REL: November 16, 2018

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ALABAMA COURT OF CIVIL APPEALS

OCTOBER TERM, 2018-2019

2170527

Russell County Community Hospital, LLC, d/b/a Jack Hughston Memorial Hospital

v.

State Department of Revenue

Appeal from Russell Circuit Court (CV-16-900160)

MOORE, Judge.

Russell County Community Hospital, LLC, d/b/a Jack Hughston Memorial Hospital ("the taxpayer") appeals from a judgment entered by the Russell Circuit Court ("the trial

court") in favor of the State Department of Revenue ("the department") on the department's appeal from a final order of the Alabama Tax Tribunal ("the tax tribunal").

Procedural History

Between February 2012 and October 2014, the taxpayer purchased software products from Medhost of Tennessee, Inc. ("Medhost"); during that period, the amounts remitted by the taxpayer to Medhost for the purchase of software products included Alabama sales tax. On March 11, 2015, a joint petition was filed on behalf of the taxpayer and Medhost for a refund of sales tax that had been collected and remitted by Medhost on the purchase of the software products in the amount of $17,907.39. On September 2, 2015, the department submitted correspondence to the taxpayer indicating that the software products sold by Medhost to the taxpayer appeared to be taxable tangible personal property; that the software products contained "canned software" that might or might not be customized; that the software products contained "canned programs" that are taxable; that the purchase invoices for the software products did not separate the canned software from the customized software; and that the full amount of the

purchase price for the software products was subject to taxation. In a letter dated November 9, 2015, the department informed the taxpayer of its decision denying the refund request and notifying the taxpayer that, if the taxpayer disagreed with the department's decision, it could request a formal hearing before the tax tribunal.

On November 24 2015, the taxpayer filed a notice of appeal and a request for a formal hearing before the tax tribunal with regard to the denial of the refund request regarding the $17,907.39 in sales tax that had been collected by Medhost and remitted to the department. The department filed an answer to the taxpayer's notice of appeal. Following a hearing, the tax tribunal entered a final order on June 13, 2016, concluding that the software products at issue constitute nontaxable custom software and directing the department to issue the taxpayer the requested refund amount, plus applicable interest.

On July 8, 2016, the department filed in the trial court a notice of appeal and a complaint,[1] seeking relief from the

[1]The department named Medhost as a defendant in its notice of appeal and the complaint before the trial court. The trial court later dismissed Medhost as a party following the filing

tax tribunal's order. A hearing was conducted on January 23, 2018, and, on January 26, 2018, the trial court entered a judgment overturning the tax tribunal's order and affirming the department's denial of the taxpayer's refund request. The taxpayer filed a notice of appeal to this court on February 28, 2018.

Facts

Sylvester Williamson, a revenue examiner for the department, testified that, in 2015, the department received a joint petition from the taxpayer and Medhost requesting a refund of approximately $17,000, the amount of sales tax that they asserted had been collected and remitted by Medhost on the purchase price paid by the taxpayer for the purchase of software products. Williamson testified that an audit was scheduled, that he began requesting documents to support the refund petition, and that he had reviewed the documents provided to him. He stated that the invoices provided showed what product or products had been purchased and the amount of the sales tax charged on the purchase price for those

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of a joint motion to dismiss by the department, the taxpayer, and Medhost.

products. According to Williamson, he determined that Medhost offers several software products that it sells to hospitals across the country and that the products purchased by the taxpayer had been standard software products rather than custom software products. Williamson testified that he had informed the taxpayer's representative of his findings and that the representative had responded that, according to Medhost, "coding" had been involved in the purchase of the software products. Williamson stated that all software products contain coding, but, he said, a "canned software" product is sold only after the coding for the product is complete, whereas a custom software product is built and programmed specifically for an individual customer. He stated that a canned software product is tangible personal property and that a custom software product is not because, he said, it involves the purchase of a service rather than a product.

Williamson testified that, considering the taxpayer's representative's response to his findings, it appeared to him that the software products purchased by the taxpayer might have included some customization, but, he said, the software products that were purchased by the taxpayer were standard, or

canned, products that are sold to multiple customers and the customization of the products had taken place after they were purchased by taxpayer. He stated that, based on the department's regulations, if a canned software product is customized after the product is purchased, the customization is nontaxable and the canned portion is taxable. Williamson stated, however, that, because the invoices submitted by the taxpayer included a single purchase price for the canned software and the customization of the canned software, the entire purchase price was taxable. According to Williamson, he had prepared a report in response to the refund petition, concluding that tangible personal property had been sold and that the entire purchase price indicated on each invoice was taxable. He testified that the refund petition was not due to be allowed because he had found nothing that would qualify for a tax exemption. Williamson stated that it was his understanding that Medhost's software products can be taken from one hospital to another and work properly at both facilities.

Bill Anderson, the chairman and chief executive officer of Medhost, testified that Medhost is an "enterprise health

care IT company." He testified that Medhost implements its software products, that each implementation is unique to the customer, but that the implementation does not involve programming. He testified that Medhost has a basic software product, or a number of different software products, and that, although Medhost's software products will work if taken from one hospital to another, the software will be inefficient if it was not customized to the individual customer. As a result, according to Anderson, Medhost makes its software products "highly configurable" to accommodate, as closely as possible, how each hospital conducts its business.

According to Anderson, the implementation of Medhost's software products is separate from the sale of those products and involves the set up of hardware products, including third-party hardware products, and the software products purchased; requires discovery, during which Medhost representatives meet with representatives of the purchasing hospital to learn how that hospital operates; requires the configuring of the purchased software to meet the specific needs of the hospital, which, he stated, does not involve programming; and includes educating the hospital's employees on how the software works.

(R. 66). He stated that, jointly with the purchasing hospital, Medhost performs an inventory of the hospital's hardware and software products and that, typically, it makes adjustments to the software product purchased by the hospital so that it interfaces with the hospital's existing hardware and/or other software products. Anderson testified that implementation of a software product is performed after the purchase of the product by the hospital, and is a service that includes diagnoses of problems, figuring out work flows, and attempting to configure the products to work.

Anderson testified further that, in response to the taxpayer's appeal, he had taken each invoice included in the refund petition, had examined those invoices and the purchase orders related to the items on those invoices, and had categorized them. He stated that "interfacing," as seen on the invoices provided to the department, is a product that Medhost sells for the purpose of configuring third-party products to work with the purchasing hospital's database and that, when Medhost performs interfacing on a third-party's product, the basic software product is not changed. He testified that interfacing is performed as part of the

implementation of the software product after the product is sold to a hospital. According to Anderson, certain of the interfaces are relatively common and are taken off the shelf from Medhost's normal product catalog. He stated that the interfaces are generally available to all of Medhost's customers and that, from a technical standpoint, nothing included in the taxpayer's petition for a refund amounted to customized programming or customized software. He testified further that there were no programmers involved in the implementation of the software products purchased by the taxpayer and that none of the items included in the refund petition involved the implementation of the software products that were purchased.

Anderson stated that Medhost installs all of its products. He also testified that a Medhost customer would have access to the records necessary to install the software products it purchases from Medhost, but, he said, the customer would not have the level of authority in the system to configure the product itself. He stated that it is technically correct that basic software products purchased from Medhost will work from hospital to hospital, but, he

said, Medhost performs a custom implementation of the software to configure the product for a purchasing hospital. He agreed that the software products offered by Medhost are highly configurable, that they can interface with other hardware and software products, and that Medhost's software products are a complex set of software packages and interfaces.

Standard of Review

Section 40-2B-2(m)(4), Ala. Code 1975, provides, in pertinent part, that an appeal to the circuit court from a tax final order of the tax tribunal "shall be a trial de novo, except that the order shall be presumed prima facie correct and the burden shall be on the appealing party to prove otherwise. The circuit court shall hear the case by its own rules and shall decide all questions of fact and law."

> "Our standard of review in cases where the trial court considers oral testimony is well settled.
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> > "'"When evidence is taken ore tenus and the trial judge makes no express findings of fact, [an appellate court] will assume that the trial judge made those findings necessary to support the judgment. Transamerica Commercial Fin. Corp. v. AmSouth Bank, N.A., 608 So. 2d 375, 378 (Ala. 1992) (citing Fitzner Pontiac-Buick-Cadillac, Inc. v. Perkins & Assocs. Inc., 578 So. 2d 1061 (Ala. 1991)). We will not disturb the findings of the

> trial court unless those findings are 'clearly erroneous, without supporting evidence, manifestly unjust, or against the great weight of the evidence.' Gaston v. Ames, 514 So. 2d 877, 878 (Ala. 1987) (citing Cougar Mining Co. v. Mineral Land & Mining Consultants, Inc., 392 So. 2d 1177 (Ala. 1981))....
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> "'"'However, the ore tenus standard of review has no application to a trial court's conclusions of law or its application of law to the facts; a trial court's ruling on a question of law carries no presumption of correctness on appeal.' Ex parte J.E., 1 So. 3d [1002,] 1008 [(Ala. 2008)].... [An appellate court] '"review[s] the trial court's conclusions of law and its application of law to the facts under the de novo standard of review."' Id. (quoting Washington v. State, 922 So. 2d 145, 158 (Ala. Crim. App. 2005))."'
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> "Lemoine Co. of Alabama, L.L.C. v. HLH Constructors, Inc., 62 So. 3d 1020, 1024-25 (Ala. 2010) (quoting Espinoza v. Rudolph, 46 So. 3d 403, 412 (Ala. 2010))."

Boyington v. Bryan, 174 So. 3d 347, 351-52 (Ala. Civ. App. 2014).

Analysis

On appeal, the taxpayer argues that the trial court erred in finding that the software products and the implementation of those products paid for by the taxpayer were "canned software" and not "custom software programming" under Ala.

Admin. Code (Dep't of Revenue), Rule 810-6-1-.37(5). That rule provides:

> "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."

Rule 810-6-1-.37 further provides, in pertinent part:

> "(3) The term 'canned computer software' as used in this regulation shall mean software programs prepared, held, or existing for general or repeated use, including software programs developed in-house and subsequently held or offered for sale or lease. Canned computer software includes all software, except custom software programming, regardless of its function and regardless of whether it is transferred to the purchaser in physical form, via telephone lines, or by another alternative form of transmission.

> "(4) Canned computer software is tangible personal property; and, on and after March 1, 1997, the retail sale or rental of canned computer software is subject to the sales, use, or rental tax, whether such transaction was affected by a transfer of title, or of possession [or] both, or a license to use or consume. Unless specifically stated otherwise, the licensing of canned computer software is considered a retail sale, and not [a] rental, and is subject to sales or use tax. The measure of tax upon which the sales, use, or rental tax is to be computed is the total amount received from the sale or rental of canned computer software to the customer. Wal-Mart Stores, Inc. v. City of Mobile and County of Mobile, [696 So. 2d 290 (Ala. 1996),] Alabama Supreme Court, decided September 13, 1996, substitute opinion released November 27, 1996."

Citing the tax tribunal's order, the taxpayer argues that Rule 810-6-1-.37 was amended following the Alabama Supreme Court's decision in Wal-Mart Stores, Inc. v. City of Mobile, 696 So. 2d 290 (Ala. 1996), to include additional language that, it says, is contradictory to other language in the definition of "custom software programming." In its order in the present case, the tax tribunal stated, in pertinent part:

> "Wal-Mart [Stores, Inc. v. City of Mobile, 696 So. 2d 290 (Ala. 1996),] 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 modified 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'....

"....

"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 programming 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 caselaw 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. In Wal-Mart, the Supreme Court, citing South Central Bell Tel. Co. v. Barthelemy, [643 So. 2d 1240, 1245 (La. 1994)], 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 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.'
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> "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 [taxpayer]. The software thus constitutes nontaxable custom software."

The department argues that it "interprets the regulation as taxing the purchase of computer software but allowing the labor charges for customizing the software to be excluded from the tax if they are separately invoiced."

In Wal-Mart Stores, our supreme court concluded that "'canned' computer software" sold to consumers at Wal-Mart stores is tangible personal property and, thus, is taxable.

696 So. 2d at 291. In reaching its conclusion, the supreme court overruled State v. Central Computer Services, Inc., 349 So. 2d 1160 (Ala. 1977), "[t]o the extent that [it] would dictate a different holding." 696 So. 2d at 291. In Central Computer Services, our supreme court concluded that "computer 'software' is not taxable tangible personal property." 349 So. 2d at 1162. It reasoned that, once the information from the software, recorded at that time on magnetic tapes and punched cards, had been translated and introduced in the computer, what remained in the computer was intangible knowledge and it was that knowledge that had been purchased, rather than the physical tapes and punch cards. Id. In Wal-Mart Stores, however, our supreme court cited South Central Bell Telephone Co. v. Barthelemy, 643 So. 2d 1240 (La. 1994), for the following observation:

> "'The software itself, i.e, the physical copy, is not merely a right or an idea to be comprehended by the understanding. 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, physically recorded on some tangible medium, constitutes a corporeal body.'"

696 So. 2d at 291 (quoting Barthelemy, 643 So. 2d at 1246).

In 1997, the department amended Rule 810-6-1-.37(5), as discussed by the tax tribunal in its final order. We agree with the tax tribunal that "pre-existing routines, utilities, or other program components" must refer to already developed canned software and that canned software that is integrated in a unique way to the specifications of a particular customer constitutes custom software programming. We disagree, however, that the statement in Rule 810-6-1-.37(5) that modifications to canned software is custom software programming only to the extent of the modification contradicts that earlier statement.

Considering the circumstances of the present case as an example, the statement in Rule 810-6-1-.37(5) that "'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" would not apply to the software in the present case. According to Anderson, the software at issue was purchased initially as a product that was available to multiple customers and was later implemented to meet the taxpayer's specifications. Thus, at the time the software was

chosen and purchased by the taxpayer, that software had not been "integrated in a unique way to the specifications" of the taxpayer. To the extent the department appears to argue that such an interpretation of the rule would run afoul of our supreme court's holding in Wal-Mart Stores, we note that our supreme court overruled Central Computer Services only to the extent that it would dictate a different holding in Wal-Mart Stores, which presented the question whether "canned" computer software was taxable. 696 So. 2d at 291. In Wal-Mart Stores, the supreme court considered that, at the time Central Computer Services was decided, the proliferation of canned computer software had not been reasonably anticipated. 696 So. 2d at 291. It noted that "the marketing of such 'canned' software presumes that the information sought [by purchasing the software] will be conveyed by way of a tangible medium." Id. Thus, it concluded, "the merchandiser is making a sale of tangible property, like the sale of the book." Id. In Central Computer Services, however, our supreme court considered specialized computer software, observing that the physical presence of the magnetic tapes and punched cards used to transfer the software was not essential to the transmittal

of the desired information because, it said, the testimony indicated that the software at issue in that case could also be transmitted via telephone to the recipient's computer or transferred from the mind of an employee of the software company. 349 So. 2d at 1162. Thus, the supreme court's decisions in Wal-Mart Stores and Central Computer Services are not mutually exclusive and still allow for the transfer of software not contemplated for transfer via a physical medium that is specially designed for a specific customer.

Rule 810-6-1-.37(5) also provides that "custom software programming" includes services for modifications to a canned computer software program that are prepared to the special order of the customer, but only to the extent of the modification. In the present case, Medhost provided those services, as contemplated by Rule 810-6-1-.37(5), when it implemented its software products to meet the individual needs of the taxpayer. Anderson's testimony is clear that taxes were not charged by Medhost on the implementation of its software. Based on the evidence presented, the trial court properly concluded that the department met its burden of proving that the tax tribunal's decision was incorrect and

that the taxpayer's refund petition was due to be denied. Accordingly, we affirm the trial court's judgment.

AFFIRMED.

Thompson, P.J., and Pittman, Thomas, and Donaldson, JJ., concur.