

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 08-24**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Application of the single article limitation to computer software and optional maintenance agreements for purposes of Tennessee sales and use taxation.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer is headquartered and incorporated outside of Tennessee. The Taxpayer licenses the use of various computer software products to customers across the U.S., including customers in Tennessee. Customers may receive delivery of the software in a tangible format, such as CD or diskette, or it may be delivered electronically on its own with no other tangible personal property (*i.e.*, manuals). In either case, customers may also purchase an optional software maintenance agreement. The maintenance agreement provides telephone support, software patches, product enhancements, and product upgrades. The software patches and enhancements are only available for electronic delivery. The product upgrades are available for delivery in both a tangible format and an electronic format.

QUESTIONS

1. Does the \$1,600 limitation to the local option sales tax apply to prewritten computer software?
 - (a) If so, assuming a local rate of 2.25%, how is the tax applied to the example of a customer purchasing three separate \$25,000 pieces of prewritten computer software on the same invoice? Specifically, is the \$1,600 limit applied once to the total price of \$75,000, resulting in \$36 (\$1,600 x 2.25%) of local option sales tax, or is the \$1,600 limit

applied to each \$25,000 piece of prewritten computer software, resulting in \$108 ($\$1,600 \times 2.25\% \times 3$) of local option sales tax?

(b) Does the application of the tax change if Taxpayer delivered the prewritten computer software electronically?

2. Does \$1,600 limitation to the local option sales tax apply to the optional software maintenance contract that includes software patches, enhancements, and upgrades, as well as telephone support?

3. If the answer to Question #2 is yes, does \$1,600 limitation to the local option sales tax apply to the aggregate maintenance agreement cost, or does it apply based on the cost of each piece of the maintenance contract by software product supported? For example:

In the hypothetical sale in 1(a) above, a maintenance agreement for the three pieces of prewritten computer software would cost \$40,500 (based on the total \$75,000 license). Taxpayer's invoice would separately state a charge of \$13,500 per each piece of prewritten computer software supported. This is because a customer may cancel support for a particular product without changing support of the others.

4. If the answer to Question #1 is yes,

(a) Is the state single article sales tax, applicable to sales of tangible personal property on the amount greater than \$1,600 and less than or equal to \$3,200, applied in the same manner with respect to prewritten computer software?

(b) Does the electronic delivery of the prewritten computer software have an impact on the application of the state single article tax limitation?

5. How is the state single article sales tax applied to the Taxpayer's software maintenance agreement as described above?

RULINGS

1. Yes. The \$1,600 limitation to the local option sales tax applies to prewritten computer software.

(a) The \$1,600 limit applies to each \$25,000 piece of prewritten computer software. Assuming a local rate of 2.25%, \$108 ($\$1,600 \times 2.25\% \times 3$) in local option sales tax is due.

(b) The application of the \$1,600 limitation to the local option sales tax is the same for the sale of prewritten computer software that is delivered electronically.

2. No. The \$1,600 limitation to the local option sales tax does not apply to the optional software maintenance contract that includes software patches, enhancements, and upgrades, as well as telephone support. Maintenance agreement costs are sales of taxable services; the \$1,600

limitation to the local option sales tax is only applicable to the sale of tangible personal property and does not apply to the sale of taxable services.

3. Not applicable. *See* Ruling #2.

4. (a) The state single article sales tax is applied with respect to prewritten computer software in the same manner as in Question #1. The tax applies to each \$25,000 package.

(b) Electronic delivery of the software package does not have an impact on the application of the state single article sales tax.

5. The state single article sales tax does not apply to the Taxpayer's software maintenance agreement, as maintenance agreements are not tangible personal property. As indicated in Ruling #2 above, the local option sales tax would apply to the total price of the package.

ANALYSIS

Under the Retailers' Sales Tax Act, Tenn. Code Ann. § 67-6-101 (2007) *et seq.*, the retail sale of tangible personal property is generally subject to the Tennessee sales and use tax. Tenn. Code Ann. § 67-6-702(a)(1) authorizes counties and incorporated cities to impose an additional tax on the first \$1,600 of the sale of any single article of tangible personal property (the "local option sales tax"). Tenn. Code Ann. § 67-6-202(a) (2007) imposes an additional state tax at the rate of 2.75 percent on the amount over \$1,600, but less than or equal to \$3,200, on the sale or use of any single article of tangible personal property (the "state single article sales tax").

1. *The local option single article cap and the local option sales tax.*

The Taxpayer's prewritten computer software products are subject to the local option single article cap for purposes of the local option sales tax.

Tenn. Code Ann. § 67-6-702(a)(1) (2007) authorizes counties and incorporated cities to impose the local option sales tax on the first \$1,600 of the sale of any single article of tangible personal property.¹ Tenn. Code Ann. § 67-6-702(d) (2007) defines the term "single article" for purposes of the local option sales tax 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." Additionally, Tenn. Code Ann. § 67-6-702(d) (2007) provides that "[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article."

The creation and transfer of computer software constitutes a taxable sale under Tennessee law, thereby subjecting the sale of software to the local option sales tax. Tenn. Code Ann. § 67-6-102(60)(A) (2007) specifies that "prewritten computer software" is tangible personal property for the purposes of the Tennessee sales and use tax. Tenn. Code Ann. § 67-6-102(60)(A) (2007) defines "prewritten computer software" as

¹ The \$1,600 limit is referred to for purposes of this revenue ruling as the "local option single article cap."

computer software, including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more “prewritten computer software” programs or prewritten portions thereof does not cause the combination to be other than “prewritten computer software.” “Prewritten computer software” includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser. Where a person modifies or enhances computer software of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person’s modifications or enhancements. “Prewritten computer software” or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains “prewritten computer software;” provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute “prewritten computer software.”²

Under the local option sales tax, a single article is taxed at the local rate only with respect to the first \$1,600 of the sales price. However, if the item being sold does not meet the definition of a “single article,” the entire sales price will be subject to taxation at the local rate. Therefore, it is necessary to determine under what circumstances prewritten computer software products are “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.” Tenn. Code Ann. § 67-6-702(d) (2007). A standard prewritten computer software product developed for sale to the general public, *i.e.*, not customized or custom created software, is commonly understood as a separate unit, and the single article cap will apply to the sale of prewritten computer software. Similarly, the Department also considers a license agreement that contemplates the transfer of rights to use certain prewritten computer software products to be a single article for purposes of the local option sales tax and the state single article sales tax, provided that the agreement separately itemizes the consideration to be paid for each separate piece of prewritten computer software and license. *See Honeywell Information Systems v. King*, 640 S.W.2d 553 (Tenn. 1982) (taxpayer must treat sale of components as individual sales and not as packaged sale for each component to be considered a single article).

In *Honeywell Information Systems, Inc.*, 640 S.W.2d at 553, the taxpayer plaintiff leased computer components. The taxpayer’s method of marketing, invoicing and record-keeping clearly demonstrated that it did not lease the component units of its computer systems as one single entity. Rather, it invoiced its customer for each of the components, each bearing its own serial number, and a specific monthly rental being charged for each component. The Tennessee Supreme Court held that since the taxpayer did not treat these components as “a single article of

² “Computer software” is defined differently than “prewritten computer software.” Under Tenn. Code Ann. § 67-6-102(17) (2007) computer software means a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task. Tenn. Code Ann. § 67-6-231 states that the sale or use of “computer software,” including “prewritten computer software,” shall be subject to the tax levied by Title 67, Chapter 6.

personal property” for purposes of its own leasing, invoicing and collections, the Commissioner for the Department of Revenue was likewise justified in treating them separately.

In *Executone of Memphis, Inc. V. Garner*, 650 S.W.2d 734 (Tenn. 1983), the Tennessee Supreme Court clarified that it is the character of each component, not how a taxpayer treats each component, that determines its status as a single article. The court dismissed the plaintiff’s argument that the plugs, the switching systems, and the telephone units in a digital telephone switching system were components of a single article because no single component is sufficient on its own. The Court held that:

In applying the considerations set out in Rule 6 to the present case, it requires no distortion to conclude that the plugs, the switching systems, and the telephone units, as they are described here, are “commonly understood” to be separate units. The Plaintiff admits that these articles have unit prices, that they can be put together to meet various office needs, and that if the occasion arose they could be sold separately to one who needs a system alteration. **To 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.**

Executone of Memphis, 650 S.W. 2d at 737 (emphasis added). Thus, it is character of each component, not how a taxpayer treats each component, that determines its status as a single article.

However, in *Colemill Enterprises, Inc. v. Huddleston*, 1996 Tenn. App. LEXIS 769 (Tenn.Ct.App. 1996), *rev’d on other grounds*, 967 S.W.2d 753 (Tenn. 1998), the Tennessee Court of Appeals held that the single article cap did not apply to a rebuilt airplane, because the plaintiff did not itemize the individual components and services separately on the invoice, with the result being that the Commissioner of Revenue had no means to determine the price of each individual component. The *Colemill* plaintiff rebuilt airplanes using numerous components, and claimed that the single article cap applied to the sale of the entire rebuilt airplane even though a portion of the sales price included charges for installation services (to which the single article cap does not apply). The Tennessee Court of Appeals rejected this argument, noting that the plaintiff charged one fee for an entire rebuilt airplane. Because the plaintiff did not itemize the individual components and services separately on the invoice, the Commissioner of Revenue had no means to determine the price of each individual component. The court agreed with the Commissioner that assessing tax on the full sales price was the only way the Commissioner could ensure that the full amount of the installation services were taxed, and that the aircraft parts were properly taxed as well. The single article cap therefore did not apply to the rebuilt airplane, and the entire sales price was subject to the local option sales tax.

Under the *Honeywell* and *Executone* analysis, the prewritten computer software components sold by the Taxpayer are properly characterized as single articles. However, under *Colemill*, if the Taxpayer does not separately invoice for each piece of prewritten computer software and sales those items for one lump-sum price, the sale will not be subject to the single article cap. Furthermore, consistent with the *Colemill* analysis, Tenn. Code Ann. § 67-6-702(d) provides that

“[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article.”

Like the plaintiff in *Honeywell Information Systems, Inc.*, the Taxpayer indicates that it treats the sales of the prewritten computer software as the sale of single items. Specifically, the Taxpayer charges separately for each piece of prewritten computer software and for each maintenance agreement.

As illustrated in the *Colemill* decision and in Tenn. Code Ann. § 67-6-702(d), if a dealer does not allocate or determine a sales price corresponding to each single article, the local option single article cap will generally not apply, and the full sales price is subject to the local option sales tax. Because the Taxpayer’s sale of prewritten computer software can be broken down, the sale will be treated as the sale of single articles. Accordingly, the local option single article cap will apply to each piece of prewritten computer software that is sold or licensed.

Furthermore, the manner in which the prewritten computer software is transferred to the customers has no effect on the application of the local option single article cap. The legislature intended to tax the transfer or fabrication of computer software programs “whatever the means used.” *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986). Furthermore, Tenn. Code Ann. § 67-6-231 (2007) specifically states that the sale or use of computer software, including prewritten computer software, shall be subject to the tax levied by Title 67, Chapter 6, regardless of whether the software is delivered electronically, by use of tangible storage media, or otherwise. Thus, the application of relevant Tennessee sales and use tax laws is the same whether the software is delivered on tangible storage media, electronically or otherwise.

In summary, the Taxpayer’s software products are subject to the local option single article cap for purposes of the local option sales tax. Each piece of prewritten computer software that is transferred to the customer, by whatever means, will be considered the sale of a single article. Finally, each license to use prewritten computer software will likewise be considered a sale of a single article.

2. *Software maintenance contracts and the local option single article cap.*

The local option single article cap does not apply to the optional software maintenance contract for purposes of the local option sales tax.

As noted above, the sale of customized or prewritten computer software is subject to Tennessee state and local sales and use tax. Charges for warranty or service contracts warranting the repair or maintenance of tangible personal property are subject to sales tax pursuant to Tenn. Code Ann. § 67-6-230(b) (2007). The Taxpayer’s maintenance agreements fall within the parameters of Tenn. Code Ann. § 67-6-230(b) (2007) and, thus, are subject to sales tax.

Under Tenn. Code Ann. § 67-6-702(a)(1), the local option single article cap only applies to the sale of tangible personal property. See *Colemill Enterprises Inc. v. Huddleston*, 1996 Tenn. App. LEXIS 769 (Tenn.Ct.App. 1996), *rev’d on other grounds*, 967 S.W.2d 753 (Tenn. 1998) (stating that the single article cap applies only to personal property, and local governments may tax the

entire amount of a taxable service provided). Even though the maintenance contract provided by the Taxpayer consists of both upgrades and telephone support, together they constitute a service agreement. The service agreement, though not a service itself, is a contractual right to receive repair or maintenance service in the future. As such, the service agreement may be properly characterized not being tangible personal property. *See Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132 (Tenn. 1992). As such, the local option single article cap does not apply to the Taxpayer's sale of the Taxpayer's maintenance agreements, and the local option sales tax will apply to the total sales price of the agreement.

3. Application of the local option single article cap to the maintenance agreements.

As set forth in Ruling #2, above, the local option single article cap does not apply to the sale of software maintenance agreements.

4. Application of the state single article sales tax to sales of prewritten computer software.

As noted above, Tenn. Code Ann. § 67-6-202(a) imposes an additional state sales tax at the rate of 2.75 percent on the amount over \$1,600, but less than or equal to \$3,200, on the sale or use of any single article of tangible personal property.³ The state single article sales tax is generally applied in the same manner as the local option single article cap, and the method of software distribution does not affect this application.

(a) The state single article sales tax is applied in the same manner as the local option single article cap with two exceptions. First, it is applied at a uniform rate of 2.75% rather than at a rate that varies according to location. Second, it is levied on the amount of the sale of a single article that is in excess of \$1,600 but less than or equal to \$3,200. Like the local option single article cap, the state single article sales tax only applies to the sale of any single article of personal property as defined in Tenn. Code Ann. § 67-6-702(a)(1). This 2.75% tax is in addition to the 7% state sales tax and is a tax for state purposes only. No county or municipality or taxing district has the power to levy any tax on the amount between \$1,600 and \$3,200, on the sale or use of any single article of personal property. Thus, if three items sold for \$25,000 each, the state single article sales tax would apply to \$1,600 of the cost of each item at the rate of 2.75% ($\$3,200 - \$1,600 = \$1,600$). The state single article tax due on such a sale is \$132 ($\$1,600.00 \times 2.75\% \times 3$).⁴

(b) The application of the state single article sales tax is the same whether the software is manually or electronically distributed. *See Analysis for Ruling #1.*

5. The State level single article sales tax as applied to the maintenance agreements.

The state single article sales tax does not apply to the Taxpayer's software maintenance agreement.

³ The \$1,600 to \$3,200 limit is referred to for purposes of this revenue ruling as the "state single article cap."

⁴ Legislation related to the Streamlined Sales and Use Tax Agreement, effective July 1, 2009, may result in changes regarding the application of sales and use tax sales to single articles of tangible personal property. The Department of Revenue encourages you to visit our website at www.tennessee.gov/revenue for updates.

For the same reasons given in response to Question # 2, the state single article tax, like the local option single article cap, does not apply to the sales of the maintenance agreements. Thus, the state single article cap does not apply to service or warranty contracts such as the Taxpayer's software maintenance contract.

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Approved: Reagan Farr
Commissioner of Revenue

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