

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 99-08**

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 sales tax to computer consulting service.

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] has contracted with a customer to provide consulting services related to computer equipment and software which the customer has previously

acquired through a separate contract. Under the terms of the contract, the Taxpayer must provide separate individuals to perform the following services:

1. Project management includes project planning, scheduling, and control monitoring throughout the duration of the project, documenting project requirements, schedules, and resources used, reporting and communicating status against the plan in meetings, and documenting changes to original plans.
2. Business consulting includes advising on practical, information-based solutions to issues the business is facing, assisting in gaining consensus on key business issues affected by the project, and assisting in prioritizing the issues related to their impact on the business.
3. Logical data modeling includes confirmation of project requirements and generation of a logical model of business data elements which shows, through diagrams, the relationships of the defined data elements to each other and the key attributes of that data. No writing or programming of software occurs in this stage.
4. Database design services emphasize translating the logical data model to a physical system database design, the construction and testing of the database, and fine tuning the design into a production database acceptable to the customer. When the customer's own staff participates in the activity of creating the design, the Taxpayer's service reviews the customer's design to offer analysis and suggestions for improvement. Computer programming is required to create the database, insert data, and access data from the database.
5. Data conversion consultation includes advising the customer on the process design and program tools and special programs that will be needed to allow the database to be loaded with the customer's data and maintained.
6. Software coding consists of creating software program code as needed by the customer. For example, it may include writing software code used for converting or loading customer data into the new database, or creating queries or applications to allow the users to get access to the database for information.

Under the contract, [NUMBER] individuals provided by the Taxpayer will perform software coding only. No other individuals under the contract will provide software coding. The contract calls for the Taxpayer to invoice its customer in accordance with a payment schedule which calls for separate lump sum installment amounts over a period of eight months. After receiving the first two invoices from the Taxpayer, the customer has requested the Taxpayer to separately identify and invoice the charge for the services of the [NUMBER] individuals who will exclusively perform the remaining software coding services under this contract, apart from the services of the consultants who will not perform software coding.

ISSUES

1. If the charge for the [NUMBER] individuals who exclusively perform software coding is separately identified on the same invoice as a taxable service, and the charge for the other individuals who provide consulting services are separately identified as non-taxable consulting services, will the charges for non-taxable services will be subject to sales tax.
2. If the charges for the non-taxable services are subject to tax when listed on the same invoice as the taxable services, will rendering a separate invoice for non-taxable services subject the non-taxable services to sales tax.
3. Will the use of two stand-alone contracts, one for taxable and one for non-taxable services, subject the non-taxable services to sales tax.

RULINGS

1. Because there are several taxable aspects of the consulting service, all services will be subject to sales tax as incident to the sale of computer software.
2. The use of separate invoices for taxable and non-taxable services would not prevent the imposition of sales tax on non-taxable services rendered pursuant to a single contract.
3. The use of two stand-alone contracts will only prevent the imposition of sales tax on the non-taxable services if the contracts do stand alone and are completely independent of each other.

ANALYSIS

The term “sales price” is defined by Tenn. Code Ann. § 67-6-102(26) as “the total amount for which a taxable service or tangible personal property is sold, including any services that are a part of the sale of tangible personal property.” The definition of “sales price” also includes certain services that are subject to tax. Tenn. Code Ann. § 67-6-102(24)(F). Computer software is defined as tangible personal property for sales and use tax purposes. Tenn. Code Ann. § 67-6-102(25)(B). If a service is neither rendered in Tennessee incident to the sale of tangible personal property nor listed as a taxable service, it is not subject to tax.

Based on the information provided, project management, business consulting, logical data modeling, and data conversion consultation are not taxable services. All these services entail advising, meeting, and planning, without involving a specifically taxable service or the sale of tangible personal property. Standing alone as independent services, then, charges for these services are not subject

to sales tax. These services do not stand alone, however, but are crucial elements of the overall service or product rendered by the Taxpayer.

The treatment of “crucial elements” of a sale was considered in *Thomas Nelson, Inc. v. Olsen*, 723 S.W. 2d 621 (Tenn. 1987). The taxpayer in *Thomas Nelson* alleged that advertising design mockups and models received pursuant to contracts for the development of advertising ideas were not tangible personal property, but were created merely incidental to the nontaxable furnishing of design services. *Thomas Nelson*, 723 S.W. 2d at 621. The court held that the models were a “crucial element” of the contracts to conceive an advertising contract and rendered the cost of the transaction subject to tax. *Id.* at 622.

In essence, the *Thomas Nelson* court held that if a crucial element of an otherwise non-taxable service is subject to tax, then the entire charge is subject to tax. *Id.* There was no dispute that the models were tangible personal property and subject to tax. *Id.* The court stated that “the bare assertion that the creation of these models constituted a minute part of what was actually a contract to provide a service does Taxpayer no good. Such an interpretation of Tennessee’s Sales and Use Tax has previously been considered and rejected by this Court as administratively unworkable.” *Thomas Nelson, Inc.*, 723 S.W. 2d at 622 (citation omitted).

Based on the facts provided, database design services include the construction and testing of a database and fine tuning the design into a production database acceptable to the customer. Software coding consists of creating software program code. The database design services and software coding service, therefore, result in the creation of software within the definition of Tenn. Code Ann. § 67-6-102(25)(B) and hence tangible personal property for the purposes of the sales and use tax statutes. *Creasy System Consultants, Inc. v. Olsen*, 716 S.W. 2d 35 (Tenn. 1986); *University Computing Co. v. Olsen*, 677 S.W.2d 445 (Tenn. 1984).

1. Charges for both database design services and software coding services are subject to sales tax as the creation of tangible personal property. Business consulting includes advising, planning, and considering the effects of the computer project on the business. Project management includes project monitoring throughout the duration of the project and is therefore ongoing throughout the creation of computer software. Logical data modeling, including the generation of a logical model of business data elements, and data conversion consultation, including rendering advice on the programs needed to load the database, appear to be rendered incident to the database design services and software coding.

These services are linked through their involvement in the creation of the database and associated software. It seems unlikely that a client would obtain one of these services without the rest, since each service comprises a step

toward the creation and implementation of the database. Considering the entire consulting service as a whole, then, it appears that the nontaxable services are rendered incident to the ultimate goal of producing a computer database and accompanying software. Therefore, because the nontaxable services are incident to the sale of tangible personal property, they are also subject to tax whether combined with the taxable charges or separated out. Tenn. Code Ann. 67-6-102(26)

2. As stated above, the services are linked as steps in a process and separate invoices will not prevent taxation of each charge.

3. Separate and distinct contracts for taxable and nontaxable services may prevent the nontaxable charges from being subject to tax. The contracts must each stand alone, however, and represent an independent service that is not bound or dependent on the prior service. Based on the facts presented, this is not the case, as stated above. To be exempt under these circumstances, the customer must be able to contract for any or all the services without any requirement that each of the six services is purchased. Since this does not appear to be the case, then even separate contracts would not be truly independent and all charges would be subject to sales tax.

Caroline R. Krivacka, Tax Counsel

APPROVED: Ruth E. Johnson, Commissioner

DATE: March 17, 1999