ROBERT SMITH FLIPFLOPFOTO 116 S. 8TH STREET OPELIKA, AL 36801-4914,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-1240
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Robert Smith ("Taxpayer"), d/b/a FlipFlopFoto, for State sales tax for January 1999 through December 2003. It also assessed the Taxpayer's corporation, FlipFlopFoto, LLC, for sales tax for January through December 2004. The Taxpayer appealed both final assessments to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on June 13, 2006. Jeff Hilyer represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

The Taxpayer is a professional photographer located in Opelika, Alabama. He contracts with individuals to take photographs at weddings, parties, and other social events. He also sells photographs to advertising agencies and other commercial customers. He performs his work using digital cameras.

The Department audited the Taxpayer for sales tax for the periods in issue and computed his liability using his bank deposits as his gross proceeds. It then backed out or excluded various nontaxable items to determine the Taxpayer's taxable gross proceeds.

The Taxpayer does not contest the Department's use of his bank deposits in determining his gross receipts. He contends, however, that various receipts taxed by the

Department were derived from nontaxable activities.

Concerning the social events, the Taxpayer charged a fixed, lump-sum amount to attend and take photographs at weddings, parties, etc. during the periods in issue. He uploaded the digital images to his website, where they could be viewed and ordered online by the customer. If a customer ordered pictures, the Taxpayer printed the selected photographs and mailed or otherwise delivered them to the customer. He then billed the customer an additional amount for the printed photographs. The Taxpayer concedes that sales tax is owed on his charge for the printed photographs. He argues, however, that his lump-sum charges for attending the events were not subject to sales tax because the charges were not contingent on the subsequent sale of the photographs.

In *Thigpen Photography v. State of Alabama*, S. 95-127 (Admin. Law Div. O.P.O. 8/30/95), the taxpayer was a professional photographer that sold photographs and provided related services. The Administrative Law Division confirmed in *Thigpen* that the sale of photographs is subject to sales tax, regardless of the expertise of the photographer. However, various services performed by the taxpayer were held to be not subject to sales tax because they did not involve and were not contingent on the subsequent sale of photographs. "A fixed rate fee for services or labor that is not based on or contingent on the subsequent sale of property is not taxable." *Thigpen* at 5.

The Taxpayer's fixed charges for attending and taking photographs at the social events were not contingent on the subsequent purchase of photographs by the customer; nor did the fees vary depending on the number of photographs the customer later purchased, if any. Consequently, under the particular facts of this case, the "appearance"

fees charged by the Taxpayer to attend the social events were not taxable because they were not derived from the sale of tangible property.

Concerning the commercial work, the Taxpayer took digital photographs as directed by the customer. He then transmitted the digital images to the customer via compact disc, over the internet, or by e-mail. The Taxpayer contends that the digital photographs were not subject to sales tax because they did not involve the sale of tangible personal property. He also argues that even if the digital photographs are deemed to be tangible property, he was primarily performing a nontaxable professional service, with the transfer of the tangible photographs only incidental to the service.

This is an issue of first impression in Alabama – Does the sale of digital photographs transmitted electronically constitute a taxable sale of tangible personal property? Two sub-issues are involved: First, do digital photographs constitute tangible personal property? If so, the second inquiry is whether the Taxpayer is providing a nontaxable service, with the transfer of the tangible photographs only incidental to the service?

The Taxpayer first argues that digital photographs are not tangible personal property. I disagree.

"Tangible personal property" is defined for Alabama lease tax purposes at Code of Ala. 1975, §40-12-220(8) as "property which may be seen, weighed, measured, felt or touched, or is in any other manner perceptible to the senses." In *Curry v. Alabama Power Co.*, 8 So.2d 521 (Ala. 1942), the Alabama Supreme Court applied an almost identical definition in holding that electricity, i.e., the flow of electrons, constituted tangible personal property for sales and use tax purposes. The Court later confirmed that holding in *State v.*

Television Corp., 127 So.2d 603 (Ala. 1961), and *Sizemore v. Franco Distributing Co., Inc.*, 594 So.2d 143 (Ala. Civ. App. 1991).

My understanding, albeit limited, is that the internet and e-mail involve the transmission of electrical impulses, i.e., electricity, which, as indicated, constitutes tangible personal property. Consequently, the electronic transfer of digital photographic images from a seller to a purchaser for a price constitutes the sale of tangible personal property.[1]

Having found that the digitized photographs constitute tangible property, the issue becomes whether the Taxpayer is providing his commercial customers with a nontaxable service, with the transfer of the tangible property only incidental to the service. An analysis of a related issue, the taxation of computer software, will help in deciding this issue.

The Alabama Supreme Court first addressed the taxability of computer software in *State v. Central Computer Services, Inc.*, 349 So.2d 1160 (Ala. 1977). The Court held in *Central Computer* that computer software primarily involved the transfer of intangible knowledge, and thus was not subject to sales tax.

The Court reversed itself in *Wal-Mart Stores, Inc. v. City of Mobile and County of Mobile*, 696 So.2d 290 (Ala. 1996). Citing a Louisiana case, *South Central Bell Tel. Co. v. Barthelemy*, 643 So.2d 1240 (La. 1994), the Court held that computer software was tangible personal property subject to sales tax.

> The purchaser of the computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter,

[1] In the prior Alabama cases holding that electricity constituted tangible personal property, only a steady stream of electricity was involved. The internet and e-mail involve electrical impulses that are patterned or configured in specific forms. However, the electrical impulses still constitute tangible property.

physically recorded on some tangible medium, constitutes a corporeal body. *Wal-Mart Stores*, 696 So.2d at 291, citing *South Central Bell*, 643 So.2d at 1246.

The Court did not distinguish in *Wal-Mart* between canned versus customized software. The Department interpreted the decision, however, as holding that only canned software was taxable. That distinction is presumably based on the Court's reference in its opinion to "the proliferation of 'canned' computer software, such as is sold by stores like Wal-Mart." *Wal-Mart*, 696 So.2d at 291.

In any case, the Department subsequently amended its computer software regulation by distinguishing between canned software, which it deems to be taxable, and custom software, which is not taxable. See, Reg. 810-6-1-.37. The regulation specifies that canned software is taxable "regardless of whether it is transferred to the purchaser in physical form, via telephone lines, or by another alternative form of transmission." See, Reg. 810-6-1-.37(3). Custom software is not taxable, regardless of how it is transferred, "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." See, Reg. 810-6-1-.37(5).[2]

The distinction between taxable canned software and nontaxable custom software is not based on the fact that canned software is tangible and custom is not. All software is

[2] The states vary in how they tax computer software, if at all. For an overview of how the various states tax software, see J. Hellerstein & W. Hellerstein, *State Taxation* (3d ed. 2001) at ¶13.06 et seq.

tangible in that it involves an "arrangement of matter, physically recorded on some tangible medium, . . ." *Wal-Mart*, 643 So.2d at 291, citing *South Central Bell*, 643 So.2d at 1246. Rather, custom software is not taxed because the software provider is deemed to be providing an intangible service, with the transfer of the tangible property only incidental to that service. See again, Reg. 810-6-1-.37(5). In that respect, the seller of customized computer software is treated the same for Alabama sales tax purposes as a dentist that provides a patient with dentures, see, *Crutcher Dental Supply Co. v. Rabren*, 246 So.2d 415 (1971), or an advertising agency that provides photographs, brochures, etc. to its customers, see, *State v. Harrison*, 386 So.2d 460 (Ala. Civ. App. 1980), to give only a few examples. In each situation, the transfer of the tangible property is deemed to be incidental to the professional service provided, and thus not taxable.

The Taxpayer argues in this case that the photographs he provides to his commercial customers are not taxable because they are in the nature of custom computer software. The Taxpayer contends in substance that he is providing a nontaxable professional service. I disagree.

The Administrative Law Division held in *Thigpen Photography* that the taxpayer/photographer was selling photographs at retail, not providing a nontaxable professional service.

> The Taxpayer cites *State v. Harrison*, 386 So.2d 461 (1980), and argues that he could designate his business as an advertising agency and thus owe no sales tax. In *Harrison*, the Court of Civil Appeals held that an advertising agency in the business of rendering public relations services was not liable for sales tax on catalogs and brochures provided to the customer. Comparing the advertising agency to a dentist or a lawyer, the Court held that the advertising agency was primarily providing a professional service to its customers. The transfer of catalogs and brochures was held to be only

incidental to that service, and thus not a taxable sale. The Court stated as follows, at page 461:

> Just as a lawyer depends upon his legal expertise in preparing a deed or will, the appellee must rely upon his creativity in producing a catalogue or brochure suitable for his individual client. We think the creation of a catalogue or brochure by the appellee and the subsequent transfer of these materials to a client after being printed is incidental to the professional service being rendered.

Prior to *Harrison*, Alabama's courts had held that individuals engaged in a "learned profession", i.e. lawyers, dentists, and some doctors, are primarily providing a professional service. In that case, the transfer of tangible personal property by the professional to the client or patient is only incidental to the service provided, and thus does not constitute a retail sale subject to sales tax. See generally, *Haden v. McCarty*, 152 So.2d 141 (1963) (dentistry held to be a learned profession). Although the term was not used, the Court in *Harrison* followed the "learned profession" rationale in holding that the advertising agency was not making retail sales.

Neither *Harrison* nor the "learned profession" exclusion applies in this case. Admittedly, taking photographs was one of the services provided by the advertising agency in *Harrison*. But clearly, the Taxpayer does not provide the wide range of advertising services provided in *Harrison*, which included "the filming of a motion picture, taking photographs, making tapes for a television or radio show, and preparing a catalog or brochure to be used by clients . . .". *Harrison*, at p. 460. The Taxpayer is in substance a professional photographer, not an advertising agency. *Harrison* thus does not apply.

Photography has never been held to be a learned profession for purposes of applying the sales tax law. The Taxpayer certainly uses skill and creativity in his business, but that skill and creativity goes into making the tangible photograph, which is sold at retail and sales tax is due thereon. Unlike a lawyer's brief or a will, or a prescription prepared by a physician, or the catalogs and brochures in *Harrison*, which are only means by which professional services are provided, the final product provided by the Taxpayer is the tangible photograph.

Thigpen Photography at 5 – 7.

The above rationale applies in this case. The Taxpayer is selling photographs at retail, albeit in digitized form. But the form in which tangible property is delivered by the seller to the purchaser should be of no consequence. Just as the sale of canned software is taxable "regardless of whether it is transferred to the purchaser in physical form, via telephone lines, or by another alternative form of transmission," see, Reg. 810-6-1.37(3), the retail sale of photographs is taxable, whether delivered in final printed form or in digital form over the internet or by e-mail.

In *Graham Packaging, Inc. v. Commonwealth*, 882 A.2d 1076 (2005 Pa. Commw. LEXIS 518), the court held that canned computer software, however delivered, constituted tangible personal property. Citing the Louisiana Supreme Court's holding in *South Central Bell*, the Pennsylvania court found "that the form of the delivery of the software-magnetic tape or electronic transfer via modem – is of no relevance." *Graham Packaging*, 882 A.2d at 1084. "We conclude that the sale of all canned software, whether transmitted electronically or on a physical medium, is taxable as the sale of tangible personal property." *Graham Packaging*, 882 A.2d at 1087.

Likewise, the form in which photographs (and other digital goods) are delivered is irrelevant. I agree with the following from a *State Tax Notes* article that discusses *Graham Packaging* and the taxability of computer software delivered electronically, which is equally applicable to other digital goods transmitted electronically.

> . . . [t]he means of delivery should be irrelevant in determining the taxability of canned software purchases. Such a distinction places form over substance and is, for lack of a better word, silly. Also, advances in technology make almost all software or programs available via electronic transfer. Taxpayer will easily be able to structure their purchases to avoid the sales tax. Providing avenues for tax avoidance strategies is bad for tax policy and it's

> unfair to require a few to bear the entire tax burden because of the idiosyncrasies of their particular software.

Carr and Griffith, "The Taxation of Canned Software: Should the Delivery Method Matter?", *State Tax Notes*, Dec. 26, 2005, p. 1088.

It is likewise irrelevant that after receiving the digitized photograph, the purchaser must then print or otherwise convert the photograph into usable form. The sale of the digital photograph, and the gross proceeds derived from that sale, is still taxable. An analogous situation would be a chair manufacturer that sold and delivered a disassembled chair to a customer. The customer may then have to assemble the chair before it could be used for its intended purpose, but the manufacturer's sale of the disassembled chair parts would still be a taxable retail sale.

Whether sales tax applies to the sale of digital goods delivered electronically is an emerging issue in state taxation. Admittedly, treating the sale of digitized photographs delivered electronically as a taxable sale of tangible personal property pushes the bounds of what has traditionally been viewed as the sale of tangible goods. But Alabama's broad definition of tangible personal property, which the Alabama Supreme Court has construed to include electricity, is sufficiently broad to include digital goods transmitted by electrical impulses. I also see no principled reason why the retail sale of goods that can now be delivered electronically due to advances in technology, i.e., photographs, music, movies, books, etc., should be taxed any differently than the sale of those goods delivered by traditional means. In all cases, the true object of the transaction is the sale of the goods,

not the providing of a non-taxable service.[3]

Taxing digital goods raises a myriad of practical concerns and questions. For example, how should "digital goods" be defined, and what if the purchaser is limited in how or where the goods can be used? Those practical problems are currently being addressed, and hopefully will be resolved, in negotiations involving the Streamlined Sales Tax Project ("SSTP"). For an informative article on the status of the SSTP as it relates to digital goods, see "An Interview with Jeff Friedman – A Business Perspective on Taxing Intangibles", *State Tax Notes*, Nov. 13, 2006, p. 461.

But while the taxation of digital goods may raise difficult issues that must be addressed, those issues are not present in this case. Under Alabama law, the Taxpayer's digital photographs constitute tangible personal property, and the gross proceeds from the retail sale of the photographs in Alabama is subject to sales tax.

The Department is directed to recompute the Taxpayer's liabilities as indicated above. A Final Order will then be entered for the adjusted amounts due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered November 17, 2006.

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BILL THOMPSON
Chief Administrative Law Judge

[3] This is not to say, however, that all goods transmitted electronically are subject to sales tax. For example, as discussed, the electronic transmission of custom computer software is treated as the providing of a non-taxable service in Alabama (and elsewhere).

bt:dr
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