

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 16-02**

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

Application of the Tennessee sales and use tax to the provision of [REDACTED] 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 ruling herein is binding upon the Department and is 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

[TAXPAYER] (the "Taxpayer") [REDACTED] delivers [REDACTED - ELECTRONICALLY GENERATED PRODUCTS] on behalf of its clients and provides [REDACTED - RELATED SERVICE] functions to its clients [REDACTED]. With respect to the [REDACTED - DELIVERY AND USE] of [REDACTED - ELECTRONICALLY GENERATED PRODUCTS], a client may use a web-based interface to [REDACTED - DESCRIPTION OF USES]. The Taxpayer stores the software, proprietary information, and customer information used for these purposes on servers located in [REDACTED - STATES].

The Taxpayer's core business functions are delivering [REDACTED - ELECTRONICALLY GENERATED PRODUCTS] and using data-gathering tools [REDACTED] to create [REDACTED] reports for clients (the "Basic Package"). Clients pay a [REDACTED] fee based on [REDACTED].¹ The Taxpayer has developed proprietary software that facilitates or automates these core functions, including a web-based interface (the ["WEB-BASED INTERFACE"]) that allows clients to efficiently interface with the Taxpayer's in-house system. Clients use the [WEB-BASED INTERFACE] to [REDACTED - DESCRIPTION OF USES].

The [WEB-BASED INTERFACE] contains a [LAYOUT DESIGN SYSTEM] that enables users to create [REDACTED - ELECTRONICALLY GENERATED PRODUCTS] themselves in a format that can be sent automatically. Using the [LAYOUT DESIGN SYSTEM], clients can [REDACTED - DESCRIPTION OF SPECIFIC USES OF THE LAYOUT DESIGN SYSTEM].

Clients use the [WEB-BASED INTERFACE] to specify when and to whom to send the [REDACTED - ELECTRONICALLY GENERATED PRODUCTS] and may upload and manage their [REDACTED - CLIENT OWNED INFORMATION] on the Taxpayer's system. [REDACTED].

Finally, clients use the [WEB-BASED INTERFACE] to access [REDACTED] data and analysis generated and compiled by the Taxpayer through its proprietary software. [REDACTED].

The Taxpayer exercises control over the [REDACTED] information gathered and made available through [REDACTED]. The Taxpayer's employees determine what information is collected, how that information is best analyzed, and what information is automatically reported to clients through the [WEB-BASED INTERFACE]. [REDACTED].

RULING

Are the Taxpayer's charges for its Basic Package subject to Tennessee sales and use tax?

Ruling: No, the Taxpayer's charges for its Basic Package are not subject to the Tennessee sales and use tax. Although the Basic Package involves the use of software, the true object of the Basic Package transaction is the provision of nontaxable [REDACTED] services.

¹ In addition to these core functions, the Taxpayer gives its clients the option to purchase a number of specific, related services. The Taxpayer's personnel perform these services for separate specified fees. [REDACTED].

ANALYSIS

LEGAL BACKGROUND

Under the Retailers' Sales Tax Act,² the retail sale in Tennessee of tangible personal property and specifically enumerated services is subject to the sales 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."³

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

² 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)).

³ TENN. CODE ANN. § 67-6-102(76) (Supp. 2015).

⁴ "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." TENN. CODE ANN. § 67-6-102(89)(A). With regard to prewritten computer software, TENN. CODE ANN. § 67-6-102(68) provides that "[p]rewritten computer software' or a prewritten 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." TENN. CODE ANN. § 67-6-102(68).

⁵ TENN. CODE ANN. § 67-6-102(78)(C).

⁶ TENN. CODE ANN. § 67-6-231(a)(1) (Supp. 2015). 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).

“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 persons to remotely access and use software over the Internet, the Tennessee General Assembly adopted into law 2015 Tenn. Pub. Acts Ch. 514, § 22 (effective July 1, 2015). This new law effectively treats all purchases of computer software in this state equally, regardless of how the software is provided to and used by a purchaser in this state. 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.

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

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).

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 sales tax as a bundled transaction. Finally, when a transaction involves taxable and nontaxable components and the transaction's true object or a "crucial,"¹⁶ "essential,"¹⁷ "necessary,"¹⁸ "consequential," or "integral" element of the transaction is subject to tax, the entire transaction is subject to sales tax. Only if the true object of

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, 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).

¹⁷ *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 "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).

¹⁸ *See supra* note 12.

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.

APPLICATION

The Taxpayer’s charges for the Basic Package are not subject to the Tennessee sales and use tax.

The Basic Package provides the customer with [REDACTED – ELECTRONICALLY GENERATED PRODUCT] services. With respect to the taxable use of computer software in this state 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. Here, as part of its Basic Package, the Taxpayer provides its clients with web-based access to its [WEB-BASED INTERFACE], which facilitates the Taxpayer’s core functions at no separate charge. The Taxpayer’s [WEB-BASED INTERFACE] constitutes computer software for Tennessee sales and use tax purposes,¹⁹ and the [WEB-BASED INTERFACE] is accessed by the Taxpayer’s clients from locations within Tennessee. A client’s use of the [WEB-BASED INTERFACE] software, however, is merely incidental to the true object of the Basic Package.

With the Basic Package, the Taxpayer generates [REDACTED – ELECTRONICALLY GENERATED PRODUCTS]. [REDACTED].

The Taxpayer uses [RELATED] data to generate reports and produce analytics that it then relays to its clients through use of the [WEB-BASED INTERFACE]. [REDACTED – DESCRIPTION OF USES].

Importantly, however, clients do not purchase the Basic Package in order to access the [WEB-BASED INTERFACE]. Rather, clients purchase the Basic Package to outsource [REDACTED – THE DELIVERY OF ELECTRONICALLY GENERATED PRODUCTS] and to receive the reports and analytics produced from [REDACTED]. The purpose of the [WEB-BASED INTERFACE] is merely to facilitate communication between the clients and the Taxpayer about the [REDACTED – ELECTRONICALLY GENERATED PRODUCTS], and it only incidentally allows clients to use the [REDACTED - WEB-BASED INTERFACE].

Accordingly, the true object of the Basic Package transaction is the provision of [REDACTED] services, *i.e.*, the delivery of [REDACTED – ELECTRONICALLY GENERATED PRODUCTS] and the creation of [RELATED] reports.

With respect to the sale of services in Tennessee, only specifically enumerated services are subject to tax under the Retailers’ Sales Tax Act. The Taxpayer’s [REDACTED] services, which are the true object of the Basic Package transaction, are not specifically enumerated under TENN. CODE ANN. § 67-6-205.

Accordingly, the Taxpayer’s charges for its Basic Package are not subject to the Tennessee sales and use tax.

¹⁹ See TENN. CODE ANN. § 67-6-102(18).

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APPROVED: Richard H. Roberts
Commissioner of Revenue

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