

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-09**

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 services.

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 revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] is a corporation located in Tennessee that provides information technology services to clients both in Tennessee and out-of-state. The Taxpayer provides a variety of services to its clients whereby the Taxpayer's employees either go to the client's site to work on the client's systems directly or the employees telecommute from home.

Depending on the client's needs, some or all of the following services are provided by the Taxpayer:

1. Development/Programming – Development of applications, systems and transaction environments. Specifically, this includes:
 - a. Coding of business applications.
 - b. Development of large-scale batch or high volume transaction environments that require IBM/MVS mainframe processing power.
 - c. Programming in business-oriented languages such as COBOL and CICS, or fourth generation languages.
 - d. Development of enterprise-oriented applications or general business applications.
 - e. Programming in business-oriented languages such as COBOL and RPG/400 or fourth generation languages on IBM AS/400 computers.
 - f. Development and implementation of computer software in Windows or UNIX using C/C++, Assembly and other low-level operating system software.
 - g. Development of GUI-based applications, systems software and embedded software.
 - h. Development of all aspects of major information systems.
2. Design – Design of applications, software, and information systems. Specifically, this includes:
 - a. Design of programming applications for a client/server architecture.
 - b. Design of computer software in Windows or UNIX using C/C++, Assembly and other low-level operating system software.
 - c. Design of all aspects of major information systems.
3. Installation – Installation of network hardware and software. Specifically, this includes:
 - a. Installation of local area networks' hardware and software.
 - b. Installation of PCs and various printer, graphics and storage peripherals.
 - c. Installation of operating systems, database management systems, compilers and utilities.
 - d. Installation of data networks.
 - e. Installation of wide area networks.
 - f. Installation of mainframe operating systems, communications systems, database management software, compilers and utility programs.
4. Analysis – Analysis of applications and operations. Specifically, this includes:
 - a. Analysis of business requirements.
 - b. Analysis of data usages within an application area.
 - c. Analysis of system function and operations to determine adequate security and controls.
 - d. Analysis of computer operations.

5. Coordination – Coordination of resources. Specifically, this includes:
 - a. Coordination of processing and transmission schedules.
 - b. Coordination of personal computers within a company to ensure compatibility and integration with company strategies.
 - c. Coordination of resources, schedules and communications for systems development projects.

6. Administration – Administration of organization’s resources, budgets, and operations. Specifically, this includes:
 - a. Administration of organization’s data resources.
 - b. Administration of department budgets and review of project managers.
 - c. Planning and overseeing of research.
 - d. Administration of development of systems within Information Systems on both mainframes and PCs.
 - e. Administration of performance appraisals, salaries, hiring and budgets.

7. Management – Management of all computer and communication activities within the company. Specifically, this includes:
 - a. Maintenance of integrity of all electronic and optical books, including review of computerized and manual systems; information processing equipment and software for acquisition, storage and retrieval; and definition of the strategic direction of all information processing and communication systems and operations.
 - b. Overall management and definition of all computer and communication activities within the company, including responsibility for providing a leadership role in the day-to-day operations of the Information Services functions as well as providing direction as the enterprise expands through internal growth and external acquisition.
 - c. Management of pre-sales and post-sales support, the help line and documentation.
 - d. Planning and direction of all computer and peripheral machine operations, data entry, data control scheduling and quality control.
 - e. Oversight of ongoing development, implementation, maintenance and overall strategy of a company’s website.

8. Training and Customer Support – Training of new users and user support.

9. Documentation – Writing and editing of program and systems documentation, user manuals, training courses and procedures.

10. Maintenance – Maintenance of computers, hardware, and software. Specifically, this includes:
 - a. Maintenance of local area networks’ hardware and software.
 - b. Maintenance of personal computers within a company to ensure compatibility and integration with company strategies.

- c. Maintenance of data networks.
- d. Maintenance of wide-area networks.
- e. Maintenance of mainframe operating systems, communications software, database management software, compilers and utility programs.
- f. Maintenance of communications network operations.

QUESTIONS

1. With regard to the taxable activities, is the activity still taxable if the employee telecommutes from another state for a Tennessee client? What if the employee telecommutes from Tennessee for a client in another state?
2. Which of the described activities are subject to sales and use tax if performed in Tennessee?

RULINGS

1. The location of the sale or service determines whether or not a taxable activity is subject to tax in Tennessee. If an employee is located out-of-state and performs a taxable activity related to software located on a server in Tennessee, then that activity is performed in Tennessee and taxable in Tennessee. If an employee is located in Tennessee and performs a taxable activity related to software located on a server out-of-state, that activity is not taxable in Tennessee.
2. The transfer of software is subject to tax. Thus, the development, programming, and design of software for customers constitute the sale of customized software, which is a taxable sale of tangible personal property. Installation of software and maintenance are taxable services. The following are not taxable services if they are optional and sold separately from the programming, installation, or maintenance services: analysis, coordination, administration, and management. The foregoing services are taxable if they are performed as part of the development and sale of programming or if performed as part of the installation or maintenance services provided by the Taxpayer to its client. Documentation,¹ training and customer support are typically sold with customized software, and therefore, are taxable as part of a sale of tangible personal property. However, if the documentation, training, and customer support were sold separately and independent of a sale of tangible personal property, they would not be taxable.

¹ If the documentation consists of a standard manual that is sold to multiple customers then it qualifies as tangible personal property and is subject to sales tax. However, if the documentation was developed specifically for one particular customer, it qualifies as a service and is not subject to sales and use tax if not sold as part of a sale of tangible personal property. Nevertheless, if the Taxpayer sells multiple copies of a custom-designed manual for its customers, those copies may be subject to tax.

ANALYSIS

1. The location of the sale or service determines whether or not a taxable activity is subject to tax in Tennessee.

For Tennessee sales and use tax purposes, the transfer of computer software is specifically defined as a sale of tangible personal property. Tenn. Code Ann. § 67-6-102(a)(34)(B); *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986). A sale consists of the transfer of title or possession, or both, of tangible personal property for a consideration. Tenn. Code Ann. § 67-6-102(a)(34)(A); *Volunteer Val-Pak v. Celauro*, 767 S.W.2d 635, 636 (Tenn. 1989). Thus, the place in which title to or possession of the software first passes to the client is the location of the sale.

The important factor in determining whether there is a taxable sale of tangible personal property is the location where the sale takes place. When an employee in one state alters software on a customer's server by remote means, a sale has occurred. If that customer's server is located in Tennessee then a taxable sale has taken place in Tennessee. It is not relevant where the employee is located when he is performing the work. As long as the employee is altering the customer's software directly (i.e. the work is not saved on the employee's computer, only on the customer's server), then there is an instantaneous delivery of software to the customer. The location of the sale is where the delivery takes place, i.e. the customer's server. If the customer's server is located outside of Tennessee, the sale has occurred outside of Tennessee; thus, the sale is not subject to sales tax in Tennessee. However, if the server is later moved into Tennessee, a use tax obligation would be incurred. Similarly, if the software was transferred onto a server in Tennessee, a use tax obligation would be incurred.

In regards to a taxable service, such as installation or maintenance, the determination of whether the service is taxable depends on where the service occurs. In *LeTourneau Sales and Service, Inc. v. Olsen*, 691 S.W.2d 531 (Tenn. 1985), the Court ruled that a service is taxable where it is performed. In this situation, an employee located in Tennessee performs maintenance on software located on a server out-of-state. This service is not taxable in Tennessee because the service of software maintenance is considered to be performed where the software is located, even if the maintenance is done by remote access. Similarly, if an employee located out-of-state performs maintenance on software on a server located in Tennessee, that service is subject to Tennessee sales tax because the service is performed in Tennessee.

2. Development, Programming, Design, Installation of Software and Maintenance are Taxable Services. The Remaining Services are Taxable if Sold as Part of the Sale of Tangible Personal Property.

Retail sales in Tennessee are subject to sales and use tax under Tenn. Code Ann. § 67-6-101 et. seq. Tenn. Code Ann. § 67-6-102(a)(32)(A) defines a retail sale to include a "taxable sale of tangible personal property or specifically taxable services to a consumer

or to any person for any purpose other than resale.” Also subject to tax are “any services that are a part of the sale of tangible personal property....” Tenn. Code Ann. § 67-6-102(a)(35).

Development, Programming and Design Activities

In some instances the taxpayer will provide its client with computer programming services designed to support third party software or integrate that software into the client’s computer system. The term “sale” is defined to include:

[the] transfer of customized or packaged computer software, which is defined to mean, information and directions loaded into a computer which dictate different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property; however, the fabrication of software by a person for such person’s own use or consumption shall not be considered a taxable “use”....

Tenn. Code Ann. § 67-6-102(a)(34)(B). The customization or modification of the client’s computer software is a sale within the definition set forth in this section. *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986). Thus, writing programs or command language scripts to support or integrate third party software within the client’s computer system constitutes a taxable sale of tangible personal property from the taxpayer to its client. Therefore, in regards to this Taxpayer, its development, programming, and design activities would constitute a sale of tangible personal property and are thus subject to sales and use tax so long as the activity is performed in Tennessee.

Installation of Software

Tenn. Code Ann. § 67-6-102(a)(32)(F)(vi) defines a retail sale as the installation of tangible personal property which remains tangible personal property after installation. Since software is defined as tangible personal property under §67-6-102(a)(34)(B), and remains tangible personal property after installation, any charge made for the installation of software is subject to tax.

Repairs and Maintenance

Tenn. Code Ann. § 67-6-102(a)(32)(F)(iv) and (ix) provides that a sale at retail includes “performing for a consideration of any repair services with respect to any kind of tangible property” and the “[c]harges for warranty or service contracts warranting the repair or maintenance of tangible personal property; provided, that any repairs to the extent covered by the contract shall not also be subject to tax.” Furthermore, TENN. COMP. R. & REGS. 1320-5-1-.54(2) states:

for the purposes of this rule, “repair services” and “repairs” of tangible personal property shall mean and include any one or all of the following for a user and consumer: work done to preserve or restore to or near the original condition made necessary by wear, normal use, wastage, injury, decay, partial destruction, or dilapidation; amending, correction, or adjustment made for any defect or defective portion; alterations; refinishing; maintenance, preventive maintenance, or warranty contract; any cleaning that is a necessary part of any repair work; “service calls” where any repair work is done or contemplated; and changes in the size, shape, or content.

Pursuant to Tenn. Code Ann. § 67-6-102(a)(32)(F), repairs, which include maintenance, and contracts for maintenance, are defined as a sale at retail and as such are subject to sales tax. Therefore, any maintenance work performed by the Taxpayer in Tennessee is taxable.

Consulting Services

Computer consulting services alone are not taxable. However, such services are frequently sold in conjunction with the transfer of software and taxable services. Otherwise nontaxable consulting services become subject to tax if they are performed as part of the sale of tangible personal property. Tenn. Code Ann. § 67-6-102(a)(35); *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 623 (Tenn. 1987). Thus, any charges for services that are performed as part of the sale of software are subject to tax. For example, in *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35 (Tenn. 1986), the Tennessee Supreme Court held that hourly consulting charges for determining the needs of a client, designing a software program to meet those needs, and then writing the software program were all subject to sales tax. Thus, if consulting services are not provided as additional services, separate and optional from the sale of software or taxable services, they are subject to tax in Tennessee.

Based upon the foregoing reasoning, the analysis, coordination, administration and management activities performed by the Taxpayer would be subject to tax if they are services sold as part of the sale of software. If the services are optional and are sold separately from the taxable sale of software, they are not subject to sales tax. However, the services would not only need to be invoiced separately, but would actually need to be sold independently from the taxable software.

It appears that the Taxpayer may sometimes provide services that relate to software sold by a third-party vendor to the taxpayer’s client. In this instance, the stand alone nontaxable services are clearly not being sold as part of the sale of taxable software. Thus, it should be noted that these services remain nontaxable. *The Austin Company v. Woods*, 620 S.W.2d 73, 76 (1981).

Documentation, Training and Customer Support

Documentation, training and customer support may be taxable if they are performed as part of the sale of software. Documentation is typically sold with the software and would therefore, be subject to tax as part of a sale of software. Training and customer support may be taxable if they were provided as part of the sale of software or other tangible personal property. Tenn. Code Ann. § 67-6-102(a)(35). In regards to training, if the Taxpayer can show that training is provided as a separate, optional service that is invoiced separately from the sale of software, it is not subject to tax. Whether or not customer support is taxable would depend on the type of service provided. If the customer support contemplates any kind of repair work², then it would be taxable as a sale at retail. However, if the customer support is similar in nature to training and if it is provided as a separate, optional service that is invoiced separately from the sale of software, then it would not be subject to tax.

Deborah A. Toon
Tax Counsel

Approved: Loren L. Chumley
Commissioner of Revenue

Date: 4/7/06

² Pursuant to Tenn. Code Ann. § 67-6-102(a)(32)(F), repair, installation, and charges for warranty or service contracts are specifically subject to tax.