the taxpayer's data processing service transferred tangible property in the form of the cards, tapes, and printouts, the essential service provided was the sale of the intangible processed data which was not subject to the state's sales tax. In reaching this decision the court adopted an "object of the transaction test."³ Under that test, the tangibility of an item is determined by whether, from the buyer's perspective, the object of the transaction is the purchase of intangible coded information or the purchase of the tangible medium used to transfer the information.

Since Janesville Data, this Commission has also had occasion to apply the object of the transaction test. In International Business Machine Corp. v. Wisconsin Department of Revenue, supra, the Commission held that IBM's built to order programs⁴ were not tangible personal property. Despite basing its decision upon Janesville Data which it recognized as controlling, the Commission also voiced some misgivings about the appropriateness of the context in which the object of the transaction test had been used.⁵ We continue to have these misgivings.

As was noted in IBM, other jurisdictions⁶ have concluded that the object of the transaction test may be more properly used to distinguish a sale of property from a sale of service, as opposed to determining whether property is tangible or intangible.⁷ Although the court used the test to determine the

tangibility of the processed data in Janesville Data, it is now clear that such an application could lead to results which, at that time, were presumably unforeseen and unintended.

Under the object of the transaction test as applied in Janesville Data, it is difficult to imagine any situations in which computer encoded programs, whether standard, feature, or custom, could be construed as anything other than intangibles. Any time a customer purchases a computer program, whether off the shelf or directly from the producer, the object of the transaction will invariably be the customer's receipt of the information contained within the program. The tangible personal property in which the information is embodied i.e. tapes, diskettes, keypunch cards, etc., will always be considered secondary to the information itself. If the principal value of the program were the tape or diskette, the customer could surely purchase those items more cheaply and easily without the encoded data.

While this result may not seem unreasonable on its face, problems arise when the test is applied to other products which in the past have been consistently recognized as being tangible property. For purposes of our analysis, we find little to distinguish computer programs from film, videotapes, cassettes, phono records and even books. Like computer programs, each has the ability to store, and later display or transmit its contents. And, like computer software, the primary reason that customers purchase these items is not so much to obtain the

physical mediums themselves⁸ as for the information, data, or entertainment value contained therein. Accordingly, were their tangibility to be determined under the object of the transaction test, these heretofore tangible items would have to be reclassified as intangible.

To avoid the problems inherent in this application, we prefer instead to use the object of the transaction test as a means of distinguishing purchases of property from purchases of services. If it is found that the transaction involves the purchase of property, it must be determined whether the property is tangible or intangible. That property held to be tangible will be subject to taxation, whereas the intangible property⁹ will not. If the transaction involves the sale of services, it will not be taxable unless the tax has been statutorily imposed upon that particular service.¹⁰ Depending upon the statutory language, it may then be necessary in some instances, such as Janesville Data, to make a further determination as to whether the service provided involves tangible personal property.¹¹

Upon applying this object of the transaction test to the facts in this case, we conclude that the standard computer programs manufactured by HMDS must be regarded as tangible personal property. Arguably, there is an individualized element of service involved in every transaction since the customers may choose the specific components which they wish to have included in the programs purchased. However, this element is minute in comparison to the motivating factor behind the customer's

purchase, that being the desire to obtain a readily usable computer program in a tangible¹², transferrable form which can be run on any number of compatible computers, and which will perform the desired task without the need for additional modifications, training, or manufacturer assistance. HMDS' standard programs meet these criteria, and for that reason its customers purchase those programs as opposed to the more service oriented custom and feature programs. Clearly, the object of the transaction is the purchase of property, i.e. the standard computer program, and not the purchase of personalized services. Since it is the product, in its tangible form, and not a service which is the motivation behind the purchase, the programs must be considered tangible personal property.

We believe that this means of determining the tangibility of products is preferable in several respects. First, it avoids the types of problems discussed earlier by insuring that those programs which are not predominantly service oriented will be treated consistently with other products of a similar nature which have previously been recognized as tangible personal property.

Second, due to this consistency in classification, products may be less likely to be taxed on the basis of how they are marketed. As we have already pointed out, under the object of the transaction test as applied in Janesville Data, a computer program would seldom, if ever, be considered tangible property. However, only those programs subjected to the test would run the

risk of being classified as intangibles. Like cassettes, videotapes, books and records, standard computer programs sold at retail in department stores are normally left unchallenged, and accordingly, are treated for tax purposes as tangible property. Conversely, where a manufacturer such as HMDS sells its standard programs customer direct, the product's tangibility is more likely to be scrutinized, and therefore less likely to be deemed tangible when subjected to the test. Under the new version of the test, those programs sold directly by the manufacturer to the customer would be treated the same as those sold at retail.

Third, under this application of the test, our conclusion that standard computer programs are tangible property, is consistent with the position taken by respondent in its administrative rules. In Tax 11.71(2)(b), Wis. Adm. Code¹³, respondent has ruled that sales of standard/prewritten programs¹⁴ are subject to the tax imposed upon tangible personal property. Obviously, if these transactions have been held taxable, respondent must have first determined the prewritten programs to be tangible.

Lastly, we believe that the outcome under this test is in line with the trend in other jurisdictions which have found standard programs to be tangible.¹⁵ As computer technology continues to evolve, so must the courts continue to become more sophisticated in their understanding and analysis of computer related issues. Should they fail to do so, the continued acceptance and application of outdated approaches shall lead to

results which are unintended, unworkable, and unfair in today's world.

III.

The final issue to be addressed is whether the computers and accessories in question were used exclusively by HMDS in manufacturing its standard programs.¹⁶ Although the term "exclusively" implies that a machine must be used 100% of the time for manufacturing, Wisconsin courts have held otherwise. In analyzing the term, the court in Pabst Brewing Co. v. Milwaukee, 125 Wis. 2d 437, 373 N.W. 2d 680 (1985), stated,

"The phrase 'exclusively used' is defined for tax exemption purposes in Black's Law Dictionary 507 (5th ed. 1979) as '[having] reference to primary and inherent [use] as over against a mere secondary and incidental use.' While neither Ladish nor Greiling defined 'exclusive and direct use,' their adoption of the function or use test implies that 'exclusively' does not have to mean 'solely' or 'purely' but rather 'principally and primarily.' Under the function or use test, the question asked is whether the structure's utility is 'principally and primarily' a significant contributing factor in the product's manufacture. Ladish, 98 Wis. 2d at 506, 297 N.W.2d at 60. Incidental use of manufacturing property for a nonexempt purpose does not violate the exclusivity requirement of sec. 70.11(27), Stats. Manitowoc Co. v. City of Sturgeon Bay, 122 Wis. 2d 406, 414, 362 N.W.2d 432, 437 (Ct.App.1984)." Id at 448.

Respondent argues that the computer equipment petitioner has claimed as exempt is used to both develop and manufacture programs, and therefore does not meet the exclusivity requirement. In his testimony, petitioner's president did not specify what percentage of time the computer equipment was used

for purposes of developing as opposed to manufacturing programs. The evidence in the record, however, supports our conclusion that the equipment was used principally and primarily to manufacture existing and updated programs.

Of the 40 computers presently used in petitioner's business, 33 are used to develop and manufacture its programs. These computers are operated 8-10 hours a day, and sometimes on the weekends as well. Mr. Poggio testified that it took 2-3 months to develop a program. The development process involved discussing and refining ideas, formulating the specifications, designing the program, and reducing it to flow charts, written instructions, and screen layouts. Only after these steps had been completed was the program actually typed into a computer. Once entered into a computer, additional modifications could be made until the program was in its final form. The same process was used to develop updates for existing programs.

Although the process by which petitioner developed and updated its programs was time consuming, the computers in question were used only a small portion of the time. The majority of the time spent developing programs occurred prior to the time the program was keyed into a computer. When one considers the relatively small number of programs offered by petitioner¹⁷, together with the fact that not all of them were developed by HMDS, the amount of time the computers would have been needed for developmental purposes is even further minimized. Finally, in light of the time and human resources expended in the

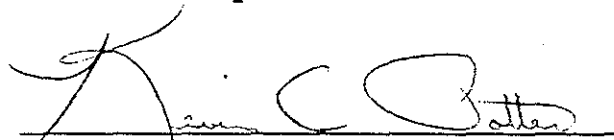
overall developmental process, it is unlikely that petitioner, with its limited staff, would have attempted to develop more than a couple of programs at any given time. Since only a couple of computers would be necessary to develop those programs, the majority of the remaining computers would continue to be used for manufacturing. We believe that this is the type of "infrequent and sporadic" use contemplated by respondent in its administrative rule Tax 11.40(1)(a), Wis. Adm. Code¹⁸. Accordingly, the developmental use of the computers must be considered incidental to their primary function, which is the manufacturing of new and updated programs.

With the exception of the three Medifile IBM Systems purchased from Sensor Based Systems, HMDS' computers and accessories meet the exclusivity requirement. As to the Sensor Based Systems programs, petitioner's president testified that some of them may have been resold to HMDS' customers and "there are some that we used for our own work." Since his testimony did not specify what petitioner's "own work" may have been, we must find that HMDS failed to meet its burden of showing that the systems were machines used exclusively in the manufacturing process.

Having found that the programs in question from Sensor Based Systems failed to meet the exclusivity requirement under Sec. 77.54(6)(a), we find it unnecessary to address whether these programs complied with the other criteria required to meet that exemption.

In summary, with the above noted exception, the computer equipment used by HMDS in the production of its standard computer programs was machinery exclusively and directly used by a manufacturer in manufacturing tangible personal property. As such it is exempt under Sec. 77.54(6)(a), Wis. Stats.

Submitted by:

A handwritten signature in cursive script, appearing to read "Kevin C. Potter", is written over a horizontal line.

Kevin C. Potter, Commissioner

HEALTH MICRO DATA SYSTEM, INC.

FOOTNOTES

¹Commissioner Junceau has dissented on the grounds that petitioner failed to present sufficient evidence to prove that the process it used to produce computer programs was one "popularly regarded as manufacturing." In his view the term "popularly regarded" requires testimony from person(s) who are familiar with both the particular process at issue and manufacturing processes in general. We do not believe that the latter is necessary in order to prove this element.

As we have already noted, a person will be considered qualified to give an opinion as to whether a specific process used within an industry is popularly regarded as manufacturing if he is "conversant" with the subject matter involved. In Dept. of Revenue v. Bailey-Bohrman Steel Corp., 93 Wis. 2d 602, 611, 187 N.W. 2d 715 (1980), each of the witnesses was found to be qualified to provide an opinion "by being conversant with manufacturing processes or with the processes utilized in the steel business." (Emphasis added). Nowhere did the court state that the witnesses had to be aggregately conversant with both of those areas. Rather, the court chose to apply a less stringent standard by allowing persons conversant with either the particular process in question or manufacturing processes in general to give their opinions. To require that both points be addressed would result in an undue burden upon taxpayers both in terms of costs (such a standard would undoubtedly require the testimony of experts in the field of manufacturing) and evidentiary expectations.

²While many courts have concluded that the data found in a computer program is intangible "knowledge" which ultimately rests in the machine, even that concept has been challenged. See Comments, Software Taxation: A Critical Reevaluation of the Notion of Intangibility, 1980 B.Y.U. L.Rev. 859, 870.

³See Bullock v. Statistical Tabulating Corporation, 549 S.W. 2d 166 (Tex. 1977).

⁴The standard programs produced by petitioner are distinguishable from the "feature" programs which were held to be intangible in

IBM. Unlike HMDS' programs the IBM programs were produced to meet the specific needs of individual users, required extensive fixes to conform the programs to the users specific equipment, required installation and testing by IBM to insure conformance with the customer's environment, and often necessitated customer training to insure effective and efficient understanding and use of the programs.

In IBM the Commission implied that these distinctions might make a difference when determining the tangibility of a product. In that opinion it stated,

"We wish to clarify that we are ruling only with respect to software which is of the 'special order' variety, and not software of a more general application such as 'pre-built' or 'canned' software."

⁵In footnote #3 in IBM the Commission stated:

"It has been concluded elsewhere that while the 'essence of the transaction' or 'predominant purpose' test is useful in distinguishing a sale of property from the sale of a service, that test is inappropriate for distinguishing between tangible and intangible property, as was done in Janesville Data Center. See, e.g. Comptroller of the Treas. v. Equitable Trust, 465 A.2d 248, 253 (Md. 1983); Chittendon Trust Co. v. King, 465 A.2d 1100, 1101-02 (Vt. 1983); Note, Software and Sales Taxes: The Illusory Intangible, 63 B.U. L.Rev. 181, 191, 204-207. The distinction between sale of property and service may be more important in states where, unlike Wisconsin, services are nontaxable under sales/use tax provisions. See also Wis. Adm. Code §TAX 11.67. The use of the 'essence of the transaction' test to distinguish tangibles from intangibles on the premise that the purpose is to obtain knowledge, information or data which results in severance from the physical medium of transfer brings to mind the analogy to such taxable items as books in human readable form, as well as motion picture films, video display discs, phono records and music cassette tapes, all in machine readable form, which are generally treated as taxable. Equitable Trust, id. at 254, 258-259; See also note 6, infra."

⁶See note 5 supra.

⁷See also S. Tax 11.67(1), Wis. Adm. Code.

⁸The obvious exception would be those situations where a person might be motivated to purchase an item due to its uniqueness, limited availability or historical value, e.g., a Guttenberg bible.

⁹E.g. stocks, bonds.

¹⁰See Sec. 77.52(2)(a), Wis. Stats.

¹¹In Janesville Data the court held that the services provided by the taxpayer were not taxable under Sec. 77.52(2)(a)11, Wis. Stats., since they did not involve the processing of tangible personal property.

¹²The fact that the program may be found in a tangible form i.e. a diskette, which can be weighed, measured, and touched, does not necessarily make the program itself tangible personal property. Again, that would depend in great part upon whether the object of the transaction was the purchase of a service, or the purchase of a product which is in a tangible form.

¹³§ Tax 11.71(2), Wis. Adm. Code states in pertinent part:

"(2) Taxable Receipts. The following transactions involving automatic data processing equipment, programs, output and services are taxable: . . .

(b) The retail sale, lease, rental or license to use prewritten programs and basic operational programs. . ."

¹⁴§. Tax 11.71(1)(h), Wis. Adm. Code defines "Prewritten programs" as follows:

"'Prewritten programs', often referred to as 'canned programs' means programs prepared, held or existing for general use normally for more than one customer, including programs

developed for in-house use or custom program use which are subsequently held or offered for sale or lease."

¹⁵As the Commission noted in note 19 in IBM, the following jurisdictions have concluded that computer software is tangible:

Greyhound Computer Corp. v. State Department of Assessments & Taxation, 271 Md. 674, 320 A.2d 52 (1974); Comptroller of the Treas. v. Equitable Trust, 464 A.2d 248 (Md.1983); Chittendon Trust Co. v. King, 465 A.2d 1100, (Vt. 1983); Citizens and Southern Systems, Inc. v. South Car. Tax Comm. 311 S.E. 2d 717 (So. Car. 1984); Hasbro Industries, Inc. v. Norberg, 487 A.2d 124, (R.I. 1985); Measurex Systems Inc. v. State Assessor, 490 A.2d 1192 (Me. 1985).

See also International Business Machines Corporation v. Director of Revenue, State of Missouri, CCH Mo. Tax Rptr. ¶201-167 March 8, 1988.

¹⁶Respondent does not dispute that the computers were used "directly" in the manufacturing of petitioner's programs. Even without this concession, we find this requirement had been met. The statutory requirement in Sec. 70.11(27) that a machine be used "directly" in manufacturing has been held to mean that it must be "principally and primarily a significantly contributive factor in the manufacturing process," and that it is "integrated into a synchronized system of manufacturing." Revenue Dept. v. Greiling, 112 Wis. 2d 602, 334 N.W. 2d 118 (1983); Manitowoc Co., Inc. v. Sturgeon Bay, 122 Wis. 2d 406, 362 N.W. 2d 432 (Ct. App. 1984). The computers used by HMDS were unquestionably an integral part of the manufacturing process. As the machines which actually encoded the data and information onto the blank diskettes, and thereafter checked the quality of the product, the computers were significantly contributive factors in the production of the programs.

¹⁷Petitioner marketed its programs to a limited class of health care organizations consisting of small hospitals, nursing homes and clinics. As of 3/22/88, HMDS had 8 programs available for sale to clinics, and 11 programs available for nursing homes. (There was no reference to the number of programs available for sale to hospitals.)

18§ Tax 11.40(1)(a), Wis. Adm. Code states:

"Exemption of machines and processing equipment.

"(1) General. (a) Section 77.54(6)(a) exempts the gross receipts from the sale of and the storage, use or other consumption of 'Machines and specific processing equipment and repair parts or replacements thereof, exclusively and directly used by a manufacturer in manufacturing tangible personal property.' Effective on December 1, 1981 and thereafter, 'exclusively' as used in s. 77.4(6)(a) and in this section means that the machines and specific processing equipment and repair parts or replacement thereof are used solely by a manufacturer in manufacturing tangible personal property to the exclusion of all other uses, except that the sales and use tax exemption will not be invalidated by an infrequent and sporadic use other than in manufacturing tangible personal property."

ROBERT C. JUNCEAU, COMMISSIONER, DISSENTING:

My disagreement stems from my conclusion that petitioner has failed to prove that the petitioner's process of producing programs is "popularly regarded as manufacturing."

I agree with the majority that the petitioner's product was a "canned" or "prewritten" program. See § Tax 11.71(1)(k), Wis. Adm. Code. The sales, lease, rental, or license to use such programs is taxable under the rule subs.(2)(b). A necessary inference drawn from the rule is that such programs must be regarded as tangible personal property, since only tangible personal property is generally sales taxable. See § 77.52(1), 1981 Stats. In addition, based on respondent's assertion of an average sale price of \$3,000 - 5,000 per program, a rebuttable presumption would arise under subs. 11.71(1)(e)5 of the rule, that petitioner's programs are not "custom programs."

Thus, I would consider inapposite to this case both Janesville Data Center, Inc. v. Department of Revenue, 84 Wis. 2d 341 (1978), as well as International Business Machines Corp. [IBM] v. Department of Revenue, WTAC Docket Nos. S-8968 and S-8984, CCH Wis. Tax Rep. ¶ 202-854(1987), aff'd, id., ¶ 202-910, Dane County Cir. Ct. Br. 13, (10-2-87), aff'd. Court of Appeals Dist. IV (unpub. 6-23-88), pet. rev. den. Wis. Sup. Ct. (8-23-88). In IBM, this Commission stated that "the better view" of that case was a special order sale [including licensed use] subject to scrutiny under § 77.51(4)(h), Stats.¹ (Slip op.at 24). We also stated that the characterization of computer

programs as "prewritten" or "custom" (see § Tax 11.71(1), supra) was of significance only as to whether the sale was one of property rather than services. Id. I would qualify that statement to the extent tangibility must be inferred, as stated above, from a characterization under § Tax 11.71 as a "prewritten program." However, the rule is directed at distinguishing service/sale rather than tangible/intangible property characteristics.

Unlike IBM and Janesville Data, supra, this case does not involve § 77.51(4)(h) "special order" sales. (See Findings of Fact No. 7, 10, 11, 13, 14, 19). Respondent's reliance on such cases is inappropriate where, as here, the programs are prewritten, in which case it is constrained to follow its own administrative rules. Thus, I find no need to consider, and as the majority has done, reject the application of the Janesville Data "essence of the transaction" test to determine a tangibility issue, however strongly I agree with the limitation of the test to distinguish property sales from service transactions. In that regard, rule § Tax 11.67 functions quite nicely.²

I likewise agree that the form, use and name of an electronically encoded diskette is different from the existing material -- blank diskette -- upon which it is placed. Electronic or electromagnetic impulses are physical, tangible embellishments in much the same way that print is to paper. The only difference is the mechanism used to discern the physical characteristics present -- the human eye versus a machine. Machines can even "electronically" read print and reproduce it.

My departure from the majority viewpoint arises where the majority concludes that petitioner has established that the process of producing programs is "popularly regarded as manufacturing" within the meaning of § 77.54(6). The precise term at issue is "production . . . by a process popularly regarded as manufacturing." The industry's view that its processes constitute manufacturing, while no doubt relevant, does not determine the matter. This requirement goes beyond the statutory criteria for defining a process as manufacturing into the industrial world to see whether a process is generally considered manufacturing apart from or in addition to the statutory elements. The word "popular," or its adverbial form "popularly," in the sense used in the statute means "accepted among people in general; common; prevalent." Webster's New World Dictionary, 2d coll. ed., p. 1109. Our Supreme Court has determined that this test is not satisfied by the viewpoint of the proverbial "man on the street", H. Samuels Co. v. Department of Revenue, 70 Wis. 2d 1076, 1085-86 (1975), and that a witness on this point should be "familiar with the industry." The opinions credited by the Court were an industrial metallurgist, a college professor of business, and a consulting metallurgist, who were able to address both the process under review there and manufacturing processes in general. A janitor or a worker in an operation might be said to be familiar with the process or the industry in which they work, but it seems to me that the ability to credibly speak to this point requires expertise and

familiarity with manufacturing processes beyond those in question or like processes in the particular industry. Otherwise the word "popularly" is left vacuous in the statute. In Department of Revenue v. Bailey-Bohrman Steel Corp., 93 Wis. 2d 602, 610-11 (1980), the Court observed that each witness to that point "was qualified by being conversant with manufacturing processes or with the processes used in the steel business." While it may not be necessary that each witness be conversant with both, I would require that in the aggregate (at least) both points be addressed. Thus, where, as here, the evidence only explains the process and how it is regarded in the computer programming industry, I would consider the point of popular regard unproven. While Mr. Poggio is well qualified to describe the processes involved and expressed the programming industry's viewpoint, there is no showing in the record that he has a sufficiently broad knowledge of manufacturing or of processes generally regarded as manufacturing to satisfactorily answer the question of whether the computer programming process is popularly regarded as manufacturing.³ Since no other evidence was brought to bear by petitioner on this point, I would consider testimony that the computer programming industry considers program production "manufacturing" inadequate.

If the legislature wanted to limit the field of inquiry to the viewpoint of the particular industry in which the process is found, it would not have chosen the broad term "popularly." Limiting the inquiry to a specific industry will not carry out

the legislative intent. Upon careful reading, I believe H. Samuels and Bailey-Bohrman, supra, support my position, and I find it dubious that an industry could declare its own processes popularly regarded as manufacturing without some meaningful reference to a broader viewpoint. For reasons of self-interest alone, this would be inconsistent with legislative intent.

I therefore dissent as I find a failure of proof of a necessary element under § 77.54(6), Stats. See Astra Plating, Inc., WTAC Docket Nos. I-6885, I-6886, CCH Wis. Tax Rep. ¶ 201-673 (1980), aff'd id., ¶ 201-947, Dane County Cir. Ct. Case No. 80-CV-4446 (1981).

I wish to state clearly that I express no opinion whether the process in question is in fact popularly regarded as manufacturing, because of the lack of proper evidence to support such a conclusion. My suspicion is that evidence is available which would support such a proposition, but it has not been presented in this case.

Submitted by:

Robert C. Junceau
Robert C. Junceau, Commissioner

FOOTNOTES

¹§77.51(4)(h), 1981 stats., provided, in material part, as follows:

"(4) 'Sale' . . . includes:

* * *

(h) A transfer for a consideration . . . of tangible personal property which has been produced, fabricated or printed to the special order of the customer or of any publication."

²Rule Tax 11.67, Wis. Adm. Code, provides, in relevant part, as follows:

"Service Enterprises. . . .

(1) General. When a transaction involves the transfer of tangible personal property along with the performance of a service, the true objective of the purchaser must be considered to determine whether such transaction is a sale of tangible personal property or the performance of a service with the transfer of property being merely incidental to the service. If the objective of the purchaser is to obtain the personal property, a taxable sale of that property is involved. However, if the objective of the purchaser is to obtain the service, a sale of a service is involved even though, as an incidence to the service, some tangible personal property may be transferred. . . . "

See also §§ 77.51(4)(L) and (29), 1983 stats., renumbered subs. (14)(L) and (5), respectively, 1985 stats.

³Mr. Poggio's background, from a "manufacturing" standpoint, appears from the record to be confined to computer programming. There is no reference in the record to similar processes outside the industry which are popularly regarded as manufacturing. The Standard Industrial Classification Manual (SIC) is often regarded an authoritative aid in such determinations. See §§70.11(27) and 70.995(2), Stats.