

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #98-16**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of single article cap to computer systems.

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

[THE TAXPAYER] is a Tennessee corporation with a single location in [TENNESSEE CITY]. The Taxpayer is in the business of selling computer

systems and accessories. Some computer systems are prepackaged and shipped to the Taxpayer by common carrier, but most computer systems are constructed in-house by the Taxpayer by assembling various components into a finished product based on the customer's needs and preferences.

The Taxpayer has presented three transactions for consideration.

1. The Taxpayer sells a notebook computer with preinstalled software and a carrying case. The manufacturer indicates that the software, carrying case, power charger, and a limited warranty are "free." The Taxpayer does not perform any additional work for this type of sale, but merely marks up the cost of the product for its profit.
2. The Taxpayer sells a prepackaged system which includes the computer processing unit, a keyboard, mouse, and speakers. Some software is preinstalled, while other software must be installed by the purchaser. These items are listed as a single line item on the invoice from the manufacturer. A monitor and printer are not part of the packaged system and are invoiced separately.
3. The Taxpayer purchases various computer components from selected vendors and manufacturers and builds the system in its store. The computer system consists of a workstation which includes a motherboard, hard disk, RAM, modem, tape backup, floppy disk slot, tower case, video card, CD-ROM drive, Read/Write CD-ROM drive, external uninterruptable power supply (UPS) unit, and sound card. The Taxpayer installs Windows '95 software, and includes a keyboard, speakers, mouse, and a monitor. With the exception of the monitor, all the other items are packaged in a single box for delivery to the customer.

Approximately 55-60% of the Taxpayer's revenue is derived from custom made computer systems as described in transaction 3.

ISSUES

1. Whether the notebook computer in transaction 1 is a single article and, if so, whether the single article cap is based on the sales price of the notebook computer only, or whether the Taxpayer should break out the various "free components."
2. Whether the single article cap is based on the selling price of the entire prepackaged system in transaction 2, exclusive of the monitor and printer, or whether the Taxpayer should break out charges for the keyboard, mouse, speakers, and software.
3. Whether the single article cap is based on the sales price of the workstation in transaction 3, excluding the software, keyboard, speakers and mouse, or

based on each separate component within the computer system assembled by the Taxpayer.

4. Whether the Taxpayer qualifies as a manufacturer.

RULINGS

1. The notebook computer in transaction 1 is a single article to the extent that the "free" components are separated from the price of the notebook. The single article cap is based on the established sales price of the notebook computer after deducting the established sales price of the "free" software, carrying case, power charger, and warranty.

2. The single article cap is based on the selling price of the prepackaged system in transaction 2, exclusive of the monitor, printer, keyboard, mouse, speakers, and software.

3. The CPU, monitor, printer, keyboard, mouse, monitor, speakers, and software are single articles.

4. The Taxpayer appears to qualify as a manufacturer because more than 50% of its revenues are derived from the assembly of computer systems. The Taxpayer should apply to the Department for an industrial machinery authorization number.

ANALYSIS

The additional sales and use tax which may be levied by local governments is limited in application to the first one thousand six hundred dollars (\$1,600) on the sale or use of any single article of personal property. Tenn. Code Ann. § 67-6-702(a)(1). Tenn. Code Ann. § 67-6-702(d) defines "single article" as

that which is regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit or as a common unit of measure, a regular billing or other obligation. Such independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article.

The statute speaks of separate units commonly understood as separate units and capable of being sold as independent units. The Tennessee Supreme Court has clarified the definition to mean that there is no need for an article to be internally sufficient. *Executone of Memphis, Inc. v. Garner*, 650 S.W. 2d 734 (Tenn. 1983). The court dismissed the plaintiff's argument that a digital telephone switching system was a single article:

In applying the considerations set out in Rule 6 to the present case, it requires no distortion to conclude that the plugs, the switching systems, and the telephone units, as they are described here, are "commonly understood" to be separate units. The Plaintiff admits that these articles have unit prices, that they can be put together to meet various office needs, and that if the occasion arose they could be sold separately to one who needs a system alteration. **To conclude that only the system itself constitutes a single unit completely ignores the separate physical character of each component part, both in the design of the system and in the ultimate benefit to the customer.**

Executone of Memphis, 650 S.W. 2d at 737 (emphasis added). The Supreme Court specifically addressed the application of the single article cap to computer systems in *Honeywell Information Systems, Inc. v. King*, 640 S.W. 2d 553, 554 (Tenn. 1982):

It may be that at some other time, or during some other audit period, this taxpayer, or other computer purveyors, may lease or sell computer systems as single entities. This taxpayer did not do so. As the state of the technology changes and progresses, it may be that smaller and more compact equipment may be marketed as a single machine or item of property. This was not the case, however, during the period of the audit involved here, 1976-78.

The Court of Appeals again considered the single article question on *Colemill v. Huddleston*, 1996 Tenn. App. LEXIS 769 (Ct. App. 1996). The taxpayer in *Colemill* rebuilt airplanes using a multitude of parts. The court rejected the application of the single article cap as applied to the entire rebuilt plane and stated:

An oil pump is separate and distinct from a hose or an engine. The fact that a provider may install all of these parts at the same time and as part of the same service does not alter their nature as separate, functional units. By common understanding, an oil pump or an engine perform their functions independently, have intrinsic value, and do not lose their separate identity simply because they become part of an aircraft. *Colemill* relies heavily on the fact that the FAA requires that some of these aircraft parts be installed with certain other parts as part of a conversion; however, we find this argument unpersuasive. The fact that the oil pump is one of many parts *Colemill* installs in the course of an FAA approved conversion does not alter the identity of an oil pump as a single, individual part of an aircraft.

Further, two decisions of the Tennessee Supreme Court support the Commissioner's assertion that each aircraft part *Colemill* installs is a single article. *Executone of Memphis, Inc. v. Garner*, 650 S.W.2d 734 (Tenn. 1983); *Honeywell Information Sys., Inc. v. King*, 640 S.W.2d 553 (Tenn. 1982). In both *Executone* and *Honeywell* the taxpayers argued, as *Colemill* does in the instant case, that because the components sold were interdependent and conveyed together as a part of a whole system they were not single articles, but rather the sum of the system was a single article. The supreme court rejected these arguments in both of the foregoing cases. *Executone*, 650 S.W.2d at 736-37; *Honeywell*, 640 S.W.2d at 554.

The *Colemill* court held, then, that various component parts are taxed separately even when combined into one large item. If a dealer is unable to allocate or determine a sales price corresponding to each single article, the single article cap will not apply and the full sales price is subject to both state and local tax.

1. The notebook computer in transaction 1 is boxed by the manufacturer and resold by the Taxpayer without any alteration to its contents. The Taxpayer has no control over what items are installed or included with the prepackaged notebook computer. There are various “free” components or additions to the computer, including preinstalled software, a carrying case, a power charger, and a limited warranty. Exclusive of these “free” items, a notebook computer constitutes a single article. The notebook computer system, as opposed to the standard multi-piece CPU, monitor, and keyboard, appears to be what the *Honeywell* court envisioned in the future: a computer system sold as a single entity. Consisting of one physical item, the notebook computer as described is a single article.

The various “free” items included with the notebook computer, however, are also single articles or otherwise not subject to the single article cap. The cap is based on the established sales price of the notebook, and is also based on prices attributable to the “free” software, carrying case, power charger, and warranty. For example, the advertisement the Taxpayer submitted shows that one version of the notebook computer costs \$[DOLLAR AMOUNT X]. Assigning a value to the other single articles in line with their retail prices,¹ the breakdown would be as follows:

Total	\$[DOLLAR AMOUNT X]
Less:	
Windows 95	[DOLLAR AMOUNT 1]

¹ The prices listed are only estimates for the purposes of illustration and are not based on any market data.

Lotus Smart Suite	[DOLLAR AMOUNT 2]
Carrying case	[DOLLAR AMOUNT 3]
Power charger	[DOLLAR AMOUNT 4]
Warranty	<u>[DOLLAR AMOUNT 5]</u>
Notebook computer	\$(DOLLAR AMOUNT Y)

With the exception of the warranty, each item is taxable at the full rate unless its price exceeds \$1600. The warranty is not subject to the single article cap regardless of the amount allocated as its value because it is not tangible personal property, but constitutes a taxable service under Tenn. Code Ann. § 67-6-102(23)(F)(ix). If the Taxpayer is unable to allocate or determine a sales price corresponding to each single article, the single article cap will not apply and the full sales price is subject to both state and local tax.

2. The computer system in package 2, exclusive of the monitor and printer, is a prepackaged computer which includes various components. Although these items are included as a part of the prepackaged system, the keyboard, mouse, and speakers are physically separate and distinct. The CPU, monitor, keyboard, mouse, speakers, “free” software, and printer are each single articles. The single article cap is based on the selling price of the CPU, monitor, keyboard, mouse, speakers, “free” software, and printer. A calculation similar to that provided above should be used to determine the established sales price and appropriate amount of tax due on each single article. As stated above, the single article cap will not apply unless the Taxpayer can allocate or determine a sales price for each single article.

3. The computer system assembled by the Taxpayer differs from the prepackaged systems. The Taxpayer selects each item that becomes part of the custom system depending on the customer’s needs and specifications. As stated above, the monitor, printer, mouse, keyboard, speakers, and software are each single articles separate and apart from the computer system. This situation is distinguished from those described in transactions 1 and 2, however, with respect to the elements of the CPU because in a prepackaged system, the customer and the Taxpayer cannot select various components or customize the prepackaged computer. The customer under those circumstances must select from a predetermined package.

The single article cap is determined in the same manner as for the prepackaged systems. To apply the single article cap, the Taxpayer must determine an established sales price for each single article and calculate the tax accordingly.

4. The industrial machinery authorization for manufacturers is granted to entities whose principal business is the fabrication or processing of tangible personal property for resale and consumption off the premises. Tenn. Code Ann. § 67-6-102(12)(A). An activity is the principal business if revenues generated from that

activity constitute more than 50% of the total revenues generated at the specific location. *Tennessee Farmers' Coop. v. State*, 726 S.W. 2d 87 (Tenn. 1987).

The Taxpayer will be deemed a manufacturer if its principal business is the fabrication or processing of tangible personal property for resale. Tenn. Code Ann. § 67-6-206(2). Approximately 55-60% of the Taxpayer's revenue is derived from the fabrication and sale of custom computer systems.

Accordingly, the Taxpayer should apply to the Department in accordance with TENN. COMP. R. & REGS. 1320-5-1-1.06. Upon approval of its application, the Taxpayer will be given an industrial machinery authorization number.

Caroline R. Krivacka, Tax Counsel

APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: 3-11-98