

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 01-11**

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 Tennessee sales and use tax to consulting services that involve computer consulting services to [TYPE OF BUSINESSES] in Tennessee as well as providing [TYPE OF BUSINESSES] in Tennessee with [TYPE OF PRODUCT] pricing information.

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

[THE TAXPAYER] will be a [STATE OTHER THAN TENNESSEE] corporation with its principal office located within the [STATE OTHER THAN TENNESSEE] and all of its employees will perform their duties in [STATE OTHER THAN TENNESSEE]. The taxpayer will have no branch office within Tennessee nor will it have any property or inventory located within the State of Tennessee. All sales to customers in Tennessee will be referred to it by an affiliate corporation which is registered to pay the sales and use tax in Tennessee. The taxpayer will not send any of its employees into Tennessee for the purpose of soliciting sales or for the purpose of conducting any other business on its behalf.

The taxpayer's activities within the State of Tennessee will be limited to the following:

1. The taxpayer will provide consulting services to its [TYPE OF BUSINESS] customers located within the State of Tennessee. Such consulting services will pertain to computer systems installed by the taxpayer's affiliate corporation. All consulting services would be rendered over the telephone. Such consulting services occasionally involve "trouble shooting," i.e., diagnosing problems the customer is having with its computer system.
2. Such diagnosis sometimes will involve having an employee of the taxpayer connect a computer system owned or used by the taxpayer in [STATE OTHER THAN TENNESSEE] by telephone line to a customer's computer system in Tennessee. On such occasions, the customer's computer system would serve as "host" to the taxpayer's computer system and the taxpayer's employee would be able to observe certain aspects of customer's computer system from its "remote" location as fully as if the taxpayer's employee were at the customer's location physically at the computer system. This ability to link up with the customer's computer system would assist the taxpayer in analyzing any problems the customer may be having and in offering the proper consultation to the customer.
3. The taxpayer would provide hardware maintenance service for the computer systems installed by the affiliate corporation of the taxpayer. Pursuant to the terms of such hardware maintenance agreements, any time a computer part would need to be replaced, the taxpayer would ship the part via common carrier to the customer in Tennessee. If on site repair services are required by the customer, such services will be provided by the affiliate corporation of the taxpayer. All such installation services will be contracted for separately between the customer and the affiliate corporation. In most cases, however, the customer can install the part himself. Typically, parts requiring replacement are computer monitors and external modems. The hardware maintenance contract between the taxpayer and its customers would cover only those parts which the customer can install without assistance.

4. The taxpayer will also be providing software maintenance services to Tennessee customers. In exchange for a monthly fee, the taxpayer will provide software upgrades to its [TYPE OF BUSINESS] customers. Such upgrades will be downloaded by the [BUSINESSES] by modem.
5. Periodically, the taxpayer will obtain various pricing information pertaining to [TYPE OF PRODUCTS]. This information will be copied onto a computer diskette and disseminated to the Tennessee customers through the U.S. Mail or by common carrier. The customers are charged a separate fee for this service.
6. Periodically, the taxpayer will obtain and compile [TYPE OF PRODUCT] information from [TYPE OF PRODUCT] manufacturers. This information is sent on diskette through the U.S. Postal Service or by common carrier to customers in Tennessee. Such customers are billed separately for this service.

QUESTIONS

1. Are the consulting services described in Paragraph 1 of the Facts above subject to Tennessee sales or use tax?
2. Is the link up of the taxpayer's computer system to the customer's computer system in order to enable the taxpayer to analyze and troubleshoot problems the customer in Tennessee may be having subject to the Tennessee sales or use tax? Would it make any difference if:
 - a. The long-distance call connecting the two systems is placed by the taxpayer at its own expense?
 - b. The taxpayer voluntarily registers to collect and pay the Tennessee sales or use tax and the long distance call connecting the two systems is placed by the taxpayer, but is charged separately to the customer. Suppose further, for the sake of convenience, a flat monthly expense or an amount to be determined by formula were charged to the customer for this long-distance expense. Would the method by which this charge were determined matter, so long as it was reasonably calculated at least to cover the long-distance charges incurred by the taxpayer in connection with this computer link up with its customers?
 - c. The long distance call connecting the two computer systems is placed by the customer at its own expense?
3. Is the taxpayer required to collect the Tennessee sales or use tax on the fees paid under the hardware maintenance contract described in Paragraph 3 of the Facts above?
4. Is the taxpayer required to collect the Tennessee sales or use tax on the fees received in connection with the software maintenance contracts as described in Paragraph 4 of the Facts above? Would it make any difference if:

- a. The software upgrade is accomplished by the taxpayer through a long distance call it places to the computer system of the pharmacy located in Tennessee, with the taxpayer bearing the cost of the long distance call?
 - b. The software upgrade is made through a long distance telephone call placed by the pharmacy customer to the taxpayer's computer system in [STATE OTHER THAN TENNESSEE], with the customer bearing the cost of the long distance telephone charge?
 - c. The software upgrade is downloaded by the pharmacy customer in Tennessee over the Internet with such information having been placed on the Internet through a computer located outside of Tennessee?
5. Is the service of obtaining and disseminating [TYPE OF PRODUCT] pricing information to the customer through the U.S. Postal Service across state lines, as described above, subject to the Tennessee sales or use tax?
 6. Is the service of obtaining and disseminating information about [TYPE OF PRODUCTS] to the customer through the U.S. Postal Service across state lines, as described above, subject to the Tennessee sales or use tax?
 7. Are any of the activities described above, whether taken singly or in combination, sufficient to create nexus in Tennessee:
 - a. For Tennessee sales or use tax purposes, assuming the taxpayer does not voluntarily register to collect the Tennessee sales or use tax (as considered in item 2.b. above)
 - b. For Tennessee franchise and excise tax purposes?

RULINGS

1. Consulting by telephone, where oral advice is given over the telephone, is not subject to Tennessee sales or use tax.
2. The link up itself is not subject to tax as a telecommunication, except when billed to the customer as a telecommunication. The facts given in (a) and (c) have no effect on the outcome. The facts given in (b) indicate that a separate charge is being made to the customer for telecommunication, which is subject to Tennessee sales tax, assuming the customer is located in Tennessee.¹ The method by which the taxpayer computes this charge is not significant. However, without respect to the taxability or nontaxability of the telecommunication, the service performed on the customer's computer may be subject to Tennessee sales tax, assuming the customer is located in Tennessee.
3. The hardware maintenance contracts are subject to the sales tax.
4. The software maintenance contracts are subject to the sales tax. The facts given in (a), (b), and (c) have no effect on the outcome.

¹ T.C.A. § 67-6-221 provides for a reduced rate of tax, 3.5%, on telecommunications services sold to businesses. The local rate is 1.5%. T.C.A. § 67-6-702(g).

5. This is a sale of tangible personal property and is subject to the sales or use tax.
6. This is a sale of tangible personal property and is subject to the sales or use tax.
7. a. The taxpayer's activities are sufficient to create nexus for sales and use tax purposes.
 - b. The taxpayer's activities as described in the ruling request, are not sufficient to rule on whether the taxpayer has nexus for franchise and excise tax purposes.

ANALYSIS

1. In the transaction described here, no property is transmitted to customers; therefore, it is not taxable as a sale of tangible personal property. In the area of services, the sales tax does not apply to all services; it applies only to those services specifically enumerated by the statute. *Ryder Truck Rental, Inc. v. Huddleston*, 1994 Tenn. App. LEXIS 444. The taxable services are listed in the definition of "retail sale," T.C.A. §67-6-102(24)(F). Providing telephone consulting does not fall within any of the taxable services; therefore, it is not subject to the sales tax. This ruling presumes that the telephone consulting is separately billed from any other services.

2. The question presented asks if the link up of the taxpayer's computer to the customer's computer is subject to tax. The link up itself, that is, the connection, is a telecommunication. Telecommunications, generally, are subject to tax.² If the connection between the two computers is being sold as a separate item, as in item (b), the charge made to the customer is subject to tax. However, it appears that the actual item that is being sold to the customer is not the link up itself; rather, it is the work being performed to the customer's computer system. When telecommunications are merely being used to deliver another service that is the true object of the transaction, the Tennessee Court of Appeals has held that a single charge for both the telecommunications and the other service cannot be subjected to tax as a telecommunication. *Equifax Check Services, Inc. v. Johnson*, 2000 WL 827963 (Tenn. Ct. App.). Therefore, the facts described in items (a) and (c) do not describe a taxable telecommunication.

However, the work being performed on the customer's computer system, itself, may be taxable as a sale of tangible personal property, or repair to or installation of tangible personal property. The ruling request states that the link up is for the purpose of observing the customer's computer system from a remote location. The ruling request states that this observation is for the purpose of assisting in the consultation with the customer, presumably the consultation described in Question 1. If the link up is only for the purpose of facilitating the telephone consultation, no tax is applicable on the charge, except to the extent a charge to the customer is billed as a telecommunication charge. But if any software is upgraded, modified, changed, repaired, or installed over the link up, such a transaction is taxable for the following reason.

² The term "telecommunication" is defined in T.C.A. § 67-6-102(30). The tax is levied under either T.C.A. § 67-6-205, the general levy of tax on services, or under T.C.A. § 67-6-221, a special tax applicable to interstate telecommunications.

The term “sale” is defined to include:

[the] transfer of customized or packaged computer software, which is defined to mean, information and directions loaded into a computer which dictate different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property; however, the fabrication of software by a person for such person’s own use or consumption shall not be considered a taxable “use”....

T.C.A. §67-6-102(24)(B). The Tennessee Supreme Court has held that the effect of this statutory provision is to treat computer software as tangible personal property. *University Computing Co. v. Olsen*, 677 S.W.2d 445 (Tenn. 1984). A dealer’s customization or modification of his customer’s computer software is a sale within the definition set forth in this section. *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986). The sale of tangible property is subject to tax, as are repair and installation of tangible personal property³. If software is loaded on a computer located in Tennessee, or if existing software, residing on a computer located in Tennessee, is upgraded, modified, changed, or repaired over the link-up, the charge would be taxable, either as a sale of tangible personal property, or as a taxable service of installation or repair of tangible personal property.

3. As described in the ruling request, this service is a “warranty or service contract warranting the repair or maintenance of tangible personal property.” Such a contract is listed as a taxable service, T.C.A. §67-6-102(24)(F)(ix).⁴

4. As explained previously, software is deemed, by statute, to be tangible personal property. The provision of upgrades to the customer is subject to tax as the sale of software. Maintenance contracts are also subject to tax as a taxable service. T.C.A. §67-6-102(24)(F)(ix). Therefore, the described transaction is subject to tax. The additional facts indicated in items (a), (b), and (c) do not impact this result.

5 & 6. While questions 5 and 6 describe the transaction as a service, the facts given show that both of these activities are accomplished by providing the customer with a computer diskette. Naming or characterizing a sale as a service does not cause the transaction to escape taxation when the transaction is essentially a transfer of tangible personal property. The use of the diskette to provide the information would appear to be no different than, for example, the use of a book to provide the information. The sale or use of tangible personal property is subject to sales or use tax. T.C.A. §§67-6-202, 67-6-203.

³ Repair and installation of tangible personal property among the taxable services listed in the statute. T.C.A. § 67-6-102(23)(F)(iv) & (vi). A made-to-order sale, where some or all of the material used to fabricate the item sold is furnished to the customer, is also subject to tax. See T.C.A. § 67-6-102(25)(A) and Tenn. Comp. R. & Regs. 1320-5-1-.41

⁴ Arguably, since under the facts presented the customer would either replace the defective part himself, or would be responsible to pay another party to do so, no repair takes place. However, this is clearly a warranty contract, and, further, even if it were not viewed as a service, the transaction is one where tangible personal property is transferred and would be taxable as a sale of tangible personal property.

7. a. Sales and use tax nexus requires a physical presence in the taxing state.⁵ See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In the facts given in the ruling request, the taxpayer itself would have no employees or property in the state. The taxpayer has a corporate affiliate which solicits sales in the state, and which is available to install replacement parts for customers who cannot perform the installation itself.

First, it should be noted that other parties that act on behalf of the taxpayer can supply the requisite nexus. For example, in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), independent contractors hired by the taxpayer to solicit sales on a part-time, non-exclusive basis were held to provide nexus. See also *Tyler Pipe Indus., Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987). Second, while the mere presence of a corporate affiliate may not alone provide nexus, the in-state activities of that affiliate can form nexus. See *Reader's Digest Association v. Mahin*, 44 Ill. 2d 354, 255 N.E.2d 458, cert. denied 399 U.S. 919 (1970). Due to the presence and activities of its affiliate, the taxpayer has nexus such as to require the taxpayer to collect Tennessee sales or use tax.

7. b. The Tennessee Supreme Court, in *J. C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), held that the physical presence requirement of *Quill, supra*, is applicable for franchise and excise tax purposes. However, in determining the taxpayer's liability for franchise and excise tax, two factors other than constitutional nexus also must be considered. The first, 15 U.S.C. §§381-384, better known as P.L. 86-272, provides that a state may not impose taxes on net income, where an out-of-state taxpayer's sole contact with the taxing state is that it enters the state for the purpose of soliciting sales of tangible personal property and closely related activities. Therefore, it is possible to have nexus for sales or use tax purposes, without the taxpayer being liable for franchise and excise taxes. However, here, some of the activities conducted in the state by other parties, representing the taxpayer, which provide nexus for sales and use tax purposes, are outside the safe harbor of P.L. 86-272. At least one of the items sold on behalf of the taxpayer is a service agreement, clearly a service and not a sale of tangible personal property. However a second factor must be considered, which is whether the taxpayer is doing business in Tennessee, within the ambit of T.C.A. 67-4-2004. While for sales and use tax purposes, the presence of a non-employee independent contractor, even if that contractor is unaffiliated with the taxpayer, is sufficient nexus to impose sales or use tax, see *Scripto, supra*, the activities of the in-state party which provides nexus for sales tax does not necessarily rise to the level of doing business nor form nexus for purpose of franchise and excise tax.⁶ If the in-state party is acting as an agent of the taxpayer, the taxpayer may be doing business in Tennessee. If, on the other hand, there is no agency relationship, the taxpayer may not be doing business in Tennessee. From the facts given in the ruling request, describing the taxpayer's relationship with its affiliate corporation, it is not clear whether an agency relationship exists, therefore, the Department cannot rule on this question.

⁵ Nexus is the connection between the taxpayer and the state seeking to impose the tax, and without which such state cannot levy a tax.

⁶ See also *J.C. Penney National Bank, supra*. In footnote 29 of its opinion, the court found that the use of an independent collection agency in Tennessee was the closest J.C. Penney National Bank came to having physical presence. The court stated "[W]e do not believe that the actions of a party so far removed from JCPNB are sufficient to allow the State of Tennessee to levy taxes on JCPNB." 19 S.W.3d at 842.

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APPROVED: Ruth E. Johnson
Commissioner

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