

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 02-37**

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 taxes to sales and installation of security systems.

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 Taxpayer is a corporation that began operations during calendar year [YEAR]. The Taxpayer is registered for Tennessee Sales and Use Taxes,¹ but has no Tennessee location. The Taxpayer currently has [NUMBER] employees. These employees are all stockholders who live in [STATE – NOT TENNESSEE]. The Taxpayer presently sells, installs, and maintains audio/video security systems. The Taxpayer does not sell monitoring services. The security systems sold consist of monitors, cabling, mounted cameras and other related accessories.

At the present time, virtually all the Taxpayer's business is with a bank in [STATE – NOT TENNESSEE] that also has branches in Tennessee. The Taxpayer will also "occasionally" install and maintain equipment for this one customer in Tennessee. When a sale is made for installation in a Tennessee bank, the Taxpayer's employee(s) load the equipment² to be installed at the Taxpayer's [CITY, STATE – NOT TENNESSEE] location and drive to Tennessee. The Taxpayer's employee(s) stay in Tennessee as long as it is necessary to install the equipment and check to see that it is operating properly. The Taxpayer contends these sales are made in [STATE – NOT TENNESSEE] since the bills are sent to the customer in [STATE – NOT TENNESSEE] and payment is made from the customer's [STATE – NOT TENNESSEE] location.

The Taxpayer will also provide maintenance and repairs on previously installed equipment located in Tennessee. Maintenance and repairs are contracted separately on an hourly or lump sum basis.

QUESTIONS

1. What taxes is the Taxpayer liable for in Tennessee?
2. When are these taxes due?

RULINGS

1. Binding rulings of the Department of Revenue are only issued with regard to taxes administered by the Department of Revenue. Of the taxes administered by the Department, the following apply to the Taxpayer:
 - (a) Franchise/excise taxes;
 - (b) Sales and/or use taxes; and
 - (c) Business taxes

¹ The Taxpayer's application for registration indicates the Taxpayer makes retail sales and installs everything that is sold. The Taxpayer's application also describes its business activity as the installation and maintenance of audio/video security systems.

² The Taxpayer states that no equipment is purchased by the Taxpayer in Tennessee.

2. (a) An annual tax return and payment of the franchise/excise taxes is required to be filed on or before the fifteenth day of the fourth month following the close of the Taxpayer's taxable year. The return coincides with the accounting period covered by the Taxpayer's federal return. If the Taxpayer's combined franchise/excise tax liability for the current year is five thousand dollars (\$5,000.00) or more, equal quarterly estimated franchise/excise tax payments are also required for the current year. Tenn. Code Ann. § 67-4-2015(a) and (b).

(b) A sales and use tax return is required to be filed together with payment of any taxes due on or before the twentieth day of each month for taxable sales occurring during the prior month. Tenn. Code Ann. § 67-6-504.

(c) The business tax is a tax levied by counties and cities in Tennessee pursuant to Tenn. Code Ann. § 67-4-704. The Taxpayer is required to register with the appropriate county and city officials before engaging in business. Since the Taxpayer will have no location in Tennessee, the Taxpayer must register with the county and city where the sale, installation and/or maintenance take place. The due date for the annual return and payment of the tax will vary dependent upon the Taxpayer's predominant business activity.

ANALYSIS

Nexus

A taxpayer must have "substantial nexus" with Tennessee as required by the Commerce Clause of the United States Constitution before Tennessee taxes may be applied. In this case, the Taxpayer will have employees in the State of Tennessee for the purpose of installing and/or maintaining security systems. Furthermore, the sale of these security systems takes place in Tennessee.³ Tenn. Code Ann. § 67-6-102(25)(A) defines "sale" to include the transfer of title or possession, or both in Tennessee. The Taxpayer states these employees will only "occasionally" enter the state to conduct the business of the Taxpayer. However, even an occasional presence of employees in Tennessee gives the Taxpayer a physical presence in Tennessee, and this physical presence appears sufficient to establish the required nexus. The exact number of days the Taxpayer's employees will be conducting future business in Tennessee is not known. However, Tennessee case law indicates the presence of employees in the state does not have to be lengthy to establish the required nexus.

In *Cole Bros. Circus, Inc. v. Huddleston*, 1993 WL 190914 (Tenn. Ct. App. 1993), the Court of Appeals found the physical presence of the Taxpayer in Tennessee for 4 days in 1985, 7 days in 1986, 13 days in 1987, and 5 days in 1988 established the required nexus. Cole Brothers' employees were only present in Tennessee for a total of 29 days during

³ The Taxpayer contends the sale of equipment to its customer takes place in [STATE – NOT TENNESSEE], but the facts are consistent with the passage of title and delivery of the equipment in Tennessee.

the entire four-year audit period. Also, in *Pearle Health Services, Inc. v. Taylor*, 799 S.W.2d 655 (Tenn. 1990), the Tennessee Supreme Court considered the nexus issue. In *Pearle*, the Court determined an out-of-state taxpayer's nexus with the state was sufficient when its agents were in Tennessee every six to eight weeks to show new products and every 15 to 18 months to conduct quality control inspections of its customers.

Application of Franchise/Excise Taxes

Tenn. Code Ann. § 67-4-2001 imposes the Tennessee excise tax on persons, including corporations, doing business in Tennessee. Similarly, Tenn. Code Ann. § 67-4-2101 imposes the franchise tax on persons, including corporations doing business in Tennessee. Doing business in Tennessee for purposes of these two taxes means:

...[A]ny activity purposely engaged in, within Tennessee, by a person with the object of gain, benefit, or advantage...

Tenn. Code Ann. § 67-4-2004(7)(A). It is clear from the facts presented that the Taxpayer is doing business in Tennessee for purposes of the franchise/excise taxes. The franchise/excise taxes will be apportioned pursuant to Tenn. Code Ann. §§ 67-4-2012 and 67-4-2111 since the Taxpayer will be doing business both within and without Tennessee.

Application of Sales and Use Taxes

Title 67, Chapter 6, of the Tennessee Code Annotated is the “Retailers’ Sales Tax Act”. This law imposes state and local, sales and use taxes on the sale or use of tangible personal property and the sale of many enumerated services. The manner in which the sales or use tax applies to the sale, installation, and maintenance of security systems is dependent upon whether the installed security system remains tangible personal property after installation.

If an installed system is tangible personal property after installation, all charges for the sale and installation, as well as any later repair or maintenance charges will be fully taxed.⁴ The sale of such a security system is taxable as a sale of tangible personal property. In addition, the installation of the system and maintenance or repairs constitute specifically enumerated services also subject to the sales tax when the installed system remains tangible personal property. Tenn. Code Ann. § 67-6-201(1) and (3). The tax base in each case is the “sales price”, i.e. the total amount for which the taxable services or tangible personal property is sold. Tenn. Code Ann. § 67-6-102(26).

On the other hand, if the security system does not remain tangible personal property after it is installed, there is an entirely different tax result. When a security system becomes part of the realty upon installation, the sales tax does not apply. Instead, the “contractors use tax” imposed by Tenn. Code Ann. § 67-6-209 applies. The tax base for this use tax is the Taxpayer’s “cost” of the security system installed. Any charges for repairs of this

⁴ From the facts presented, there would be no applicable exemption for these transactions.

security system while it remains realty are also not subject to the sales tax. However, the “contractors use tax” would apply to materials used to make the repair.

Obviously, it is extremely important for the Taxpayer to determine whether a security system remains tangible personal property after installation. This determination must be made by the application of the law of fixtures to the controlling facts on a case-by-case basis. In this case, the relevant facts and intent of the parties concerning future installations have not been established by the Taxpayer. Therefore, a ruling as to whether installed security systems remain tangible personal property or become part of the realty after installation is not possible. However, a discussion of the case law on this subject may be helpful.

The primary test in determining whether property affixed to realty is deemed realty or personal property is the intention and purpose of the installation. As explained by the Tennessee Supreme Court, this test looks at how the parties intend the property to be used:

The tendency of modern decisions is to make the rights of the parties to fixtures and buildings depend, not on the manner in which they are attached to the freehold, but upon the character of the parties, the intention in erecting the improvements, and the uses to which they are put. Whether attached by screws or by nails, once material, is no longer so.

W. J. Savage & Co. v. Mayfield, 11 S.W.2d 855, 856 (Tenn. 1928); *see also General Carpet Contractors, Inc. v. Tidwell*, 511 S.W.2d 241, 242-243 (Tenn. 1974)(stating that intent of the parties must be ascertained in order to determine if an item is real or tangible personal property). In the most recent sales or use tax case on this subject, *Process Systems Inc. v. Huddleston*, 1996 WL 614526 (Tenn. Ct. App., 1996) the Court of Appeals reviewed the law on fixtures and stated it this way:

In determining whether property affixed to realty is deemed realty or personal property, the controlling factor is the intention and purpose of the installation. *Hubbard v. Hardeman County Bank*, 868 S.W.2d 656, 660 (Tenn.App.1993); *Johnson v. Patterson*, 81 Tenn. 626, 631-32 (1884). Personal property does not become part of the realty to which it is attached " [i]f it is intended to be removable at the pleasure of the owner." *Memphis Hous. Auth. v. Memphis Steam LaundryCleaner, Inc.*, 225 Tenn. 46, 52, 463 S.W.2d 677, 679 (1971) (quoting *Hickman v. Booth*, 131 Tenn. 32, 34, 173 S.W. 438, 438 (1914)). In determining the intent and purpose of the parties, a court should look at both the objective and subjective elements. *See Hubbard*, 868 S.W.2d at 660. Personal property becomes part of the realty, though, if removing it would seriously damage the building to which it is affixed. *Memphis Hous. Auth.*, 225

Tenn. at 52, 463 S.W.2d at 679. It is also considered realty if removal would destroy its essential character as personalty. *Green v. Harper*, 700 S.W.2d 565, 567 (Tenn.App.1985). In a lease situation, trade fixtures generally remain personal property removable by the lessee when "the removal can be affected without material

injury to the freehold" and when the fixtures do not lose their essential character as personalty. *Id.* Whether a fixture remains personal property or becomes realty is a mixed question of law and fact. *Fuson v. Whitaker*, 28 Tenn.App. 338, 341, 190 S.W.2d 305, 307 (1945).

Id. p. 3.

New York courts have specifically considered whether security systems remain tangible personal property upon installation. In that state, it was held that installed security systems remained tangible personal property in *ADT Company, Inc. v. State Tax Commission*, 495 N.Y.S.2d 274, 275 (N.Y. App. Div. 1985) and *Central Office Alarm Co., Inc. v. State Tax Commission*, 396 N.Y.S.2d 494, 495 (N.Y. App. Div. 1977). However, the security systems considered in these cases were provided to customers only for a specified period of time. Whether security systems purchased by a customer remain tangible personal property after installation is a more difficult determination.

One factor that indicates an audio/video security system remains tangible personal property after installation is that major components of the security system are easily removed. The removal of audio/video monitors, audio/video recorders, cameras, etc. should do little damage to the equipment or the freehold. Of course, other indicators of the intent of the parties could outweigh this one factor. Nonetheless, it appears such a security system attached to the realty by a lessee will normally remain tangible personal property. In *Green v. Harper*, 700 S.W.2d 565 (Tenn. App. Ct. 1985), the Tennessee Court held that a movie screen, theater marquee and car speakers installed at a drive-in theater by the lessee of the realty remained personal property.

Application of the Business Tax

Application of the business tax follows closely on the heels of the sales or use tax. However, the business tax rate is lower. The business tax applies based upon the statutory classification of a taxpayer according to its dominant business activity. *See*: Tenn. Code Ann. § 67-4-708. The tax rates are slightly different dependent upon the classification of a taxpayer. Also, retail sales are taxed at a different rate from wholesale sales. Tenn. Code Ann. § 67-4-709 sets out the applicable rates for each classification under the business tax. Since the Taxpayer will have no location in Tennessee, the Taxpayer must register with the county and/or city where each taxable privilege, i.e. the sale, installation and/or maintenance, will take place. Tenn. Code Ann. § 67-4-704(a).

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APPROVED: _____
Ruth E. Johnson
Commissioner of Revenue

DATE: 10-11-02 _____