

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #07-36**

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 an agreement to install and service equipment is a service contract, not a lease, and therefore exempt from sales and use tax.

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

[TAXPAYER] assembles compressors in [STATE-NOT TENNESSEE] that are used in connection with [NATURAL RESOURCE] exploration, production, processing and transportation. Historically, either the assembled compressors are sold to third party customers or [TAXPAYER] retains ownership and the compressors are used by [TAXPAYER] at customer

locations to provide compression for a fee. Most of [TAXPAYER'S] current contractual agreements with its customers are structured so that they would be considered a "rental" or "lease" for Tennessee sales and use tax purposes.

[TAXPAYER] is in the process of reorganizing its business. As a result of the reorganization, [TAXPAYER] will have four primary entities involved in the compression business in Tennessee. Three of these entities will be new entities. One entity, [LEASE COMPANY 1], will lease compressors to a related entity through agreements that should be considered bare rentals. One of the purposes of doing so will be to streamline sales tax compliance procedures by eliminating inefficiencies in the sales/use tax self-assessment process, accomplished by changing the nature of the tax from a use tax to a sales tax in most jurisdictions.

The lessee of the compressors from [LEASE COMPANY 1], [SERVICE COMPANY], will provide compression services to third parties. [TAXPAYER] will contribute a portion of its current fleet of compressors, subject to certain liabilities, to [LEASE COMPANY 1] in a transaction that will be tax-free for federal income tax purposes. The remaining compressors will be contributed to a new entity owned by [TAXPAYER], [LEASE COMPANY 2], which will lease the compressors to [TAXPAYER] for use in its compression business. This contribution will also be tax-free for federal income tax purposes. [LEASE COMPANY 1] and [LEASE COMPANY 2] will be disregarded entities for federal tax purposes.

As part of the reorganization, [TAXPAYER] is also changing its contracts with certain customers. The revised contracts will be used by both [SERVICE COMPANY] and [TAXPAYER]. After these changes, the following contractual provisions indicate that the new service contract is properly treated as a services agreement for federal income tax purposes, rather than a lease:

- Risk of loss, control, and certain other characteristics will be the responsibility of [SERVICE COMPANY/TAXPAYER] rather than the customer.
- The new contract does not specify a particular compressor or model of compressor that will be used to perform the service. Rather, the contract stipulates only that the compression services will be provided based on certain agreed upon parameters. Thus, as the contract acknowledges, the compressors are tools used by the [SERVICE COMPANY/TAXPAYER] to perform services.
- Ad valorem taxes will be responsibility of [SERVICE COMPANY/TAXPAYER].
- [SERVICE COMPANY/TAXPAYER] will be responsible for insurance for the compressors.
- The fee charged for compression services is substantially higher than the cost of bare rental of a compressor.
- The contracts are typically for approximately three years, or less than 15 percent of a compressor's economic life.
- [SERVICE COMPANY/TAXPAYER] bears the risk of performance of its contractual obligation to provide compression services. Thus, to the extent that [SERVICE COMPANY/TAXPAYER] is unable to provide compression services to its customers, the [SERVICE COMPANY/TAXPAYER] will suffer a reduction in the fee for compression services that it charges the customer.

- [SERVICE COMPANY/TAXPAYER] does not own the [PRODUCT] at any point in the process, but [SERVICE COMPANY/TAXPAYER] compresses the [NATURAL RESOURCE] for its customers that typically sell the [PRODUCT] to third parties.

QUESTIONS

1. Will the Tennessee Department of Revenue treat the attached Master Services Agreement (“Agreement”) as a service agreement rather than a lease or rental for Tennessee sales and use tax purposes?
2. Will there be any Tennessee sales or use taxes due as the result of transferring the existing compressors from [TAXPAYER] to [LEASE COMPANY 2 and LEASE COMPANY 1]? Will the resale exemption apply to the transfer?

RULINGS

1. Under the Retailers Sales Tax Act, the Agreement will be treated as a lease or rental of tangible personal property and subject to sales and use tax.
2. The transfer of the compressors from [TAXPAYER] to [LEASE COMPANY 2 and LEASE COMPANY 1] will not be subject to sales and use tax provided [LEASE COMPANY 2 and LEASE COMPANY 1] both possess valid resale certificates.

ANALYSIS

1. Tenn. Code Ann. § 67-6-102(25) defines “lease or rental” as “the leasing or renting of tangible personal property and the possession or use thereof by the lessee or renter for a consideration, without transfer of the title of such property.” The agreement states that Taxpayers will provide compressors on site at the customer’s place of business for a stated fee. Once installed, the Agreement states that the compressors remain property of the Taxpayers and will remain tangible personal property once installed. As such, the Agreement meets the definition of a lease or rental in this state and will be treated as a rental of tangible personal property. Tenn. Code Ann. § 67-6-204 states:

(a) It is declared to be the intention of this chapter to impose a tax on the gross proceeds of all leases and rentals of tangible personal property in this state where the lease or rental is a part of the regularly established business, or the lease or rental is incidental or germane thereto. The tax is levied as follows:

(1) At the rate of the tax levied on the sale of tangible personal property at retail by the provisions of § 67-6-202 of the gross proceeds derived from the lease or rental of tangible personal property, as defined herein, where the lease or rental of such property is an established business, or part of an established business, or the same is incidental or germane to the business.

(2) At the rate of the tax levied on the sale of tangible personal property at retail by the provisions of § 67-6-202 of the monthly lease or rental price by lessee or renter, or contracted or agreed to be paid by lessee or renter, to the owner of the tangible personal property.

(b) If the owner of the property maintains continuous supervision over the personal property being leased or rented, and furnishes an operator or crew to operate such property, the owner is rendering a service, and the service is not subject to sales or use tax. On the other hand, if the owner does not furnish the crew or operator, but merely rents the property, and the lessee operates it personally for a stated consideration or price, either by the day or week or month, in such case, the sales or use tax would apply as the lessee has the possession, use and control of the property. If the owner of the property furnishes flight training, the owner is rendering a service, and the property used therein shall not be subject to sales or use tax.

Tenn. Code Ann. § 67-6-204 (a)(1), (a)(2) and (b) (2006). The Taxpayers will be subject to sales and use tax unless they meet the requirements of Tenn. Code Ann. § 67-6-204(b).

In *Hyatt v. Taylor*, 788 S.W.2d 554, 556 (Tenn. 1990), the Plaintiff leased and serviced water conditioning units to residential, commercial and industrial users. The transactions involved in the case concerned leases of the units for a monthly fee, pursuant to a written contract. The contract was not referred to as a lease and it stated that the customer agreed that the Plaintiff had reserved the right to remove water conditioning units and that the Plaintiff was granted the right to enter premises for the purpose of service or removal of the water conditioning units.

The water conditioning units were referred to as auto care units and porta care units. The Plaintiff performed all of the installations on the premises of their customers and made all of the service calls. The Plaintiffs would analyze a customer's water and determine the necessary filtering or treatment process. The auto care unit worked automatically but had to be brought to the Plaintiff's facility to be cleaned periodically. The porta care units were exchanged every two weeks to a month and service calls were made between exchanges. The Plaintiff would make a service call if a customer called with a problem; otherwise the Plaintiff would make routine or periodic calls in order to service the water conditioning units. When the units were working correctly, they functioned automatically, without the need of an operator or crew.

The Supreme Court of Tennessee held that the water treatment units do not require an operator or crew. The function of the units is to purify or treat water, and that function is performed automatically by the filter or other treatment installed in the unit. The Chancery Court judge found that the customer did not have any physical contact with the operation of the unit and, therefore, the Plaintiff was entitled to the exemption listed under Tenn. Code Ann. § 67-6-204(b). In overturning the Chancery Court's decision, the Court reasoned that the leased property worked by itself and that such "operation," as is required to cause it to produce the result it is designed to accomplish, is performed by the customer turning on a water faucet.

The Tennessee Supreme Court went on to note:

[T]he legislature intended the exemption created by Chapter 994 Acts of 1984 to be limited to tangible personal property that requires the continuous presence of an operator or crew in order for the property to perform the function it is designed to accomplish. The primary example intended by the legislature was expressly stated in the last sentence of the Act - the owner of an airplane furnishing a pilot or crew to operate the airplane. Other obvious examples are the leasing of drag lines, backhoes, buses, etc., where the lessor also furnishes the operator.

Hyatt v. Taylor, 788 S.W.2d 554, 556 (Tenn. 1990).

In addition to the compression services detailed in the Agreement, Schedule A of the Agreement lists the taxpayers' duties consisting of:

1. Mobilization and transportation of all of Contractor's employees, tools, equipment and property to Company's site.
2. Installation and connection supervision and start-up.
3. Compressing Company's [PRODUCT] in accordance with the above specifications.
4. Maintaining Contractor's equipment in accordance with Contractor's usual maintenance practices, including preventive maintenance, inspections and repairs.
5. Providing anti-freeze in accordance with Contractor's requirements.
6. Providing lubricants in accordance with Contractor's requirements.
7. 97% service availability guarantee, subject to the terms and conditions of Contractor's prevailing "Service Availability Guarantee" schedule.
8. De-installation and disconnection supervision, if required.
9. Demobilization and transportation of all of Contractor's employees, tools, equipment and property from Company's Site.

Nowhere in the Agreement or in Schedule A is it provided that the Taxpayers have complete control over the compressors or are operating the compressors on a full time basis. Furthermore, it does appear that the customers have possession, use and control of the compressors. In the Agreement provided, it appears that the compressor is actually installed at the customer's location. After installation, the Taxpayers do not provide continuous operation, but instead provide maintenance to ensure the compressor compresses the customer's [PRODUCT] in accordance with the specifications of the Agreement and Schedule A. Finally, the facts in this situation do not substantially differ from the facts presented in *Hyatt v. Taylor*, 788 S.W.2d 554, 556 (Tenn. 1990).

For the foregoing reasons, under the Retailers Sales Tax Act, the Agreement is a lease or rental of tangible personal property subject to sales and use tax in the State of Tennessee.

As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 the definition of "lease or rental" will be changed to mean any transfer of possession or control of tangible personal

property for a fixed or indeterminate term for consideration. A lease or rental may include future options to purchase or extend. A lease or rental will not include providing tangible personal property along with an operator for a fixed or indeterminate period of time. A condition of this exclusion is that the operator is necessary for the equipment to perform as designed and an operator must do more than maintain, inspect, or set-up the tangible personal property. Furthermore, a lease will be taxed on its sales price, not on the gross proceeds. The analysis of the facts presented here will have the same outcome under the new definition of a lease or rental.

2. The compressors that [TAXPAYER] intends to transfer to [LEASE COMPANY 2 and LEASE COMPANY 1] qualify as inventory held for resale. Tenn. Code Ann. § 67-6-102(36)(A) defines “sale” as “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 . . .” [TAXPAYER] is in the business of leasing compressors. The transfer of inventory from [TAXPAYER] to [LEASE COMPANY 2 and LEASE COMPANY 1] meets the definition of a sale in the State of Tennessee. [TAXPAYER] will not be entitled to the occasional and isolated sales exemption under T.C.A. § 67-6-102(3) because it is in the business of leasing compressors. However, [TAXPAYER] would be entitled to a sale for resale exemption provided that [LEASE COMPANY 2 and LEASE COMPANY 1] both possess valid resale certificates.

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APPROVED: Reagan Farr
Commissioner of Revenue

DATE: 11/26/07