

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 15-09**

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.

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

[CORPORATION] is a [STATE OTHER THAN TENNESSEE] corporation engaged in providing [REDACTED SERVICES]. [CORPORATION] has business units operating in [CITIES IN TENNESSEE], as well as numerous other locations outside of Tennessee. [CORPORATION] wholly owns a Tennessee limited liability company, [LIMITED LIABILITY COMPANY] which is headquartered in and operates out of [CITY IN TENNESSEE]. [LIMITED LIABILITY COMPANY] is a disregarded entity for federal income tax

purposes. For purposes of this letter ruling, [CORPORATION] and [LIMITED LIABILITY COMPANY] will be referred to collectively as the “Taxpayer.”¹

The Affiliate-Hosted Software

The Taxpayer purchases licenses for [THREE TYPES OF AFFILIATE-HOSTED SOFTWARE] (collectively, the “Affiliate-Hosted Software”) from foreign affiliates that purchase the applications from third-party vendors and host them on servers in foreign locations. The affiliates annually charge the Taxpayer for the costs of these licenses on a per-seat basis. The Taxpayer is billed at the location of each of its business units, including those [TENNESSEE CITIES].² The following services are provided by the foreign affiliates in conjunction with the Affiliate-Hosted Software, all for a single price: hosting applications and data servers, application monitoring, data storage and backups, disaster recovery, technical support, and incident management (the “Additional Services”).

The employees of the Taxpayer access the [FIRST TYPE OF AFFILIATE-HOSTED SOFTWARE] through a desktop icon that links to the software stored on a server in [FOREIGN COUNTRY]. A particular employee’s level of access to the software varies depending upon his or her role. Certain employees use the software to input, manipulate, and process [REDACTED] data, while others have access for the sole purpose of running reports.

The employees of the Taxpayer access the [SECOND TYPE OF AFFILIATE-HOSTED SOFTWARE] (also hosted on a server in [FOREIGN COUNTRY]) through an intranet link, a web-based link, or a [APPLICATION] platform—unrelated software allowing users to remotely access other software and information through the Internet. The access rights of the Taxpayer’s Tennessee employees are limited to [ADDING INFORMATION AND RUNNING REPORTS]. The Taxpayer’s [REDACTED] department personnel and [REDACTED EMPLOYEES] in [STATE OTHER THAN TENNESSEE] have expanded access rights for [REDACTED – VARIOUS PURPOSES].

The employees of the Taxpayer access the [THIRD TYPE OF AFFILIATE-HOSTED SOFTWARE], hosted on a server in [FOREIGN COUNTRY], through either a web-based link or a [APPLICATION] platform. The Taxpayer’s business units throughout the United States mail [REDACTED – DOCUMENTS] to the Taxpayer’s shared service center in Tennessee, where the Taxpayer’s employees use the software to process the [REDACTED – DOCUMENTS]. Employees outside of the shared service center remotely access the software for purposes of viewing and approving [REDACTED – DOCUMENTS].

The Vendor-Hosted Software

The Taxpayer also pays fees directly to third parties for subscriptions to remotely access and use [REDACTED – VENDOR HOSTED SOFTWARE] (collectively the “Vendor-Hosted Software”) that remain

¹ TENN. CODE ANN. § 48-249-1003 (2013) states that “for purposes of all state and local Tennessee taxes, a domestic or foreign LLC shall be treated as a partnership or an association taxable as a corporation, as such classification is determined for federal income tax purposes.” [LIMITED LIABILITY COMPANY] is a single member limited liability company wholly-owned by [CORPORATION] and disregarded for federal income tax purposes. [LIMITED LIABILITY COMPANY] is therefore disregarded and treated as a division or business unit of [CORPORATION] for purposes of the Tennessee sales and use tax.

² This includes [LIMITED LIABILITY COMPANY’S] headquarters location in Tennessee.

in the possession of the third-party vendors on servers located outside of Tennessee. All charges for these applications are billed by the third-party vendor to the Taxpayer's headquarters in [STATE OTHER THAN TENNESSEE]. The Taxpayer internally allocates the subscription costs for the software to each of its internal business units in the United States, including the locations in Tennessee.³

The employees of the Taxpayer remotely access the Vendor-Hosted Software via a web browser. Those employees in the Taxpayer's [STATE OTHER THAN TENNESSEE] [REDACTED] shared services center access and use the Vendor-Hosted Software to perform [REDACTED] service functions on behalf of the Taxpayer's business units throughout the country, including those in Tennessee. The [REDACTED] shared services center in [STATE OTHER THAN TENNESSEE] gathers information from the applications to provide [REDACTED – FUNCTIONS AND INFORMATION]. Employees of both entities in Tennessee access the Vendor-Hosted Software for the purpose of recording or approving [REDACTED – INFORMATION AND DOCUMENTS].

Internally Hosted Software

Finally, the Taxpayer purchases various other software applications from third-party vendors that it downloads or installs on computers or servers located both inside and outside of Tennessee ("Internally Hosted Software"). The charges for these software applications, along with the labor costs incurred at any data center where the application may be hosted, are passed along through an intercompany expense to each of the Taxpayer's business units, including those in Tennessee.⁴

RULINGS

1. Are the charges incurred by the Taxpayer for the Affiliate-Hosted Software subject to Tennessee sales and use tax?

Ruling: Yes, all charges for the Affiliate-Hosted Software attributable to access and use by the Taxpayer's Tennessee users are subject to Tennessee sales and use tax. The sales price includes any Additional Services that are bundled together with the Affiliate-Hosted Software and sold at a single price.

2. Are the charges incurred by the Taxpayer for the Vendor-Hosted Software subject to Tennessee sales and use tax?

Ruling: The Taxpayer is purchasing software that is remotely accessed and used both inside and outside of Tennessee. That portion of the charges incurred by the Taxpayer and attributable to access and use by the Taxpayer's Tennessee users is subject to Tennessee sales and use tax.

3. Are the charges incurred by the Taxpayer for Internally Hosted Software subject to Tennessee sales and use tax?

³ This includes [LIMITED LIABILITY COMPANY'S] headquarters location in Tennessee.

⁴ This includes [LIMITED LIABILITY COMPANY'S] headquarters location in Tennessee.

Ruling: The charges incurred by the Taxpayer for Internally Hosted Software are subject to Tennessee sales and use tax insofar as the purchased software is physically or electronically transferred to the Taxpayer in Tennessee. The charges incurred for software that is purchased and downloaded or installed by the Taxpayer in locations outside of Tennessee, and remotely accessed by the Taxpayer in Tennessee, are not subject to tax.

ANALYSIS

LEGAL BACKGROUND

1. TAXATION OF SOFTWARE

Under the Retailers' Sales Tax Act,⁵ 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."⁶

TENN. CODE ANN. § 67-6-102(78)(A) (Supp. 2015) 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 "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."⁷

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.⁸ One of the "things" specifically taxable is:

⁵ Tennessee Retailers' Sales Tax Act, Ch. 3, §§ 1-18, 1947 Tenn. Pub. Acts Ch. 22, 22-54 (codified as amended at TENN. CODE ANN. §§ 67-6-101 to -907 (2013)).

⁶ TENN. CODE ANN. § 67-6-102(76) (Supp. 2015).

⁷ "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." TENN. CODE ANN. § 67-6-102(89)(A). With regard to prewritten computer software, TENN. CODE ANN. § 67-6-102(68) 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).

⁸ TENN. CODE ANN. § 67-6-102(78)(C).

[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.⁹

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”¹⁰ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”¹¹ 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.¹²

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.¹³

In response to advances in technology that allow persons to remotely access and use software over the Internet, the Tennessee General Assembly adopted into law 2015 Tenn. Pub. Acts Ch. 514, § 22 (effective July 1, 2015). This new law effectively treats all purchases of computer software in this state equally, regardless of how the software is provided to and used by a purchaser in this state. It amends TENN. CODE ANN. § 67-6-231(a) to include a new subdivision (2), which states in pertinent part that

[f]or purposes of subdivision (a)(1), “use of computer software” includes the access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer. If the customer accesses the software from a location in this state as indicated by the residential street address or the primary business address of the customer, such access shall be deemed equivalent to the sale of licensing of the software and electronic delivery of the software for use in the state.¹⁴

⁹ TENN. CODE ANN. § 67-6-231(a)(1) (Supp. 2015). 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).

¹⁰ TENN. CODE ANN. § 67-6-102(18).

¹¹ TENN. CODE ANN. § 67-6-102(24).

¹² See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

¹³ TENN. CODE ANN. § 67-6-102(78)(K).

¹⁴ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

As a result, effective for all billing periods beginning on or after July 1, 2015, the access and use of computer software in this state, which has generally been subject to tax since 1977,¹⁵ remains subject to sales and use tax regardless of a customer's chosen method of use.

Additionally, 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 sales tax as a bundled transaction.¹⁶ Finally, when a transaction involves taxable and nontaxable components and the transaction's true object or a "crucial,"¹⁷ "essential,"¹⁸ "necessary,"¹⁹ "consequential,"²⁰ or "integral"²¹ element of the transaction is subject tax, the entire transaction is subject to sales tax.²² 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.²³

¹⁵ The General Assembly amended the definition of "tangible personal property" in 1977 to specifically include computer software in response to the Tennessee Supreme Court's holding to the contrary in *Commerce Union Bank*, 538 S.W.2d at 408. 1977 Tenn. Pub. Acts Ch. 42 (defining "tangible personal property" to include computer software); see also *Univ. Computing Co. v. Olsen*, 677 S.W.2d 445, 447 (Tenn. 1984) (detailing the General Assembly's actions taken to subject computer software to sales and use tax).

¹⁶ See generally Tenn. Dept. of Rev. Ltr. Rul. 14-10 (Oct. 14, 2014) [hereinafter "Ltr. Rul. 14-10"] (discussing Tennessee law regarding bundling and the "true object" test), available at <http://www.tennessee.gov/assets/entities/revenue/attachments/14-10.pdf>.

¹⁷ 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).

¹⁸ *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).

¹⁹ See *supra* note 17.

²⁰ 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").

²¹ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²² See generally Ltr. Rul. No. 14-10, *supra* note 16.

²³ See generally *id.*

2. PAYMENT OF TAX

If a person purchases remote access to software for use wholly within Tennessee, applicable sales tax on the transaction generally must be collected by the seller.²⁴ However, if the seller does not collect the tax, the purchaser must remit tax directly to the Department.

Alternatively, a person might purchase remote access to software for use across several states in a single transaction. To ensure the purchaser pays Tennessee sales and use tax only on the portion of the sales price reflecting its access and use of software in Tennessee, 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)), provides that

[i]f the sale price or purchase price of the software relates to users located both in this state and outside this state as indicated by a residential street or business address, the dealer or customer may allocate to this state a percentage of the sales price or purchase price that equals the percentage of users in this state.

To make this allocation, a purchaser of remotely accessed software must determine the number of persons accessing and using the remotely accessed software in this state and divide that number by the total number of persons represented in the transaction that are accessing and using the software everywhere. A purchaser should determine the location of each user, insofar as possible, by the user's primary residential street or business address at the time of sale. If the location of users is difficult to determine, a purchaser should use a reasonable and consistent method of allocation that accurately reflects the percentage of users in Tennessee based on its books and records at the time of sale. A purchaser must include any person for whom it has purchased access and use of the software in the calculation, regardless of any person's level of access or extent of use.

If the purchaser pays for access to software that will be used by individuals who are located in this state, and other individuals who are located outside this state (for example, the purchaser's employees), then the purchaser may allocate the sales price subject to Tennessee tax based on the percentage of its users located in Tennessee. The purchaser must maintain adequate records supporting the allocation percentage applied to any particular transaction. If a purchase is ongoing or recurring in nature, the purchaser must take reasonable steps to update its allocation percentage upon a material change in its user ratio.

A purchaser may present to a seller a Remotely Accessed Software Direct Pay Permit and remit sales tax to the Department on the portion of the sales price that corresponds to the percentage of its users located in Tennessee at the time of sale. A seller is not obligated to collect and remit the applicable sales tax when a purchaser presents a Remotely Accessed Software Direct Pay Permit or when the seller is not on notice that the customer will be using the software in Tennessee. When a customer presents the seller with a fully completed Streamlined certificate of exemption,²⁵ a seller

²⁴ TENN. CODE ANN. § 67-6-502 (2013). A dealer will not be required to collect tax on a sale of remotely accessed software where it is not readily apparent to the dealer that the customer is using the software in Tennessee. Due to the nature of remotely accessed software, the dealer may not be aware that the software is used in Tennessee.

²⁵ The Streamlined certificate must include the customer's Tennessee sales and use tax registration number. In addition, on Line 5, "Reason for Exemption," the customer should circle "Other" with an explanation such as,

must collect and remit sales tax only on the portion of the sales price that corresponds to the percentage of the customer's users located in Tennessee.²⁶

APPLICATION

1. *The Affiliate-Hosted Software*

The charges that the Taxpayer incurs for its users to remotely access and use the Affiliate-Hosted Software in Tennessee are subject to sales and use tax.

The Affiliate-Hosted Software remains on a server located outside of Tennessee at all times, and no sale or transfer of tangible personal property or electronic delivery of the software occurs in Tennessee. The Taxpayer instead purchases licenses from its foreign affiliates allowing its employees in Tennessee to remotely access and use the Affiliate-Hosted Software. Effective July 1, 2015, such remote access and use of software is "deemed equivalent to the sale or licensing of the software and electronic delivery of the software for use in this state."²⁷ Thus, for periods on or after July 1, 2015, the purchase and use of the Affiliate-Hosted Software in Tennessee by the Taxpayer is subject to Tennessee sales and use tax. If sales tax is not collected by the dealer, the Taxpayer is responsible for reporting and remitting the tax due on the purchase price of the software. The sales or purchase price for each Affiliate-Hosted Software application includes the Additional Services that have been bundled together with the software and sold for a single sales price.²⁸

Every person accessing and using the software sold in any particular transaction is considered a user for purposes of TENN. CODE ANN. § 67-6-231(a)(2) regardless of the person's level of access or extent of use. Therefore, even though the Taxpayer's employees in Tennessee may use the [SECOND TYPE OF AFFILIATE-HOSTED SOFTWARE], for example, only to run reports or upload [INFORMATION], the Tennessee employees are nonetheless accessing and using the software.

As discussed above, TENN. CODE ANN. § 67-6-231(a)(2) allows a taxpayer purchasing remote access to software for use by persons inside and outside of Tennessee in a single transaction to pay Tennessee sales and use tax only on the portion of the sales price reflecting its access and use of software in Tennessee. Although the Taxpayer purchases access to the Affiliate-Hosted Software for use by its employees located inside and outside of Tennessee, it does not purchase such access in a single transaction. Rather, the Taxpayer purchases access for each Tennessee business unit in a separate transaction for each unit. Therefore, if all of the Taxpayer's personnel for a particular business unit access and use the Affiliate-Hosted Software from a location in Tennessee, there is no

"remote access software used by employees located in multiple states" and specify the percentage of users located outside of Tennessee.

²⁶ For additional information, see Sales and Use Tax Notice # 15-14, available at <http://tn.gov/assets/entities/revenue/attachments/sales15-14.pdf>, and Sales and Use Tax Notice # 15-24, available at <http://tn.gov/assets/entities/revenue/attachments/sales15-24.pdf>.

²⁷ TENN. CODE ANN. § 67-6-231(a)(2).

²⁸ See TENN. CODE ANN. § 67-6-102(79)(A)(iv); *supra* note 16.

access by users outside of Tennessee. In such a case, the Taxpayer must remit sales tax on the full sales price of the software access and use purchased by the Taxpayer.

2. The Vendor-Hosted Software

The charges that the Taxpayer incurs for its users to remotely access and use the Vendor-Hosted Software are subject to Tennessee sales and use tax.

No sale or transfer of tangible personal property or electronic delivery of computer software occurs in Tennessee as part of these transactions. Instead, the Taxpayer is purchasing, through its [STATE OTHER THAN TENNESSEE] headquarters, remote access to the Vendor-Hosted Software for the Taxpayer's use at its business locations in Tennessee and elsewhere. The software remains in the possession of third-party vendors on servers located outside of Tennessee. Each seller bills the Taxpayer in a single transaction at its [STATE OTHER THAN TENNESSEE] headquarters. If it is not readily apparent to a seller that the Taxpayer is accessing and using the software in Tennessee, or if the Taxpayer provides to the seller a Remotely Accessed Software Direct Pay Permit, the seller is not obligated to collect tax. The Taxpayer must, however, remit tax to the Department on the portion of the sales price allocated to its Tennessee users. Alternatively, if the Taxpayer presents the seller with a fully completed Streamlined certificate of exemption, the Taxpayer must pay, and the seller must collect, tax based on the Taxpayer's percentage of users located inside of Tennessee.

The Taxpayer must allocate the sales price based on the number of users located in Tennessee divided by the total number of users represented in the transaction. The Taxpayer must determine the location of its users by looking to the residential street address or primary business address of each user. The Taxpayer should use its best efforts to determine the number and location of users at the time of sale based on the information available to it at the time. If a material change in this number occurs during a purchase of a recurring nature, the Taxpayer must take reasonable steps to adjust the allocation percentage accordingly.

3. Internally Hosted Software

The charges incurred by the Taxpayer for its purchase of any software that is installed or downloaded on a computer or server in Tennessee is subject to Tennessee sales and use tax.²⁹ The sale, lease, license, or transfer of such software was subject to taxation before the General Assembly adopted 2015 Tenn. Pub. Acts Ch. 514, § 22, and it remains taxable.

The charges that the Taxpayer pays for software that it purchased and hosts on servers outside of Tennessee and that is only remotely accessed by the employees of the Taxpayer in Tennessee are not subject to Tennessee sales and use tax. Under these circumstances, there is no sale, lease, license, or transfer of tangible personal property or electronic delivery of the computer software in this state. Although the Taxpayer's employees remotely access and use the applications in Tennessee, the sale of software has already occurred outside of Tennessee. The Taxpayer's subsequent provision of access and use of software to itself is not subject to Tennessee sales and use tax. The access and use of the software is not under the remotely accessed software provisions because the software is not in the possession of the seller.

²⁹ See TENN. CODE ANN. § 67-6-231(a)(1).

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APPROVED: Richard H. Roberts
Commissioner of Revenue

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