

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #98-17**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of sales and use tax to charges for consulting and computer programming services.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[THE TAXPAYER], is a corporation located in Tennessee which provides various services designed to assist its clients in purchasing and setting up software products which are provided by third party vendors. The software packages are purchased by the client directly from the third party vendor, and may be custom made or off-the-shelf depending on the needs of the client. Although the software package is purchased from a third party, in certain cases the taxpayer will provide supplemental programming designed to support the software or integrate it into the client's computer system. The charges for this supplemental programming will generally be much less than the total charges for other services and less than 5% of the purchase price of the third party software.

Depending on the needs of the client, some or all of the following services will be provided by the taxpayer:

- 1) Feasibility Studies -- Looking at a business issue and seeing if a particular class of information systems will address the issue.
- 2) Project Planning -- Laying out the tasks to be accomplished and determining the resources to accomplish the tasks.
- 3) Vendor Selection -- Requesting and/or reviewing bids for a given system or choosing an organization to build the system.
- 4) Product Review -- Review of a product to see if it addresses the company's business requirements.
- 5) Design -- The analysis of user needs and translating those needs into instructions for technical personnel to use in programming.
- 6) Programming -- Writing programs or command language scripts to support or integrate third party software in the client's computer system.
- 7) Development of forms, spreadsheets, or documents -- For client use in addressing repetitive business needs.
- 8) Testing -- Testing of programs or products to see if they perform required functions and/or properly conform to design specifications. Ensuring the products address the business issues for which they are developed or purchased.

- 9) Installation -- Installing the product in the company's business environment.
- 10) Training -- Conducting training for a given product or products to be used by a company in addressing its business requirements.
- 11) Documentation -- Development of documentation, user instructions, or guidelines for use of an information system or information tool.
- 12) Status Reporting -- Reporting to management of the status of one or more of the tasks noted above.

Under the contract with its clients, the taxpayer agrees to provide "contract services for the purpose of managing or executing projects or tasks, selecting software or hardware, or development of systems solutions to business needs." The specific services to be provided are not set out in the contract. It appears that the client can choose the services which fit its needs as the contract progresses, with no obligation to purchase particular services. Regardless of which services are provided, the taxpayer bills its client an hourly fee plus expenses such as travel and meals. Thus, no set contract price exists.

QUESTIONS

1. Which of the described activities are subject to sales and use tax?
2. For those activities which are taxable, which local tax rate will apply, that of the county in which the activities took place or that of the county in which the taxpayer is located?
3. For purposes of applying the local option tax, will the single article cap apply to the total fee? If not, will each type of service be considered a single article?

RULINGS

1. Programming constitutes the sale of customized software, which is a taxable sale of tangible personal property. Installation of software is a taxable service. Under the particular facts provided, the following are nontaxable services: feasibility studies, project planning, vendor selection, product review, testing, training, documentation, status reporting, and development of forms, spreadsheets, or documents. Design, as described in the facts, is taxable only if it is performed as part of the development and sale of programming by the taxpayer to its client.

2. Taxable sales, both the sale of tangible personal property and taxable services, are subject to local tax where the taxpayer's place of business is located, regardless of whether the sales were technically made inside or outside of that locality. The applicable tax rate will be the rate imposed by that locality.

3. The taxpayer provides customized software and consulting services. The single article cap does not apply to customized software, nor does it apply to services. Thus, the single article cap will not apply to any of the taxpayer's charges.

ANALYSIS

1. Retail sales in Tennessee are subject to sales and use tax under T.C.A. §67-6-101 et. seq. T.C.A. §67-6-102(23)(A) defines a retail sale to include a "taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose other than resale." Also subject to tax are "any services that are a part of the sale of tangible personal property...." T.C.A. §67-6-102(25).

In some instances the taxpayer will provide its client with computer programming services designed to support third party software or integrate that software into the client's computer system. The term "sale" is defined to include:

[the] transfer of customized or packaged computer software, which is defined to mean, information and directions loaded into a computer which dictate different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property; however, the fabrication of software by a person for such person's own use or consumption shall not be considered a taxable "use"....

T.C.A. §67-6-102(24)(B). The customization or modification of the client's computer software is a sale within the definition set forth in this section. *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986). Thus writing programs or command language scripts to support or integrate third party software within the client's computer system constitutes a taxable sale of tangible personal property from the taxpayer to its client.

The taxpayer also develops forms, spreadsheets, and other documents for client use in performing repetitive tasks. To accomplish this the taxpayer uses existing software to set up a spreadsheet or other document which the client can use to perform a task, and the client can use the document again and again. This does not constitute the creation of software and is not a sale of tangible personal property. Whether this is a taxable service is discussed below.

T.C.A. §67-6-102(23)(F) lists the following services as specifically subject to tax in Tennessee:

- (i) The sale, rental, or charges for any rooms lodgings or accommodations furnished to transients by any hotel, inn, tourist court, tourist camp . . .
- (ii) Charges for services rendered by persons operating or conducting a garage, parking lot, or other place of business for the purpose of parking or storing motor vehicles . . .
- (iii) The furnishing, for a consideration, of either intrastate or interstate telecommunication services . . .
- (iv) The performing for a consideration of any repair services . . .
- (v) The laundering or dry cleaning of any kind of tangible personal property . . .
- (vi) The installing of tangible personal property which remains tangible personal property after installation . . .
- (vii) The enriching of uranium materials . . .
- (viii) The renting or providing of space to a dealer or vendor without a permanent location in this state . . .
- (ix) Charges for warranty or service contracts . . .

Under the facts, one service provided by the taxpayer is installation of software into the client's computer system. Software is defined by statute as tangible personal property under T.C.A. §67-6-102(24)(B) and remains tangible personal property after installation. Therefore, any charge made for the installation of software is subject to tax under T.C.A. §67-6-102(23)(F)(vi).

Other than the installation of tangible personal property, the taxpayer does not engage in any of the activities listed in the statute. Consequently, the other services provided by the taxpayer are not specifically subject to tax in Tennessee.

It should be noted, however, that in certain cases otherwise nontaxable consulting services may become subject to tax if they are performed as part of the sale of tangible personal property. T.C.A. §67-6-102(25); *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 623 (Tenn. 1987). This applies only to services rendered by the seller of the tangible personal property, as a part of the sale to the purchaser. *The Austin Company v. Woods*, 620 S.W.2d 73, 76 (1981). It does not include services rendered by a third party to the sale. *Id.* Therefore, services rendered by the taxpayer which relate to the sale of software from a third party vendor to the client remain nontaxable. Whereas, any services which are a part of the sale of programming from the taxpayer may become taxable.

“Design” is the only service described in the facts which may be a part of the sale of programming from the taxpayer. “Design” is described as “the analysis of user needs and translating those needs into instructions for technical personnel

to use in programming.” If this refers to programming performed by the taxpayer, then it appears to be a part of the process of developing the program for sale, thus making it taxable as a part of the sale of tangible personal property from the taxpayer to the client. If, on the other hand, this service relates to the purchase of customized software from a third party, then it remains nontaxable.

With respect to the remaining services, it appears the client can choose those which fit its needs as the contract progresses, with no obligation to purchase particular services. The taxpayer simply bills the client at a specified rate for whichever services are requested. These services are not considered part of the sale of programming by the taxpayer because the client can purchase them, or not, as it deems necessary. There is no requirement that any of these services be purchased in order to receive the tangible personal property.

Where the sale of nontaxable services is combined with either the sale of taxable services or the sale of tangible personal property, charges for nontaxable services must be separately identified in order to be removed from the tax base.

2. The Local Option Revenue Act authorizes counties and incorporated towns and cities to impose sales and use taxes “on the same privileges subject to this chapter as the same may be amended, which are exercised within such county, city or town.” T.C.A. §67-6-702(a)(1). Local taxes are thus authorized to be imposed on the same transactions and in the same manner as state taxes are imposed.

At issue is which locality may impose the local tax. The incidence of the local option tax is upon the privilege of engaging in retail sales. *Pidgeon-Thomas Iron Company v. Garner*, 495 S.W.2d 826, 830 (Tenn. 1973). Taxable sales, both the sale of tangible personal property and taxable services, are thus subject to local tax in the locality in which the taxpayer’s place of business is located, regardless of whether the sales were technically made inside or outside of that locality. *Id.*; TENN. COMP. R & REGS. 1320-5-2-.05. Also, the applicable tax rate will be the rate imposed by that locality.

3. The additional sales and use tax which may be levied by local governments is limited in application to the first one thousand six hundred dollars (\$1,600) on the sale or use of any single article of personal property. T.C.A. §67-6-702(a)(1). A “single article” is “that which is regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit or as a common unit of measure, a regular billing or other obligation. Such independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article.” T.C.A. §67-6-702(d).

In some cases the taxpayer sells software to its customers. This software is customized rather than off-the-shelf. While software clearly constitutes tangible

personal property, customized software is not subject to the single article cap. By its very nature, customized software is designed specifically for the need of an individual customer. There is neither a common understanding of the customized software as a separate unit, nor is it subject to a common unit of measure. Accordingly, customized software does not fall within the parameters of the definition of a "single article."

The taxpayer also provides services. The Court of Appeals has held that services are not subject to the single article cap. *Colemill Enterprises, Inc. v. Huddleston*, No. 01-A-01-9605-CH-00218, 1996 Lexis 769 (Tenn. Ct. App. December 4, 1996). In so holding, the Court stated, "The legislature has expressly limited the \$1,600 cap only to the sale or use of personal property and, by doing so, authorized local governments to tax the full price charged for those services identified as taxable by title 67, chapter 6." *Id.*

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APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: 3-17-98