

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 15-07

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The application of the Tennessee sales and use tax to remotely accessed software.

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

[REDACTED – TAXPAYER'S NAME] (the "Taxpayer") is a company located in [REDACTED], Tennessee, that assists in the management of its clients' (the "Client" or "Clients") [SPECIFIED DOCUMENTS] through an offering of [REDACTED -DESCRIPTION OF BUSINESS SOLUTIONS].

The Taxpayer offers [REDACTED] packages, a Subscription Package and a [BUSINESS PROCESS OUTSOURCING] Package (“[BUSINESS PROCESS OUTSOURCING] Package”). Through both packages, the Taxpayer grants a non-exclusive, non-transferable right to access and use its proprietary software. The Taxpayer hosts the software on its own servers, which the Clients access over the Internet from locations within Tennessee. The Taxpayer bills its Clients for either package monthly, quarterly, or annually, depending on the terms of the contract with the particular Client.

Subscription Package

Under its Subscription Package, the Taxpayer licenses its proprietary software to the Client. The Client accesses the software via a web portal with a username and password. The software provides the Client with a central depository to view [SPECIFIED DOCUMENTS] and permits the Client to [REDACTED - DESCRIPTION OF VARIOUS ACTIONS]. To achieve this result, the Client’s [REDACTED] information is uploaded into the software, along with the [SPECIFIED DOCUMENTS] on a monthly basis. Typically, these [SPECIFIED DOCUMENTS] are received in an electronic format and automatically uploaded to the software. However, if the Taxpayer receives a paper [SPECIFIED DOCUMENT], the Taxpayer scans the [SPECIFIED DOCUMENT] into an electronic format and uploads it to the software.

Upon the upload of [SPECIFIED DOCUMENTS], the software automatically populates key data fields, such as [REDACTED]. Clients typically use the software to [REDACTED – DESCRIPTION OF VARIOUS ACTIONS].

[REDACTED].

[BUSINESS PROCESS OUTSOURCING] Package

Under the [BUSINESS PROCESS OUTSOURCING] Package, the Taxpayer provides the Clients with the identical proprietary software that it provides under the Subscription Package; however, the Taxpayer provides services under the [BUSINESS PROCESS OUTSOURCING] Package that the Client would perform itself under the Subscription Package, including [REDACTED - DESCRIPTION OF VARIOUS ACTIONS]. Although the Client maintains access to the software under the [BUSINESS PROCESS OUTSOURCING] Package, it rarely, if ever, uses the software for more than generating a report.

RULING

1. Are the Taxpayer’s charges for the Subscription Package subject to Tennessee sales and use tax?

Ruling: Yes, the Taxpayer’s Subscription Package is subject to the Tennessee sales and use tax as remotely accessed software.

2. Are the Taxpayer’s charges for the [BUSINESS PROCESS OUTSOURCING] Package subject to the Tennessee sales and use tax?

Ruling: No, the Taxpayer's [BUSINESS PROCESS OUTSOURCING] Package is not subject to the Tennessee sales and use tax. Although the [BUSINESS PROCESS OUTSOURCING] Package includes both remotely accessed software and services, the true object of the [BUSINESS PROCESS OUTSOURCING] Package is the provision of nontaxable [BUSINESS PROCESS] management services.

ANALYSIS

LEGAL BACKGROUND

Under the Retailers' Sales Tax Act,¹ the retail sale in Tennessee of tangible personal property and specifically enumerated services are subject to the sales and use tax, unless an exemption applies. "Retail sale" is defined as "any sale, lease, or rental for any purpose other than for resale, sublease, or subrent."²

TENN. CODE ANN. § 67-6-102(78)(A) (Supp. 2015) defines "sale," in pertinent part, to mean "any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever of tangible personal property for a consideration." "Tangible personal property" includes "property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses."³ Tangible personal property also includes "prewritten computer software," which is defined in TENN. CODE ANN. § 67-6-102(68) in pertinent part as "computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser."⁴

In addition to the transfer of tangible personal property, the term "sale" also includes "the furnishing of any of the things or services" taxable under the Retailers' Sales Tax Act.⁵ One of the "things" specifically taxable is:

[t]he retail sale, lease, licensing or use of computer software in this state, including prewritten and custom computer software . . . regardless of whether the software is delivered electronically, delivered by use of tangible storage media, loaded or

¹ Tennessee Retailers' Sales Tax Act, Ch. 3, §§ 1-18, 1947 Tenn. Pub. Acts Ch. 22, §§ 22-54 (codified as amended at TENN. CODE ANN. §§ 67-6-101 to -907 (2013 & Supp. 2015)).

² TENN. CODE ANN. § 67-6-102(76) (Supp. 2015).

³ TENN. CODE ANN. § 67-6-102(89)(A).

⁴ TENN. CODE ANN. § 67-6-102(68) further provides that "[p]re-written computer software' or a pre-written portion of the computer software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software." Note, however, that "where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for the modification or enhancement, the modification or enhancement shall not constitute prewritten computer software." *Id.*

⁵ TENN. CODE ANN. § 67-6-102(78)(C).

programmed into a computer, created on the premises of the consumer or otherwise provided.⁶

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”⁷ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”⁸ The Tennessee Supreme Court has stated that the fabrication of, or customized modification or enhancement to, computer software is considered a taxable sale of computer software.⁹

Additionally, the term “sale” specifically includes the transfer of computer software, including the creation of computer software on the premises of the consumer and any programming, transferring, or loading of computer software onto a computer.¹⁰

In response to advances in technology that allow the remote access and use of software over the Internet, the Tennessee General Assembly adopted into law 2015 Tenn. Pub. Acts Ch. 514, § 22. This new law effectively treats all uses of computer software in this state equally, regardless of how a person accesses the software. It amends TENN. CODE ANN. § 67-6-231(a) to include a new subdivision (2), which states in pertinent part that

[f]or purposes of subdivision (a)(1), “use of computer software” includes the access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer. If the customer accesses the software from a location in this state as indicated by the residential street address or the primary business address of the customer, such access shall be deemed equivalent to the sale of licensing of the software and electronic delivery of the software for use in the state.¹¹

As a result, effective for all billing periods beginning on or after July 1, 2015, the access and use of computer software in this state, which has generally been subject to tax since 1977,¹² remains subject to sales and use tax regardless of a customer’s chosen method of use.

⁶ TENN. CODE ANN. § 67-6-231(a) (2013). The term “sale” specifically includes the transfer of computer software, including the creation of computer software on the premises of the consumer and any programming, transferring, or loading of computer software onto a computer. TENN. CODE ANN. § 67-6-102(78)(K).

⁷ TENN. CODE ANN. § 67-6-102(18).

⁸ TENN. CODE ANN. § 67-6-102(24).

⁹ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

¹⁰ TENN. CODE ANN. § 67-6-102(78)(K).

¹¹ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

¹² The General Assembly amended the definition of “tangible personal property” in 1977 to specifically include computer software in response to the Tennessee Supreme Court’s holding to the contrary in *Commerce Union Bank*, 538 S.W.2d at 408. 1977 Tenn. Pub. Acts Ch. 42 (defining “tangible personal property” to include computer software); see also *Univ. Computing Co. v. Olsen*, 677 S.W.2d 445, 447 (Tenn. 1984) (detailing the General Assembly’s actions taken to subject computer software to sales and use tax).

The sales and use tax also applies to retail sales of services specifically enumerated in the Retailers' Sales Tax Act.¹³ Notably, the application of the sales tax to retail sales of services in Tennessee remains unaffected by the enactment of 2015 Tenn. Pub. Acts Ch. 514, § 22. The sales tax remains applicable only to those services specifically enumerated in the Retailers' Sales Tax Act.¹⁴ As reassurance of this fact, the General Assembly included language in Section 22 stating that nothing in the new subdivision (a)(2) of TENN. CODE ANN. § 67-6-231

shall be construed to impose a tax on any services that are not currently subject to tax under this chapter, such as, but not limited to, information or data processing services, including the capability of the customer to analyze such information or data provided by the dealer; payment or transaction processing services; payroll processing services; billing and collection services; Internet access; the storage of data, digital codes, or computer software; or the service of converting, managing, and distributing digital products.¹⁵

Therefore, while the new TENN. CODE ANN. § 67-6-231(a)(2) modernizes taxation on the use of computer software in this state, it has no effect on the taxation of services.

Additionally, whenever two or more items are sold for a single sales price and at least one of the items is subject to sales tax, the entire sales price is subject to the sales tax as a bundled transaction.¹⁶ Finally, when a transaction involves taxable and nontaxable components and the transaction's true object or a "crucial,"¹⁷ "essential,"¹⁸ "necessary,"¹⁹ "consequential,"²⁰ or "integral"²¹

¹³ The Retailers' Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. *See, e.g.,* TENN. CODE ANN. § 67-6-205 (2013); *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994) (sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹⁴ The Retailers' Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. *See, e.g.,* TENN. CODE ANN. § 67-6-205 (2013); *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994) (sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹⁵ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

¹⁶ *See generally* Tenn. Dept. of Rev. Ltr. Rul. 14-10 (Oct. 14, 2014) [hereinafter "Ltr. Rul. 14-10"] (discussing Tennessee law regarding bundling and the "true object" test), *available at* <http://www.tennessee.gov/assets/entities/revenue/attachments/14-10.pdf>.

¹⁷ *See, e.g., Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 624 (Tenn. 1987) (holding that a transaction involving the sale of non-taxable intangible advertising concepts was nevertheless subject to sales tax on the entire amount of the transaction because advertising models, which were tangible personal property, were an "essential," "crucial," and "necessary" element of the transaction).

¹⁸ *Id.*; *see also AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *8 (Tenn. Ct. App. Oct. 8, 2002) (holding that a transaction involving the sale of engineering services along with separately itemized tangible telecommunications systems was subject to sales tax on the entire amount of the contract because

element of the transaction is subject tax, the entire transaction is subject to sales tax.²² Only if the true object of the transaction is not independently subject to sales tax and the items that would be subject to sales tax are “merely incidental” to the true object of the transaction will the transaction not be subject to sales tax.²³

APPLICATION

1. SUBSCRIPTION PACKAGE

The Taxpayer’s Subscription Package is subject to the Tennessee sales and use tax.

Prior to the enactment of 2015 Tenn. Pub. Acts Ch. 514, § 22, effective July 1, 2015, no sale, transfer, or electronic delivery of tangible personal property or computer software occurred in Tennessee when the Taxpayer charged its Clients for the Subscription Package. However, the Taxpayer’s Subscription Package now constitutes a taxable sale as remotely accessed software.

With respect to the taxable use in this state of computer software that remains in possession of the dealer, TENN. CODE ANN. § 67-6-231(a)(2) requires the access and use of the computer software by a customer within this state. The Taxpayer’s software is a set of coded instructions that enables a computer to perform a task and, thus, constitutes computer software for Tennessee sales and use tax purposes.²⁴ The Taxpayer’s software is housed on its own server, but the Clients use this software to manage their [REDACTED - BUSINESS PROCESS] from within Tennessee.

Analysis under the principles set forth in the “true object” test is unnecessary because the sole value of the Subscription Package is the access to the software.

Accordingly, the Subscription Package is subject to the Tennessee sales and use tax as remotely accessed software.

“equipment, engineering, and installation combine in this instance to produce BellSouth’s desired result: a functioning item of tangible personal property assembled on the customer’s premises,” and further describing the engineering services as “essential” and “integral” to the sale of tangible personal property).

¹⁹ See *supra* note 18.

²⁰ See *Rivergate Toyota, Inc. v. Huddleston*, No. 01A01-9602-CH-00053, 1998 WL 83720, at *4 (Tenn. Ct. App. Feb. 27, 1998) (holding that a transaction involving the commission and distribution of advertising brochures was subject to sales tax on the “entire cost of the transaction” because, although the transaction involved a number of services, the brochures themselves “were not inconsequential elements of the transaction but, in fact, were the sole purpose of the contract”).

²¹ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²² See generally *Ltr. Rul. No. 14-10*, *supra* note 16.

²³ See generally *id.*

²⁴ The Taxpayer does not provide nontaxable data processing services through its Subscription Package. Instead, the Clients use the Taxpayer’s data processing software to process information contained in their [SPECIFIED DOCUMENTS].

2. [BUSINESS PROCESS OUTSOURCING] PACKAGE

The Taxpayer's [BUSINESS PROCESS OUTSOURCING] Package is not subject to the Tennessee sales and use tax.

The [BUSINESS PROCESS OUTSOURCING] Package includes both the provision of [REDACTED - BUSINESS PROCESS] management services and access over the Internet to the Taxpayer's proprietary software. However, the Clients' access of the software is merely incidental or secondary to the primary purpose of outsourcing the Clients' [REDACTED - BUSINESS PROCESS] management operations whereby the Taxpayer [REDACTED = DESCRIPTION OF VARIOUS ACTIONS]. The value of the [BUSINESS PROCESS OUTSOURCING] Package is in avoiding the need to use the Taxpayer's software, and to this end, the Taxpayer is the ultimate user of the software. Thus, the true object of the transaction is the provision of nontaxable services.²⁵

Accordingly, the [BUSINESS PROCESS OUTSOURCING] Package is not subject to the Tennessee sales and use tax.

Grant Marshall
Assistant General Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: November 23, 2015

²⁵ See, e.g., *Nashville Mobilphone Co., Inc. v. Woods*, 655 S.W.2d 934, 937 (Tenn. 1983) (providing that merely using otherwise taxable items in order to furnish a service does not alone subject the transaction to sales and use tax if the primary purpose of the sale is nontaxable); *Equifax Check Services, Inc. v. Johnson*, No. M1999-00782-COA-R3-CV, 2000 WL 827963 at *3 (Tenn. Ct. App. June 27, 2000) (same).