

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 14-11

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 services and software furnished by contract personnel during different stages of a software development project.

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 [TYPE OF ENTITY], located in Tennessee. The Taxpayer provides information technology ("IT") personnel on a contract basis to supplement the IT staffs of [REDACTED] companies via staff augmentation services. The Taxpayer provides its IT

contract personnel (the “Taxpayer IT Personnel”) by charging an hourly rate for their time. The Taxpayer does not engage in fixed-price contracts to develop or modify software for specific delivery to a customer. The Taxpayer only contracts to provide Taxpayer IT Personnel by the hour to supplement its customers’ staffs.

As part of their staffing duties some of the Taxpayer IT Personnel are involved in the development or modification of software for the Taxpayer’s customer. Those Taxpayer IT Personnel create or modify application programs, command language scripts, and database scripts. The personnel may also develop web pages.

To ensure that the Taxpayer’s customers own any software developed by the Taxpayer IT Personnel, the Taxpayer’s contracts with its customers specify that title to and all rights in any software created or modified by the Taxpayer IT Personnel is transferred to the customer.

The time spent actually writing programming code and scripts is often only a small fraction of the total necessary time spent during the development of any piece of software. Before writing a line of code, the developer must learn the requirements, needs, and goals for the software or modification; must negotiate with end users about the deliverables; must analyze the technical software design needed; and must determine a method for testing the new or modified software to ensure that it will work properly and will not cause other software to cease working properly. After writing or modifying the software, the developer must test it thoroughly, arrange for the software to be installed into its production environment, and verify that it is operating properly.

On larger projects, different activities are handled by different people who specialize in one particular part of the software development life-cycle. The software development life-cycle is the process that leads to the creation, maintenance, or modification of software for the customer. Some of these people could be the Taxpayer’s personnel and some could be full-time employees of the customer.

The software development process involves the following categories of Taxpayer IT Personnel: Business Analysts, Systems Analysts or Systems Designers, Programmers and Developers,¹ Quality Assurance, Database Administrators, and Project Managers.

- Business Analysts study, analyze, and document existing and proposed business processes and data flows, as well as, gather goals and objectives from managers and communicate with end-users in connection with a particular software development or software installation project.
- Systems Analysts or Systems Designers design new or modified computer screens, web page layouts, data field validation rules, database tables and fields and reports. When the designs are finalized, the Systems Analyst presents them to the programming team with detailed, module-by-module, programming requirements that specify exactly what work needs to be done by the programmers.

¹ Programmers and Developers are not discussed in detail because the Taxpayer recognizes that the services and software provided by these types of Taxpayer IT Personnel are subject to the Tennessee sales and use tax.

- The Quality Assurance team thoroughly tests every prompt or response and all defined transactions and interactions in the software before it is released. The quality assurers send their results back to the programmers so that any deviations or unexpected behaviors can be fixed.
- A Database Administrator may spend time on software development tasks. Most software development projects will require modification to the database management system. The Database Administrator reviews the proposed changes and assesses their functionality, as well as, writes application logic to be stored in the database in order to promote application functionality and/or improve performance. The Database Administrators also program with the database's scripting tools to load data into the database format for the application being developed.
- The Project Manager assigns tasks to members of the project team, tracks the progress of all work, communicates with all involved parties, coordinates tasks which must be done by people who do not report to the Project Manager, ensures that the Programmers have the tools and resources needed for each stage of the project, and identifies and chooses corrective actions if the project has gotten off of schedule.

Each of the Taxpayer IT Personnel positions carries out a specialized role in a software development project.

RULING

Are the charges for the services and software furnished by the Taxpayer IT Personnel during the software development project subject to the Tennessee sales and use tax?

Ruling: The Taxpayer should collect and remit Tennessee sales and tax on charges for the services and software furnished by its Programmers and Database Administrators, when provided on a stand-alone basis. No charges for the services of other Taxpayer IT Personnel would be subject to the Tennessee sales tax, if provided on a stand-alone basis.

However, otherwise non-taxable charges for services furnished by Taxpayer IT Personnel may be subject to the Tennessee sales tax if such charges are required to be included in the sales price of a taxable item or service.

If the Taxpayer exclusively provides all of the IT personnel necessary to achieve a specific software development project, and the customer obtains the software, the Taxpayer should collect and remit Tennessee sales and use tax based on all charges for the services and software furnished by all contract personnel involved in that specific project.

ANALYSIS

LEGAL BACKGROUND

Under the Retailers' Sales Tax Act,² 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."³ 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."⁴ Tangible personal property also includes "prewritten computer software," which is defined in TENN. CODE ANN. § 67-6-102(68) in pertinent part as "computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser."⁵ 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.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 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

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

³ TENN. CODE ANN. § 67-6-102(76) (Supp. 2014).

⁴ TENN. CODE ANN. § 67-6-102(89)(A).

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

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).

programmed into a computer, created on the premises of the consumer or otherwise provided.⁸

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”⁹ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”¹⁰ 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.¹¹

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.¹²

The sales tax also applies to retail sales of services specifically enumerated in the Retailers’ Sales Tax Act.¹³ 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.”¹⁴ 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.”¹⁵

Thus, the sale of all computer software, both prewritten or customized, as well as the installation and repair thereof is subject to the Tennessee sales and use tax.

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

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).

⁹ TENN. CODE ANN. § 67-6-102(18).

¹⁰ TENN. CODE ANN. § 67-6-102(24).

¹¹ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

¹² TENN. CODE ANN. § 67-6-102(78)(K).

¹³ 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).

¹⁴ TENN. CODE ANN. § 67-6-205(c)(6).

¹⁵ TENN. CODE ANN. § 67-6-205(c)(4).

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.¹⁶ 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. This treatment derives from TENN. CODE ANN. § 67-6-102(79)(A)(iv)¹⁷, 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.”¹⁸ Moreover, there is no conceptual reason why bundling principles 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.¹⁹

¹⁶ 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.”).

¹⁷ 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.

¹⁸ 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 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”).

¹⁹ 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).

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”²⁰ of the transaction.²¹ In applying this test, the courts essentially look at the totality of the facts and circumstances²² to determine what objective is really being accomplished by the transaction.²³

If the true object (or a true object) of a transaction would independently be taxable, then the true object and any “crucial,”²⁴ “essential,”²⁵ “necessary,”²⁶ “consequential,”²⁷ or “integral”²⁸ elements of the transaction will be subject to sales tax.²⁹ In addition, if a taxable component of a

²⁰ 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).

²¹ 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).

²² *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”).

²³ 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).

²⁴ *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).

²⁵ *Id.*; *see also* *AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *8 (Tenn. Ct. App. Oct. 8, 2002) (holding that a transaction involving the sale of engineering services along with separately itemized tangible telecommunications systems was subject to sales tax on the entire amount of the contract because “equipment, engineering, and installation combine in this instance to produce BellSouth's desired result: a functioning item of tangible personal property assembled on the customer's premises,” and further describing the engineering services as “essential” and “integral” to the sale of tangible personal property).

²⁶ *See supra* note 26.

²⁷ *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”).

²⁸ *See AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²⁹ *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).

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.³⁰

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.³¹

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.³²

A “mixed transaction” is generally understood to be a transaction involving the inseparable³³ transfer of tangible personal property along with a service, where at least one aspect of the transaction is independently taxable.³⁴ 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

³⁰ See e.g., *supra* note 25.

³¹ 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.

³² 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).

³³ 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 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.

³⁴ 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.

tangible personal property.³⁵ 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*,³⁶ 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”³⁷ 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.³⁸ 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.³⁹ 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.⁴⁰ Under Tennessee law, the provision of temporary workers is not a taxable service, but repairing tangible personal property is a taxable service.⁴¹ Accordingly, a court would 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.

³⁵ 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).

³⁶ No. 01A01-9604-CH-00149, 1996 WL 596955, at *2 (Tenn. Ct. App. Oct. 18, 1996).

³⁷ *Id.*

³⁸ See, e.g., TENN. CODE ANN. § 67-6-205.

³⁹ See generally REEDER, *supra* note 33, at 7-8.

⁴⁰ *Cf. id.* at 8-9 (giving the examples of managerial services and hourly labor).

⁴¹ See TENN. CODE ANN. § 67-6-205(c)(4).

APPLICATION

The Taxpayer offers the services of the Taxpayer IT Personnel on an hourly basis, and its customers may contract for the Taxpayer's provision of a single type of Taxpayer IT Personnel or multiple combinations thereof.

To determine the taxability of a transaction,⁴² it is necessary to determine first whether the charges for services provided by a particular type of Taxpayer IT Personnel would be subject to the Tennessee sales tax if provided on a stand-alone basis, since a customer might contract for only the provision of a single type of service performed by Taxpayer IT Personnel. Then, one must consider how the result might change if the Taxpayer were to provide a combination of different types of services to the same customer.

SERVICES PERFORMED BY EACH TYPE OF TAXPAYER IT PERSONNEL

The provision of services by each type of Taxpayer IT Personnel must be analyzed to determine if the transaction involves the provision of an enumerated service. If the service performed by any of the following Taxpayer IT Personnel is properly characterized as an enumerated service, the Taxpayer's charges for the services provided by that type of personnel on a stand-alone basis will be subject to sales tax.

The services and software provided by its Programmers are subject to sales tax as the creation of software on its customer's premises. Likewise, the services provided by its Database Administrators also would be subject to sales tax if provided on a stand-alone basis, because the transaction includes the programming of software.

The services provided by the other types of Taxpayer IT Personnel would not be subject to sales tax if provided on a stand-alone basis, as explained below.

Business Analyst

Business Analysts study, analyze, and document existing and proposed business processes and data flows. Additionally, they gather goals and objectives from managers and communicate with end-users in connection with a particular software development or software installation project. As described above, a Business Analyst never programs, creates, modifies, transfers, loads, or installs software, or performs another specifically enumerated taxable service. Accordingly, the services provided by the Business Analysts are not taxable on a stand-alone basis.

Systems Analyst or Systems Designer

Systems Analysts or Systems Designers design the new or modified computer screens, web page layouts, data field validation rules, database tables and fields and reports. After finalizing the designs, the Systems Analyst presents the designs to the programming team with detailed,

⁴² Because the Taxpayer's customers may contract for only the provision of a single type of Taxpayer IT Personnel or multiple combinations thereof, this ruling cannot specifically address the applicability of the sales tax to all possible scenarios involving combinations of different Taxpayer IT Personnel.

module-by-module, programming requirements that specify exactly what work needs to be done by the programmers. As described above, a System Analyst or System Designer never programs, creates, modifies, transfers, loads, or installs software, or performs another specifically enumerated taxable service. Accordingly, the services provided by the Systems Analysts or Systems Designers are not taxable on a stand-alone basis.

Quality Assurance Personnel

The Quality Assurance team thoroughly tests every prompt or response and all defined transactions and interactions in the software before it is released. The Quality Assurance Personnel send their results back to the Programmers so that any deviations or unexpected behaviors can be fixed. As described above, a Quality Assurance staffer never programs, creates, modifies, transfers, loads, or installs software, or performs another specifically enumerated taxable service. Accordingly, the services provided by the Quality Assurance Personnel are not taxable on a stand-alone basis.

Database Administrator

A Database Administrator performs software development tasks. Most software development projects will require modification to the database management system. The Database Administrator reviews the proposed changes and assesses their functionality, as well as writes application logic to be stored in the database in order to promote application functionality. The Database Administrator also programs with the database's scripting tools to load data into the database format for the application being developed. These tasks, particularly the programming of scripting tools, involve the creation of computer software on the customer's premises. Consequently, the services provided by the Taxpayer's Database Administrator would be taxable as the sale of computer software.

Project Manager

The Project Manager assigns tasks to members of the project team, tracks the progress of all work, communicates with all involved parties, coordinates tasks which must be done by people who do not report to the Project Manager, ensures that the Programmers have the tools and resources needed for each stage of the project, and identifies and chooses corrective actions if the project has gotten off of schedule. To the extent that a Project Manager never programs, creates, modifies, transfers, loads, or installs software, or performs another specifically enumerated taxable service, the services provided by the Project Manager are not taxable on a stand-alone basis.

TRANSACTIONS INVOLVING MULTIPLE TYPES OF TAXPAYER IT PERSONNEL

Whenever the Taxpayer provides to a customer a combination of Taxpayer IT Personnel that includes either a Programmer or a Database Administrator, the entire transaction is subject to sales and use tax, unless the Taxpayer maintains suitable records, as discussed below, to separate the transaction on a per-project basis.

If the Taxpayer provides its customer a combination of Taxpayer IT Personnel, and none of the services performed by the various types of IT personnel provided are subject to tax on a stand-alone basis, then the entire transaction is not subject to tax, regardless of the project in which each IT staffer participates. Similarly, if the Taxpayer provides to its customer a combination of only Programmers and Database Administrators, then the entire transaction is subject to sales tax because the services of all of the Taxpayer IT Personnel provided are taxable on a stand-alone basis.

On the other hand, the Taxpayer may provide a combination of Taxpayer IT Personnel for a single project, including personnel whose services are not subject to tax on a stand-alone basis as well as Programmers or Database Administrators. In such cases, the true object of the transaction would be the provision of a taxable item or service – *i.e.*, the sale or creation of computer software. This conclusion is supported by the totality of the circumstances. Moreover, each contract staffer's role during the project is "crucial," "essential," "necessary," "consequential," or "integral" to the creation or modification of the software by other personnel as part of the software development project.⁴³

TRANSACTIONS INVOLVING ALL TYPES OF TAXPAYER IT PERSONNEL ON A SPECIFIC PROJECT

If the Taxpayer exclusively provides a customer with all of the Taxpayer IT Personnel necessary to complete a specific software development project, it should collect and remit sales tax based on all of the services and software furnished by every IT staffer involved on that specific project.

When the Taxpayer supplies all of the Taxpayer IT Personnel involved in a specific software development project, the true object of that transaction is the creation of the computer software provided to the customer at the end of the transaction. Thus, under these circumstances, regardless of how the Taxpayer bills for the provision of services or software by each individual type of Taxpayer IT Personnel, all of its charges for the project are subject to sales tax as the creation of software on its customer's premises, under TENN. CODE ANN. § 67-6-102(78)(K).

MAINTAINING RECORDS FOR TRANSACTIONS INVOLVING TAXPAYER IT PERSONNEL

Although separate itemization is generally insufficient to defeat the application of the sales and use tax to a transaction,⁴⁴ in the Taxpayer's case, itemization may have relevance when a customer hires several different types of Taxpayer IT Personnel to work on completely different projects.

For example, a customer may hire a Programmer and a Project Manager to work on a software development project, along with a Business Analyst to work on a completely different, unrelated project analyzing the customer's business model. In that case, even if the Taxpayer includes the charges for services and software furnished by all three members of its IT personnel on the same invoice to the customer, the services performed and software furnished by the Programmer and

⁴³ Although not applicable under the facts presented in this ruling, certain transactions may arise whereby the creation or transfer of computer software may not be the true object of the transaction.

⁴⁴ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

the Project Manager could be separable from the services performed by a Business Analyst, if appropriately documented. While the services and software furnished by the Programmer and the Project Manager would be subject to sales and use tax, the unrelated services performed by the Business Analyst would not be subject to sales tax, provided the Taxpayer keeps adequate records to support the separate nature of the transactions.⁴⁵

In order to sufficiently show that each project should be treated separately for sales and use tax purposes, the Taxpayer must maintain adequate records. The following non-exhaustive list is illustrative of the types of records the Department would consider in its analysis:

- At a minimum, the Taxpayer must identify the projects that the Programmers and/or Database Administrators worked on, and maintain records showing whether any other Taxpayer IT Personnel, provided to the same customer, worked on the same project.
- Additionally, the Taxpayer must keep general work reports, time sheets, diaries, or like documentation, and descriptions of actual inputs and job descriptions performed for the customer.
- Generally, the contract between the Taxpayer and its customer should specify the job and project descriptions and should include job classifications for the provided employees.

Failure to keep adequate records will likely result in all charges for services and software provided to a particular customer being subject to sales and use tax.⁴⁶

CONCLUSION

To determine the application of the Tennessee sales and use tax to the services and software furnished by the Taxpayer's IT Personnel, the Taxpayer must examine the totality of the circumstances for each individual customer contract. If the Taxpayer provides a customer with all of the Taxpayer IT Personnel for a specific software development project, it should collect and remit sales tax based on all of the charges billed for the services of every contract staff person involved. When the Taxpayer provides a combination of Taxpayer IT Personnel, it should

⁴⁵ See TENN. CODE ANN. § 67-1-113 (2013).

⁴⁶ Dealers, including providers of taxable services, see TENN. CODE ANN. § 67-6-102(23)(H), have an affirmative duty to maintain suitable records. TENN. CODE ANN. §§ 67-1-113(a), 67 -6-523 (2013). See also TENN. COMP. R. & REGS. 1320-5-1-.80 (1974). Failure maintain adequate records will result in the Department assessing "taxes, plus any applicable penalty and interest based on the best information available to the department; and the burden shall be on the taxpayer to show by clear and cogent evidence that the assessment is incorrect." TENN. CODE ANN. § 67-1-113(b).

consider whether the circumstances suggest that the true object of the transaction or any of the “crucial,” “essential,” “necessary,” “consequential,” or “integral” elements thereof would be subject to sales tax. If so, the entire transaction is subject to sales tax.

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