

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 14-14**

Revenue rulings are not binding on the Department. 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 the Tennessee sales and use tax to the provision of network neutral interconnection and co-location services.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer performs network neutral interconnection and co-location services for Internet dependent businesses through data centers located across [NUMBER OF] states. It owns and operates [REDACTED] data centers located in [CITY], Tennessee, from which it provides services to Tennessee customers.

Basic Services

The Taxpayer provides two basic services, its Cloud Infrastructure Service and its Co-location Service. The Taxpayer's Master Service Agreement covers both the Co-location Service and the Cloud Infrastructure Service, and its Cloud Master Service Agreement covers the provision of the Cloud Infrastructure Service only.

1) Cloud Infrastructure Service

The Taxpayer's Cloud Infrastructure Service provides customers with storage space and computing capacity on servers located in Tennessee. Utilizing this storage space, customers may store a variety of electronic information including software and digital goods. The Taxpayer offers three distinct types of Cloud Infrastructure Services: [TYPE 1 CLOUD SERVICE], [TYPE 2 CLOUD SERVICE], and [TYPE 3 CLOUD SERVICE]. In each cloud environment, customers can store a variety of electronic information including software and digital goods. With regard to each of the Cloud Infrastructure Services, the Taxpayer bills each customer according to the amount of electronic storage space required.

[TYPE 1 CLOUD SERVICE] delivers services in a fully hosted, public cloud-like model. Services are delivered per cloud "server" and take advantage of the multi-tenant model with resource pooling, dynamic load sharing, redundant infrastructure, etc. [TYPE 2 CLOUD SERVICE] offers both virtual and dedicated service delivery models. The Taxpayer's

customer can choose a model designed to its exact specifications including availability and scalability, or a model which gives it storage and processing capabilities delivered through resource pools connected to the Taxpayer's multi-tenant storage infrastructure. The Taxpayer provides some of the services using customer-owned equipment, and in other cases, the Taxpayer purchases equipment for the sole use of the customer. The third type of Cloud Infrastructure Service, [TYPE 3 CLOUD SERVICE], offers customers the ability to replicate assets, both computing and storage, to a geographically disparate data center.

2) Co-location Service

The Taxpayer offers customers services related to the co-location of their computer equipment at a data center located in Tennessee. The Taxpayer's Co-location Service provides customers with the opportunity to place their equipment in racks or cabinets at the Taxpayer's data center in a climate controlled and secure environment with a uniform power supply and backup capabilities.

Optional Items and Services

In addition to charging its customers for the Cloud Infrastructure Service and the Co-location Service, the Taxpayer may separately bill its customers for a number of other items and services that a customer has the option of having the Taxpayer provide ("Optional Items and Services") that include:

1) Data Protection

At the option of a customer, the Taxpayer backs up a customer's information onto tapes or discs at regular intervals, both at its Tennessee facility and at other facilities across the country. The customer does not receive these tapes and discs, but the Taxpayer maintains them so that the data is available in the case of customer data loss or corruption. The Taxpayer's detailed invoices contain individual charges for its various data protection service offerings, such as file backup or restore initiated, related to the backup and maintenance of each customer's information.

2) System Administration, Monitoring, Anti-Virus, Patch Management, and Application Management

At the option of a customer, the Taxpayer's employees apply configuration changes to the operating system or supported applications, rotate backup tapes, power up/power off/reset servers, apply operating system patches, verify correct operation of anti-virus software, and monitor a customer's equipment for functionality. The Taxpayer facilitates repair of customers' equipment when there is a mechanical failure; however, the Taxpayer does not perform the repairs or hold the maintenance agreements. The Taxpayer separately invoices each service that it performs within this category. At times, the Taxpayer subcontracts out these services, and an outside third party performs the services, separate and apart from the Taxpayer. The Taxpayer's sales price of this service is its cost plus a mark-up.

3) Managed Network Security Services

At the option of its customer, the Taxpayer provides dedicated managed security services including firewall, intrusion detection and prevention, virtual private networks, web application firewalls, two-factor access controls, and vulnerability management. As part of

this service, the Taxpayer's experts install hardware, configure security appliances, and provide ongoing management. Customers never gain access to a security appliance, but it may reside in the Taxpayer's cabinet with a customer's equipment stored at a data center through the Taxpayer's Co-location Service.

4) Dedicated Computer Equipment and Installation of Dedicated Computer Equipment

In most cases when customers utilize the Taxpayer's Co-location Service, customers provide their own equipment for placement in rack and cabinet space at a data center; however, the Taxpayer does offer computer equipment for a customer's use at a co-location facility.

The equipment provided by the Taxpayer includes items such as computer hardware, including servers. A customer may not remove the computer equipment from the data center and does not obtain the equipment if it no longer utilizes the Taxpayer's services. If the Taxpayer provides a customer with dedicated computer equipment, it separately bills the customer both for the provision of dedicated computer equipment and for the installation of the equipment.

Additional Invoiced Items

The Taxpayer also passes along to the customer certain costs that it incurs in providing the services. The Taxpayer separately itemizes the charges for the following costs (the "Additional Invoiced Items"):

1) Power

The Taxpayer invoices its customers for charges it incurs for power used to run a customer's equipment and connections within a co-location space. The Taxpayer purchases its power from the local utility company. A fee for power reflects a charge for a specified portion of the electrical infrastructure of the facility and an estimate of the related electrical power consumed for a customer's equipment to be functional. The fee is based on the maximum capacity of a particular power connection. A significant portion of the fee is a fractional component intended to cover the cost to the Taxpayer for tangible personal property needed to maintain its infrastructure related to providing an uninterrupted power source. The fee for power includes a cost mark-up.

2) Software Applications

The Taxpayer pays monthly software application license fees (for example, [REDACTED]) for software it uses to provide services to its customers. The Taxpayer passes these software costs on to its customers, with a mark-up, as a separate charge listed on an invoice.

3) Installation and Configuration Charges

If the Taxpayer incurs certain installation charges, in most cases the Taxpayer charges a separate line item for its costs and references the service to which that charge applies. Such charges include the Taxpayer's costs for installation and configuration of software applications, download and installation of the latest service packs, hot fixes and/or patches, installation of common applications included with each supported operating system, installation of operating system optional or application software, and installation of power connections from the power distribution unit to a customer's equipment.

Other Charges

Finally, the Taxpayer also provides Metro Ethernet and Internet Access to customers. Metro Ethernet is a communications circuit between the Taxpayer's data center and the premises of the Taxpayer's customer that transmits data between the locations in a secure and high-speed fashion. The Taxpayer purchases the Metro Ethernet connection from a third party telecommunications provider and resells the service to a customer with a mark-up.

The Taxpayer also provides Internet Access to its customers for both individual and business use. The Taxpayer's charges to a customer vary according to the amount of bandwidth a particular customer requests. The Taxpayer provides all customers with individual IP addresses for their websites. Customers access the Internet with their own equipment, and customers generate information and messages sent or received. The Taxpayer separately itemizes charges for a particular customer's Internet usage on the invoice.

RULING

Are the Taxpayer's charges for the Co-location Service, the Cloud Infrastructure Service, Internet Access, Metro Ethernet, Optional Items and Services, and Additional Invoiced Items subject to the Tennessee sales and use tax?

Ruling: The Taxpayer must collect and remit the Tennessee sales and use tax on its charges for the optional provision and installation of Dedicated Computer Equipment as well as on its charges for Metro Ethernet. Its charges for the Cloud Infrastructure Service, the Co-location Service, Internet Access, Additional Invoiced Items, and other Optional Items and Services are not subject to the Tennessee sales and use tax.

ANALYSIS

LEGAL BACKGROUND

Under the Retailers' Sales Tax Act,¹ 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."²

TENN. CODE ANN. § 67-6-102(78)(A) (2013) 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 "property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses."³ Tangible personal property also 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

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

² TENN. CODE ANN. § 67-6-102(76) (Supp. 2014).

³ TENN. CODE ANN. § 67-6-102(89)(A).

or other creator to the specifications of a specific purchaser.”⁴ Conversely, the sale or use of intangible intellectual property generally is not subject to the Tennessee sales and use tax unless stored on a tangible storage media.⁵

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.⁶ One of the “things” specifically taxable is:

[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.⁷

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”⁸ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”⁹ 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.¹⁰

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.¹¹

The sales tax also applies to retail sales of services specifically enumerated in the Retailers’ Sales Tax Act.¹² One such enumerated service is “the installing of computer software, where a charge is

⁴ TENN. CODE ANN. § 67-6-102(68) further 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.” *Id.*

⁵ Compare *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27, 29 (Tenn. 1948) (rental films are taxable tangible personal property), with *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405, 407 (Tenn. 1976) (finding a tangible method of data transfer “merely incidental” to the underlying transaction, and thus not subject to sales and use tax).

⁶ TENN. CODE ANN. § 67-6-102(78)(C).

⁷ TENN. CODE ANN. § 67-6-231(a) (2013). 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).

⁸ TENN. CODE ANN. § 67-6-102(18).

⁹ TENN. CODE ANN. § 67-6-102(24).

¹⁰ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

¹¹ TENN. CODE ANN. § 67-6-102(78)(K).

¹² The Retailers’ Sales Tax Act imposes the sales tax only on services specifically enumerated in the Act. See, e.g., TENN. CODE ANN. § 67-6-205 (2013); *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994)

made for the installation, whether or not the installation is made as an incident to the sale of . . . computer software, and whether or not any . . . computer software is transferred in conjunction with the installation service.”¹³ Another enumerated service is “the performing, for a consideration, of any repair services with respect to any kind of tangible personal property or computer software.”¹⁴

Thus, the sale of all computer software, both prewritten or customized, as well as the installation and repair thereof is subject to the Tennessee sales and use tax.

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 of 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.

However, if a transaction involves a mixture of items that are subject to sales tax and those that are not, itemization becomes important.¹⁵ In Tennessee, 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 the sales tax. This treatment derives from TENN. CODE ANN. § 67-6-102(79)(A)(iv)¹⁶, which provides that the sales price includes “[t]he value of exempt personal property given to the purchaser where taxable and exempt personal property have been bundled together and sold by the seller as a single product or piece of merchandise.”¹⁷ Moreover, there is no conceptual reason why bundling principles

(sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹³ TENN. CODE ANN. § 67-6-205(c)(6).

¹⁴ TENN. CODE ANN. § 67-6-205(c)(4).

¹⁵ Separately itemizing an item that, taken in isolation, would not be subject to sales tax is merely a prerequisite to a claim of non-taxability – it is not the dispositive factor. *See AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *8 (Tenn. Ct. App. Oct. 8, 2002) (“A taxpayer cannot transform a properly taxable amount into a nontaxable amount through the simple expedient of a separately stated invoice charge.”).

¹⁶ Part 1 of 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”).

Tennessee has statutorily adopted the Streamlined Sales Tax Agreement’s definition, but it is not effective until July 1, 2015. *See* TENN. CODE ANN. § 67-6-102(8)(A) (Supp. 2014, effective July 1, 2015). Tennessee has also adopted certain bundled transaction provisions from the Streamlined Sales Tax Agreement that are currently effective, but they are narrowly applied to telecommunications and related services. *See* TENN. CODE ANN. § 67-6-539 (2013).

The Streamlined Sales Tax Agreement is notably silent on the tax consequences of a bundled transaction, deferring instead to state law. TENN. CODE ANN. § 67-6-102(79)(A)(iv) thus controls, regardless of whether the Streamlined Sales Tax Agreement’s definition of a “bundled transaction” is effective in Tennessee.

¹⁷ Tennessee addresses the bundled transaction doctrine in the unreported case of *Tomkats Catering, Inc. v. Johnson*, No. M2000-03107-COA-R3-CV, 2001 WL 1090516, at *2 (Tenn. Ct. App. Sept. 19, 2001), wherein the Tennessee Court of Appeals looked to whether a caterer’s provision of optional wait staff was separate or severable from the provision of wait staff that was already included in the customer’s purchase of food. The court found that the

should be limited to transactions involving solely tangible personal property, and in fact, Tennessee case law suggests that these principles apply to bundles of services as well.¹⁸

Finally, not all transactions readily lend themselves to classification for sales tax purposes. In order to resolve the tension in these difficult transactions, Tennessee courts have developed a line of inquiry that focuses on what is the “true object”¹⁹ of the transaction.²⁰ In applying this test, the courts essentially look at the totality of the facts and circumstances²¹ to determine what objective is really being accomplished by the transaction.²²

If the true object (or a true object) of a transaction would independently be taxable, then the true object and any “crucial,”²³ “essential,”²⁴ “necessary,”²⁵ “consequential,”²⁶ or “integral”²⁷ elements of

provision of optional wait staff was in fact separate, and the inquiry into whether two services are separate and severable is similar to the Streamlined Sales Tax Agreement’s requirement that bundled products be “distinct and identifiable.”

The bundled transaction doctrine was statutorily incorporated when the “sales price” definition was amended to include the language currently codified at TENN. CODE ANN. § 67-6-102(79)(A)(iv). *See* Act of May 26, 2005, ch. 499, § 68, 2005 Tenn. Pub. Acts 1214, 1234 (codified as amended at TENN. CODE ANN. § 67-6-102(79)(A)(iv) (Supp. 2014)); *cf.* TENN. CODE ANN. § 67-6-102(79)(A) (Supp. 2014) (providing that the sales price of a good or service equals the “total amount of consideration . . . for which personal property or services are sold”).

¹⁸ *See generally Tomkats Catering, Inc.*, 2001 WL 1090516, at *2; *see also* TENN. CODE ANN. § 67-6-102(8)(A) (Supp. 2014, effective July 1, 2015).

¹⁹ This inquiry is sometimes stated as the “primary purpose” test. *See generally Qualcomm, Inc. v. Chumley*, No. M2006-01398-COA-R3-CV, 2007 WL 2827513, at *4-5 (Tenn. Ct. App. Sept. 26, 2007) (giving a synopsis of the “true object” or “primary purpose” test in Tennessee).

²⁰ This analysis is not entirely unique to Tennessee, but the application of the test does vary in other states. *See generally* 2 JEROME HELLERSTEIN ET AL., STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 12.08[1], at 12-108 (3d ed. 1998 & Supp. 2014) (discussing the “true object” test).

²¹ *See, e.g., AOL, Inc. v. Roberts*, No. M2012-01937-COA-R3-CV, 2013 WL 4067977, at *6 (Tenn. Ct. App. Aug. 12, 2013) (basing the holding on the “totality of the circumstances”).

²² Note that it could be possible that there is not a single true object of the transaction, but rather multiple objects of the transaction. In that case, each object of the transaction should be analyzed separately for tax purposes. *Cf. Penske Truck Leasing Co. v. Huddleston*, 795 S.W.2d 669, 670-71 (Tenn. 1990) (holding that a long-term truck lease agreement and a fuel agreement were truly separate agreements and should be treated as separate transactions for sales tax purposes, despite being embodied in a single contract document).

²³ *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).

²⁴ *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).

²⁵ *See supra* note 26.

the transaction will be subject to sales tax.²⁸ In addition, if a taxable component of a transaction is “crucial,” “essential,” “necessary,” “consequential,” or “integral,” the transaction will be subject to sales tax even if the true object of the transaction is not independently subject to sales tax.²⁹

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.³⁰

In practice, the true object test is applied in three specific types of transactions, all of which are usually capable of being characterized in different manners. These include 1) so called “mixed transactions,” 2) transfers of tangible personal property in association with a sale of intangible property, and 3) certain service transactions.³¹

A “mixed transaction” is generally understood to be a transaction involving the inseparable³² transfer of tangible personal property along with a service, where at least one aspect of the transaction is independently taxable.³³ For example, a transaction involving the commission of an artist to paint a

²⁶ 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”).

²⁷ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

²⁸ Cf. *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27, 29 (Tenn. 1948) (holding that a transaction involving the sale of a license to display motion pictures accompanied by a film reel on which the movies were recorded was a taxable sale of tangible personal property).

²⁹ See e.g., *supra* note 25.

³⁰ In *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (Tenn. 1976), the Tennessee Supreme Court addressed a situation involving the sale of computer software encoded on a magnetic tape. At the time, computer software was not subject to sales tax, but magnetic tapes would have been subject to sales tax as the sale of tangible personal property. See generally *id.* at 408. The taxpayer argued that the sale was of intangible property, while the Tennessee Department of Revenue argued that the sales of tangible personal property and should be subject to tax. *Id.* at 407. The Court held in favor of the taxpayer, finding that what was actually purchased was intangible information, and stated that a “[t]ransfer of tangible personal property under these circumstances is merely incidental to the purchase of the intangible knowledge and information stored on the tapes.” *Id.* at 408. Although the Court did not, at that time, present the analysis as a “true object” test, it nevertheless employed the same logic.

³¹ See KIMBERLY M. REEDER ET AL., TRUE OBJECT OF TRANSACTION AND TAXATION OF SERVICES 2-3 (ABA/IPT Advanced Sales & Use Tax Seminar Mar. 29, 2006), available at <http://meetings.abanet.org/meeting/tax/IPT06/media/wilson.pdf> (last visited July 8, 2014) (offering examples of the types of transactions that typically give rise to the use of the true object test).

³² Whether business activities are separable does not turn solely on how the activities are itemized and presented to the customer. As previously stated, separately itemizing an item that would, standing alone, not be subject to tax is merely a prerequisite to a claim of non-taxability. See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8 (“A taxpayer cannot transform a properly taxable amount into a nontaxable amount through the simple expedient of a separately stated invoice charge.”). If two items are separable, then they should be analyzed as either separate transactions or, if sold for a single price, as a bundled transaction.

³³ The concept of a “mixed transaction” developed from case law analyzing transactions under the Uniform Commercial Code. The Tennessee Court of Appeals has recognized that “many transactions are neither pure sale of goods nor pure service transactions, but a combination of the two, i.e. a hybrid contract,” *Audio Visual Artistry v.*

portrait could be characterized as either the provision of services or the sale of tangible personal property.³⁴ Tennessee generally does not impose a tax on the service of painting portraits, but it does impose tax on a portrait because it is tangible personal property. Since the sales tax treatment turns on the characterization of the transaction, courts look to the true object of the transaction to determine its real character.

Similarly, transfers of tangible personal property in association with a sale of intangible property raise characterization issues because intangible property rights are generally not subject to sales tax in Tennessee. For example, in the unreported case of *Barnes & Noble Superstores, Inc. v. Huddleston*,³⁵ the Tennessee Court of Appeals held that the sale of a discount card that entitled its bearer to future discounts on merchandise was not subject to sales tax because, even though tangible personal property in the form of the discount card was transferred to the customer, the true object of the transaction was really the purchase of an “intangible right”³⁶ that was not subject to sales tax.

Finally, some services are themselves inherently difficult to classify because many states, like Tennessee, only impose the sales tax on enumerated services.³⁷ In a time when organizations are outsourcing operations to service providers that were traditionally performed by internal employees, the question often arises as to whether characterization of the service should be limited to what the service provider claims to provide, or should be properly characterized according to the true object of the customer’s broader operation for which service is rendered.³⁸ An example of this type of transaction would be a staffing company providing temporary workers for its client to assist with repairing tangible personal property.³⁹ Under Tennessee law, the provision of temporary workers is not a taxable service, but repairing tangible personal property is a taxable service.⁴⁰ Accordingly, a court would have to determine the true object of the transaction to determine the sales tax consequences of the transaction.

In conclusion, in order for a transaction to be subject to sales tax in Tennessee, it generally must involve: 1) the sale of tangible personal property or computer software in Tennessee; 2) the furnishing of taxable things or services in Tennessee; 3) a bundled transaction containing at least one item subject to sales tax; or 4) a transaction where the true object or one of the “crucial,” “essential,” “necessary,” “consequential,” or “integral” elements thereof are subject to sales tax.

Tanzer, 403 S.W.3d 789, 797 (Tenn. Ct. App. 2012), and the Tennessee Supreme Court has adopted the “predominant purpose” test to determine whether a contract involves predominantly the sale of goods or the sale of a service. *See Hudson v. Town & Country True Value Hardware, Inc.*, 666 S.W.2d 51, 54 (Tenn.1984). This inquiry is quite relevant under the Uniform Commercial Code since its provisions only apply to sales of goods, *see id.* at 53, and the inquiry is remarkably similar to the “true object” test employed in the tax context.

³⁴ *See generally* 2 JEROME HELLERSTEIN ET AL., STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 12.08[1], at 12-108 (3d ed. 1998 & Supp. 2014).

³⁵ No. 01A01-9604-CH-00149, 1996 WL 596955, at *2 (Tenn. Ct. App. Oct. 18, 1996).

³⁶ *Id.*

³⁷ *See, e.g.*, TENN. CODE ANN. § 67-6-205.

³⁸ *See generally* REEDER, *supra* note 33, at 7-8.

³⁹ *Cf. id.* at 8-9 (giving the examples of managerial services and hourly labor).

⁴⁰ *See* TENN. CODE ANN. § 67-6-205(c)(4).

APPLICATION

FEES CHARGED BY THE TAXPAYER

Basic Services

The Taxpayer here provides two basic services, its Cloud Infrastructure Service and its Co-location Service. On occasion, at the option of a customer, the Taxpayer also provides a customer with dedicated computer equipment for use in its co-location facilities and separately bills such customer for the provision of dedicated computer equipment and the installation of dedicated computer equipment.

Neither the Taxpayer's Cloud Infrastructure Service nor its Co-location Service is subject to the Tennessee sales and use tax.

1) Cloud Infrastructure Service

The Taxpayer's Cloud Infrastructure Service is not subject to the Tennessee sales and use tax.

No sale or transfer of tangible personal property or computer software occurs in Tennessee in conjunction with the Taxpayer's furnishing of remote data storage and computing capacity through its Cloud Infrastructure Service. The Taxpayer's customers access the cloud infrastructure stored on servers through the Internet. After a customer uploads its data to the Taxpayer's server, that customer retains all ownership of the data. Regardless of whether the infrastructure meets the statutory definition of "computer software" or "prewritten computer software," a customer cannot download any part of the cloud infrastructure itself. Moreover, the Taxpayer does not transfer title, possession, or control of the cloud infrastructure to the customer at any time. As such, the infrastructure is never delivered to, transferred to, or installed on the customer's computers but remains on the Taxpayer's servers.

Additionally, the Taxpayer's Cloud Infrastructure Service does not come within the scope of an enumerated service and therefore does not constitute the furnishing of a taxable service in Tennessee for purposes of the Tennessee sales and use tax.

Accordingly, the Taxpayer's Cloud Infrastructure Service is not subject to the Tennessee sales and use tax.

2) Co-location Service

The Taxpayer's Co-location Service is not subject to the Tennessee sales and use tax.

No sale, lease, or rental of tangible personal property or computer software occurs in Tennessee in conjunction with the Taxpayer's co-location services. As previously stated, "lease or rental" is "any transfer of possession or control of tangible personal property for a fixed or indeterminate time for consideration."⁴¹ The primary purpose of the Co-location Service is to allow a customer to locate and remotely operate equipment at the Taxpayer's data center in racks or cabinets in a secure, climate controlled environment with a uniform power supply and backup capabilities. After a customer places equipment in the cabinet or rack space, the Taxpayer retains ownership of that space.

⁴¹ TENN. CODE ANN. § 67-6-102(49)

The Taxpayer does not transfer title, possession, or control of the rack or cabinet space to customer at any time. [REDACTED]. The Taxpayer retains control over all space in its data center and over the racks and cabinets that a customer utilizes. The customer simply has the right of occupation. Accordingly, a customer does not have any access to or use or control over the space in the data center, and thus does not have any requisite dominion or control over the rack or cabinet space to constitute possession.

Additionally, the Taxpayer's Co-location Service does not constitute the furnishing of a taxable service in Tennessee for purposes of the Tennessee sales and use tax. As stated above, only specifically enumerated services are subject to the Tennessee sales and use tax. The provision of a Co-location Service is not one of those taxable services. Moreover, charges for the Co-location Service are not included as part of the sale of a taxable good or service.⁴²

Accordingly, the Taxpayer's Co-location Service is not subject to the Tennessee sales and use tax.

Optional Items and Services

None of the Taxpayer's charges for its Optional Items and Services are subject to the Tennessee sales and use tax, except for its charges for the provision of Dedicated Computer Equipment and Installation of Dedicated Computer Equipment.

In addition to invoicing its customers for costs that it incurs in providing its Co-location and Cloud Infrastructure services, the Taxpayer also separately bills its customers for the optional provision of Data Protection; System Administration, Monitoring and Management; and Managed Network Security Services if its customer chooses to have the Taxpayer provide any of those services. Through any of these services, the Taxpayer does not perform a specifically enumerated service that would be subject to the sales and use tax on a stand-alone basis. Because these services are optional to the Taxpayer's customers, when the Taxpayer provides its Cloud Infrastructure Service and/or Co-location Service, the services are not "crucial," "essential," or "integral" to the Taxpayer's Cloud Infrastructure Service and/or Co-location Service and not subject to the sales and use tax as part of the sales price of those basic services.

The Taxpayer's provision of Dedicated Computer Equipment and its Installation of Dedicated Computer Equipment, however, are subject to the Tennessee sales and use tax.

Occasionally, instead of providing its own hardware and servers to store and make use of in the Taxpayer's data center through a Co-location Service, a customer pays a fee to utilize the Taxpayer's equipment in a co-location facility. If a customer uses the Taxpayer's Dedicated Computer Equipment in a co-location facility, it may not remove that equipment from the data center and does not retain the equipment if it no longer utilizes the Taxpayer's services. The fee for provision of Dedicated Computer Equipment is an option associated with the Co-location Service.

As discussed above, "sale" is defined in pertinent part as "any transfer of title or possession, or both, exchange, barter, lease, or rental, conditional or otherwise, in any manner or any means whatsoever of tangible personal property for a consideration."⁴³ "Lease or rental" is the "transfer of possession or

⁴² It should be noted that if the Co-location Service were to be characterized as something, it would be the non-taxable lease of real property.

⁴³ TENN. CODE ANN. § 67-6-102(78)(A).

control of tangible personal property for a fixed or indeterminate period of time for consideration.”⁴⁴ Thus, if the Taxpayer transfers control or possession of the Dedicated Computer Equipment, and the transfer is for a determinate period of time, such transfer will be subject to the Tennessee sales and use tax. Although the equipment remains at the Taxpayer’s data center, a customer has the ability to use and direct the equipment and, thus, the customer has the requisite control of the equipment. As such, the Taxpayer’s provision of Dedicated Computer Equipment is subject to the sales and use tax as the lease or rental of tangible personal property.⁴⁵

Because the installation of tangible personal property that remains tangible personal property after installation is a service subject to the sales and use tax under TENN. CODE ANN. § 67-6-205(c)(6), the Taxpayer’s Installation of Dedicated Computer Equipment is subject to the sales and use tax.

Accordingly, of the Taxpayer’s Optional Items and Services, only its provision of Dedicated Computer Equipment and Installation of Dedicated Computer Equipment are subject to the Tennessee sales and use tax.

Additional Invoiced Items

The Taxpayer’s charges for Additional Invoiced Items are not subject to the sales and use tax.

In fulfilling its contracts with customers, the Taxpayer bills its customers separately for costs it incurs in conjunction with providing its Cloud Infrastructure Service and Co-location Service. Such items include charges for power, software applications used by the Taxpayer to provide its services, and installation and configuration of software and hardware used by the Taxpayer to provide its services.

The separate billing of charges is not in itself determinative of the application of the sales and use tax.⁴⁶ Thus, the appropriate inquiry is whether a specific charge is part of the non-taxable sales price of the Taxpayer’s Cloud Infrastructure Service and/or its Co-location Service.

As discussed above, an expense of a taxpayer that it passes along to a customer is part of the sales price of a service provided or product sold, regardless of whether it is included in a lump sum charge for the service provided or product sold or separately itemized to a customer.⁴⁷ Thus, if the Taxpayer passes on an expense to a customer in providing a service or selling an item of tangible personal property, the taxation of that item follows the taxation of the service or item provided. Because both the Taxpayer’s Cloud Infrastructure Service and its Co-location Service are not subject to the sales tax, any expenses that the Taxpayer incurs in providing those services that it passes on to a customer

⁴⁴ TENN. CODE ANN. § 67-6-102(49).

⁴⁵ The Taxpayer’s taxable provision of Dedicated Computer Equipment, for which it separately bills its customers, does not result in its provision of Co-location Services also being taxable. The Taxpayer’s provision of dedicated computer equipment is optional when the Taxpayer provides its Co-location Services. Moreover, when the two are viewed together, the “true object” of the transaction would not be the provision of a taxable item or service. Moreover, the Taxpayer’s provision of dedicated computer equipment is not “crucial,” “essential,” “necessary,” “consequential,” or “integral” to the provision of its Co-location Service.

⁴⁶ *AT&T v. Johnson*, 2002 WL 31247083 at * 8.

⁴⁷ See TENN. CODE ANN. § 67-6-102(79)(A)(ii).

also are not subject to the sales and use tax. The fact that the Taxpayer marks up the expenses that it passes along to a customer does not change this result because, in this case, the Taxpayer is providing non-taxable services.

One example of this type of fee is the Taxpayer's separately itemized charge to its customers for Power. This charge is for the estimated power usage in the Taxpayer's data center that the Taxpayer purchases from its local utility company. Such charges are expenses of the Taxpayer in providing its services that it passes on to a customer because the Taxpayer uses power to run its data center and to provide a secure location for a customer to locate its equipment.⁴⁸

Another example of this type of charge is the Taxpayer's charges for Software Applications. The Taxpayer states that it passes on its software license costs to its customers with a mark-up. Regardless of how the Taxpayer bills its customers, these charges are part of the sales price of either the Taxpayer's non-taxable Cloud Infrastructure or Co-location services and, thus, are not subject to the sales and use tax.

The Taxpayer separately itemizes charges for its own costs of Installation and Configuration. Such charges are included as a separate billing line item on its invoices. Such charges are part of the sales price of Taxpayer's services sold, if the Taxpayer must perform the installation and configuration to prepare for providing its service to a customer. For example, suppose the Taxpayer is setting up a cloud services network port that the Taxpayer acquired at its own expense and must use in order to provide its Cloud Infrastructure Service. In that case, the separately itemized charge for Installation and Configuration is part of the sales price of the Cloud Infrastructure Service, because the Taxpayer is passing along its cost of providing the service. All such charges are part of the sales price of either the Taxpayer's non-taxable Cloud Infrastructure or Co-location services provided and, thus, are not subject to the sales and use tax.

As such, the Taxpayer's charges for its Additional Invoiced Items are not subject to the Tennessee sales and use tax.

Other Charges

1) Metro Ethernet

The Taxpayer's Metro Ethernet service constitutes the furnishing of a taxable telecommunications service in Tennessee for purposes of the sales and use tax.⁴⁹

As stated above, only specifically enumerated services, such as telecommunications services, are subject to the Tennessee sales and use tax. Because Metro Ethernet acts as a communications circuit between the Taxpayer's data center and the premises of the Taxpayer's customer and transmits data between the locations in a secure and high-speed fashion, it routes data "to a point, or between or among points" and uses "computer processing applications that act on the form, code, or protocol of the content for purposes of transmission, conveyance, or routing."⁵⁰ In *IBM Corporation v. Farr*,⁵¹

⁴⁸ The Taxpayer does not separately meter each customer's power usage.

⁴⁹ Based on the facts provided, it does not appear that Metro Ethernet can be considered Internet access, which is not subject to the sales and use tax.

⁵⁰ See TENN. CODE ANN. § 67-6-102(90)(A).

⁵¹ No. M2012-01714-COA-R3-CV, 2013 WL 5433501, at *7, (Tenn. Ct. App., Sept. 24, 2013).

the Tennessee Court of Appeals stated that “whether a service is a taxable telecommunications service does not turn on whether or not the service provides the transmission of information, but whether communication between users of the service was the primary purpose of the service.” Because the primary purpose of Metro Ethernet is communication between users as it transmits data between the Taxpayer’s data center and the Taxpayer’s customers, it is properly characterized as a taxable telecommunications services.

Accordingly, the Taxpayer’s Metro Ethernet service is subject to the Tennessee sales and use tax.

2) Internet Access

The Taxpayer’s fees for the provision of the Internet Access service are not subject to the Tennessee sales and use tax.

Under both the Internet Tax Freedom Act⁵² and the Tennessee sales and use tax laws, the retail sale of Internet access to end-user customers is not subject to Tennessee sales and use taxation.

The Internet Tax Freedom Act defines the term “Internet Access” in pertinent part as “a service that enables users to connect to the Internet to access content, information, or other services offered over the Internet.”⁵³ Based upon the facts provided, the Taxpayer provides Internet access as defined under the Internet Tax Freedom Act to its customers.

The Tennessee Retailers’ Sales Tax Act imposes the sales tax only on specifically enumerated services, which do not include Internet access. Moreover, although Internet access could be potentially be characterized as a telecommunications service under TENN. CODE ANN. § 67-6-102(90)(A), TENN. CODE ANN. § 67-6-102(90)(B)(iv) specifically excludes from the definition of “telecommunications service” “Internet access service.” As such, the service that the Taxpayer provides fits within the exclusion from the definition of a taxable telecommunications service. Thus, the Taxpayer’s provision of the Internet Access service is not a taxable telecommunications service.

Accordingly, the Taxpayer’s Internet Access service is not subject to the Tennessee sales and use tax.

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APPROVED: Richard H. Roberts
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⁵² 47 U.S.C. § 151 note.

⁵³ *Id.*