

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 05-09**

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

Whether contracts for the sale and installation of certain refrigeration systems are for the improvement of real property. Also, whether warranty contracts for maintenance and repair of the refrigeration systems are for maintenance of real property.

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 his detriment.

FACTS

The Company operates [STORES] in Tennessee and some other locations. The Company sells a variety of general merchandise, including food and other household products, at wholesale and retail. A typical [STORE] also includes a full-service bakery, a fresh meat-cutting department, a service deli, and a food court.

Certain food products prepared on-site or purchased for resale require a temperature-controlled environment. For this purpose, the Company enters into contracts with a Contractor to manufacture, construct, and install refrigeration systems, together with certain partitions, enclosures, and rooms, in each of the Company's [STORES] and central distribution depots.

The systems installed by Contractor at one of the Company's sites typically include a combination of walk-in coolers, walk-in freezers, other refrigerated rooms (meat/deli prep rooms; fresh produce room), and refrigerated display cases. Contractor designs, manufactures, and constructs the various enclosures and display cases, along with the associated refrigeration equipment, piping, and electrical wiring and equipment. Many of the refrigeration systems for these various areas are interconnected for optimal functioning of the refrigeration equipment. None of the units for which this ruling is sought is entirely self-contained.¹ Each is connected by coolant piping to refrigeration equipment located on the roof or elsewhere in the building and wired directly into the building's main electrical system (as opposed to being merely "plugged in"). The cooling systems function similarly to central air conditioning, using a "loop system," but are separate from the HVAC system that serves the normal air conditioning needs of each building.

Contractor contracts directly with the Company for this work rather than acting as a subcontractor to the building general contractor. Contractor's contracts may involve the remodeling of an existing building or system or the installation of enclosures and refrigeration systems in a building under construction. Under either type of contract, Contractor agrees to "design, build and install" the necessary enclosures, display cases, and associated refrigeration systems. Components are specifically selected and assembled on site according to the architectural design of, and the Company's business plans for, each building. As part of its service, Contractor consults with the building's architect to determine how each mechanical component should be located and affixed to the building, given the architect's general design for the building. Contractor also routes and installs the necessary piping to carry coolant throughout the building, between each refrigerated area and the remotely located refrigeration equipment. Contractor's contracts also call for it to install all necessary electrical wiring and equipment to serve the cooling systems and cooled enclosures from the building's main electrical system installed by the electrical

¹ Contractor also supplies and services various "self contained" refrigerated cases, such as floral cases and pie cases. Unlike the systems that are the subject of this ruling request, the "self-contained" cases are not integrated into the building refrigeration and electrical systems. The Company acknowledges that the sale of such "self-contained" cases constitutes a taxable sale of tangible personal property, including any amounts charged for installation.

contractor. Contractor typically prepares detail drawings showing these design features and showing the construction details for affixing each system element to the building. Construction/building permits (and associated local-government building inspections) are required for Contractor's work, whether for a new building, for a renovation to an existing building, or for removal of one of these systems from a building.

The labor and services provided by Contractor include setting, joining, and piping all refrigeration cases; setting and piping all compressors in machine rooms and on building roofs; hanging and piping all coils in coolers and walk-in freezers; furnishing and installing all refrigeration tubing, fittings, hangers, and insulation; furnishing all necessary refrigerant, valves, and accessories for complete installation; furnishing all labor to complete installation; running coil drains to floor drains; providing crane service; and securing the necessary building permits for the work performed by Contractor. Other contractors install the floor drains and perform any trenching, backfill, concrete and carpentry work required in connection with Contractor's work. Permits for such work are obtained by parties other than Contractor. Additionally, other electrical contractors bring power to the mechanical rooms and near the sales coolers and set the necessary distribution panels and breakers in the mechanical room and near the sales freezer.

Contractor submits a "Proposal Summary and Contract" which breaks down the contract price into three categories: equipment, installation, and refrigeration electrical. The dollar amount for each category is indicated as a lump sum. The cost of the equipment is not itemized for the different types of components. Upon completion of the work, Contractor submits an invoice for payment. The invoice includes sales tax on the total amount.

As noted above, the systems consist of two types of units: (1) walk-in coolers and walk-in freezers, which include bakery coolers, meat coolers, produce coolers, refrigerated rooms, point of sale freezers/ice-cream freezers, and bakery freezers; and (2) refrigerated display cases, which include open dairy and produce cases and closed deli cases.

The walk-in coolers include refrigerated rooms which are separate rooms within the structure for fresh meat cutting, processing and wrapping in a temperature-controlled environment. The "service deli" is also a separate refrigerated room for preparing fresh foods such as fresh salads, party-size appetizer trays and wrapped sandwiches (for off-site consumption) and other fresh foods requiring a temperature-controlled environment.

The walk-in coolers and freezers are assembled from pre-constructed panels manufactured in the Contractor's factory and delivered to the construction site. Depending on the particular design, the panels can be set into "LP" channel sills that are anchored to the concrete floor in the building, or can be set in place and sealed to the floor with silicone caulk. Panels are set into place one at a time until the enclosure is completed. The panels then form large, fixed, cold storage units that essentially constitute rooms within the building. A ceiling-mounted cooling unit (evaporator) is hung on the inside of the assembled walk-in cooler or freezer, and piping runs to a remotely mounted compressor/condenser unit. Copper coolant lines and electric power lines previously installed by Contractor are then connected to the cooler unit(s). Drain lines are run from

the cooling and freezing units in tubes through the cooler walls to a drain location. The cooler lines are run using copper tubing and can be piped into the building and secured to the building walls. The lines are run through the building walls or roof to the exterior condenser units and compressor racks.

Walk-in coolers and freezers are protected at the base by permanently installed concrete bumpers, which are not otherwise necessary for construction of the cooler. Any relocation or removal of a walk-in cooler or freezer would require not only complete disassembly of the portion to be removed, but also would require significant remodeling to the building, such as removal of the concrete bumpers, removal of the “U” channels and associated hardware (if used), modification to the building wiring and electrical system, removal or filling of any floor drain, performing the necessary, associated repairs to the building floor and walls, and, generally, removal of the coolant piping and any associated conduit. This work would require a building permit and inspections. Although it is physically possible to dismantle and reinstall the system at a different location, from a practical and historical perspective, this is not normally done by the Company.

Closed display cases are essentially complete units manufactured by Contractor as standard equipment. The cases themselves require no further on-site fabrication other than installation, assembly and connection to the building’s electrical service and the coolant piping. Display cases are installed on the floor in a fixed position in accordance with applicable building codes, with electrical connection directly to the structural electrical panel. Coolant piping is run from the display cases to remotely located cooling equipment, similar to walk-in coolers. Drain systems connect the display cases to the structural plumbing system. The display cases may be removed by cutting the electrical lines and piping. However, severing a case from the system by cutting the electrical, water and refrigeration supply and drain lines renders it inoperable until it is reconnected. Additionally, if a display case is removed and not replaced, the building floor drains must be capped and covered, and the floor must be repaired where the bumpers around the display case are removed.

Open dairy and open produce cases are generally 8 feet long, 42 inches deep and 7 feet high. These cases are not bolted to the concrete floor but generally are laid out to form a continuous line along a wall. Produce cases open from the rear to allow entry by Company personnel from building storage areas for merchandise restocking. Copper tubing for the refrigeration lines is run from the display case through the walls of the building to the refrigeration compressor. The compressor is generally a six-parallel compressor with approximately 150 horsepower capacity, typically installed in a separate machine room. The refrigeration and electrical wiring lines are run in copper and steel conduits attached to the interior of the building, through the walls or roof, from the display case to the refrigeration compressor units.

Deli cases are set in place and sealed to the building floor using silicone caulk. The cases are connected directly to the electrical panel. The wiring conduit from the main building electrical system normally comes from overhead and is secured to the deli case or building walls. The drain line is generally run from the equipment to a floor drain. Refrigeration lines are connected in a similar manner to produce cases described above.

The intent at the time of contracting is to leave all of these various system components in place until normal wear and tear require replacement. Normal useful life is approximately seven years for display cases, approximately fifteen years for walk-in coolers or freezers, and approximately seven to ten years for the remote mechanical elements. Because federal tax law and GAAP allow such treatment, these items are depreciated for income tax and “book” purposes over shorter periods, usually five years. Also, by convention in Tennessee, these items are generally returned as tangible personal property for property tax purposes. However, neither of these tax treatments is specified by the Company’s contracts with Contractor.

Contractor and the Company also enter into agreements whereby Contractor services and maintains the installed cooling systems. Contractor agrees to maintain the equipment; furnish labor and materials as specified in the agreement; and perform annual, semi-annual or quarterly preventive maintenance as specified in the agreement. Contractor also agrees to indemnify the Company for any injury resulting from the property and for product damage due to loss of refrigeration caused by Contractor. The agreement calls for payment, annually in advance, to Contractor for work performed at a specified rate. The term of such contracts is generally for five years.

As already noted, Contractor has to date collected, and the Company has paid, tax on the full contract consideration (materials and labor), under both the contracts to install the cooling systems and the warranty agreements.

QUESTIONS

1. Whether the contracts for sale and installation of the refrigeration systems described above are contracts for improvements to real property for purposes of Tennessee sales and use tax, and whether sales/use tax therefore is due only on the cost of the materials used by Contractor in carrying out the contracts.
2. Whether the warranty agreements for periodic service, maintenance, and repair of the refrigeration systems are contracts for the repair and maintenance of real property, and whether sales and use tax is due only on the cost price of any supplies and materials used in performing the agreements.

RULING

1. The installation of the walk-in freezers and walk-in coolers as described herein is for the improvement of real property. Therefore, the Contractor is using goods and materials in the performance of a contract to improve realty. Accordingly, the Contractor must pay sales tax to its supplier when the goods and materials are purchased. If the supplier does not collect sales tax, the Contractor must remit use tax directly to the Department of Revenue. If the supplier collects less than the

applicable rate of tax in Tennessee, the Contractor must remit the difference directly to the Department.

The display cases remain tangible personal property after installation. The Contractor must collect and remit sales tax on the total amount charged to the Company for equipment and installation. If the Contractor does not collect sales tax, the Company must remit use tax directly to the Department of Revenue.

2. Charges for warranty agreements covering the display cases are subject to sales and use tax because the display cases remain tangible personal property. Charges for warranty agreements covering the walk-in coolers and walk-in freezers are not subject to sales and use tax because those items become realty upon installation. The Contractor must pay use tax to its supplier or remit tax to the Department on the cost of materials and supplies used in the performance of a warranty agreement covering real property.

ANALYSIS

A sale at retail in Tennessee is subject to sales tax. Tenn. Code Ann. § 67-6-202. The elements necessary to constitute a sale are transfer of title or possession, or both, of tangible personal property, for a consideration. Tenn. Code Ann. § 67-6-102(a)(25)(A); *Security Fire Protection Company, Inc. v. Huddleston*, 138 S.W. 3d 829 (Tenn. Ct. App. 2003). Generally, the manner in which sales tax applies depends on whether the property is sold at retail as tangible personal property or is installed pursuant to a contract for the improvement of real property.

Retail sale includes the installing of tangible personal property which remains tangible personal property after installation where a charge is made for such installation. Tenn. Code Ann. § 67-6-102(a)(25)(F)(vi). In those cases where tax applies to the retail sale of tangible personal property, the tax base is the sales price of the item. “Sales price” is defined, in pertinent part, as “the total amount for which . . . tangible personal property is sold, including any services that are a part of the sale of tangible personal property . . .” Tenn. Code Ann. § 67-6-102(a)(28).

In contrast to a retail sale, charges for installing property that becomes a permanent part of the realty upon installation are not subject to sales tax. Tenn. Code Ann. § 67-6-209(c);² Tenn. Comp. R. & Regs. 1320-5-1-.27³ and 1320-5-1-.07.⁴ Instead, the property

² Tenn. Code Ann. §67-6-209(c) provides in pertinent part that “the transfer of tangible personal property by a contractor who contracts for the installation of such tangible personal property as an improvement to realty does not constitute a sale . . .”

³ Tenn. Comp. R. & Regs. 1320-5-1-.27 states in pertinent part as follows: “Charges made for installing tangible personal property which becomes a part of real property, are not subject to the Sales or Use Tax. The person so installing the property shall be liable for any Sales or Use Tax that may be due, if any, on property bought and/or used in making the installation.”

⁴ Tenn. Comp. R. & Regs. 1320-5-1-.07 provides in pertinent part as follows: “Contractors engaged in constructing or improving real property, whether on a lump sum or a cost-plus basis, are purchasers and

installed as a part of realty is used and consumed by the contractor in the performance of its contract, and a contractor must pay sales tax to its supplier or remit use tax directly to the Department of Revenue if the supplier fails to collect the tax. Tenn. Comp. R. & Regs. 1320-5-1-.27.

Thus, if the refrigeration systems installed by the Contractor at the Company's various locations remain tangible personal property after installation, the Contractor must collect sales tax on the full sales price including charges for installation. If there is an additional charge for a warranty or service contract warranting repairs or maintenance, that is also considered a retail sale subject to sales tax. Tenn. Code Ann. § 67-6-102(a)(25)(F)(ix) However, sales and use tax does not apply to tangible personal property used by the Contractor for repairs or replacements of parts or goods covered by warranty contracts if Tennessee sales tax or use tax was paid on the purchase price of the warranty contract.

If the system becomes real property upon installation, the Contractor is considered the final user and tax is due only on the material costs. If there is an additional charge for a warranty or service contract warranting repairs or maintenance for the system that becomes real property, sales or use tax is not due on the charge for the warranty. If parts or goods are used in performing repairs, replacements, or services covered by warranty contracts on which no Tennessee sales tax was required to be paid and on which such tax was not in fact collected or remitted, as would be the case with warranty contracts on real property, then Tennessee sales or use tax must be paid by the Contractor on the repair parts or goods at the time of purchase.

The primary test for distinguishing tangible personal property from fixtures is not so much the manner in which the property is affixed to the realty as it is the intention with which the property is connected with the realty. The Tennessee Supreme Court has stated the test as follows:

In Tennessee only those chattels are fixtures which are so attached to the freehold that, from the intention of the parties and the use to which they are put, they are presumed to be permanently annexed, or a removal thereof would cause serious injury to the freehold. The usual test is said to be the intention with which a chattel is connected with realty. If it is intended to be removable at the pleasure of the owner, it is not a fixture.

Magnavox Consumer Electronics v. King, 707 S.W.2d 504, 507 (Tenn. 1986)(quoting *Hickman v. Booth*, 173 S.W.2d 438 (Tenn. 1974)).

Such intent may be shown by examining both objective and subjective factors. *See Hubbard v. Hardeman County Bank*, 868 S.W.2d 656, 660 (Tenn. Ct. App. 1993). Objective factors include the type of structure, the mode of attachment, and the use and purpose of the property. *Harry J. Whelchel Company v. King*, 610 S.W.2d 710, 713-714 (Tenn. 1980). The subjective factor is the expressed intent, if any, of the parties. *See, Id.*

consumers of the materials used by them, and are required to pay Sales or Use Tax on such materials or equipment purchased or imported into this State for use in connection with their contracts.”

Tangible personal property becomes a part of the realty, though, if removing it would seriously damage the building to which it is affixed. *Process Systems, Inc. v. Huddleston*, No. 02A01-9503-CH-00063, 1996 Tenn. App. LEXIS 695 (Tenn. Ct. App. October 25, 1996) (citing *Memphis Housing Authority v Memphis Steam Laundry-Cleaners, Inc.*, 463 S.W.2d 677, 679 (Tenn. 1971)). Tangible personal property also becomes realty if removal would destroy its essential character as personalty. *Id.* (citing *Green v. Harper*, 700 S.W.2d 565, 567 (Tenn. Ct. App. 1985)).

Thus, whether the personal property at issue becomes part of the realty depends on the particular factual circumstances that exist. For example, the court in *General Carpet Contractors, Inc. v. Tidwell*, 511 S.W.2d 241 (Tenn. 1974), examined carpet which was laid using the tackless strip method and was therefore easily removable. The court found that the carpet became realty because the parties installed it with the intent that it remain in place for the length of its useful life. *Id.* at 243. In another case, the court found that the removal of a conveyor system at issue would damage the building and destroy the essential character of the conveyor system. *Process Systems, Inc., supra*. Accordingly, the conveyor system was held to be an improvement to real property. *Id.*

As stated by the Company, the walk-in units are “assembled from pre-constructed panels” which are, at least sometimes, “set into channel sills that are anchored to the concrete floor.” When assembled, the panels form enclosures that “essentially constitute rooms within the building.” Removal would require disassembly of the panels as well as removal of any channels anchored to the floor. Further, the Company states its intent to leave all of these systems in place until normal wear and tear warrant replacement. Based on the cases cited herein, the walk-in coolers and freezers become realty upon installation and sales and use tax should be applied only to the contractor’s purchase of the materials and supplies used.

Likewise, the Company indicates its intent to leave the display cases and deli cases in place until normal wear and tear warrant replacement; however, these units are not installed with the permanency of the walk-in units. Unlike the walk-in units, the display cases “are essentially complete units manufactured...as standard equipment.” No on-site fabrication is required other than connection to the building’s electrical service and the coolant piping. The cases are not anchored to the floor or attached to “channel sills” that are anchored to the floor. They may be removed as a unit by severing their connection to the electrical lines and coolant piping. Likewise, the deli cases are complete units requiring no additional fabrication other than being connected to the building’s electrical service and coolant piping. If necessary, installing or altering the piping and wiring to connect to the walk-in units is an improvement to real property. The cases are often simply placed against a wall. Their installation and removal does require more than “plugging and unplugging” a cord to an outlet, but each of these units could be removed before it has reached the end of its useful life. Thus, for sales tax purposes, the deli and other display cases should be treated as tangible personal property.⁵

⁵ Although not specifically at issue in this ruling, it should be noted that the installation of piping and wiring in situations such as this are often improvements to realty even if the equipment is not.

As to the portion of the property that is installed as an improvement to realty, sales and use taxes would not apply to the charges made by the Contractor to the Company related to that property. However, if the Contractor has charged a single lump sum price for the retail sale of certain tangible personal property and the installation of other property to realty, instead of separating taxable and non-taxable charges, the entire amount becomes subject to tax.⁶

Whether the charge is separated or not, the Contractor cannot use a resale certificate to purchase the materials that it has contracted to install as an improvement to real property. Tenn. Comp. R. & Regs. 1320-5-1-.27; Tenn. Comp. R. & Regs. 1320-5-1-.68. If the Contractor purchases items that it intends to resell at the same time that it purchases items that it intends to install, the Contractor should issue a resale certificate only for those items that it intends to resell and should tell the vendor to collect sales tax on the items it intends to install as improvements to real property. Under Tenn. Comp. R. & Regs. 1320-5-1-.08(1) a Contractor may purchase materials under a certificate of resale where it is not known, at the time of purchase, whether the materials will be resold or used by the Contractor in the performance of a contract. If the Contractor resells the materials, it must collect and pay the applicable sales tax on the sales price. Tenn. Comp. R. & Regs. 1320-5-1-.08(2). If it withdraws them from inventory for its use as a Contractor it is liable for the applicable tax on its purchase price. Notwithstanding the general rule, a supplier who delivers materials to a job site for use in a job being performed by the contractor must collect the applicable tax on those sales. Tenn. Comp. R. & Regs. 1320 - 5-1-.08(3). Thus, suppliers may not sell property under a certificate of resale where they know the property is not for resale, but for the Contractor's own use. Read together, the rules provide a mechanism through which the imposition of sales tax is delayed until such time as the property is either resold or used by a Contractor who, at the time of purchase, does not know whether the property will be used by the contractor/dealer or resold. *Security Fire Protection Company, Inc. v. Huddleston*, 138 S.W.3d 829 (Tenn. Ct. App. 2003) *perm. app. denied*.

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APPROVED: Loren L. Chumley
Commissioner of Revenue

DATE: 6/9/05

⁶ See Tenn. Comp. R. & Regs. 1320 -5-1-.23(a), 1320-5-1-.25(1), 1320-5-1-.41, 1320-5-1-.61(2), 1320-5-1-.99(3) for numerous examples where failure to separately state a nontaxable charge causes the entire charge to be subject to tax.