

TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING # 23-10

**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 Tennessee sales and use tax to customized software developed in an enterprise level software system.

**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**

[REDACTED] (the "Taxpayer") is a contractor headquartered in [REDACTED], Tennessee serving [REDACTED] customers throughout middle Tennessee and the surrounding states. The Taxpayer provides [SERVICES].

The Taxpayer engaged [REDACTED] (the "Project Team") to migrate the Taxpayer's previous enterprise resource planning ("ERP") system to [REDACTED] (the "New System"). The New System is a cloud-based

software-as-a-service ERP and customer relationship management system. The Taxpayer purchased the New System licenses directly from the third-party publisher, and the Taxpayer's internal IT team downloaded and installed the software. Approximately 15% of the licenses were for the Taxpayer's employees that access the software from outside of Tennessee.

The Project Team was engaged to implement the New System across [REDACTED – THE TAXPAYER'S BUSINESS]. High level goals of the engagement included the implementation of the New System; adoption of a "best practices" approach for business processes; and avoidance of customizations or non-standard processes unless necessitated by the business lines. A key project objective was to implement the New System with a focus on using the New System's out-of-the-box capabilities. The project was spread across three statements of work. The engagement was based on time and materials for professional fees.

Statement of Work #1 ("SOW 1") contained four distinct phases:

#### *Blueprint Phase*

In the Blueprint Phase, the Project Team provided consulting resources to host discovery workshops to break down the high-level phases of the project. Following the discovery process, the Project Team provided a set of documentation that clarified business and application process flows, integration points, and relationships of data. The documents were live and updated throughout the course of the project. During this phase, the Project Team also identified requirements needed to support each business process in addition to configuring applications to support prototyping and testing. Data migration from the Taxpayer's legacy system was included in this phase as well. This included data mapping between the Taxpayer's legacy system and the New System and import (or manual entry) of an initial sampling of legacy data.

One result of these workshops was the foundation for writing "user stories." The user stories formed the deliverables and requirements against which the Project Team configured the application and developed it as needed. After the workshops, user stories were created and refined, then imported back into the product backlog.

#### *Build and Validate Phase*

This phase consisted of configuration, technical design, and development. Applications were configured to support prototyping and testing. The Project Team applied security and began initial testing of roles. Troubleshooting support was provided along with training. The Project Team continued to refine user stories in the backlogs to drive the development work. In this phase, the Project Team worked with the Taxpayer to design how the system would be configured and customized to support the user stories included in the backlog. Process flows and prototypes were used to document the design. The Project Team performed testing to determine whether user stories, business process flows, and roles were successfully implemented and functioning as expected.

Various functions were customized and tested by the Project Team to provide functionality that was not already available in the New System. According to SOW 1, customization is considered anything requiring code or the use of developer tools. This customization includes JavaScript, custom flows, plug-ins, web service calls, etc. The customized functions include finance and supply chain

customization and customer engagement customization. The customized functions are specifically identified in SOW 1.

The time incurred for customization is tracked separately from the configuration services. There is sufficient line-item detail regarding rates, hours, and personnel on every invoice to delineate which lines relate to custom code development and which do not. Because of how detailed the customization is tracked, if needed, the Project Team can state the invoices separating the customization into a separate billing. As mentioned above, one of the high-level goals of implementing the New System was to avoid customization unless absolutely necessary to support additional features requested by a business line. The additional features are not necessary for the completion of the project, but instead are incidental add-ons requested by the Taxpayer. The exact time required to develop the custom code may vary from the hours defined in SOW 1. If the hours required are more than specified in SOW 1, the Project Team and the Taxpayer will discuss options including the Taxpayer developing certain customizations, purchasing third-party solutions, or adding more hours to the budget. The Project Team issued addendums to the related SOWs confirming that the customizations were optional.

#### *Validate and Deploy Phase*

In the Validate and Deploy Phase, the Project Team facilitated and coached the Taxpayer's employees through User Acceptance Testing ("UAT"). They also supported the Taxpayer in the system for go-live readiness.

#### *Operate Phase*

During the Operate Phase, the Project Team provided eight weeks of functional support during the go-live period. Resources included the consultants utilized during the Build and Validate Phase. Deliverables in this phase included items such as a project plan/schedules, issue logs, project status reports, user stories, product backlogs, training plans, functional requirements documents, and functional design documents, and comprehensive user manuals.

Statement of Work #2 ("SOW 2") is for an implementation, i.e., configuration of a Field Service Computerized Maintenance Management System ("CMMS") for a business unit which outsources facility maintenance for commercial customers. SOW 2 was structured similar to SOW 1, however, there was no customization provided to the Taxpayer.

Statement of Work #3 ("SOW 3") is for the modification of licensed software related to timekeeping, manpower planning and construction financial forecasting. The software modifications are owned by the Project Team and the Taxpayer's rights to use the software customizations are the same as rights with respect to licensed software. The Taxpayer submits that SOW 3 is subject to sales tax in Tennessee.

#### *Master Service Agreement*

The Master Service Agreement ("MSA") provides that the client may terminate the MSA or a SOW at its convenience with written notice, and termination of a SOW does not result in termination of the MSA. Additionally, the client is solely responsible for the evaluation, selection, purchase, licensing,

installation, implementation, compatibility, use and performance of and results obtained from any third-party products unless otherwise expressly agreed upon.

## RULINGS

1. What elements of SOW 1 are subject to Tennessee sales and use tax?

Ruling: The costs incurred to provide customization are subject to Tennessee sales and use tax.

2. What elements of SOW 2 are subject to Tennessee sales and use tax?

Ruling: Costs incurred under SOW 2 are not subject to Tennessee sales and use tax.

3. May the Taxpayer allocate a percentage of the taxable elements of SOW 1 to the Taxpayer's out-of-state employees?

Ruling: No. The Taxpayer downloads the software to its servers.

## ANALYSIS

In Tennessee, computer software is broadly defined under TENN. CODE ANN. § 67-6-102(18) (2022) as a set of coded instructions designed to cause a computer to perform a task, and it is subject to sales and use tax.<sup>1</sup> Additionally, custom computer software and the customized modification or enhancement of computer software are considered taxable sales of computer software.<sup>2</sup>

Tennessee also imposes sales tax on certain, enumerated services. The sales tax does not apply to all services; rather, it only applies to services specifically enumerated by the statute.<sup>3</sup> TENN. CODE ANN. § 67-6-205(c)(4) (2022) imposes sales tax on the service of repairing computer software. Similarly, TENN. CODE ANN. § 67-6-205(c)(6) imposes sales tax on the service of installing computer software. 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 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. Whenever two or more items are sold for a single

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<sup>1</sup> Retail sales of tangible personal property in Tennessee are subject to sales and use tax under the Retailer's Sales Tax Act, codified at TENN. CODE ANN. § 67-6-101 (2022) *et seq.* "Retail sale" is defined as "any sale, lease, or rental for any purpose other than for resale, sublease, or subrent." TENN. CODE ANN. § 67-6-102(84) (2022). The term "sale" is defined under the Tennessee sales and use tax laws in pertinent part as "any transfer of title or possession, or both . . . of tangible personal property for a consideration . . ." "Tangible personal property" is defined in pertinent part as "personal property that can be seen, weighed, measured, felt, or touched," and specifically includes prewritten computer software. TENN. CODE ANN. § 67-6-102(97)(A).

<sup>2</sup>The sale of computer software, including prewritten and custom computer software, is subject to Tennessee sales and use tax regardless of whether it is created on the premises of the customer or otherwise provided. TENN. CODE ANN. § 67-6-231(a) (2022); *see also Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W. 2d 35, 36 (Tenn. 1986).

<sup>3</sup> *Ryder Truck Rental, Inc. v. Huddleston*, 1994 WL 420911 (Tenn. Ct. App. Aug. 12, 1994).

sales price and at least one of the items is subject to sales tax, the entire sales price is subject to the sales tax.<sup>4</sup>

However, under the Tennessee Supreme Court Case *Penske Truck Leasing Co. v. Huddleston*, provisions within a contract that are separate and divisible must be analyzed separately for taxability.<sup>5</sup> If a contractual agreement provides for the sale of certain elements that are taxable and other items or services that are non-taxable in isolation, and that contract is found to be severable, and operate independently, according to the intention of the parties, then the taxability of the items or services will be analyzed separately.<sup>6</sup> The intention of the parties is determined by: the fair construction of the terms and provisions of the contract; the subject matter to which the contract has reference; the circumstances of the particular transaction giving rise to the question; and by the construction placed on the agreement by the parties in carrying out its terms.<sup>7</sup>

The Department has reviewed the MSA and SOWs 1, 2, and 3, and has found them to be separate and distinct; the Department does not view the SOWs as being substantively controlled by the MSA for tax purposes. Therefore, each SOW may be analyzed independently. Additionally, the purchase of the New System from a separate vendor, which the Taxpayer installed itself on its own servers, is a separate transaction from the SOWs analyzed in this ruling.

### **1. Elements of SOW 1 are subject to sales and use tax as computer software.**

The costs incurred for providing custom functions in the New System are subject to sales and use tax as computer software. The other elements of SOW 1 are not subject to sales and use tax.

#### *Blueprint Phase*

We first look to see if individual elements of SOW 1 are subject to sales and use tax. The Blueprint Phase of SOW 1 does not contain any enumerated taxable services. The installation of the computer software was conducted by the Taxpayer's internal IT team; therefore, there are no charges for installation. The Blueprint Phase does not involve the repairing, modification, or enhancement of computer software. Rather, the Blueprint Phase predominantly comprises project planning and data migration services, which are not enumerated services subject to sales and use tax.

#### *Build and Validate Phase*

The Build and Validate phase comprises two main components: configuration and customization. Configuration involves using the existing functionality within the software to meet the requirements

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<sup>4</sup> Part 1 of the 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").

<sup>5</sup> 795 S.W.2d 669 (Tenn. 1990).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 671.

set by the user, which is not an enumerated taxable service.<sup>8</sup> Accordingly, the costs incurred by the configuration process are not subject to sales and use tax.

In contrast to the configuration services provided by the Project Team, customization of the New System involves developing software code, either by writing new code or using developer tools, to provide functionality that is not otherwise available in the New System. The customization at issue in this ruling, then, is considered the modification of computer software, which is subject to sales and use tax. Customization also involves unit testing the custom code to ensure functionality. This testing is essential to ensuring that the custom code works as designed. Because the unit testing is a necessary part of the sale of the customization, the costs of unit testing the custom code will be considered a part of the sales price of the custom code. Accordingly, the costs incurred for developing and testing the custom code are subject to sales and use tax.

#### *Validate and Deploy Phase*

The Validate and Deploy phase does not include any items that are subject to sales and use tax. During the Validate and Deploy phase, the Project Team coaches the Taxpayer's employees through User Acceptance Training and provides remote support in the system for go-live readiness. The training and support services are not enumerated taxable services.

#### *Operate Phase*

The Operate Phase does not include any items that are subject to sales and use tax. During the Operate Phase, the Project Team provides on-site and remote functional support to the Taxpayer during the go-live period, along with project plans and schedules, issue logs, project status reports, user stories, product backlogs, training plans, functional requirement documents, functional design documents, and comprehensive user manuals. The functional support provided by the Taxpayer is part of the implementation of the software and is thus not taxable. The manuals, plans, reports, documents, and manuals are all incidental to the provision of that functional support.

The element that is taxable in SOW 1 is the customization component of the build and validate phase. The relevant question then, is whether the taxable customization component is severable from the rest of the contract, or does its taxability subject the rest of SOW 1 to sales and use tax.

Generally, if a statement of work includes both software configuration services and custom software development services (or any other service that involves the creation, fabrication, installation, upgrade, or repair of software), then the software configuration services would be subject to taxation as part of the sale of software.<sup>9</sup> However, the Tennessee Supreme Court in *Penske Truck Leasing Co. v. Huddleston* provides a rule more applicable to the specific provisions of SOW 1.<sup>10</sup> In *Penske*, there was a single contract that governed a transaction involving long-term truck leases and fuel sales agreements.<sup>11</sup> The taxpayer in that case claimed that the provisions governing each type of agreement

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<sup>8</sup> See Tenn. Dept. Rev. Ltr. Rul. 11-29 (June 23, 2011) (configuration involves the act of setting pre-defined software toggles or switches or building tables that give direction within the standard delivered application software, it does not involve developing, modifying, or creating software code.).

<sup>9</sup> See Tenn. Dept. Ltr. Rul. 11-29 (June 23, 2011).

<sup>10</sup> 795 S.W. 2d 669 (Tenn. 1990)

<sup>11</sup> *Id.* at 670.

were severable, and that the truck leases should be taxed separately from the fuel sales, which would have been exempt for the taxpayer, while the Commissioner argued that the fuel costs should be included in the rental price of the equipment and the total price should be subject to sales and use tax.<sup>12</sup> The court found that an agreement can be either an entire contract or a severable contract according to the intention of the parties; severable provisions would be subject to sales tax separately.<sup>13</sup> The court determined the intention of the parties by: the fair construction of the terms and provisions of the contract; the subject matter to which the contract has reference; the circumstances of the particular transaction giving rise to the question; and by the construction placed on the agreement by the parties in carrying out its terms."<sup>14</sup>

Here, we apply the court's same basic criteria to determine if the software customization component of SOW 1 is severable. First and foremost, the Project Team issued addendums to SOW 1 confirming that the customization components were optional. As an optional item, the rest of SOW 1 is not dependent on the sale of the customization component. In other words, if the customization component was stricken from the contract, the contract would remain in effect, and the other services in the contract continue to be meaningful services without the customization component. As such, the parties intended for the customization component to be severable.

Next, SOW 1 states that a key project objective is to implement the New System with a focus on using the New System's out-of-the-box capabilities. This shows that at the outset, the parties intended to avoid software customization. Again, this supports that the software customization was intended to be severable.

Additionally, in SOW 1, the section on custom development provides that if the hours required to develop the customizations are more than anticipated, the Project Team and the Taxpayer will discuss options including the Taxpayer developing certain customizations on its own, purchasing third-party solutions, or adding more hours to the budget. This provision further shows that the customization provision is not a necessary part of the contract because it allows for other parties to perform the customizations. Indeed, the rest of SOW 1 could be implemented without the customization provision. It should be noted that although the facts state that the customization is necessary to support additional features requested by a business line, the additional features themselves are not necessary, and therefore, the customization is not necessary for the rest of the contract to be performed.

Another factor supporting the severability of the customization provision is that the time incurred for customization is tracked separately from the configuration services. There is sufficient line-item detail regarding rates, hours, and personnel on every invoice to delineate which lines relate to custom code development and which do not. Because of how detailed the customization is tracked, if needed, the Project Team can restate the invoices separating the customization into a separate billing. This detailed tracking and ability to bill separately for the customization component provides yet additional support that the parties intended for the customization component to be severable.

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<sup>12</sup> *Id.* (the Commissioner relied on the holding in *Magnavox Consumer Electronics v. King*, 707 S.W. 2d 504 (Tenn. 1986).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 671.

Considering the above factors, it is apparent that the parties intended for the customization provision in SOW 1 to be severable from the rest of the contract. Accordingly, the taxability of the software customization is analyzed separately from the rest of SOW 1. Thus, even though the charges for the custom functions are subject to sales and use tax, the rest of the services provided for in SOW 1 are not subject to sales and use tax.

**2. SOW 2 contains no elements subject to sales and use tax.**

SOW 2 provides the same implementation and configuration services found in SOW 1, but SOW 2 does not contain any provisions for customizing functions. Accordingly, the services provided under SOW 2 are not subject to Tennessee sales and use tax.

**3. The Taxpayer may not allocate a percentage of the taxable elements to the Taxpayer's out-of-state employees.**

The Taxpayer suggests it may allocate a percentage of the taxable customization elements from SOW 1 to the location of the Taxpayer's out-of-state employees pursuant to TENN. CODE ANN. § 67-6-231(b) (2022), which provides that:

[i]f the sales price or purchase price of the software relates to users located 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.

The provisions of TENN. CODE ANN. § 67-6-231(b) apply to remotely accessed software that remains on the server of the seller and is accessed and used by the employees of the purchaser. That is not the nature of the transaction at issue in this ruling. The Taxpayer downloads the New System before its employees use it. When the Project Team does the implementation work for the Taxpayer, the software is already in the Taxpayer's possession. Accordingly, the Taxpayer may not allocate a percentage of the taxable customization elements in SOW 1.

APPROVED: David Gerregano  
Commissioner of Revenue

DATE: November 17, 2023