TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 13-21

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 computer software consulting services.

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") is a Tennessee [ENTITY] with its principal place of business in [CITY], Tennessee. The Taxpayer provides technology consulting services, including the analysis, testing, installation, configuration, and integration of new computer software and hardware into the customer's existing system.

A customer wishing to implement new software functionality will consult with the Taxpayer to determine the software and hardware configuration that best meets the customer's needs. Often, the recommended configuration involves significant cost. Therefore, before the customer commits to full installation and integration of the software and hardware into its existing systems, the Taxpayer tests the recommended configuration to ensure proper functionality.

The Taxpayer begins by backing up the customer's data files to the Taxpayer's servers anytime it will be manipulating the customer's data to ensure there is no data loss that results from the Taxpayer's services. The Taxpayer then proceeds to begin testing, which requires that the Taxpayer set up a virtual lab, either by using the customer's hardware or the Taxpayer's hardware. To conduct the testing, the Taxpayer must temporarily install and configure the recommended software. Once the recommended software is configured, data from the customer's system is copied into the virtual lab for testing and demonstration purposes. No software is purchased for, or transferred to the customer at this time. Instead, at the testing phase, the Taxpayer uses licensed trial version software or software owned by the Taxpayer. After the testing is completed, the Taxpayer will remove any software installed in a virtual lab created using the customer's hardware.

After testing and demonstration of the configuration, the Taxpayer provides the customer with price estimates for the installation and integration of the recommended software and hardware. If the customer chooses not to move forward, the relationship ends, and the Taxpayer provides the customer with an itemized invoice for services rendered.

If the customer wants to proceed, it enters into a contract with the Taxpayer for the installation and integration of the recommended software and hardware. The Taxpayer will most often purchase the necessary software and license it to the customer. However, depending on the cost and the customer's preference, sometimes the customer will buy the software from a third-party vendor. In either case, as provided by contract, the Taxpayer will install and integrate the software into the customer's existing data system. The Taxpayer provides the customer with an itemized invoice for services rendered.

RULINGS

1. When the Taxpayer creates a virtual lab and, for testing or demonstration purposes, inputs its own software or a trial version for which it has a license onto the customer's computer hardware, is the charge subject to the Tennessee sales and use tax?

   Ruling: No, when the Taxpayer creates a virtual lab and, for testing or demonstration purposes, temporarily inputs its own software or a trial version for which it has a license onto the customer's computer hardware, the charge is not subject to the Tennessee sales and use tax.

2. When the Taxpayer creates a virtual lab and, for testing or demonstration purposes, inputs its own software or a trial version for which it has a license onto the Taxpayer's computer hardware, is the charge subject to the Tennessee sales and use tax?

   Ruling: No, when the Taxpayer creates a virtual lab and, for testing or demonstration purposes, temporarily inputs its own software or a trial version for which it has a license

onto the Taxpayer's computer hardware, the charge is not subject to the Tennessee sales and use tax.

3. Does the Tennessee sales and use tax apply when the Taxpayer backs up the customer's data to the Taxpayer's servers?

   Ruling: No, the Tennessee sales and use tax does not apply when the Taxpayer backs up the customer's data to the Taxpayer's servers.

ANALYSIS

Under the Retailers' Sales Tax Act,[1] the retail sale in Tennessee of tangible personal property and specifically enumerated services is subject to the sales 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."[2] TENN. CODE ANN. § 67-6-102(78)(A) (2013) 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."[3] 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,[4] including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser."[5] Conversely, the sale of intangible intellectual property is generally not subject to the Tennessee sales and use tax, unless delivered via a tangible storage medium.[6]

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.[7] One of

---

[1] 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)).

[2] TENN. CODE ANN. § 67-6-102(76) (2013).

[3] TENN. CODE ANN. § 67-6-102(89)(A).

[4] Computer software" is defined for Tennessee sales and use tax purposes as "a set of coded instructions designed to cause a computer . . . to perform a task." TENN. CODE ANN. § 67-6-102(18).

[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." TENN. CODE ANN. § 67-6-102(68).

[6] *Compare Crescent Amusement Co. v. Carson*, 213 S.W.2d 27, 29 (Tenn. 1948) (rental films are taxable tangible personal property), *with Commerce Union Bank v. Tidwell*, 538 S.W.2d 405, 407 (Tenn. 1976) (finding a tangible method of data transfer "merely incidental" to the underlying transaction, and thus not subject to sales and use tax).

[7] TENN. CODE ANN. § 67-6-102(78)(C).

the "things" specifically taxable is the "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."[8]

The sales tax also applies to retail sales of services specifically enumerated in the Retailers' Sales Tax Act.[9] One such enumerated service is "the installing of computer software, where a charge is made for the installation, whether or not the installation is made as an incident to the sale of . . . computer software, and whether or not any . . . computer software is transferred in conjunction with the installation service."[10] Conversely, the Retailers' Sales Tax Act does not specifically enumerate consulting, designing, testing, and training services;[11] such services are therefore not in and of themselves subject to taxation.

There are two ways that non-enumerated services, however, may be included in the sales price of a given transaction, despite not being directly subject to tax. First, an otherwise nontaxable service or item may be subject to taxation when charges for the service or item are included in the sales price of a taxable good or service. Specifically, TENN. CODE ANN. § 67-6-102(79)(A) provides in pertinent part that the sales price of a good or service equals the "total amount of consideration . . . for which personal property or services are sold," without deduction for the seller's cost of goods sold, labor or service costs, and other expenses. Thus, if taxable goods or services and nontaxable goods or services are sold together for a single charge, the entire charge is generally subject to taxation, with the bundled sales price as the measure of the tax.[12]

The second manner in which a non-enumerated service may be included in the sales price of a transaction is where the service is intertwined with the sale of taxable tangible personal property. The definition of "sales price" provides in pertinent part that there will be no deductions for "labor or service" costs incurred by the seller and also includes "[c]harges by the seller for any

---

[8] TENN. CODE ANN. § 67-6-231(a) (2013). 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). Computer software is "delivered electronically" if delivered "by means other than tangible storage media." TENN. CODE ANN. § 67-6-102(24).

[9] The Retailers' Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. *See, e.g.*, TENN. CODE ANN. § 67-2-205 (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).

[10] TENN. CODE ANN. § 67-6-205(c)(6) (2013).

[11] *See, e.g.*, TENN. CODE ANN. § 67-6-205.

[12] *See Tomkats Catering, Inc. v. Johnson*, No. M2000-03107-COA-R3-CV, 2001 WL 1090516, at *2 (Tenn. Ct. App. Sept. 19, 2001); *cf.* TENN. CODE ANN. § 67-6-102(79)(A)(vi) ("Sales price" includes "[t]he value of exempt personal property given to the purchaser where taxable and exempt personal property have been bundled together and sold by the seller as a single product or piece of merchandise.").

services necessary to complete the sale."[13] Thus, when the sale of a non-enumerated service is a necessary part of the sale of a taxable good or service, the charges for that service are included in the sales price and subject to the sales tax.

Accordingly, the Taxpayer's charges will be subject to the Tennessee sales and use tax if the charges relate to: 1) the sale of tangible personal property or computer software in Tennessee; 2) the furnishing of a taxable service in Tennessee; 3) the furnishing of an otherwise nontaxable good or service that is bundled with a taxable good or service; or 4) the furnishing of a non-enumerated service that necessary to complete the sale of a taxable good or service.

1. & 2. ***Virtual Lab***

When the Taxpayer creates a virtual lab and, for testing or demonstration purposes, temporarily inputs software onto the customer's computer hardware or the Taxpayer's own hardware, the charge is not subject to the Tennessee sales and use tax.

First, no sale of tangible personal property, including prewritten computer software, occurs when the Taxpayer sets up a virtual lab and temporarily inputs software onto its own computer hardware or the customer's hardware, and then removes that software when the consultation is complete.

As discussed above, "sale" is defined in pertinent part as "any transfer of title or possession, or both . . . of tangible personal property for a consideration,"[14] and includes "any transfer of title or possession . . . of computer software for consideration . . . and any programming, transferring or loading of computer software into a computer."[15] A sale also includes "the furnishing of any of the things or services" taxable under the Retailers' Sales Tax Act,[16] including "[t]he retail sale,

---

[13] TENN. CODE ANN. § 67-6-102(79)(A)(iii). A line of cases, beginning with *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27 (Tenn. 1948), expand this concept, establishing that where a sale of a non-enumerated service is accompanied by tangible personal property that is a "crucial," "essential," or "integral" element of the transaction, the sales price will include the entire cost of the transaction, including the value of the non-enumerated service, *see, e.g., Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 625 (Tenn. 1987), and conversely, where a sale of tangible personal property is accompanied by a non-enumerated service that are a "crucial," "essential," or "integral" element of the transaction, the sales price will include the entire cost of the transaction, including the value of the non-enumerated services. *See, e.g., AT&T v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *7-9 (Tenn. Ct. App. Oct. 8, 2002); *see also Rivergate Toyota, Inc. v. Huddleston*, No. 01A01-9602-CH-00053, 1998 WL 83720, at *4 (Tenn. Ct. App. Feb. 27, 1998). In contrast, where a transfer of tangible personal property or a service is "merely incidental" to a sale of a non-enumerated service, the transaction would not be subject to the sales tax. *See Commerce Union Bank v. Tidwell*, 538 S.W.2d 405, 407 (Tenn. 1976) (citing *Washington Times-Herald, Inc. v. District of Columbia*, 213 F/2d 23 (1954)); *cf. Nashville Mobilphone v. Woods*, 655 S.W.2d 934, 935-37 (Tenn. 1983) (holding that the renting of radio equipment was merely incidental to the taxpayer's principal business of "furnishing services as a 'radio common carrier system,'" and therefore the taxpayer's purchase of the radio equipment was subject to sales or use tax).

[14] TENN. CODE ANN. § 67-6-102(78)(A).

[15] TENN. CODE ANN. § 67-6-102(78)(K).

[16] TENN. CODE ANN. § 67-6-102(78)(C).

lease, licensing or use of computer software."[17] Thus, if the Taxpayer transfers title, possession, or control of any computer software to its customers, then such transfer will be subject to the Tennessee sales and use tax.[18]

Here, the facts indicate that the Taxpayer does not transfer title or possession of the software to its customers. In instances where the virtual lab is set up on the Taxpayer's hardware, there is no question that the software always remains on the Taxpayer's hardware and the Taxpayer maintains control of the software at all times; neither title nor possession transfer to the customer at any time.

In instances where the Taxpayer creates the virtual lab on the customer's hardware, there is still no transfer of title or possession of the software to the customer. First, the facts indicate that title to the software does not transfer to the customer; the Taxpayer retains the license to the software. Next, although the software used for the virtual lab demonstration has been placed on the customer's computer hardware, there is no transfer of possession to the customer. The virtual lab configuration is not set up for use by the customer; rather, the software is placed onto the computer hardware for the Taxpayer's demonstration to the customer, and is subsequently removed. Significantly, the Taxpayer remains the exclusive operator of the virtual lab configuration. The customer does not have any access to or use or control of the software, and thus does not have any requisite dominion or control over the software to constitute possession.[19]

Next, the virtual lab does not involve an enumerated service. As stated above, only specifically enumerated services are subject to the Tennessee sales and use tax. Based on the facts provided, the only taxable service that the Taxpayer potentially furnishes is "the installing of computer software, where a charge is made for the installation, whether or not the installation is made as an incident to the sale of . . . computer software, and whether or not any . . . computer software is transferred in conjunction with the installation service."[20]

In this case, no installation of computer software takes place. Neither the Tennessee Code nor the Tennessee courts have defined the terms "install" or "installation" for purposes of Tennessee sales and use taxation. However, the Tennessee Supreme Court has specifically stated that, because the Retailers' Sales Tax Act does not contain a definition of the term "installing," the

---

[17] TENN. CODE ANN. § 67-6-231(a).

[18] Note that TENN. CODE ANN. § 67-6-231 specifically provides that the sale or use of computer software is subject to the sales and use tax, regardless of whether the software is delivered electronically or via tangible storage media.

[19] "Possession" is not defined under the Retailers' Sales Act. When a term is not defined under that statute, the Tennessee Supreme Court has stated that the term must be given its ordinary and common meaning. *See e.g., Byrant v. Genco Stamping & Mfg. Co.*, 33 S.W.3d 761, 765 (Tenn. 2000); *Tenn. Farmers Assur. Co. v. Chumley*, 197 S.W.3d 767, 782-83 (Tenn. Ct. App. 2006); *Beare Co. v. Tenn. Dep't of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993). Possession is generally understood to mean having or holding property in one's power, the exercise of dominion over property, or the right to exercise exclusive control over something. *See* BLACK'S LAW DICTIONARY 8TH EDITION (2007); *see also, Ford v. Oklahoma Tax Commission*, 285 P.2d 436, 437 (Okl. 1955). In this case, the customer has none of these incidents of possession.

[20] TENN. CODE ANN. § 67-6-205(c)(6).

term must be given its ordinary and common meaning.[21] The Tennessee Supreme Court has also generally stated that when a statute does not define a term, it is proper to look to common usage to determine the term's meaning.[22]

In common usage, the term "install" generally means to set up something for use or service.[23] Although not dispositive, courts in other jurisdictions have also adopted this or a similar definition of the term.[24] This definition, however, is overly vague. As a result, it is proper to consider what a reasonably prudent person would consider "installation" in the context of sales and use taxation. Under the common understanding of the term, the concept of installation does not encompass a service, the furnishing of which includes the seller's own tangible personal property being set up for the seller's use and then removed in the context of a single event.

In this case, the Taxpayer provides a service in which its *own* tangible personal property, in the form of prewritten computer software, is both set up for use and removed in the context of a single event (*i.e.*, the creation of a virtual lab for product demonstration purposes). Here, the Taxpayer only temporarily inputs the software onto either its own computer hardware or the customer's hardware, to demonstrate to the customer how the program will work in conjunction with that customer's data. After demonstration and consultation, the Taxpayer removes the software. The temporary placement of the Taxpayer's own software onto computer hardware for demonstration purposes, followed immediately by the removal of such software, is not an activity that a reasonably prudent person would consider "installation" in the context of the sales and use tax.

Moreover, even if the input of the Taxpayer's software on the customer's computer hardware could be characterized as installation, the transaction would nevertheless not be taxable. The primary purpose of the transaction is the consulting service, to which the temporary input of the software onto the computer is merely incidental. Tennessee's courts "have developed a method whereby judicial inquiry is made into the 'primary purpose' or 'true object' of the activity or business at issue."[25] Although there is loading of the software onto the customer's hardware, it is not set up with the intention of any use by the customer. Customers purchase the consulting service so that they can determine their software needs and preferences in conjunction with their data. The temporary input of software, while necessary to conduct the virtual lab demonstration, is not the "true object" of the transaction.

---

[21] *Eusco, Inc. v. Huddleston*, 835 S.W.2d 576, 580 (Tenn. 1992).

[22] *See e.g.*, *Byrant v. Genco Stamping & Mfg. Co.*, 33 S.W.3d 761, 765 (Tenn. 2000); *Tenn. Farmers Assur. Co. v. Chumley*, 197 S.W.3d 767, 782-83 (Tenn. Ct. App. 2006); *Beare Co. v. Tenn. Dep't of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993).

[23] *See* MERRIAM-WEBSTER COLLEGIATE DICTIONARY 11TH EDITION (2007).

[24] *E.g.*, *Cent. Me. Power Co. v. Johnson*, 263 A.2d 713 (Maine 1970) (defining the term "install" as "to set up for use or service" for state taxation purposes).

[25] *Qualcomm Inc. v. Chumley*, No. M2006-01398-COA-R3-CV, 2007 WL 2827513, at *4 (Tenn. Ct. App. Sept. 26, 2007).

Since the Taxpayer's service does not fall within the scope of any other section in the Retailers' Sales Tax Act describing taxable services, the Taxpayer's service is not subject to the Tennessee sales and use tax as an enumerated service.

Additionally, the facts indicate that the Taxpayer does not make sales of tangible personal property or computer software and does not furnish any services enumerated in the Retailers' Sales Tax Act. Provided that the Taxpayer does not make sales of taxable goods or services in conjunction with the sale of its consulting services, the sale of such consulting 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.[26]

Finally, the analysis of whether the sale of a non-enumerated service is accompanied by tangible personal property that is a "crucial," "essential," or "integral" element of the transaction[27] is unnecessary because the Taxpayer under these facts does not sell any item of tangible personal property or software in conjunction with the virtual lab consulting and demonstration services.

Accordingly, when the Taxpayer creates a virtual lab and, for testing or demonstration purposes, temporarily inputs software onto computer hardware, the charge is not subject to the Tennessee sales and use tax. It is immaterial whether the Taxpayer creates the virtual lab utilizing the Taxpayer's hardware or utilizing the customer's hardware.

3. *Data Backup*

The Tennessee sales and use tax does not apply to charges for the backup of the customer's data to the Taxpayer's servers.

The Taxpayer's backup service will be subject to the Tennessee sales and use tax if the charges for the service relate to: 1) the sale of tangible personal property or computer software in Tennessee; 2) the furnishing of a taxable service in Tennessee; 3) the furnishing of an otherwise nontaxable good or service that is bundled with a taxable good or service; or 4) the furnishing of a non-enumerated service that necessary to complete the sale of a taxable good or service.

First, no sale or transfer of tangible personal property, including prewritten software, occurs in conjunction with the Taxpayer's furnishing of the backup service. A "sale" in part is "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."[28]

In the case of the backup of data, no transfer of tangible personal property or computer software occurs between the Taxpayer and its customer. Additionally, the Taxpayer does not sell, lease, license, or otherwise provide the use of tangible personal property or computer software to its client in conjunction with this service. Here, the Taxpayer is taking the customer's data, copying

---

[26] *See* TENN. CODE ANN. § 67-6-102(79)(A).

[27] *See supra* note 15.

[28] TENN. CODE ANN. § 67-6-102(78)(A) (emphasis added).

it, and moving it to another device for storage. The Taxpayer does not transfer title or possession of tangible personal property or software to its customers during the backup service. The only thing transferred is the customer's data from the customer to the Taxpayer. Accordingly, there is no sale of tangible personal property or computer software in conjunction with the backing up of a customer's data to the Taxpayer's servers.

Second, the Taxpayer's backup service does not constitute a taxable service for Tennessee sales and use tax purposes. As noted above, only specifically enumerated services are subject to the Tennessee sales and use tax. Data backup is not a specifically enumerated service and cannot be properly characterized as any of the enumerated services.

Third, because the Taxpayer does not make sales of tangible personal property in conjunction with the backup service, and does not provide a taxable service, no part of the backup service can be characterized as the furnishing of an otherwise nontaxable service that is sold as part of the sale of a taxable good or service. [29]

Finally, analysis of whether sale of a non-enumerated service is accompanied by tangible personal property that is a "crucial," "essential," or "integral" element of the transaction[30] is unnecessary because the Taxpayer under these facts does not sell any item of tangible personal property or software in conjunction with backing up the customer's data.

Accordingly, charges for the Taxpayer's backup service are not subject to the Tennessee sales and use tax.[31]

Lauren A. Fields
Assistant General Counsel – Research and Taxation

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: November 25, 2013

[29] *See* TENN. CODE ANN. § 67-6-102(79)(A).

[30] *See supra* note 15.

[31] Note that the Retailer's Sales Tax Act does not require that the Taxpayer maintain specific documentation with respect to its sales of nontaxable services. However, there is a general requirement that each dealer keep records of its sales and purchases. TENN. CODE ANN. § 67-6-523 (2006) generally requires all taxpayers to establish and maintain records that are adequate for auditors to use in determining the correct amount of the taxpayer's tax liability. The Taxpayer should therefore keep records of its sales and purchases, including copies of invoices and purchase orders. Records of business transactions must be retained for a minimum of three years from December 31 of the year in which the associated Tennessee sales and use tax return was filed.