Alabama Justices Clear On Taxing Software, But Issues Remain

By Maria Koklanaris

Law360 (May 24, 2019, 7:14 PM EDT) -- An Alabama Supreme Court decision holding that all software is tangible personal property subject to sales and use tax provides clarity in its result, but leaves a wake of unanswered questions.

The court recently ruled that custom software, like canned software, is subject to sales and use tax, rebuffing a hospital’s contention that it was owed a refund on its purchase of software because the software was part of “custom software programming” services. The court also said that programming services, unlike software, would not be taxable. However, the ruling did not clarify how businesses should differentiate such transactions in their invoices.

“We hold that all software, including custom software created for a particular user, is 'tangible personal property' for purposes of Alabama sales tax,” the court said in its May 17 ruling. “There are, however, nontaxable services that can accompany the conveyance of software.”

The decision is garnering attention as businesses and states continue to tangle with what is and is not taxable for software and other digital products as commerce moves increasingly to the internet. Many states exempt custom software because customization is considered a service, but that may change if, like the Alabama court, states characterize custom software as a tangible — and taxable — goods apart from customization as a nontaxable service.

While the Alabama justices didn’t have to go as far as they did, said Bruce Ely of Bradley Arant Boult Cummings LLP, they clearly sought to separate the taxation of software itself from software programming. And in making their provocative ruling, the Alabama justices provided an argument other states could follow.

“The court was likely aware of the ongoing disputes between taxpayers and [tax agencies] over what is and isn’t taxable in this area,” Ely said. “It’s very likely that the court will follow this ruling in future disputes, as will our lower courts and the tax tribunal. Other state taxing authorities will certainly cite it as persuasive authority.”

The court in Alabama was building on another Alabama Supreme Court decision from 23 years ago, Walmart Stores v. City of Mobile. In that case, the court decided that software sold at Walmart was tangible personal property. Decades later, the court may have declared all software as taxable to answer the question for businesses tangling with tax agencies, particularly since state tax law does not provide an answer, and there is only a regulation for guidance.

The case points to the struggle states have had in determining how to tax software. The issue is complex, and because legislators are often unsure how to deal with it, they simply have preferred not to. But sometimes tax agencies take the lead, as Alabama did, noted Richard Cram, director of the national nexus program for the Multistate Tax Commission. As a result, questions of taxability wind up in the courts.

“The difficulty comes when states try to administratively tax before legislators adopt statutes,” Cram said.
That leads to many gray areas. For example, the Alabama high court didn’t say whether its holding that custom software is taxable tangible personal property could be applied retroactively. The court also left open to interpretation how far businesses can go to avoid tax on custom software.

In an opinion concurring with the majority on the result, Justice Greg Shaw cautioned that the state Legislature should get involved to prevent what he called “artful invoicing,” in which businesses can decide if they will label custom software as software — taxable — or programming services — not taxable. Justice Michael Bolin said he was concerned as well.

“I write specially to encourage the Legislature to clarify how a transaction involving software and services is to be documented and invoiced,” Justice Bolin said. “It should not be left to private entities to determine the taxability of a transaction for the state of Alabama.”

And the ruling did not address how to tax software as a service, known as SaaS, a variety of cloud computing in which internet users can access applications on a provider’s server. Sixteen states and the District of Columbia tax SaaS. Up to now, Alabama has not taxed SaaS, but the high court’s ruling could spur the state, and others not now taxing SaaS, to take another look.

“We’ll have to see how broadly the department decides to interpret the case,” said Diane Yetter of Yetter Tax, who founded the Sales Tax Institute. “I’m guessing they will take the opportunity to interpret it broadly in a regulation to state that all software including SaaS is taxable.”

But states should be cautious about reading too much into the ruling, said Carolynn Kranz of Kranz & Associates PLLC and Industry Sales Tax Solutions. She said she thought that the court reached the correct conclusion in affirming that the software in question was taxable, but that its larger conclusion was a bridge too far. Kranz took issue with characterizing the software as "custom," saying that even when software requires a great deal of customization, the underlying software is still canned software.

Said Kranz: “I think they should have rendered that [the software] was canned and therefore taxable. Not that it was custom software and therefore custom software is taxed.”

--Editing by Tim Ruel and John Oudens.