STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. R. 85-173
CANDLE CORPORATION 1999 South Bundy Drive West Los Angeles, CA 90025,	§	
Taxpayer.	§	

ORDER

This case involves a disputed preliminary assessment of lease tax entered by the Revenue Department (Department) against Candle Corporation (Taxpayer) for the period January 1, 1981 through March 31, 1985. A hearing was conducted in the matter on February 19, 1987. The Taxpayer was represented by the Hon. Lee Bains and the Hon. Kirby Sevier. Assistant counsel Wade Hope appeared on behalf of the Department. As a result of said hearing, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The determinative issue in this case is whether computer software constitutes tangible personal property for purposes of taxation under Alabama law.

The Department audited the Taxpayer for the period January 1, 1981 through March 31, 1985 and set up a lease tax liability on the gross proceeds derived by the Taxpayer from the rental of computer software. The Department recognizes that the Alabama Supreme Court, in State v. Central Computer Services, Inc., 349 so.2d 1160,

has declared that computer software does not constitute tangible personal property for purposes of the use tax. However, the Department has taken the position, formerly through the passage of Reg. 810-6-1-.37, that the Central Computer case is applicable to "customized' software only, and that "canned" software does constitute taxable tangible personal property.

At the February 19, 1987 hearing, both parties offered documentary evidence (affidavits, letters, etc.) going to the factual question of whether the software in issue should be classified as canned or customized. Both parties properly objected to the other's evidence as presented. In view of the obvious evidentiary problems concerning the canned versus customized issue, and in an attempt to prevent any unnecessary expenses and delays in gathering the proper evidence, it was suggested by the Administrative Law Judge, and agreed to by the parties, that the matter should be submitted on the legal issue on whether there is a legal distinction between canned (tangible) and customized (intangible) software, as argued by the Department. only if such a distinction is valid would an evidentiary hearing be necessary to determine the nature of the software in dispute.

CONCLUSIONS OF LAW

As stated, the Central Computer case controls the taxability of computer software in Alabama. That case clearly holds that such software constitutes intangible personal property and thus is not

subject to taxation. As concluded by Judge Holmes for the Court of Civil Appeals:

> We therefore hold that computer software does not constitute tangible personal property within the meaning of Title 51, §788, Code of Alabama 1940 (Code of Alabama 1975, §40-23-61).

The Supreme Court heard the case by writ of certiorari and upheld the Court of Civil Appeals decision as follows:

> We hold that computer "software" does not constitute tangible personal property for purposes of Title 51, §788, Code of Alabama 1940. The decree of the Court of Civil Appeals is hereby affirmed.

As stated, the Department's position is based on its interpretation of the Central Computer case as distinguishing between custom and canned programs. The perceived distinction is drawn by the Department from certain language in the Court of Civil Appeals opinion, at page 1157, in which the subject programs are described "expressly tailored for the taxpayer's operations". Thus, the Department argues that because the software in Central Computer was customized to fit the user's needs, the finding that computer software is intangible personal property should be limited to only such software.

However, neither appellate court drew a distinction between canned and custom software. As quoted above, both courts held that computer software, without exception, constitutes intangible personal property. Further, the Supreme Court's rendition of the facts does not even note that the software was modified or tailored

to fit the user's needs. Clearly the Court did not consider the nature of the software to be a relevant factor and certainly had no intention to limit its opinion to customized software only.

The Department, citing Ex parte White, 477 So.2d 422, argues that Reg. 810-6-1-.37, which, as noted, distinguishes between custom and canned software, is reasonable on its face and must be upheld. In Ex parte White, the Alabama Supreme Court held that unless proven to be unreasonable, a Department regulation must be followed which set out a particular method by which utility services and the corresponding utility tax should be calculated and reported to the Department.

However, the regulation in Ex parte White was a "bookkeeping" regulation, and did not attempt to substantively interpret a statute or appellate court decision, as does Reg. 810-6-1-.37. A regulation that seeks to interpret a statute ("declaratory" regulation) must conform to the language of the subject statute and/or the prevailing case law, and should only be followed if it provides a proper and reasonable interpretation of such statute or appellate decision. Boswell v. Bonham, 297 So.2d 379; East Brewton Materials, Inc. v. State, Dept. of Revenue, 223 So.2d 751. Applying that principle to the present case, Reg. 810-6-1-.37, insofar as it deems canned software to be taxable, is invalid as an overbroad interpretation of the Central Computer decision.

The conflicting opinions reached by the courts in various

states illustrates the difficulty of the issue in question. The courts of Maryland, in Comptroller of the Treasury v. Equitable Trust Co., 464 A.2d 248 (1983), South Carolina, in Citizens and Southern Systems, Inc. v. The South Carolina Tax Comm., 311 S.E.2d 717 (1984), and Vermont, in Chittenden Trust Co. v. King, 465 A.2d 1100 (1983), have all found software to be taxable, whereas Texas, in First National Bank of Fort Worth v. Bullock, 584 S.W.2d 548 (1979), Illinois in First National Bank of Springfield v. Dept. of Revenue, 421 N.E.2d 175 (1981), and Missouri, in James v. Tres Computer Services, Inc., 642 S.W.2d 347 (1982), have held that such software is intangible and thus not taxable.

In holding against taxation, most courts, including Alabama's in the Central Computer case, have applied the "essence of the transaction" test, a variation of the substance over form principle by which the courts have concluded that the essence of the transaction is the purchase or lease of intangible information. As opposing viewpoint was set out by Justice Maddox in his dissent in Central Computer, wherein he challenges the distinction drawn by the majority between software tapes and the motion picture film involved in Boswell v. Paramount Television Sales, Inc., 282 So.2d 892 (1973).

However, until the Supreme Court overrules or extends its Central Computer decision, or the Legislature sees fit to address the issue, in Alabama all computer software constitutes intangible

personal property. Accordingly, the Department is hereby directed to reduce and make final the assessment in issue showing no tax due.

Done this 14th day of April, 1987.

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BILL THOMPSON
Chief Administrative Law Judge