

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 16-01

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

Application of the Tennessee sales and use tax to remotely accessed software.

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

[TAXPAYER] (the "Taxpayer") is an [REDACTED - SERVICE] provider headquartered in [CITY], Tennessee. The Taxpayer's [REDACTED - PRODUCTS] include [REDACTED]. The Taxpayer directly owns and controls one hundred percent of [REDACTED] operating subsidiaries that provide [REDACTED - PRODUCTS] (the "Affiliates").

Website Access

As part of its [REDACTED – PRODUCTS] offerings, the Taxpayer provides Web-based access to [CUSTOMERS] (a “User” or the “Users”) to access information on the [REDACTED – PRODUCTS]. The Taxpayer provides Users with a non-exclusive, non-transferable, limited right to access and use the Website. Through a username and password, a User may access the content on the Website to obtain information on its [REDACTED – PRODUCTS]. A [CUSTOMER] may review information such as [REDACTED] or make [REDACTED] changes (e.g., [REDACTED]). A [CUSTOMER] generally evaluates [REDACTED] information or pulls reports of data maintained and owned by the Taxpayer. The Taxpayer does not charge Users for access to the Website or for the ability to obtain information from the Website. Access to the Website is part of the overall [REDACTED] contract entered into between the parties and is never sold separately from the sale of [REDACTED] services.

The System

The Taxpayer provides its customers with the option to subscribe to a web-based [REDACTED – PRODUCT] technology solution (the “System”) that allows a [CUSTOMER] to manage its own [INFORMATION]. The Taxpayer’s customers access the System through a hosted extranet site with a username and password. The customer itself uses the System for the purpose of managing and administering [REDACTED – INFORMATION]. The Taxpayer does not use the System to provide [REDACTED – SERVICES], and the Taxpayer’s only role after implementation of the System is technical support.

The Taxpayer licenses the System from a third party ([THIRD PARTY]) that hosts the System on its own computer servers. The [THIRD PARTY] grants the Taxpayer a non-exclusive, non-transferable license for its own use and for use by the Taxpayer’s customers. The Taxpayer then modifies the software to identify it as being provided by the Taxpayer itself, rather than the [THIRD PARTY] (i.e., the System includes the Taxpayer’s own name, logo, and trademarks). The Taxpayer, itself, does not use the System [REDACTED].

The price the Taxpayer charges a customer is based on [REDACTED]. The Taxpayer separately itemizes its charges for the System from its [REDACTED – SERVICES].

Taxpayer’s Remote Access of Various Software Applications

In order to provide its [REDACTED – SERVICES], the Taxpayer purchases and uses software applications that its employees access remotely over the Internet from locations both inside and outside of Tennessee.

RULINGS

1. Is the Taxpayer’s provision of customer access to its Website subject to the Tennessee sales and use tax?

Ruling: No. The Taxpayer offers access to the Website in order to provide [REDACTED – SERVICES].

2. May the Taxpayer purchase the System from the [THIRD PARTY] exempt from the Tennessee sales tax if it provides the [THIRD PARTY] with a properly completed resale certificate?

Ruling: Yes. The Taxpayer licenses the System from the [THIRD PARTY] for resale to its own customers.

3. Are the Taxpayer's charges to its customers for access to the System subject to the Tennessee sales and use tax?

Ruling: Yes. The customers' access to the System is subject to the Tennessee sales and use tax as remotely accessed software.

4. Is the Taxpayer required to remit Tennessee sales tax on its purchases of remotely accessed software used by persons located inside and outside of Tennessee?

Ruling: The Taxpayer may present the seller with a Remotely Accessed Software Direct Pay Permit at the time of purchase and remit sales tax directly to the Department on the portion of the sales price that corresponds to the percentage of its users located inside Tennessee. Alternatively, the Taxpayer may present the seller with a fully completed Streamlined certificate of exemption at the time of purchase to exclude the portion of the sales price that corresponds to its percentage of users located outside Tennessee, and pay sales tax based on its percentage of users located inside of Tennessee.

ANALYSIS

LEGAL BACKGROUND

1. Taxation of Software

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) (Supp. 2015) 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 "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

¹ Tennessee Retailers' Sales Tax Act, ch. 3, §§ 1-18, 1947 Tenn. Pub. Acts Ch. 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. 2015).

designed and developed by the author or other creator to the specifications of a specific purchaser.”³

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.⁴ 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.⁵

“Computer software” is “a set of coded instructions designed to cause a computer . . . to perform a task.”⁶ Computer software is “delivered electronically” if delivered “by means other than tangible storage media.”⁷ 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.⁸

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.⁹

In response to advances in technology that allow persons to remotely access and use software over the Internet, the Tennessee General Assembly adopted into law 2015 Tenn. Pub. Acts Ch. 514, § 22

³ 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.” TENN. CODE ANN. § 67-6-102(89)(A).

With regard to prewritten computer software, TENN. CODE ANN. § 67-6-102(68) 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.” TENN. CODE ANN. § 67-6-102(68),

⁴ TENN. CODE ANN. § 67-6-102(78)(C).

⁵ TENN. CODE ANN. § 67-6-231(a)(1) (Supp. 2015). 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).

⁶ TENN. CODE ANN. § 67-6-102(18).

⁷ TENN. CODE ANN. § 67-6-102(24).

⁸ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

⁹ TENN. CODE ANN. § 67-6-102(78)(K).

(effective July 1, 2015). This new law effectively treats all purchases of computer software in this state equally, regardless of how the software is provided to and used by a purchaser in this state. It amends TENN. CODE ANN. § 67-6-231(a) to include a new subdivision (2), which states in pertinent part that

[f]or purposes of subdivision (a)(1), “use of computer software” includes the access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer. If the customer accesses the software from a location in this state as indicated by the residential street address or the primary business address of the customer, such access shall be deemed equivalent to the sale of licensing of the software and electronic delivery of the software for use in the state.¹⁰

As a result, effective for all billing periods beginning on or after July 1, 2015, the access and use of computer software in this state, which has generally been subject to tax since 1977,¹¹ remains subject to sales and use tax regardless of a customer’s chosen method of use.

The sales tax also applies to retail sales of services specifically enumerated in the Retailers’ Sales Tax Act.¹² The furnishing of “intrastate, interstate or international telecommunication services” is one such specifically enumerated service.¹³ “Telecommunications service” is defined by TENN. CODE ANN. § 67-6-102(90)(A) as the “electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points.” TENN. CODE ANN. § 67-6-102(90)(B)(i) excludes from the definition of “telecommunications service,” however, “[d]ata processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by electronic transmission to a purchaser, where such purchaser’s primary purpose for the underlying transaction is the processed data or information.”

Notably, the application of the sales tax to retail sales of services in Tennessee remains unaffected by the enactment of 2015 Tenn. Pub. Ch. 514, § 22. The sales tax remains applicable only to those services specifically enumerated in the Retailers’ Sales Tax Act.¹⁴ As reassurance of this fact, the

¹⁰ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

¹¹ The General Assembly amended the definition of “tangible personal property” in 1977 to specifically include computer software in response to the Tennessee Supreme Court’s holding to the contrary in *Commerce Union Bank*, 538 S.W.2d at 408. 1977 Tenn. Pub. Acts Ch. 42 (defining “tangible personal property” to include computer software); see also *Univ. Computing Co. v. Olsen*, 677 S.W.2d 445, 447 (Tenn. 1984) (detailing the General Assembly’s actions taken to subject computer software to sales and use tax).

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) (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)(3) (2013).

¹⁴ 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; *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck*

General Assembly included language in Section 22 stating that nothing in the new subdivision (a)(2) of TENN. CODE ANN. § 67-6-231

shall be construed to impose a tax on any services that are not currently subject to tax under this chapter, such as, but not limited to, information or data processing services, including the capability of the customer to analyze such information or data provided by the dealer; payment or transaction processing services; payroll processing services; billing and collection services; Internet access; the storage of data, digital codes, or computer software; or the service of converting, managing, and distributing digital products.¹⁵

Therefore, while the new TENN. CODE ANN. § 67-6-231(a)(2) modernizes taxation of computer software in this state, it has no effect on the taxation of services.

Additionally, 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 sales tax as a bundled transaction.¹⁶ Finally, when a transaction involves taxable and nontaxable components and the transaction's true object or a "crucial,"¹⁷ "essential,"¹⁸ "necessary,"¹⁹ "consequential,"²⁰ or "integral"²¹ element of the

Rental, Inc. v. Huddleston, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994) (sales tax does not apply to all services; rather, it only applies to retail sales of services specifically enumerated by the statute).

¹⁵ 2015 Tenn. Pub. Acts Ch. 514, § 22 (codified at TENN. CODE ANN. § 67-6-231(a)(2) (Supp. 2015)).

¹⁶ See generally Tenn. Dept. of Rev. Ltr. Rul. 14-10 (Oct. 14, 2014) [hereinafter "Ltr. Rul. 14-10"] (discussing Tennessee law regarding bundling and the "true object" test), available at <http://www.tennessee.gov/assets/entities/revenue/attachments/14-10.pdf>.

¹⁷ 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).

¹⁸ *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).

¹⁹ See *supra* note 18.

²⁰ 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").

²¹ See *AT&T Corp. v. Johnson*, 2002 WL 31247083, at *8.

transaction is subject tax, the entire transaction is subject to sales tax.²² 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.²³

2. Payment of Tax

If a person purchases remote access to software for use wholly within Tennessee, applicable sales tax on the transaction generally must be collected by the seller.²⁴ However, if the seller does not collect the tax, the purchaser must remit tax directly to the Department.

Alternatively, a person might purchase remote access to software for use across several states in a single transaction. To ensure the purchaser pays Tennessee sales and use tax only on the portion of the sales price reflecting its access and use of software in Tennessee, TENN. CODE ANN. § 67-6-231(a)(2), provides that

[i]f the sale price or purchase price of the software relates to users located both in this state and outside this state as indicated by a residential street or business address, the dealer or customer may allocate to this state a percentage of the sales price or purchase price that equals the percentage of users in this state.

To make this allocation, a purchaser of remotely accessed software must determine the number of persons accessing and using the remotely accessed software in this state and divide that number by the total number of persons represented in the transaction that are accessing and using the software everywhere. A purchaser should determine the location of each user, insofar as possible, by the user’s primary residential street or business address at the time of sale. If the location of users is difficult to determine, a purchaser should use a reasonable and consistent method of allocation that accurately reflects the percentage of users in Tennessee based on its books and records at the time of sale. A purchaser must include any person for whom it has purchased access and use of the software in the calculation, regardless of any person’s level of access or extent of use.

If the purchaser pays for access to software that will be used by individuals who are located in this state, and other individuals who are located outside this state (for example, the purchaser’s employees), then the purchaser may allocate the sales price subject to Tennessee tax based on the percentage of its users located in Tennessee. The purchaser must maintain adequate records supporting the allocation percentage applied to any particular transaction. If a purchase is ongoing or recurring in nature, the purchaser must take reasonable steps to update its allocation percentage upon a material change in its user ratio.

²² See generally *Ltr. Rul. No. 14-10*, *supra* note 16.

²⁴ TENN. CODE ANN. § 67-6-502 (2013). A dealer will not be required to collect tax on a sale of remotely accessed software where it is not readily apparent to the dealer that the customer is using the software in Tennessee. Due to the nature of remotely accessed software, the dealer may not be aware that the software is used in Tennessee.

A purchaser may present to a seller a Remotely Accessed Software Direct Pay Permit and remit sales tax to the Department on the portion of the sales price that corresponds to the percentage of its users located in Tennessee at the time of sale. A seller is not obligated to collect and remit the applicable sales tax when a purchaser presents a Remotely Accessed Software Direct Pay Permit or when the seller is not on notice that the customer will be using the software in Tennessee. When a customer presents the seller with a fully completed Streamlined certificate of exemption,²⁵ a seller must collect and remit sales tax only on the portion of the sales price that corresponds to the percentage of the customer's users located in Tennessee.²⁶

APPLICATION

1. Website Access

The Taxpayer's provision of customer access to its Website is not subject to Tennessee sales and use tax.

As part of its [REDACTED – PRODUCTS] offerings, the Taxpayer provides Users with access to its Website at no separate charge. The Taxpayer's Website is a set of coded instructions that enables a User to perform a task and, thus, constitutes computer software for Tennessee sales and use tax purposes.

With respect to the taxable use of computer software in this state that remains in possession of the dealer, TENN. CODE ANN. § 67-6-231(a)(2) requires the access and use of the computer software by a customer within this state. The Website is accessed by the Taxpayer's customers from locations within Tennessee.

However, the true value of the right to access the Website is the ability for the Users to view information relating to their own [REDACTED – INFORMATION]. Furthermore, any manipulation of [REDACTED – INFORMATION], such as {REDACTED}, which requires use of the Website, is merely incidental to the Taxpayer's provision of [REDACTED – SERVICES]. Therefore, the true object of granting access to the Website is the provision of [REDACTED – SERVICES]. To this end, the Taxpayer is the user of the Website in the provision of its [REDACTED – SERVICES].

Accordingly, the access of the Website is not subject to the Tennessee sales and use tax.

²⁵ The Streamlined certificate must include the customer's Tennessee sales and use tax registration number. In addition, on Line 5, "Reason for Exemption," the customer should circle "Other" with an explanation such as, "remote access software used by employees located in multiple states" and specify the percentage of users located outside of Tennessee.

²⁶ For additional information, see Sales and Use Tax Notice #15-14, available at <http://tn.gov/assets/entities/revenue/attachments/sales15-14.pdf>, and Sales and Use Tax Notice #15-24, available at <http://tn.gov/assets/entities/revenue/attachments/sales15-24.pdf>.

2. The Taxpayer's License of the System

The Taxpayer may license the System from the [THIRD PARTY] exempt from the Tennessee sales and use tax as a sale for resale if it presents the [THIRD PARTY] with a properly completed resale certificate.

With respect to the taxable use in this state of computer software that remains in possession of the dealer, TENN. CODE ANN. § 67-6-231(a)(2) requires the access and use of the computer software by a customer within this state. The [THIRD PARTY'S] software is a set of coded instructions that enables a computer to perform a task and, thus, constitutes computer software for Tennessee sales and use tax purposes. The [THIRD PARTY'S] software is housed on its own server, but the Taxpayer is granted a license to use, rebrand, and sublicense the software.

The license of the System generally would be subject to the Tennessee sales and use tax as remotely accessed software because the Taxpayer accesses and uses the software housed at the [THIRD PARTY'S] servers. However, TENN. CODE ANN. § 67-6-231(a)(2) provides that “[a]ny dealer that purchases computer software only for the purpose of reselling access and use of such software . . . shall be entitled to purchase such software exempt from” the Tennessee sales and use tax. The term “resale” means “a subsequent, bona fide sale of the property, services, or taxable item by the purchaser.”²⁷ A service provider that purchases computer software to be used in the furnishing of such service is the end user of the software.²⁸

Here, the Taxpayer does not use the System to facilitate the provision of [REDACTED – PRODUCTS]. Instead, the Taxpayer purchases the System solely for the purpose of offering the System to its customers in a separate transaction. Therefore, the sale to the Taxpayer’s clients constitutes a bona fide resale, and the Taxpayer may purchase the license of the System exempt from the Tennessee sales and use tax if it presents to the [THIRD PARTY] a properly completed resale certificate.

3. Charges for Customer Access to the System

The Taxpayer’s charges to its customers for access to the System are subject to Tennessee sales and use tax.

With respect to the taxable use of computer software in this state that remains in possession of the dealer or a third party on behalf of such dealer, TENN. CODE ANN. § 67-6-231(a)(2) requires the access and use of the computer software by a customer from within this State. Here, the System is housed on the [THIRD PARTY'S] servers and accessed remotely by the Taxpayer’s customers from locations within Tennessee. Accordingly, the Taxpayer’s provision of access to the System to its customers is subject to Tennessee sales and use tax.

4. Payment of Tax

In order to provide its [REDACTED – SERVICES], the Taxpayer purchases and uses software, including software that it accesses remotely via the Internet from locations in Tennessee. The seller of such

²⁷ TENN. CODE ANN. § 67-6-102(75)(A).

²⁸ See TENN. CODE ANN. § 67-6-102(75)(B)(i).

software used by the Taxpayer in Tennessee must generally collect tax from the Taxpayer on the retail sales price of such software. However, if it is not readily apparent to the seller that the Taxpayer is accessing and using the software in Tennessee, or if the Taxpayer provides to the seller a Remotely Accessed Software Direct Pay Permit, the seller is not obligated to collect tax. The Taxpayer must, however, remit tax to the Department on the portion of the sales price allocated to its Tennessee users. Alternatively, if the Taxpayer presents the seller with a fully completed Streamlined certificate of exemption, the Taxpayer must pay, and the seller must collect, tax based on the Taxpayer's percentage of users located inside of Tennessee.

The Taxpayer must allocate the sales price based on the number of users located in Tennessee divided by the total number of users represented in the transaction. The Taxpayer must determine the location of its users by looking to the residential street address or business address of each user. The Taxpayer should use its best efforts to determine the number and location of users at the time of sale based on the information available to it at the time. If a material change in this number occurs during a purchase of a recurring nature, the Taxpayer must take reasonable steps to adjust the allocation percentage accordingly.

Grant Marshall
Assistant General Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

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