

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 00-51**

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 [PROGRAM].

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

The [TAXPAYER] is an [ORGANIZATION] exempt from payment of federal income tax under § 501(c)(6) of the Internal Revenue Code of 1986, as amended. The taxpayer is a not-for-profit corporation formed under the laws of [STATE OTHER THAN TENNESSEE] and is headquartered in [STATE OTHER THAN TENNESSEE]. It also

has an office in [CITY], [STATE OTHER THAN TENNESSEE]. Taxpayer has no office or other facility in Tennessee. The taxpayer has registered with the Tennessee Department of Revenue for sales and use tax purposes.

[PROGRAM]

The [PROGRAM] consists of the [FACILITY TESTING] to determine whether the facilities meet certain standards as required by federal law and by the taxpayer. Under the [FEDERAL LAW], every facility in the United States must be accredited periodically by the [FEDERAL AGENCY] or another agency recognized by [FEDERAL AGENCY] as having standards that are equivalent to or more stringent than federal accreditation standards. [FEDERAL LAW]. The only entities that [FEDERAL AGENCY] has recognized for these purposes are the taxpayer, other not-for-profit organizations, and agencies of a few state governments.

In order to obtain accreditation, a facility must, *inter alia*, participate in a [PROGRAM]. The [PROGRAM] evaluates the ability of participating facilities to accurately perform [SERVICES] for their customers. Specifically, the [PROGRAM] involves (i) the transfer to a participating facility of the [PROGRAM MATERIALS], the composition of which is unknown to the facility, (ii) the analysis of the [PROGRAM MATERIALS] by the facility and transmission of the facility's findings to the taxpayer, and (iii) the processing and evaluation of the facility's findings by the taxpayer. By federal law, the furnishing of the [PROGRAM MATERIALS] to the facility must be by a government agency or a not-for-profit entity.

Most of the [PROGRAM MATERIALS] consist of a [MATERIALS] for which each participating facility must test. The taxpayer purchases the [PROGRAM MATERIALS] from various manufacturers.

The manufacturer generally delivers the [PROGRAM MATERIALS] by common carrier to a third party repackager retained by the taxpayer or ships the [PROGRAM MATERIALS] by common carrier directly to each participating facility. The manufacturer invoices the taxpayer for the [PROGRAM MATERIALS] shipped to the repackager or directly to the facilities. The repackager breaks down the manufacturer's bulk shipment into individual packages for shipment to the facilities, adds printed instructions supplied by the taxpayer, and then ships the materials by U.S. mail or by common carrier to the participating facilities.

The facility has no independent use for the [PROGRAM MATERIALS] apart from participating in the [PROGRAM]. Once a participating facility has concluded its analysis for the [PROGRAM MATERIALS], the facility generally disposes of those materials. The facility sends a report of its analysis to the taxpayer at its headquarters in [STATE OTHER THAN TENNESSEE], where the taxpayer reviews the facility's report. The taxpayer evaluates the facility's analysis, and it provides its findings to the facility and to the accreditation organization designated by the facility. When the taxpayer provides the facility with its results for each test, the taxpayer also provides the facility with the

mean result for that test, the standard deviation, the number of facilities that participated in the test, the standard deviation index, the lower and upper limits of acceptability, and a plot of the relative distance of the facility's results from the established target as a percentage of the allowed deviation.

The taxpayer charges facilities a single subscription amount for participating in the [PROGRAM]. No separate charge is made for the [PROGRAM MATERIALS] and for the [SERVICE]. On average, the cost to the taxpayer of the [PROGRAM MATERIALS] was historically about [X%] of the amount it invoiced customers for providing the [SERVICE]. That percentage has been decreasing recently, and this year is expected to be approximately [Y%].

From time to time, the taxpayer also sells [PROGRAM MATERIALS] to facilities (without providing [SERVICES] as replacements of [PROGRAM MATERIALS] that were lost or broken prior to or during a test. The total sales of [PROGRAM MATERIALS] apart from the [PROGRAM] are less than [Z%] of the taxpayer's total receipts from the [PROGRAM].

The specific [MODULES] in which a facility will enroll depends on the scope of the work done at the facility. Thus, a facility performing a wide range of analyses will participate in a larger number of modules than a facility doing only basic testing. Each specific [MODULE] is priced separately.

QUESTIONS

1. Is the taxpayer's transfer of the [PROGRAM MATERIALS] as a part of its [PROGRAM] a sale of tangible personal property, and, therefore, are the charges made for participation in the [PROGRAM] subject to the sales or use tax?
2. Is the taxpayer's sale of the [PROGRAM MATERIALS], not a part of the [PROGRAM], subject to sales or use tax?
3. If the taxpayer's transfer of the [PROGRAM MATERIALS] as a part of the [PROGRAM] does not constitute a sale of tangible personal property, is the taxpayer liable for use tax on the [PROGRAM MATERIALS]?
4. If the taxpayer is liable for use tax on the [PROGRAM MATERIALS], is the taxpayer entitled to a credit for sales or use tax properly paid to the state from which such materials were shipped?

RULINGS

1. The transfer of the [PROGRAM MATERIALS] is incidental to the [PROGRAM] and does not constitute a taxable sale. The charges for participation in the [PROGRAM] are not subject to sales or use tax.
2. The sale of [PROGRAM MATERIALS], when separate from the charge for participating in the [PROGRAM], is subject to sales or use tax.
3. The taxpayer is liable for use tax on its purchase of [PROGRAM MATERIALS] distributed to participants in the [PROGRAM].

4. The taxpayer is entitled to credit for a legally imposed sales or use tax paid to another state.

ANALYSIS

1-2. The [PROGRAM] itself is not a taxable service, and the charge made to a facility for its participation in the program cannot be subjected to the sales or use tax as a taxable service. The sales tax is imposed on certain services, but only on those services specifically mentioned in the statute. See Ryder Truck Rental, Inc. v. Huddleston, 1994 Tenn. App. LEXIS 444. A [PROGRAM] such as that described in the ruling request is not among the services listed in T.C.A. § 67-6-102(24)(F). Therefore, the charge for the test cannot be subject to tax on the basis that it is a service.

If the charge is to be subjected to tax, it must be as a sale of tangible personal property. Tangible personal property is defined by statute as:

... personal property, which may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses. Notwithstanding any other provision of law to the contrary, any sale of a prepaid telephone calling card and/or the recharge of the card shall be deemed the sale of tangible personal property, subject only to such taxes as are imposed on the sale of tangible personal property. "Tangible personal property" does not include stocks, bonds, notes, insurance, or other obligations or securities. "Tangible personal property" does not include utility poles, anchors, guys, and conduits, and such facilities shall be deemed to be real property for the purposes of this chapter;

T.C.A. § 67-6-102(29). The [PROGRAM MATERIALS] are clearly tangible personal property, and, if a sale of the materials to the customer takes place, the sale is subject to tax. T.C.A. § 67-6-202. However, it is significant that not only the [PROGRAM MATERIALS], but also services, are being provided to the customer for a single charge. The Tennessee appellate courts have several times addressed transactions where a mixture of tangible personal property and services were sold to the customer.

In Saverio v. Carson, 186 Tenn. 166, 208 S.W.2d 1018 (1948), the taxpayer was engaged in a diaper service. The court rejected a contention that the majority of the charge was for the service of collecting, delivering, and laundering¹ the diapers, and that only a small portion of the fee charged by the taxpayer was actually for the rental of the diapers. The court held that although the nontaxable services did constitute the majority of the taxpayer's cost in providing the service, the rental of the diaper was still central to the transaction and subjected the entire amount received to tax as a rental of tangible personal property. In Essary v. Huddleston, 1995 Tenn. App. LEXIS 443, the Tennessee Court of Appeals rejected a similar contention regarding the furnishing of

¹ It should be noted that under the law in effect at the time of this decision, the laundering and cleaning of tangible personal property was not a taxable service.

portable toilets, declining to find that the servicing of the toilet was the performing of a service rather than a rental of the toilets. In both of these cases, property was provided as the central part of the transaction, and the services were performed directly on the property so provided. In the instant ruling, the service being purchased, the [PROGRAM] conducted by the taxpayer is not performed on, or in conjunction with, the property being provided. Therefore, these cases do not provide strong support for the proposition that the transaction is one where the [PROGRAM MATERIALS] are sold to the customer.

The courts have also considered cases where the taxpayer has contended that it was providing information or “intellectual property” rather than tangible personal property, in a transaction where tangible personal property was provided to the customer. In Crescent Amusement Co. v. Carson, 187 Tenn. 112, 213 S.W.2d 27 (1948), the taxpayer argued that the price received for the rental of a motion picture film should be regarded as a fee for the exercise of an intangible property right. The court rejected that contention, stating (quoting from a New York case) “The license to exhibit without the transfer of possession would be valueless. Together, they are one transaction and constitute a sale ...” 213 S.W.2d at 28.

In Commerce Union Bank v. Tidwell, 538 S.W.2d 405 (Tenn. 1976), the Tennessee Supreme Court addressed the taxability of the sale of computer software. The court held that the software was an intangible property right which could be transmitted by several methods, including punch cards, magnetic tapes or discs, or other methods, and that the software did not become tangible personal property because it was transferred by the use of tangible means.² In Commerce Union Bank the court explained Crescent Amusement, supra, as follows:

In Crescent the tax was levied on the rental of a motion picture film. The film is inherently related to the movie; **without the film there could have been no movie**. Therein lies the crucial difference. **Magnetic tapes and cards are not a crucial element of software**. The whole of computer software could be transmitted orally or electronically without any tangible manifestations of transmission.

538 S.W.2d 407-8. (Emphasis supplied.)

In Thomas Nelson, Inc. v. Olsen, 723 S.W.2d 621 (Tenn. 1987), the Tennessee Supreme Court, held that the transfer of “design models” (layouts, camera-ready art, mock-ups, and other tangible items) used to transmit advertising ideas were taxable as a sale of tangible personal property.

In each of the cases involving intangible information or intellectual property, it is important to note that, regardless of the outcome of the case, the items of tangible personal property which the Department sought to tax as a sale of the tangible personal

² The General Assembly has since amended the statute to provide for the taxation of computer software. See T.C.A. § 67-6-102(25)(B).

property was a medium which carried the desired end result, the information or idea. The courts' holding on whether the transaction constituted a sale turned on whether the property constituted "incidental methods of transmitting the intangible intellectual creations" or a "crucial element" of the information involved. Id. at S.W.2d 622-3.

Here, the [PROGRAM MATERIALS], while necessary for the facilities' participation in the [PROGRAM], are not the culmination of the test involved, nor do they transmit the result. While their cost to the taxpayer is a relatively high dollar amount in relation to the amount charged the facilities for participation in the [PROGRAM], and they are certainly necessary to the program, the [PROGRAM MATERIALS] are distinguishable from the property involved in the above-discussed cases. The [PROGRAM MATERIALS] are not in any way what the facility is seeking to obtain, nor do they serve to transmit what the participating facility seeks, that is, the [RESULT]. The facility seeks the [RESULTS], not the [PROGRAM MATERIALS]. Therefore, the [PROGRAM MATERIALS] are neither an incidental means of transmitting the results of the [PROGRAM], nor are they a crucial element of the final result. They are a tool necessary to carry out the [PROGRAM], and the charge for participating in the [PROGRAM] is not subject to sales tax as a sale of tangible personal property, in those cases where the [PROGRAM MATERIALS] are provided as a part of the fee to participate in the [PROGRAM].

However, in those cases where the [PROGRAM MATERIALS] are provided for a separate charge, independent from the fee to participate in the [PROGRAM], there is clearly a sale of tangible personal property. As stated previously, such a sale is subject to tax. The taxpayer has should collect and pay the Tennessee use tax on such sales.

3. T.C.A. § 67-6-203 imposes a use tax on the cost price of tangible personal property "when the same is not sold but is used, consumed, distributed, or stored for use and consumption..." T.C.A. § 67-6-210 imposes a use tax "[o]n all tangible personal property imported, or caused to be imported from other states or foreign countries, and used ..." Therefore, use tax is applicable to the [PROGRAM MATERIALS] shipped by the taxpayer to Tennessee locations. The fact that the property is shipped to another party and is not possessed by the taxpayer in Tennessee does not relieve the taxpayer of the tax, because the taxpayer caused the [PROGRAM MATERIALS] to be imported. See J.C. Penney Co. v. Olsen, 796 S.W.2d 943 (Tenn. 1990).³

Certain tax-exempt organizations are exempt from the sales and use tax upon tangible personal property and taxable services sold, given, or donated to them. See T.C.A. § 67-6-322, which lists the types of organizations covered by the exemption statute. The taxpayer is exempt from federal income tax under § 501(c)(6) of the Internal Revenue Code. Organizations exempt under § 501(c)(6) are not listed as exempt in T.C.A. § 67-6-322. Therefore, the taxpayer is liable for use tax on the cost price of those

³ J.C. Penney was decided under T.C.A. § 67-6-203(a). T.C.A. § 67-6-203(b), which is specifically applicable to the type of goods shipped into Tennessee in J.C. Penney, was enacted after J.C. Penney was decided.

[PROGRAM MATERIALS] it ships to Tennessee, where no charge is made to the recipient.

4. T.C.A. § 67-6-507(a) states:

The provisions of this chapter do not apply with respect to the use, consumption, distribution or storage of tangible personal property for use or consumption in this state, upon which a like tax equal to or greater than the amount imposed by this chapter has been paid in another state, the proof of payment of such tax to be according to rules and regulations made by the commissioner. If the amount of tax paid in another state is not equal to or greater than the amount of tax imposed by this chapter, then the dealer shall pay to the commissioner an amount sufficient to make the tax paid in the other state and in this state equal to the amount imposed by this chapter.

For further guidance, TENN. COMP. R. & REGS. 1320-5-1-.91 has been promulgated, and that rule has the following provision:

- (1) Persons actually paying a legally imposed Sales or Use Tax to another State on tangible personal property or taxable services imported into this State may claim such payment as a credit against any Use Tax liability accruing in this State. The Commissioner may require persons claiming such credit to furnish the name of the vendor from whom he purchased the property, and an affidavit that such a tax has been paid.

Therefore, if the tax paid to another state on the [PROGRAM MATERIALS] is legally imposed, a credit for that tax may be taken against the use tax due to Tennessee.

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APPROVED: Ruth E. Johnson
Commissioner

DATE: 12/13/00