

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 07-34**

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 the Tennessee sales and use tax single article limitation, described in Tenn. Code Ann. § 67-6-702, to sales of computer servers.

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] manufactures, sells, and services computer and printing equipment. It is registered to do business in Tennessee and collects and remits Tennessee sales and use tax. The Taxpayer's sales of computer servers are the focus of this ruling request. The Taxpayer stated that in today's market, servers must be tailored to meet a customer's needs. The Taxpayer's business, consequently, involves guiding the customer through all of the variables involved in selecting a server including processing speed, storage

capacity, connectivity to other computers or networks, size, price, etc. The end-product is a server that has the specific characteristics necessary to meet the customer's needs.

The Taxpayer's typical computer server has standard components, which include CPUs, memory, I/O drives, fans, a power supply, and battery backup devices. Depending on the customer's needs, the server it purchases may include several processors, disk drives for data storage, fans, etc. None of these components operate separately or have any utility as a stand-alone item.

Computer servers are delivered to the customer as a complete, plug-and-play unit that requires little installation. The various server components are factory integrated, configured and tested before shipment to the customer. There may be separate power cables, or other ancillary items that have to be attached at the customer's site in order to operate the server.

Sometimes the Taxpayer will bill the customer a lump-sum amount for the purchase of a server. At other times, the Taxpayer will bill the customer a lump-sum amount for the server and provide a description of the server that lists the various characteristics of the server (e.g., number of processors, disk drives, etc.); however, this bill does not price the components. Still other times, the Taxpayer will bill the customer for the server base price and also provide the description and price of additional components that have been built into the server per the customer's specifications.

Additionally, the Taxpayer may sell computer components separately to end-user customers who want to upgrade their existing servers or replace defective parts.

QUESTIONS¹

1. Based on the description of the computer servers and how they are sold by the Taxpayer, how does the single article limitation apply to these computer servers?
 - (a) Does the answer to question 1 change depending on whether the computer server is pre-manufactured or built-to-order?
 - (b) Does the answer to question 1 change depending on whether the invoice:
 - (i) has the computer server price as a lump sum amount with no details of the components built into the server;
 - (ii) has the server price as a lump sum amount, but with details (except price) of the components built into the server; or
 - (iii) the invoice provides the server base price and the price of other components that are built into the server?
2. With respect to the question on whether servers should be considered single articles, how would the answers change, if at all, if the Taxpayer also sells

¹ Because letter rulings are binding upon the Department and are applicable only to the individual taxpayer being addressed, any questions included in the original request regarding the tax liability of entities other than the Taxpayer have not been addressed.

computer components (such as disk drives, memory cards, etc.) separately to end-user customers wanting to upgrade their existing servers or replace a defective part?

RULINGS

1. The computer server, including any components inside the server's metal case, is a single article. Any items that have a separate physical existence outside of the server's metal case (except for accessories and extra parts such as cables and power cords) are separate single articles.
 - (a) No. The application of the single article cap to a server is the same whether it is pre-manufactured or built-to-order.
 - (b) No. The described invoicing options do not affect whether the server is treated as a single article. This determination is based upon the physical characteristics of the items as described above.
2. The above responses do not change if the Taxpayer also sells server components separately to end-user customers wanting to upgrade their existing servers or replace defective parts.

ANALYSIS

Generally, a state sales tax of 7% is imposed upon the sale of tangible personal property in Tennessee. Tenn. Code Ann. § 67-6-201. Local tax, however, only applies to up to a certain amount on each single article of tangible personal property sold. Consequently, in addition to the state rate of 7%, an additional local sales tax of up to 2.75% may apply to the first \$1,600 of any "single article" of tangible personal property sold. Tenn. Code Ann. § 67-6-702(a). Furthermore, an additional state sales tax of 2.75% applies to the amount of any "single article" in excess of \$1,600 but less than or equal to \$3,200. Tenn. Code Ann. § 67-6-202(a). A "single article" is defined in pertinent part as:

that which is regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit or as a common unit of measure, a regular billing or other obligation. Such independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article.

Tenn. Code Ann. § 67-6-702(d). Under this definition, an item is a single article if it is 1) regarded by common understanding as a separate unit and 2) capable of being sold either as an independent unit or a common unit of measure.

1. The computer server including any components that are housed inside the computer server's metal case is a single article. Any items server components that have a separate physical existence outside the computer server's metal case are considered separate single articles.

The server, including any components that are housed inside its metal case, such as a central processing unit itself, memory, I/O drives, a fan and a power supply, is commonly regarded as a separate unit and is capable of being sold as an independent unit. A server, even though comprised of assembled components, therefore, would constitute a “single article” for purposes of applying Tenn. Code Ann. § 67-6-702.

On the other hand, an external battery backup device, which would be a separate physical item outside of the server’s metal case, would be commonly understood as a separate unit and is capable of being sold independently. It would, therefore, be deemed a single article separate from the server. Similarly, any other computer server component that has a separate physical existence from the server, such as a monitor, keyboard, mouse, or printer, would be deemed separate single articles. Power cables used to power the server are considered ancillary items that are part of the single article.

The Tennessee courts have rejected the argument that physically separate components could be bundled together to constitute a single article because they are part of a larger system. In *Executone of Memphis, Inc. v. Garner*, 650 S.W.2d 734 (Tenn. 1983), the Tennessee Supreme Court held that telephone systems sold by the taxpayer were not single articles of personal property for purposes of the local option sales tax. The court stated that “(t)o conclude that only the system itself constitutes a single unit completely ignores the separate physical character of each component part, both in the design of the system and in the ultimate benefit to the customer.” *Id.* at 737. The Court’s decision supports the conclusion that battery backup devices and other items that have a separate physical character from the server constitute separate single articles for purposes of applying the provisions of Tenn. Code Ann. § 67-6-702.

(a) Whether the server is pre-manufactured or built-to-order does not change the answer to Issue # 1.

Whether a particular server is pre-manufactured or built-to-order by the Taxpayer for its customer is not determinative of whether all individual components of the server will be considered a single article. It is the physical characteristics of the final product that determine whether it is a single article, not the process by which it was manufactured or created.

(b) Invoicing practices described by the Taxpayer with respect to its computer server sales do not affect whether individual components housed inside the server’s metal case are deemed single articles.

It is the physical nature or characteristic of the product being sold that determines whether it qualifies as a single article for purposes of applying the local sales tax single article cap. The server will qualify as a single article to the extent that its component parts are physically located inside the metal casing that is the “server.” Providing the

customer with an invoice that describes the components that are built into the server does not alter this result, nor does pricing the components that are built into the server.²

Although there may be instances in which the physical nature of a product is not sufficient in and of itself to make a determination as to whether it is properly characterized as one item or many,³ here a single product is clearly being sold – a server.

2. The sale of computer server components separately to end-user customers wanting to upgrade their existing servers or replace defective parts has no bearing on whether the computer servers sold by the Taxpayer should be treated as single articles for purposes of applying the local sales tax cap.

Sales of server components, such as drives or memory cards, by the Taxpayer to existing customers for the purpose of upgrades or replacement do not change the single article analysis set forth above. Separate physical existence, not the purpose of the sale, is the key to determining whether an item is a single article.

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APPROVED: Reagan Farr
Commissioner

DATE: 11/26/07

² While not addressed in this ruling request, the Taxpayer should note, however, that the single article limitation will not apply if multiple single articles (e.g. more than one server) are sold for one lump sum price. In order to apply the single article cap, each single article must be separately priced on the invoice.

³ See, e.g., *Honeywell Information Systems, Inc. v. King*, 640 S.W.2d 553 (Tenn. 1982) (relying on the taxpayer's treatment of components of a computer system as individual items in its own marketing, invoicing and record-keeping as support for its decision to uphold the Commissioner's determination that each component should be treated as a single article for purposes of applying the local sales tax cap).