

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 14-10**

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 tax to 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 consulting firm based in [CITY], Tennessee. The Taxpayer is a reseller and certified service provider of several mid-market enterprise resource planning ("ERP") software systems that integrate internal management information across an entire organization and include finance/accounting, manufacturing, sales and service, customer relationship management, and other components. The software publishers develop, write, and distribute the software, as well

any software upgrades and patches. Any software maintenance contracts/end user license agreements are between the Taxpayer's clients and the software publisher.

In addition to reselling ERP software systems, the Taxpayer offers a variety of services to its clients. If the Taxpayer sells a software system to a client, a client is under no obligation to contract with the Taxpayer for the provision of any service. If a client chooses to utilize the Taxpayer's services, it can select from the Taxpayer's service offerings those services that fit its needs.

If a client contemplates purchasing software from the Taxpayer as well as utilizing the Taxpayer's services, the Taxpayer will provide that client with a separate software sales proposal and a consulting proposal, both of which include cost estimates. The Taxpayer tailors each consulting proposal according to the specific needs of a client. The Taxpayer prepares separate invoices for the sale of software and the provision of services. For services performed, the Taxpayer bills a client for each service that it performs as costs are incurred at an hourly rate. A client can terminate the Taxpayer's services at any time.

In instances where the Taxpayer performs installation of software, upgrades/updates to software, custom development services, and customizations to software, it collects sales tax on the fees it charges for those services. The Taxpayer may perform any combination of the following other services ("Additional Services") upon the request of a client:

Training: The Taxpayer trains its clients on functionality within a software package.

Configuration: The Taxpayer works to configure an ERP software program for a client's best and most efficient use. This activity typically involves the Taxpayer's review of all the front-end configuration options within the software and assisting the client in making these decisions. Once the Taxpayer completes its design plans, it uses screens and tools provided by the software publisher to configure the software. Most of the Taxpayer's work involves clicking boxes and selecting options for the front-end screens of the software. In some cases, the Taxpayer uses tools provided by a software publisher to load lists, such as terms and vendor lists, into the software. In configuring software for a client, the Taxpayer never programs software or otherwise creates computer code.

Project Management and Client Correspondence: The Taxpayer offers optional project management and client correspondence services whereby it coordinates projects, schedules resources, communicates with clients, and reports on the status of projects.

Data Conversion: The Taxpayer assists its clients with loading data into a new module or system. For example, if a client wants invoice information from its old system copied to the new system, the

Taxpayer can key this information into the front-end of the system or The Taxpayer can load the data into the system using standard templates completed by the client.

Documentation: The Taxpayer prepares documentation associated with its projects. This documentation includes system design documentation, client-specific training guides, cheat sheets, and other general project documentation. The Taxpayer delivers this documentation to clients electronically.

Testing: The Taxpayer assists with the creation of end user test plans for a client's use in testing that the software was configured according to its wishes and functions properly. In addition, a client may

ask the Taxpayer to be on-site while the client performs a test to provide guidance as needed. On occasion, the Taxpayer may perform services to test for proper software configuration.

Report Writing: At a client's request, the Taxpayer will provide report writing services associated with ERP software systems. The Taxpayer utilizes built-in report writer modules that allow end users to create queries, reports, and screen modifications using functions and screens available within the front-end of the software system. The Taxpayer uses "click and drag" type interfaces to pull data from the system in the format needed for reporting purposes. The Taxpayer also may use tool kits provided by a software publisher to change the appearance of standard reports within a software application. An example of this type of service would be moving fields around on a report based upon a client's request.

The Taxpayer performs a different combination of services for each of its clients, and no two client proposals or invoices are alike.

RULING

Are the Taxpayer's Additional Services subject to the Tennessee sales tax?

Ruling: The only Additional Service that, provided on a stand-alone basis, would be subject to the Tennessee sales tax is the Taxpayer's provision of its Report Writing service in instances where that service includes coding or programming that is not merely incidental to Report Writing. None of the other Additional Services, provided on a stand-alone basis, would be subject to the Tennessee sales tax. Every other Additional Service is of a type that generally is not subject to the Tennessee sales tax when sold on a stand-alone basis. However, charges for Additional Services may be subject to the sales tax if they are required to be included in the sales price of a taxable item or service.

ANALYSIS

LEGAL BACKGROUND

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) (2014) 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

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) (Supp. 2014).

³ TENN. CODE ANN. § 67-6-102(89)(A).

“computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser.”⁴ Conversely, the sale or use of intangible intellectual property generally is not subject to the Tennessee sales and use tax unless stored on a tangible storage media.⁵

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

The sales tax also applies to retail sales of services specifically enumerated in the Retailers’ Sales Tax Act.¹² One such enumerated service is “the installing of computer software, where a charge is

⁴ 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.*

⁵ 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).

⁶ TENN. CODE ANN. § 67-6-102(78)(C).

⁷ 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).

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).

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.”¹³ Another enumerated service is “the performing, for a consideration, of any repair services with respect to any kind of tangible personal property or computer software.”¹⁴

Many transactions involve more than the sale of a single item or service. When a transaction involves items or services that are all independently subject to sales tax, the entire transaction is subject to sales tax, regardless of how the invoice is itemized. Similarly, if all of the items or services are independently either not subject to sales tax or are exempt, the entire transaction is not subject to sales tax, regardless of how the invoice is itemized.

However, if a transaction involves a mixture of items that are subject to sales tax and those that are not, itemization becomes important.¹⁵ In Tennessee, 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.¹⁶ This treatment derives from TENN. CODE ANN. § 67-6-102(79)(A)(iv), which provides that the 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.”¹⁷ Moreover, there is no conceptual reason why bundling principles

¹² 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).

¹³ TENN. CODE ANN. § 67-6-205(c)(6).

¹⁴ TENN. CODE ANN. § 67-6-205(c)(4).

¹⁵ Separately itemizing an item that, taken in isolation, would not be subject to sales tax is merely a prerequisite to a claim of non-taxability – it is not the dispositive factor. *See AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *8 (Tenn. Ct. App. Oct. 8, 2002) (“A taxpayer cannot transform a properly taxable amount into a nontaxable amount through the simple expedient of a separately stated invoice charge.”).

¹⁶ Part 1 of Appendix C to the October 30, 2013 Streamlined Sales Tax Agreement defines a “bundled transaction” in pertinent part as “the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price.” *See also* 2 JEROME HELLERSTEIN ET AL., STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 19A.04[2][a][iv], at 19A-14 (3d ed. 1998) (defining a “bundled transaction” as “a transaction in which two or more items that are potentially subject to different tax treatment are sold for one undifferentiated price”).

Tennessee has statutorily adopted the Streamlined Sales Tax Agreement’s definition, but it is not effective until July 1, 2015. *See* TENN. CODE ANN. § 67-6-102(8)(A) (Supp. 2014, effective July 1, 2015). Tennessee has also adopted certain bundled transaction provisions from the Streamlined Sales Tax Agreement that are currently effective, but they are narrowly applied to telecommunications and related services. *See* TENN. CODE ANN. § 67-6-539 (2013).

The Streamlined Sales Tax Agreement is notably silent on the tax consequences of a bundled transaction, deferring instead to state law. TENN. CODE ANN. § 67-6-102(79)(A)(iv) thus controls, regardless of whether the Streamlined Sales Tax Agreement’s definition of a “bundled transaction” is effective in Tennessee.

¹⁷ Tennessee addresses the bundled transaction doctrine in the unreported case of *Tomkats Catering, Inc. v. Johnson*, No. M2000-03107-COA-R3-CV, 2001 WL 1090516, at *2 (Tenn. Ct. App. Sept. 19, 2001), wherein the Tennessee

should be limited to transaction involving solely tangible personal property, and in fact, Tennessee case law suggests that these principles apply to bundles of services as well.¹⁸

Finally, not all transactions readily lend themselves to classification for sales tax purposes. In order to resolve the tension in these difficult transactions, Tennessee courts have developed a line of inquiry that focuses on what is the “true object”¹⁹ of the transaction.²⁰ In applying this test, the courts essentially look at the totality of the facts and circumstances²¹ to determine what objective is really being accomplished by the transaction.²²

If the true object of a transaction would independently be taxable, then the true object and any “crucial,”²³ “essential,”²⁴ “necessary,”²⁵ “consequential,”²⁶ or “integral”²⁷ elements of the transaction

Court of Appeals looked to whether a caterer’s provision of optional wait staff was separate or severable from the provision of wait staff that was already included in the customer’s purchase of food. The court found that the provision of optional wait staff was in fact separate, and the inquiry into whether two services are separate and severable is similar to the Streamlined Sales Tax Agreement’s requirement that bundled products be “distinct and identifiable.”

The bundled transaction doctrine was statutorily incorporated when the “sales price” definition was amended to include the language currently codified at TENN. CODE ANN. § 67-6-102(79)(A)(iv). *See* Act of May 26, 2005, ch. 499, § 68, 2005 Tenn. Pub. Acts 1214, 1234 (codified as amended at TENN. CODE ANN. § 67-6-102(79)(A)(iv) (Supp. 2014)); *cf.* TENN. CODE ANN. § 67-6-102(79)(A) (Supp. 2014) (providing that the sales price of a good or service equals the “total amount of consideration . . . for which personal property or services are sold”).

¹⁸ *See generally Tomkats Catering, Inc.*, 2001 WL 1090516, at *2; *see also* TENN. CODE ANN. § 67-6-102(8)(A) (Supp. 2014, effective July 1, 2015).

¹⁹ This inquiry is sometimes stated as the “primary purpose” test. *See generally Qualcomm, Inc. v. Chumley*, No. M2006-01398-COA-R3-CV, 2007 WL 2827513, at *4-5 (Tenn. Ct. App. Sept. 26, 2007) (giving a synopsis of the “true object” or “primary purpose” test in Tennessee).

²⁰ This analysis is not entirely unique to Tennessee, but the application of the test does vary in other states. *See generally* 2 JEROME HELLERSTEIN ET AL., STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 12.08[1], at 12-108 (3d ed. 1998 & Supp. 2014) (discussing the “true object” test).

²¹ *See, e.g., AOL, Inc. v. Roberts*, No. M2012-01937-COA-R3-CV, 2013 WL 4067977, at *6 (Tenn. Ct. App. Aug. 12, 2013) (basing the holding on the “totality of the circumstances”).

²² Note that it could be possible that there is not a single true object of the transaction, but rather multiple objects of the transaction. In that case, each object of the transaction should be analyzed separately for tax purposes. *Cf. Penske Truck Leasing Co. v. Huddleston*, 795 S.W.2d 669, 670-71 (Tenn. 1990) (holding that a long-term truck lease agreement and a fuel agreement were truly separate agreements and should be treated as separate transactions for sales tax purposes, despite being embodied in a single contract document).

²³ *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).

²⁴ *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

will be subject to sales tax.²⁸ In addition, if a taxable component of a transaction is “crucial,” “essential,” “necessary,” “consequential,” or “integral,” the transaction will be subject to sales tax even if the true object of the transaction is not independently subject to sales tax.

Only if the true object of the transaction is not independently subject to sales tax and the items that would be subject to sales tax are “merely incidental” to the true object of the transaction will the transaction not be subject to sales tax.²⁹

In practice, the true object test is applied in three specific types of transactions, all of which are usually capable of being characterized in different manners. These include 1) so called “mixed transactions,” 2) transfers of tangible personal property in association with a sale of intangible property, and 3) certain service transactions.³⁰

A “mixed transaction” is generally understood to be a transaction involving the inseparable³¹ transfer of tangible personal property along with a service, where at least one aspect of the transaction is

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).

²⁵ See *supra* note 26.

²⁶ 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”).

²⁷ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²⁸ Cf. *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27, 29 (Tenn. 1948) (holding that a transaction involving the sale of a license to display motion pictures accompanied by a film reel on which the movies were recorded was a taxable sale of tangible personal property).

²⁹ In *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (Tenn. 1976), the Tennessee Supreme Court addressed a situation involving the sale of computer software encoded on a magnetic tape. At the time, computer software was not subject to sales tax, but magnetic tapes would have been subject to sales tax as the sale of tangible personal property. See *generally id.* at 408. The taxpayer argued that the sale was of intangible property, while the Tennessee Department of Revenue argued that the sales of tangible personal property and should be subject to tax. *Id.* at 407. The Court held in favor of the taxpayer, finding that what was actually purchased was intangible information, and stated that a “[t]ransfer of tangible personal property under these circumstances is merely incidental to the purchase of the intangible knowledge and information stored on the tapes.” *Id.* at 408. Although the Court did not, at that time, present the analysis as a “true object” test, it nevertheless employed the same logic.

³⁰ See KIMBERLY M. REEDER ET AL., TRUE OBJECT OF TRANSACTION AND TAXATION OF SERVICES 2-3 (ABA/IPT Advanced Sales & Use Tax Seminar Mar. 29, 2006), available at <http://meetings.abanet.org/meeting/tax/IPT06/media/wilson.pdf> (last visited July 8, 2014) (offering examples of the types of transactions that typically give rise to the use of the true object test).

³¹ Whether business activities are separable does not turn solely on how the activities are itemized and presented to the customer. As previously stated, separately itemizing an item that would, standing alone, not be subject to tax is merely a prerequisite to a claim of non-taxability. See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8 (“A taxpayer cannot transform a properly taxable amount into a nontaxable amount through the simple expedient of a

independently taxable.³² For example, a transaction involving the commission of an artist to paint a portrait could be characterized as either the provision of services or the sale of tangible personal property.³³ Tennessee generally does not impose a tax on the service of painting portraits, but it does impose tax on a portrait because it is tangible personal property. Since the sales tax treatment turns on the characterization of the transaction, courts look to the true object of the transaction to determine its real character.

Similarly, transfers of tangible personal property in association with a sale of intangible property raise characterization issues because intangible property rights are generally not subject to sales tax in Tennessee. For example, in the unreported case of *Barnes & Noble Superstores, Inc. v. Huddleston*,³⁴ the Tennessee Court of Appeals held that the sale of a discount card that entitled its bearer to future discounts on merchandise was not subject to sales tax because, even though tangible personal property in the form of the discount card was transferred to the customer, the true object of the transaction was really the purchase of an “intangible right”³⁵ that was not subject to sales tax.

Finally, some services are themselves inherently difficult to classify because many states, like Tennessee, only impose the sales tax on enumerated services.³⁶ In a time when organizations are outsourcing operations to service providers that were traditionally performed by internal employees, the question often arises as to whether characterization of the service should be limited to what the service provider claims to provide, or should be properly characterized according to the true object of the customer’s broader operation for which service is rendered.³⁷ An example of this type of transaction would be a staffing company providing temporary workers for its client to assist with repairing tangible personal property.³⁸ Under Tennessee law, the provision of temporary workers is not a taxable service, but repairing tangible personal property is a taxable service,³⁹ so a court would

separately stated invoice charge.”). If two items are separable, then they should be analyzed as either separate transactions or, if sold for a single price, as a bundled transaction.

³² The concept of a “mixed transaction” developed from case law analyzing transactions under the Uniform Commercial Code. The Tennessee Court of Appeals has recognized that “many transactions are neither pure sale of goods nor pure service transactions, but a combination of the two, i.e. a hybrid contract,” *Audio Visual Artistry v. Tanzer*, 403 S.W.3d 789, 797 (Tenn. Ct. App. 2012), and the Tennessee Supreme Court has adopted the “predominant purpose” test to determine whether a contract involves predominantly the sale of goods or the sale of a service. *See Hudson v. Town & Country True Value Hardware, Inc.*, 666 S.W.2d 51, 54 (Tenn.1984). This inquiry is quite relevant under the Uniform Commercial Code since its provisions only apply to sales of goods, *see id.* at 53, and the inquiry is remarkably similar to the “true object” test employed in the tax context.

³³ *See generally* 2 JEROME HELLERSTEIN ET AL., STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 12.08[1], at 12-108 (3d ed. 1998 & Supp. 2014).

³⁴ No. 01A01-9604-CH-00149, 1996 WL 596955, at *2 (Tenn. Ct. App. Oct. 18, 1996).

³⁵ *Id.*

³⁶ *See, e.g.*, TENN. CODE ANN. § 67-6-205.

³⁷ *See generally* REEDER, *supra* note 33, at 7-8.

³⁸ *Cf. id.* at 8-9 (giving the examples of managerial services and hourly labor).

³⁹ *See* TENN. CODE ANN. § 67-6-205(c)(4).

have to determine the true object of the transaction to determine the sales tax consequences of the transaction.

In conclusion, in order for a transaction to be subject to sales tax in Tennessee, it generally must involve: 1) the sale of tangible personal property or computer software in Tennessee; 2) the furnishing of taxable things or services in Tennessee; 3) a bundled transaction containing at least one item subject to sales tax; or 4) a transaction where the true object or one of the “crucial,” “essential,” “necessary,” “consequential,” or “integral” elements thereof are subject to sales tax.

APPLICATION

The Taxpayer sells ERP software, software installation services, and performs software programming for its clients.⁴⁰ The Taxpayer also offers Additional Services at an hourly rate, and its customers may contract for various combinations of these items and services.

To determine the taxability of a transaction,⁴¹ it is necessary to determine first whether each type of Additional Service would be subject to tax on a stand-alone basis since a customer might contract for only that one type of Additional Service. Then, one must consider how the result might change if the Taxpayer were to provide a combination of different types of Additional Services and, possibly, taxable ERP software, software installation, and/or software programming to the same customer.

I. SALES TAX TREATMENT OF EACH TYPE OF ADDITIONAL SERVICE

Each type of Additional Service must be analyzed to determine if the transaction involves the provision of an enumerated service. If any of the following Additional Services is properly characterized as an enumerated service, the Taxpayer’s provision of that Additional Service on a stand-alone basis will be subject to sales tax.

Training

The Taxpayer’s Training services themselves are not the sale of tangible personal property or computer software. Moreover, through its Training services, the Taxpayer does not fabricate, modify, or enhance computer software, nor does it perform a specifically enumerated taxable service. Accordingly, Training services are not taxable on a stand-alone basis.

Configuration

After consulting with a client as to how that client wants to utilize ERP software, the Taxpayer clicks boxes and selects options already built into that software that give direction within the software. This service does not constitute the sale of prewritten or custom computer software. Significantly, this activity does not involve the modification or enhancement of software code; the Taxpayer simply

⁴⁰ The installation of computer software and the creation of software on its customer’s premises are each subject to the Tennessee sales tax. *See* TENN. CODE ANN. §§ 67-6-102(78)(K); 67-6-205(c)(6) (2013).

⁴¹ Because the Taxpayer’s customers may contract for only a single type of service or multiple combinations thereof, this ruling cannot specifically address the applicability of the sales tax to all possible scenarios involving sales of the Taxpayer’s Additional Services.

activates features already coded within the existing software to optimize the software's functionality. As such, the Configuration services are not taxable on a stand-alone basis.

Note that because Configuration is often an integral part of the sale of software or a taxable service, such as software installation, a separately itemized charge for Configuration could nevertheless be taxable when provided in conjunction with such software or taxable service. See below for further discussion.

Project Management and Client Correspondence

The Taxpayer states that the Project Management and Client Correspondence service involves its coordination of projects, scheduling of resources, communication with clients, and reporting on the status of projects. This type of service does not itself involve the sale of tangible personal property or computer software. Additionally, this service does not involve the creation, fabrication, modification, or enhancement of computer software, nor does it constitute a specifically enumerated taxable service. Thus, Project Management and Client Correspondence services are not taxable on a stand-alone basis.

Data Conversion

The Taxpayer describes its Data Conversion service as assisting a client in loading that client's existing data into a new module or system. This type of service does not involve the sale of tangible personal property or computer software. Through this service, the Taxpayer is relocating preexisting data that belongs to its customer and never gains control of such data. Additionally, through this service, the Taxpayer does not fabricate, modify, or enhance computer software. The Taxpayer also does not perform a specifically enumerated taxable service. Accordingly, Data Conversion services are not taxable on a stand-alone basis.

Documentation

The Taxpayer states that through this service it prepares documentation associated with its projects and transmits this information to clients electronically. Since the documentation is transmitted electronically, it does not involve a sale of tangible personal property, and electronic records are not computer software. Documentation services also are not a specifically enumerated taxable service. Consequently, Documentation services are not taxable on a stand-alone basis.

Testing

When providing testing services, the Taxpayer assists a client with the creation of test plans to determine if software was configured properly or provides on-site guidance while the client performs its own test. Testing may further entail the Taxpayer performing services to test for proper configuration. Testing of computer software, in contrast to the repair or installation of computer software, is not a specifically enumerated service. Therefore, Testing services are not taxable on a stand-alone basis.

Report Writing

With regard to its Report Writing service, the Taxpayer states that it utilizes built-in report writer modules, “click and drag” type interfaces that are part of a software package, and tool kits provided by a software publisher to generate reports for its clients.

If the Report Writing service involves only the clicking of boxes and selecting of options within an already existing software program or using “click and drag” interfaces within an existing software program to run reports, the Taxpayer does not perform customized modifications or enhancements to software code but rather uses tools provided by a software publisher to optimize software functionality. Under such particular facts, the Taxpayer’s Report Writing services would not constitute a specifically enumerated service and, as such, would not be a taxable service on a stand-alone basis.

Note that if the Taxpayer’s Report Writing service involves an amount of software coding or programming that is not merely incidental to Report Writing, the Report Writing would be subject to the sales and use tax as the sale of computer software.⁴²

II. TRANSACTIONS INVOLVING MULTIPLE TYPES OF SERVICES

Transactions involving multiple types of services and items raise additional issues not present when the Taxpayer provides a single service on a stand-alone basis. Some combinations are relatively straightforward. For example, if the Taxpayer provides its customer a combination of Additional Services, all of which are independently not subject to tax, then the entire transaction is not subject to tax.

However, the Taxpayer may provide its customer a combination of services including some of which are independently subject to sales tax, particularly if the transaction involves the provision of both nontaxable Additional Services and taxable items or services. In this case, the result necessarily will depend upon the totality of the circumstances.

For example, suppose one of the Taxpayer’s contracts requires that it provide Project Management and Client Correspondence services or Documentation services in conjunction with installing, creating, or customizing software. Project Management, Client Correspondence, and Documentation services are not independently taxable services, but if the Taxpayer performs these services in conjunction with the primary taxable item or service, the circumstances would suggest that such activity is a “crucial,” “essential,” “necessary,” “consequential,” or “integral” element of providing the taxable service. The Taxpayer would not be able to effectively perform the taxable service without the related Project Management, Client Correspondence, or Documentation service. Separately stating a fee for these elements of a service does not render that fee non-taxable. If the item or service to which a Project Management, Client Correspondence, or Documentation service fee relates is a service subject to tax, the Project Management, Client Correspondence, or Documentation service fee also will be subject to tax as a necessary component of a taxable item or service.

⁴² It should be noted that if the Taxpayer charges one sales price for its Report Writing services that covers both services where the Taxpayer codes and programs software as well as services where the Taxpayer clicks boxes and selects options within an already existing software program or uses “click and drag” interfaces within an existing software program to run reports, the entire sales price for Report Writing services would be subject to tax as a bundled transaction.

Likewise, suppose one of the Taxpayer's contracts requires the Taxpayer to provide Testing services in conjunction with creating or customizing software. Testing of computer software is not an independently taxable service, but if the Taxpayer performs Testing services on the created or customized software, the circumstances would suggest that the Testing was a "crucial," "essential," "necessary," "consequential," or "integral" element of providing the taxable service of creating or customizing software to ensure that the software meets the customer's specifications. As such, under those circumstances, the required Testing services would be subject to sales tax in addition to the software programming.⁴³

The Taxpayer has described its Additional Services as optional and separate from its sale of ERP software. If, however, there is an otherwise non-taxable Additional Service that the Taxpayer always requires be purchased with its sale of either ERP software or a taxable item or service, the totality of circumstances would indicate that such Additional Service was a "crucial," "essential," "necessary," "consequential," or "integral" element of the transaction, and would therefore be subject to sales tax. For example, if the Taxpayer never sells the ERP software without its Training services, the Training services would be necessary to complete the sale of the software and, thus, subject to the sales tax.

Along the same lines, if the Taxpayer never sells its otherwise non-taxable Configuration services separately from its taxable installation of software, the totality of the circumstances might indicate that the Configuration services would be necessary to complete the sale of the taxable installation service, and thus subject to the sales tax.

CONCLUSION

To determine the sales tax consequences of its service offerings, the Taxpayer must examine the totality of the circumstances for each individual client contract. When the Taxpayer sells a combination of items and services, it should consider whether the circumstances suggest that the true object of the transaction or any of the crucial elements thereof would be subject to sales tax. If so, the entire transaction is subject to sales tax.

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⁴³ Alternatively, if the Taxpayer were to provide Testing services in addition to creating or customizing software, but the Testing services were performed on a *different* and unrelated piece of software from what the Taxpayer created or customized, then the transaction would properly be viewed as having two separate objects that should be treated separately for sales tax purposes. The Testing service in that case would most likely not be subject to sales tax. This assumes that the Taxpayer separately itemizes the services, thus avoiding any potential bundling issues. However, if the charges for the nontaxable services are included in the sales price of a taxable good or service, such charges will be subject to taxation as a bundled transaction.

