RUSSELL COUNTY COMMUNITY HOSPITAL & MEDHOST OF TENNESSEE, INC.	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
	§	DOCKET NO. S. 15-1683
Petitioners,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

Russell County Community Hospital, LLC ("Hospital") and Medhost of Tennessee, Inc., d/b/a Healthcare Management Systems ("Medhost"), jointly petitioned the Revenue Department for a refund of sales tax for February 2012 through August 2014. The Department denied the refund, and the Hospital and Medhost ("Petitioners") appealed to the Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. A hearing was conducted on March 10, 2016. The Petitioners' representative was notified of the hearing, but failed to attend.[1] Assistant Counsel Margaret McNeill represented the Revenue Department.

The facts on the record are undisputed.

The Hospital contracted with Medhost for Medhost to provide the Hospital with various computer software programs for use by the Hospital. The Hospital paid Alabama sales tax to Medhost on the software, which in turn remitted the tax to the Department.

The Petitioners subsequently filed a joint petition for refund of the amount paid. The Department denied the petition "because the software contained canned software that was

[1] The representative notified the Tribunal after the hearing that he did not attend the hearing because the facts are undisputed and the case involves only a question of law.

customized and the nontaxable customized portion was not separated from the taxable canned portion on the invoice, . . ." See, Department's November 9, 2015 denial letter. The Department relied on Dept. Reg. 810-6-1-.37 in denying the refund. The Petitioners timely appealed to the Tax Tribunal.

The Petitioners argue that the software in issue was custom software because it was modified by Medhost for the exclusive use of the Hospital. The Petitioners' appeal letter reads in part:

> We are requesting a formal hearing for the denial of $17,907.39 because the software in question is customized software, which was adapted specifically for Russell County Community Hospital. Russell County Community Hospital purchased a patient flow management software, physician documentation software, and radiology imaging software implementation solution from Medhost. This implementation consisted of a 5 step process that allowed Medhost to customize the software to Russell County Community Hospital's unique workflow and environment. I have attached an email from Medhost Account Executive Chris Thomas which explains the 5 step implementation process.[2]
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> This customized software implementation was denied on the basis of Alabama Department of Revenue Sales & Use Tax Rule 810-6-1-.37, which discusses the taxability of computer hardware and software. Specifically, the request for refund was denied because the auditor reviewing the refund believed customized software implementation is only exempt if the charges for the customized portion are separately stated from charges for canned software.
>
> However, his denial of this refund is incorrect. Section 5 of this rule defines custom software programming as, "software programs created specifically for one user and prepared to the special order of that user." The rule also states that custom software programming "includes program that contain pre-existing routines, utilities, or other program components that are integrated in a unique way to the specifications of a specific purchaser." Furthermore, this situation was addressed in AL HealthSouth Corporation v. State of AL Dept. of Rev., Docket # S. 06-243, 8/10/2006. In this case, HealthSouth Corporation purchased canned software that was adjusted to fit their specific needs. The canned software purchase was determined to be custom

[2] The email from Chris Thomas is attached to and made a part of this Order.

software because it was modified exclusively for HealthSouth Corporation. Petitioners' Appeal Letter at 1.

Alabama's appellate courts have twice addressed whether computer software sold or used in Alabama is subject to Alabama sales or use tax. In *State v. Central Computer Services, Inc.*, 349 So.2d 1160 (Ala. 1977), the Alabama Supreme Court held that Central Computer's use of eight computer programs, or "software," to provide data processing services in Alabama was not subject to Alabama use tax. Rather, the Court found "that the essence of this transaction was the purchase of nontaxable intangible information." *Central Computer*, 349 So.2d at 1162.

The Supreme Court revisited the issue in 1996 in *Wal-Mart Stores, Inc. v. City of Mobile and County of Mobile*, 696 So.2d 290 (Ala. 1996). The issue in that case was whether computer software sold off the shelf by Wal-Mart constituted a taxable sale of tangible personal property.

The Court acknowledged its prior holding in *Central Computer*, but also recognized that "there has been a shift in the view of many courts . . . 'and courts began holding computer software to be tangible for sales, use and property tax purposes.'" *Wal-Mart*, 696 So.2d at 291, quoting from *South Central Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240, 1245 (La. 1994).

The Court pointed out that one of the changes involved "the proliferation of 'canned' computer software, such as is sold by stores like Wal-Mart. As a practical matter, the marketing of such 'canned' software presumes that the information sought will be conveyed by way of a tangible medium. In this sense, the merchandiser is making a sale of tangible

property, like the sale of a book." *Wal-Mart*, 696 So.2d at 291. The Court thus held that Wal-Mart's off the shelf sales of canned computer software were subject to sales tax.

Wal-Mart holds that the sale of canned computer software in Alabama is a taxable sale of tangible personal property, whereas the sale of custom software is not. The issue in this case is what constitutes canned versus custom software, and whether the vendor must allocate its charges if it modifies canned into custom software.

The Revenue Department amended its regulation on computer software, Reg. 810-6-1-.37, after the *Wal-Mart* decision so as to recognize the distinction between taxable canned software and nontaxable custom software. Paragraph (5) of the regulation defines "custom software programming," as follows:

> The term "custom software programming" as used in this regulation shall mean software programs created specifically for one user and prepared to the special order of that user. The term "custom software programming" also includes programs that contain pre-existing routines, utilities, or other program components that are integrated in a unique way to the specifications of a specific purchaser. Custom software programming also includes those services represented by separately stated charges for modifications to a canned computer software program when such modifications are prepared to the special order of the customer. Modification to a canned computer software program to meet the customer's needs is custom software programming only to the extent of the modification. Custom software programming is not subject to tax regardless of the manner or medium of transfer to the customer since the charge for the custom software programming is a charge for professional services and the manner or medium of transfer is considered incidental to the sale of the service.

The definition contradicts itself. It first explains that custom software "includes programs that contain pre-existing routines, utilities, or other program components that are integrated in a unique way to the specifications of a specific purchaser." The phrase "pre-existing routines, utilities, or other program components" can only be referring to already developed canned software. Consequently, according to the above language in the

regulation, canned software that is integrated or customized in a unique way to the specifications of a particular customer constitutes custom software.

But paragraph (5) also states that "[m]odification to a canned computer software program to meet the customer's needs is custom software programing only to the extent of the modification." That statement – that custom software includes only modifications to canned software – is directly contrary to the prior statement discussed above that custom software includes "pre-existing routines, utilities, or other program components," i.e., canned software, that is modified to the specifications of a purchaser.

I find nothing in Alabama statutory or case law that supports the regulation's premise that canned software that is modified to the particular specifications of a purchaser constitutes custom software only to the extent of the modifications.[3] In *Wal-Mart*, the Supreme Court, citing *South Central Bell Tel. Co. v. Barthelemy*, supra, stated that "[i]n a narrow sense, 'software' is synonymous with 'program.' "Program' has been defined as 'a complete set of instructions that tells a computer how to do something.'" (cite omitted) Computer software or a computer program is thus "a complete set of instructions." Consequently, if a pre-existing, canned software program is modified to the specific needs

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[3] California exempts custom computer programs, but by statute exempts modifications to canned software only to the extent of the modifications. Cal. Rev.& Tax. Code, §6010.9(d); see generally, J. Hellerstein & W. Hellerstein, State Taxation, ¶ 13.06(3) (3d ed. 2001). Alabama has no such statutory provision.

Some states also have regulations that attempt to identify canned versus custom software, depending on all facts and circumstances. For example, a Wisconsin regulation specifies seven factors that should be considered, see Wisconsin Admin. Code § Tax 11.71(1)(e). For a Wisconsin Supreme Court case that analyzed those seven factors and determined that the software in issue was custom, see *Wisconsin Department of Revenue v. Menasha Corp.*, 754 N.W.2d 95 (Wis. 2008).

of a user, the resulting custom program would include both the initial canned software and the modifications because both are a part of the "complete set of instructions."

Importantly, the above is consistent with the Supreme Court's holding in *Wal-Mart*. That case is controlling law in Alabama, and while it is unfortunate that the Court did not attempt to fully explain the distinction between canned and custom software, it did hold that the sale of "'canned' computer software, such as is sold by stores like Wal-Mart," is subject to sales tax. Consequently, based on the Court's holding in *Wal-Mart*, only unmodified computer software sold to nonexempt customers over the counter is subject to Alabama sales or use tax. The Department concedes that the software in issue has been modified to fit the specific needs of the Petitioner Hospital. The software thus constitutes nontaxable custom software.[4]

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[4] In his leading treatise on state and local taxation, J. Hellerstein & W. Hellerstein, State Taxation, ¶ 13.06 (3d ed. 2001), Professor Walter Hellerstein provides an insightful overview of how the various states tax, or don't tax, the sale or use of computer software. In my opinion, Professor Hellerstein rightly criticizes the states that distinguish the taxability of canned versus custom software. I agree in principle with the Louisiana Supreme Court's holding in *South Central Bell Telephone Co. v. Barthelemy*, supra, that canned and custom software should both be taxable.

> We likewise decline to adopt the canned versus custom distinction invoked by a few state legislatures, commentators and courts. "Canned" software is software which has been pre-written to be used by more than one customer, or mass marketed; "custom" software is specially designed for exclusive use by one particular customer. Oreck, *supra*, § 2.2[1](a); Schontz, *supra*, at 164 n.10, 12; Richard Harris, *supra*, at 171-72. Under the canned versus custom distinction, canned programs are classified as taxable on the theory that the buyer acquires an end product; whereas, custom programs are classified as non-taxable services on the theory that the buyer acquires professional services. See e.g. Hanlon, *supra*; Robert W. McGee, Recent Developments in the Taxation of Computer Software, 19 Golden Gate U. L. Rev. 265, 272-74 (1989).

While the Louisiana Department of Taxation's current sales tax regulation regarding software adopts the "custom" versus "canned" distinction, see Oreck, *supra* at 2.2[1](a) (discussing the Department's regulations), it has been observed that this distinction departs entirely from the general Louisiana property law concepts applicable for making the tangible versus intangible distinction. Oreck, *supra*, at § 2.2[1](a), p. 2-4. See also Shontz, *supra*, at 166. To put it simply, whether the software is custom or canned, the nature of the software is the same.

Another problem with the custom/canned distinction, as illustrated by the facts in this case, is that often the software at issue is mixed, i.e., canned software is modified to the buyer's specifications, and fits neatly into neither category. As the court of appeal commented, "the uncontroverted facts in this case tend to establish that the programs at issue were a combination of canned and custom programs. The programs were pre-made but apparently significant adaptions were required before [Bell] could use them." 93-1072, at p. 8, 631 So. 2d at 1344.

As one commentator aptly articulated, several problems arise when the canned versus custom distinction is substituted for the tangible versus intangible distinction, including the following:

> There is an element of delusion in categorizing any but the simplest and most standard types of software as "canned." In many of the decided cases, both those holding software programs non-taxable, as well as in those in which software was held taxable, some modification in the programs was needed in order to adapt them to the taxpayer's requirements. It seems probable that a substantial part of even standardized software that is purchased by larger businesses is modified in some respects. Consequently, the line between customized and canned programs is so vague and imprecise that a rule that taxes canned, but not customized, software is difficult to administer and tends to encourage tax avoidance through minor adaptive modifications.

Hellerstein and Hellerstein, 2 State Taxation, Sales and Use, Personal Income and Death and Gift Taxes § 13.05[2] (1991). See also Oreck, *supra*, at § 2.2[1](a), p. 3-7 (echoing these criticisms and noting that "the degree of customization . . . [is] less than a credible standard. Virtually all software must be customized by the end user to operate properly.) For the foregoing reasons we reject the canned versus custom distinction, particularly where there is nothing in the ordinance to indicate that such a distinction was intended to be applicable.

The Department is directed to issue the Petitioners the refund in issue, plus applicable interest. Judgment is entered accordingly.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-2(m).

Entered June 13, 2016.

Bill Thompson

BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Matthew E. Soifer

> In sum, once the "information" or "knowledge" is transformed into physical existence and recorded in physical form, it is corporeal property. The physical recordation of this software is not an incorporeal right to be comprehended. Therefore we hold that the switching system software and the data processing software involved here is tangible personal property and thus is taxable by the City of New Orleans.

South Central Bell, 643 So.2d at 1249, 1250.

Gmail by Google

Aaron C. Giles <aaron.giles@salesandusetax.com>

MEDHOST Customization

Aaron C. Giles <aaron.giles@salesandusetax.com> Thu, Aug 20, 2015 at 10:25 AM
To: "Williamson, Sylvester" <Sylvester.Williamson@revenue.alabama.gov>
Cc: Matthew Soifer <matthew.soifer@salesandusetax.com>

Sylvester,

Please see the email below from Chris at HMS Medhost. The "file build" step he mentions is the programming. A unique "file" or program is built for each hospital client according to their needs. Once it's complete, the file is installed in the hospital's servers.

So, to summarize the implementation includes:
1. Discovery/Analysis of Needs
2. File Build/Programming
3. Installation/Uploading to the Hospital's Servers
4. Onsite Training
5. Go-Live Support

There is no separation of the cost between exempt and taxable charges because all charges are for custom software programming. Please let me know if you have any additional questions.

Thanks,

Aaron C. Giles
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---------- Forwarded message ----------
From: **Chris Thomas** <chris.thomas@medhost.com>
Date: Wed, Aug 19, 2015 at 3:28 PM
Subject: MEDHOST Customization
To: "Aaron C. Giles" <aaron.giles@salesandusetax.com>
Cc: "Hadzega, Angela D." <ahadzega@jhmhospital.com>, "George, Joseph" <jgeorge@jhmhospital.com>, Benjie Graham <Benjie.Graham@medhost.com>, "McKinney, Booth" <cmckinney@jhmhospital.com>, Matthew Soifer <matthew.soifer@salesandusetax.com>, Robert Youngkins <Robert.Youngkins@medhost.com>

Aaron,

Per our conversation last Friday, the MEDHOST application software implementation is unique to each hospital's workflow and environment, and is not "canned". There is a discovery and file build done for our applications unique to the individual project and oftentimes involves onsite training and go-live support. While our programs serve and deliver similar functions at each hospital, our implementation projects are directed by project management in a manner suited for the individual customer needs.

Please let me know if you have any questions.

Thank you!

Chris Thomas
Account Executive

MEDHOST

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