STATE OF ALABAMA,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE
V.	§	ADMINISTRATIVE LAW DIVISION
BURROUGHS CORPORATION Burroughs Place Detroit, MI 48232,	§	DOCKET NO. R.85-122
Taxpayer.	§	

ORDER

This matter concerns a lease tax preliminary assessment entered by the Revenue Department against the Burroughs Corporation (Taxpayer) for the period April 1, 1981 through March 31, 1984. Under the provisions of the Alabama Administrative Procedure Act, Code of Alabama 1975, §41-22-1, et sec., a hearing was conducted by the Administrative Law Division of the Revenue Department on September 11, 1985. At said hearing, the parties were represented by attorneys Marshall Timberlake and William E. Shanks, Jr., for the Taxpayer, and assistant counsel Adolph Dean, for the Department.

Based on the testimony and exhibits submitted by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

During the period in issue, the Taxpayer was engaged in the leasing of computer software to various customers in Alabama. The Revenue Department audited the Taxpayer and determined that the lease tax levied at Code of Alabama 1975, §40-12-220, et seq. was due on said transactions. The issues presented for review are as follows (1) Is computer software "tangible personal property" within

the scope of the lease tax law; and (2) is there a valid legal distinction between "canned" and "customized" software for purposes of applying the lease tax, and if so, in which category does the software in issue fall.

The lease transactions in issue evolved substantially as follows: To begin, the Taxpayer would study the software needs of a customer, and thereafter submit to the customer a proposed software package. After acceptance of the proposal, the Taxpayer would perform a detailed evaluation of the customer's specific software requirements, i.e. the "requirements definition" stage. Next would come the "conceptual design" and "detail design" stages, in order, in which the Taxpayer would form and modify the software package to satisfy and fit the particular needs of the customer. Finally, In the "development" and "implementation" phases, the program would be physically created and packaged, and thereafter applied to the customer's hardware. In some instances, the above process took as long as six months to complete, depending on the complexity of the customer's individual software requirements.

The completed software program was transmitted to the customer by either magnetic media or wire, generally magnetic tapes or discs. After the program was read into the customer's hardware memory, the transmittal media was either stored, reused or destroyed by the customer. In any case, after delivery of the program the media was not essential or necessary for the effective utilization of the program by the customer. The cost of the media used in each

transaction was approximately $20.00, depending on the number of tapes or discs used, as compared to a software program cost of at least $4,000.00. Separate invoices were issued for the media and the program, with the Taxpayer collecting sales tax on only the media charges. While the program was transmitted as set out above, the information could have been delivered by phone lines or directly by an employee of the Taxpayer, although such delivery methods would have been Impractical. If a fully Implemented program had been lost due to power failure or computer malfunction, the Taxpayer would have resupplied the program and charged the customer only for the cost of the tapes or discs used for delivery.

In developing the programs in question, the Taxpayer would begin with a standard shell program, which was then modified as described above to fit the specific needs and requirements of the particular customer. The shell programs contained the basic requirements necessary to fit a general type of customer, i.e. banks, savings and loans, etc. However, the shell programs were useless without substantial modification, and no standard modification package was available that could have satisfied the particular needs of any of the Taxpayer's customers. That is, individual and varying modifications were necessary in each case. None of the software programs in issue could have been used effectively by a second customer, unless that customer also had the exact software requirements and needs as the customer for which the program was designed.

CONCLUSIONS OF LAW

The primary issue is whether computer software is tangible personal property within the purview of the Alabama lease tax law, Code of Ala. 1975, §40-12-220. That section reads in pertinent part as follows:

> For purposes of this article, the following terms shall have the respective meanings ascribed by this section;
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> (8)TANGIBLE PERSONAL PROPERTY. Personal property which may be seen, weighed, measured, felt or touched, or is in any other manner perceptible to the senses. The term 11 tangible personal property" shall not include stocks, bonds, notes, insurance or other contracts, or securities.

The only Alabama case that has addressed the question of whether computer software is tangible personal property is a use tax case, State of Alabama v. Central Computer Services, Inc., 349 So.2d 1156 (1977). While the Alabama use tax law, found at Code of Ala. 1975, §40-23-60, et seq., provides no definition of "tangible personal property", there can be no question that the term must be given the same meaning relative to both use tax and lease tax, especially in light of the broad, general lease tax definition quoted above. Accordingly, the holding of the Central Computer case is applicable in the present case.

The essential facts in the Central Computer case were as follows: The taxpayer, a subsidiary of a bank holding company, purchased eight software programs from a Texas corporation. The programs were delivered to the taxpayer in the form of punched cards and magnetic tapes of general applicability to the banking industry. The

taxpayer subsequently modified the programs to fit its specific software needs and requirements. The modified programs, after being transferred onto a magnetic disk, were then used to program the taxpayer's computers.

Given the above facts, both the Court of Civil Appeals and the Supreme Court found that the computer software did not constitute tangible personal property. The relevant facts in the present case are identical in substance to the Central Computer facts. Accordingly, it must be found that the software in issue is not tangible personal property for purposes of the Alabama lease tax.

The Revenue Department seeks to tax the software on the theory that it was canned, as opposed to customized. That distinction was formalized by the Department in Regulation 810-6-1-.37. That regulation limits the applicability of the Central Computer case to only custom written programs, and states that "[C]anned programs, prewritten for any prospective purchaser, sold over the counter are subject to the tax however, from a reading of the Central Computer case, no basis can be found for the attempted distinction by the Department. Both appellate courts have found that "computer software does not constitute tangible personal property". No distinction has been made between custom and canned software.

Because the Alabama courts have exempted all software, the distinction between canned and custom software has not been addressed, nor is there statutory guidance on the subject. However,

a reasonable distinction would be as follows: canned software is mass produced and can be used off the shelf; custom software denotes a package developed for a specific user, tailored to their needs.

From a review of the facts in issue, it is clear that the software was extensively modified to fit the particular needs of each customer. The Taxpayer did, in some cases, begin with a standard program shell which was applicable to a general class of customers. However, in all such cases the shell was altered so as to fit the requirements of the particular customer. Thus, without statutory or judicial direction to the contrary, the software in issue was clearly customized under the definition set out above. Further, even under the Department's regulation, the software would not be canned in that it was not "prewritten for any prospective customer".

State courts throughout the country are in conflict as to whether computer software is taxable as being tangible personal property. A number have held for taxation, Hasbro Industries, Inc. v. Norberg, 487 A.2d 124; Citizens and Southern Systems, Inc. v. South Carolina Tax Commission, 311 S.E.2d 717; Chittenden Trust Company v. King, 465 A.2d 1100; Comptroller of the Treasury v. Equitable Trust Company, 464 A.2d 248, while an equal number have decided to the contrary, First National Bank of Fort Worth v. Bullock, 584 S.W.2d 548; First National Bank of Springfield v. Department of Revenue, 421 N.E.2d 175. In some of the cases, the distinction between canned versus custom programs has been accepted,

Hasbro Industries, Inc. v. Norberg, supra, while in others the distinction has been rejected, First National Bank of Fort Worth v. Bullock, supra, James v. Tres Computer Services, Inc., 642 S.W.2d 347. For a detailed analysis of the present tax status of software, see "The Sales Tax Status of Software Revisited", found in Vol. 4, No. I of The Journal of State Taxation (Spring, 1985).

Notwithstanding the above conflict of views, the Alabama law on the subject, as set out in the Central Computer case, is settled. Computer software does not constitute tangible personal property. Accordingly, it is hereby determined that the software in issue, not constituting tangible personal property, is not subject to the Alabama lease tax. The Revenue Department is hereby directed to make the preliminary assessment in issue final showing no tax due.

Done this the 2nd day of December, 1985.

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BILL THOMPSON
Chief Administrative Law Judge