

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 15-04**

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The application of the Tennessee sales and use tax to the service of converting digital products.

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") provides [REDACTED] testing and analysis services for [REDACTED] (the "Clients"). The Taxpayer's services range from [REDACTED - DESCRIPTION OF SPECIFIC SERVICES].

Typically in the field of [REDACTED] testing, [REDACTED - TAXPAYER CLIENTS] request lab tests [REDACTED]. In doing so, a [REDACTED - TAXPAYER CLIENT] professional takes a [REDACTED] sample [REDACTED], transports the sample to an independent lab, and requests the lab to conduct a

specified test on the sample. The lab then communicates the test results to the [REDACTED – TAXPAYER CLIENT].

The Taxpayer serves as the independent lab, described above, for its Clients. [REDACTED].

The Taxpayer [UTILIZES] a web-based platform whereby its Clients can order lab tests, receive test results, [REDACTED]. The platform is cloud-based and allows access to [REDACTED] records over the Internet.

To order a lab test, a Client, using a web browser on its own computer, sends a universal resource locator (“URL”) link to the web server located on the Taxpayer’s central computer. The server fetches a log-in page from the database and sends it to the Client’s computer. After the Client logs in with the correct user name and user password, the server sends an ordering document URL link to the Client’s web browser. The Client fills in the test order and sends a test order URL back to the server. The Client communicates with the central computer to order a test, to ascertain the results of a test, and to handle administrative functions associated with the test order, such as billing and customizing of pages showing [REDACTED]. Upon successful communication to order a test by the Client computer, a requisition for the test [REDACTED] are generated.

The performing lab [REDACTED] performs the testing. The lab sends the results to the Taxpayer’s central computer. The central computer (or a computer at the performing lab) may interpret the test result and provide an alert [REDACTED].

The central computer then releases the test results to the Client computer. The Taxpayer provides the test results by electronic transmission over the Internet at the Client’s request, providing a method for viewing or printing test results [REDACTED].

The lab orders and results are sent over the Internet between the Client’s computer and the Taxpayer’s central computer in the form of [REDACTED]¹ messages through each party’s [REDACTED] records (“[RECORDS MANAGEMENT]”) systems. Both the Taxpayer and its Clients have their own unique [RECORDS MANAGEMENT] systems that cannot directly communicate the [REDACTED] messages between each other. Therefore, the configuration of [REDACTED – DESCRIPTION OF SOFTWARE PROGRAM] allows the two conflicting systems to accurately exchange data.

The Taxpayer does not develop these [SOFTWARE PROGRAMS]. Instead, the Taxpayer’s Clients direct the Taxpayer to the [RECORDS MANAGEMENT] provider that is most knowledgeable with their specific [RECORDS MANAGEMENT SYSTEM]. The Taxpayer then works with the [RECORDS MANAGEMENT] vendor to develop and provide the [PROGRAM] services used to connect the Client’s [RECORDS MANAGEMENT SYSTEM] to the Taxpayer’s [RECORDS MANAGEMENT SYSTEM]. These [PROGRAMS] include computer code or instructions that manipulate the format of the data sent in the [REDACTED] messages so that each party’s respective [RECORDS MANAGEMENT SYSTEM] correctly reads the data.

These [PROGRAMS] neither change nor utilize the software used in either party’s [RECORDS MANAGEMENT SYSTEM]. The purpose of the [PROGRAM] is to provide a translation service (or data

¹ [REDACTED].

manipulation) necessary to electronically transmit the [REDACTED] order and results data between the two systems. The [PROGRAM] processes the [REDACTED] messages and displays them within the [RECORDS MANAGEMENT SYSTEM] software located at the Client's office.

Neither the Taxpayer nor its Clients have access or rights to the [PROGRAM]. Access to the [PROGRAM] is restricted solely to the [RECORDS MANAGEMENT] vendor creating the [PROGRAM]. The [PROGRAM] automatically performs the translation services without the interaction of the Taxpayer or its Clients. The only data exchanged by and to the Taxpayer and its Clients are [REDACTED] messages.

RULING

Are the [PROGRAM] charges that the Taxpayer pays to various [RECORDS MANAGEMENT] vendors subject to the Tennessee sales and use tax?

Ruling: No, the [PROGRAM] charges that Taxpayer pays to various [RECORDS MANAGEMENT] vendors are not subject to the Tennessee sales and use tax because the [RECORDS MANAGEMENT] vendors are providing the non-taxable service of converting digital products.

ANALYSIS

LEGAL BACKGROUND

Under the Retailers' Sales Tax Act,² the retail sale in Tennessee of tangible personal property and specifically enumerated services are subject to the sales and use tax, unless an exemption applies. "Retail sale" is defined as "any sale, lease, or rental for any purpose other than for resale, sublease, or subrent."³

TENN. CODE ANN. § 67-6-102(78)(A) (Supp. 2015) defines "sale," in pertinent part, to mean "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." "Tangible personal property" includes "property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses."⁴ Tangible personal property also includes "prewritten computer software," which is defined in TENN. CODE ANN. § 67-6-102(68) in pertinent part as "computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser."⁵

² Tennessee Retailers' Sales Tax Act, ch. 3, §§ 1-18, 1947 Tenn. Pub. Acts 22, 22-54 (codified as amended at TENN. CODE ANN. §§ 67-6-101 to -907 (2013)).

³ TENN. CODE ANN. § 67-6-102(76) (Supp. 2015).

⁴ TENN. CODE ANN. § 67-6-102(89)(A).

⁵ TENN. CODE ANN. § 67-6-102(68) further provides that "[p]rewritten computer software' or a prewritten portion of the computer software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software." Note, however, that "where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for the modification or enhancement, the modification or enhancement shall not constitute prewritten computer software." *Id.*

In addition to the transfer of tangible personal property, the term “sale” also includes “the furnishing of any of the things or services” taxable under the Retailers’ Sales Tax Act.⁶ One of the “things” specifically taxable is:

[t]he retail sale, lease, licensing or use of computer software in this state, including prewritten and custom computer software . . . regardless of whether the software is delivered electronically, delivered by use of tangible storage media, loaded or programmed into a computer, created on the premises of the consumer or otherwise provided.⁷

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”⁸ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”⁹ The Tennessee Supreme Court has stated that the fabrication of, or customized modification or enhancement to, computer software is considered a taxable sale of computer software.¹⁰

Additionally, the term “sale” specifically includes the transfer of computer software, including the creation of computer software on the premises of the consumer and any programming, transferring, or loading of computer software onto a computer.¹¹

In response to advances in technology that allow the remote access and use of software over the Internet, the Tennessee General Assembly adopted into law 2015 Tenn. Pub. Acts Ch. 514, § 22. This new law effectively treats all uses of computer software in this state equally, regardless of how a person accesses the software. It amends TENN. CODE ANN. § 67-6-231(a) to include a new subdivision (2), which states in pertinent part that

[f]or purposes of subdivision (a)(1), “use of computer software” includes the access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer. If the customer accesses the software from a location in this state as indicated by the residential street address or the primary business address of the customer, such

⁶ TENN. CODE ANN. § 67-6-102(78)(C).

⁷ TENN. CODE ANN. § 67-6-231(a) (Supp. 2015). The term “sale” specifically includes the transfer of computer software, including the creation of computer software on the premises of the consumer and any programming, transferring, or loading of computer software onto a computer. TENN. CODE ANN. § 67-6-102(78)(K).

⁸ TENN. CODE ANN. § 67-6-102(18).

⁹ TENN. CODE ANN. § 67-6-102(24).

¹⁰ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

¹¹ TENN. CODE ANN. § 67-6-102(78)(K).

access shall be deemed equivalent to the sale or licensing of the software and electronic delivery of the software for use in the state.¹²

As a result, effective for all billing periods beginning on or after July 1, 2015, the access and use of computer software in this state, which has generally been subject to tax since 1977,¹³ remains subject to sales and use tax regardless of a customer's chosen method of use.

The sales and use tax also applies to retail sales of services specifically enumerated in the Retailers' Sales Tax Act.¹⁴ Notably, the application of the sales tax to retail sales of services in Tennessee remains unaffected by the enactment of 2015 Tenn. Pub. Ch. 514, § 22. The sales tax remains applicable only to those services specifically enumerated in the Retailers' Sales Tax Act.¹⁵ As reassurance of this fact, the General Assembly included language in Section 22 stating that nothing in the new subdivision (a)(2) of TENN. CODE ANN. § 67-6-231

shall be construed to impose a tax on any services that are not currently subject to tax under this chapter, such as, but not limited to, information or data processing services, including the capability of the customer to analyze such information or data provided by the dealer; payment or transaction processing services; payroll processing services; billing and collection services; Internet access; the storage of data, digital codes, or computer software; or the service of converting, managing, and distributing digital products.¹⁶

Therefore, while the new TENN. CODE ANN. § 67-6-231(a)(2) modernizes taxation on the use of computer software in this state, it has no effect on the taxation of services.

Additionally, whenever two or more items are sold for a single sales price and at least one of the items is subject to sales tax, the entire sales price is subject to the sales tax as a bundled

¹² 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

¹³ The General Assembly amended the definition of "tangible personal property" in 1977 to specifically include computer software in response to the Tennessee Supreme Court's holding to the contrary in *Commerce Union Bank*, 538 S.W.2d at 408. 1977 Tenn. Pub. Acts Ch. 42 (defining "tangible personal property" to include computer software); see also *Univ. Computing Co. v. Olsen*, 677 S.W.2d 445, 447 (Tenn. 1984) (detailing the General Assembly's actions taken to subject computer software to sales and use tax).

¹⁴ The Retailers' Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. See, e.g., TENN. CODE ANN. § 67-6-205 (2013); *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994) (sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹⁵ The Retailers' Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. See, e.g., TENN. CODE ANN. § 67-6-205 (2013); *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994) (sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹⁶ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

transaction.¹⁷ Finally, when a transaction involves taxable and nontaxable components and the transaction's true object or a "crucial,"¹⁸ "essential,"¹⁹ "necessary,"²⁰ "consequential,"²¹ or "integral"²² element of the transaction is subject tax, the entire transaction is subject to sales tax.²³

APPLICATION

The [RECORDS MANAGEMENT] vendors' [PROGRAM] charges are not subject to the Tennessee sales and use tax.

No sale, transfer, or electronic delivery of tangible personal property or computer software occurs in Tennessee when the [RECORDS MANAGEMENT] vendors charge the Taxpayer for the [PROGRAMS]. The [RECORDS MANAGEMENT] vendors do not transfer title, possession, or control of the [PROGRAMS] at any time, nor does the Taxpayer electronically download the [PROGRAMS].

Moreover, the [RECORDS MANAGEMENT] vendors are not furnishing taxable services or things in Tennessee. As previously stated, only specifically enumerated services and things, such as the use of computer software, are subject to the Tennessee sales and use tax.

With respect to the taxable use of computer software in this state that remains in possession of the dealer, TENN. CODE ANN. § 67-6-231(a)(2) requires the access and use of the computer software by a customer in this state. Although [A PROGRAM], which is housed on a server in possession of an [RECORDS MANAGEMENT] vendor, is a set of coded instructions that enables a computer to perform

¹⁷ See generally Tenn. Dept. of Rev. Ltr. Rul. 14-10 (Oct. 14, 2014) [hereinafter "Ltr. Rul. 14-10"] (discussing Tennessee law regarding bundling and the "true object" test), available at <http://www.tennessee.gov/assets/entities/revenue/attachments/14-10.pdf>.

¹⁸ See, e.g., *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 624 (Tenn. 1987) (holding that a transaction involving the sale of non-taxable intangible advertising concepts was nevertheless subject to sales tax on the entire amount of the transaction because advertising models, which were tangible personal property, were an "essential," "crucial," and "necessary" element of the transaction).

¹⁹ *Id.*; see also *AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *8 (Tenn. Ct. App. Oct. 8, 2002) (holding that a transaction involving the sale of engineering services along with separately itemized tangible telecommunications systems was subject to sales tax on the entire amount of the contract because "equipment, engineering, and installation combine in this instance to produce BellSouth's desired result: a functioning item of tangible personal property assembled on the customer's premises," and further describing the engineering services as "essential" and "integral" to the sale of tangible personal property).

²⁰ See *supra* note 18.

²¹ See *Rivergate Toyota, Inc. v. Huddleston*, No. 01A01-9602-CH-00053, 1998 WL 83720, at *4 (Tenn. Ct. App. Feb. 27, 1998) (holding that a transaction involving the commission and distribution of advertising brochures was subject to sales tax on the "entire cost of the transaction" because, although the transaction involved a number of services, the brochures themselves "were not inconsequential elements of the transaction but, in fact, were the sole purpose of the contract").

²² See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²³ See generally *Ltr. Rul. No. 14-10*, *supra* note 17.

a task and, thus, constitutes computer software for Tennessee sales and use tax purposes,²⁴ the Taxpayer is not using the [PROGRAM]. Rather, the [RECORDS MANAGEMENT] vendor is providing a service through the [PROGRAM].

TENN. CODE ANN. § 67-6-231(a)(2) clarifies that the application of the sales and use tax to remotely accessed software does not make otherwise nontaxable services subject to tax. One such service is that of “converting, managing, and distributing digital products.”²⁵ Here, the [RECORDS MANAGEMENT] vendors develop the [PROGRAMS] to convert data from one type of [DATA INTERCHANGE] digital content into a different, readable form. The fact that computer software is used to perform these tasks is inconsequential because the [RECORDS MANAGEMENT] vendors use the software that they develop internally in the service of converting digital products. Thus, the [PROGRAMS] developed by the [RECORDS MANAGEMENT] vendors and used in the provision of services is not subject to tax as remote access software.

Because the [RECORDS MANAGEMENT] providers do not make sales of taxable goods or services in conjunction with the sale of the service of converting digital products, the sale of such services cannot be characterized as the furnishing of an otherwise nontaxable service that is sold as part of the sale of a taxable good or service.

Analysis under the principles set forth in the “true object” test is unnecessary because the [RECORDS MANAGEMENT] vendors do not sell a taxable service or item of tangible personal property with the information or data processing service.

Accordingly, the [RECORDS MANAGEMENT] vendors’ [PROGRAM] charges are not subject to the Tennessee sales and use tax.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: October 19, 2015

²⁴ See TENN. CODE ANN. § 67-6-102(18).

²⁵ TENN. CODE ANN. § 67-6-231(a)(2).