

**TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 07-05**

**WARNING**

**Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.**

**SUBJECT**

Application of sales and use tax to various transactions involving computer connections, telecommunications, and related 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 is a Tennessee domestic corporation that provides computer services from [LOCATION]. The Taxpayer also sells various computer hardware and software support services which may be provided via the Internet, telephone, onsite from its [LOCATION] office, or offsite at the customer's location.

The Taxpayer has nexus in various other jurisdictions due to installation and training provided at customer locations in states outside of Tennessee. The Taxpayer collects and remits sales tax in various jurisdictions throughout the United States.

The Taxpayer is providing a computer service known as ASP (application software provider). This service involves providing a customer with the use of software located on the Taxpayer's computer server rather than on the customer's computer. The customer accesses the application software (on the Taxpayer's server) by using an icon (installed on the customer's computer) and access code provided by the Taxpayer. As an ASP, the Taxpayer contracts to provide its customers with the following services:

1. Use of application software located on the Taxpayer's server to process data for such purposes as accounting, spreadsheet preparation, and word processing.

2. Use of an operating connection (icon) located on the customer's computer required to access the application software.
3. Data hosting—the customer's data will be located on the Taxpayer's server.
4. Internet access with e-mail service.
5. Basic web site hosting.
6. Domain name registration.
7. Virus protection management.

The operating connection (#2 above) is downloaded onto the customer's computer. No software is downloaded to the customer. The application software remains on the Taxpayer's server while being used by the customer. The customer's data is stored on the Taxpayer's server. The customer does have the ability to print reports at its own location. The software located on the server consists of licenses that are either purchased or subscribed to by the Taxpayer. The Taxpayer must obtain a license from its software supplier for each ASP customer.

The customer will connect with the Taxpayer's server via the customer's Internet service or telephone lines. The connection is made using an icon that enables a remote customer to access an offsite server. This connection belongs to the Taxpayer but is installed on the customer's computer by either the Taxpayer or the customer. The operational connection allows the customer to access the applications software which is loaded on the Taxpayer's servers. The customer cannot download the applications software onto its computers. The ASP service also includes telephone technical support provided by the Taxpayer's employees located in Tennessee.

A single monthly fee is charged for the services listed above. The fee is either a flat monthly charge or a varying monthly usage fee based upon the number of times the software is utilized during the month. The usage fee requires a minimum payment.

Other services billed as a separate line item on the contract and on the invoice are as follows:

1. Database set-up: The fee covers set-up of the customer's database on the Taxpayer's Tennessee computer server by the Taxpayer's employees located in Tennessee.
2. Icon installation and configuration: The Taxpayer's employees will go to the customer's location and install or configure the necessary connection for accessing the server. Phone installation assistance is available as an alternative.
3. Bank reconciliation services: The reconciliation is to be performed by the Taxpayer's employees located in Tennessee. The employees will access the customer's data via the computer server, perform the reconciliation, and place the information on the server for the customer to access.
4. Software training: The Taxpayer trains the customer how to use the ASP services. The training can be provided onsite at the customer's location or offsite at the Taxpayer's Tennessee office.

The Taxpayer has contracted with an outside computer hosting service to provide the services to the customer. The hosting service is located in Tennessee. The Taxpayer's computer servers will be installed at the hosting service location. The hosting service will monitor and arrange the use of the servers. The following specific services will be provided by the hosting service and will be billed to the Taxpayer separately by line item on a monthly basis:

1. Cabinet rental for storage of the client's servers
2. Internet access
3. Line usage, i.e. the use of telecommunication lines to provide internet access.
4. Firewall management service
5. Tape backup service
6. Monitoring the use of the client's servers
7. Installation charges for:
  - a. Installing the Taxpayer's computers at the host facility
  - b. Establishing domain names for each of the Taxpayer's customers
  - c. Installing a line to the Taxpayer's office
  - d. Installing firewall management
  - e. Installing tape backup systems
  - f. Installing backup servers and software

## QUESTIONS

1. Is the monthly ASP fee subject to Tennessee sales tax when the ASP services are sold to and used by a customer located in Tennessee?
2. If yes, which of the seven ASP services would be exempt if billed separately?
3. Does Tennessee sales tax apply to the monthly ASP services purchased and used by out-of-state customers?
4. Is the one-time database set-up fee subject to Tennessee sales tax if sold to Tennessee customers and billed separately?
5. Is the one-time database set-up fee subject to Tennessee sales tax if sold to out-of-state customers and billed separately?
6. Are the hardware/software installation and configuration fees subject to Tennessee sales tax if performed at a customer's Tennessee location and billed separately?
7. Are bank reconciliation service fees subject to Tennessee sales tax if provided to Tennessee customers and billed separately?
8. Are bank reconciliation service fees subject to Tennessee sales tax if provided to out-of-state customers and billed separately?
9. Are ASP training charges subject to Tennessee sales tax if the training is performed in Tennessee and billed separately?
10. Are ASP training charges subject to Tennessee sales tax if the training is performed outside Tennessee and billed separately?
11. Should the Taxpayer pay Tennessee sales or use tax on the monthly software subscription fees that the Taxpayer pays to its suppliers?

12. Should the Taxpayer pay Tennessee sales or use tax on its acquisition of individual software licenses?
13. Should the Taxpayer pay Tennessee sales tax on all of the services for which the outside computer hosting service charges the Taxpayer?
14. Would the sales tax consequences of the ASP services and the services purchased to provide such services change if the hosting service was located outside Tennessee?

## **RULINGS**

1. The monthly ASP fee charged to Tennessee customers is not subject to Tennessee sales tax unless the fee is bundled (combined) with the sale of a taxable product or taxable service.
2. None of the seven ASP services the Taxpayer included in the facts are subject to Tennessee sales and use tax.
3. The monthly ASP fee charged to out-of-state customers is not subject to Tennessee sales tax.
4. The database set-up fee is not subject to Tennessee sales tax.
5. Please see the response to question 4.
6. Charges for the installation of computer hardware and software in Tennessee are subject to sales tax.
7. Bank reconciliation service fees are not subject to Tennessee sales tax.
8. Please see the response to question 7.
9. ASP training charges are not subject to Tennessee sales tax.
10. Please see the response to question 9.
11. The supplier should collect sales tax on the sale of the monthly software subscription fees to the Taxpayer. If the supplier did not collect sales tax, the Taxpayer should remit use tax to the Department of Revenue.
12. The supplier should collect sales tax when it grants the individual software license to the Taxpayer. If the supplier did not collect sales tax, the Taxpayer should remit use tax to the Department of Revenue.
13. The services which include the lease or rental of tangible personal property are subject to sales and use tax. The installation of tangible personal property will be taxable if the property remains tangible personal property after installation. The remaining services are not taxable.
14. No.

## **ANALYSIS**

1. Standing alone, the ASP fee is not taxable. However, if the ASP fee is combined (bundled) with the sale of tangible personal property or a taxable service, and the charges for the non-taxable services are not separate and optional from the taxable charges, then the sales tax applies to the total package.

Tenn. Code Ann. § 67-6-102(a)(34)(B) defines software as tangible personal property for the purposes of the sales and use tax. Specifically, it provides:

“Sale” also means such 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...

The software remains on the Taxpayer’s servers. Thus, the Taxpayer, rather than the Taxpayer’s customer, is the end user and consumer. The customers are provided an icon and access code to access the software from their computers. Based on the facts as presented, the access connection is not considered “computer software” and therefore, is not a taxable sale as defined above.

2. As provided in Tenn. Code Ann. § 67-6-201, the sale or use of tangible personal property is taxable unless specifically exempt. Conversely, services are exempt from sales tax unless they are either identified as taxable under Tenn. Code Ann. §§67-6-205 and 67-6-102(a)(32)(F), or provided as part of the sale of tangible personal property. Tenn. Code Ann. § 67-6-102(a)(35). None of the seven services listed in the facts are taxable; neither firewall management nor tape back-up constitutes installation of software. Similarly, none of the seven services listed in the facts are provided as part of the sale or tangible personal property. These services are, therefore, not taxable if billed separately from a taxable transaction.
3. As provided in the response to question 2, the services are not subject to Tennessee sales and use tax. Because no taxable transaction occurred in Tennessee, the fees charged to the out-of-state customers would not be subject to Tennessee sales tax.
4. Services are not subject to the sales and use tax unless specifically included in Tenn. Code Ann. §§67-6-205 and 67-6-102(a)(32)(F). Setting up a database on the Taxpayer’s server is not a taxable service when sold independently from otherwise taxable property or services.
5. Please see the response to question 4.
6. Tenn. Code Ann. § 67-6-102(a)(32)(F)(iv) and (vi) provide that the installation of tangible personal property (which remains tangible personal property after installation) and repair services are taxable services. However, since no software or hardware is installed, the installation and configuration fees charged to a Tennessee customer are not subject to sales and use tax.

7. Services are not subject to sales and use tax unless specifically included by Tenn. Code Ann. §§67-6-205 and 67-6-102(a)(32)(F). Bank reconciliation fees are not a taxable service when sold independently from otherwise taxable property or services.

8. Please see the response to question 7.

9. Services are not subject to sales and use tax unless specifically included by Tenn. Code Ann. §§67-6-205 and 67-6-102(a)(32)(F). Training charges are not a taxable service when sold independently from otherwise taxable property or services.

10. Please see the response to question 9.

11. Tenn. Code Ann. § 67-6-203 imposes sales and use tax on the user and consumer of tangible personal property and taxable services. The statute provides that:

A tax is levied at the rate of the tax levied on the sale of tangible personal property at retail by the provisions of § 67-6-202 of the cost price of each item or article of tangible personal property when the same is not sold but is used, consumed, distributed, or stored for use or consumption in this state...

The Taxpayer is the ultimate user and consumer of the software used to provide the ASP service. As noted above, software is defined as tangible personal property, thus the subscription fees paid by the Taxpayer to its software supplier would be subject to sales and use tax. The Taxpayer is also the user and consumer of any telecommunications service purchased to provide its service and it must pay sales and use tax for those services.

12. Tenn. Code Ann. § 67-6-204 provides that sales and use tax applies to “the gross proceeds of all leases and rentals of tangible personal property in this state...” if such a lease is part of a regular business practice. Tenn. Code Ann. § 67-6-102(a)(24) defines “lease or rental” to mean the leasing or renting of tangible personal property and the possession or use thereof by the lessee or renter for a consideration, without transfer of the title of such property.” Tenn. Code Ann. § 67-6-102(a)(34)(B) provides that computer software is tangible personal property. A license to use software is a lease of tangible personal property, and therefore, is subject to sales tax.

13. As noted in the previous question, the lease or rental of tangible personal property is subject to sales and use tax. Although the Taxpayer may pass along some of the supplier costs to its customers, the Taxpayer is the end user and consumer. As the end user and consumer, Taxpayer is liable for sales tax on the lease or rental of tangible personal property and any related taxable services. *Nashville Mobilphone Co., v. Woods*, 655 S.W.2d 934 (Tenn. 1983). The cabinet rental for storage on the Taxpayer’s servers is a rental of tangible personal property, and therefore, is subject to sales tax. As noted in the response to question 7, charges for the installation of tangible personal property which remains tangible personal property after installation is subject to sales tax. The

following services provided by the host and billed to the Taxpayer, if sold separately from the taxable items, would not be subject to sales tax: Internet access, line use, firewall management service, tape backup service, the monitoring of the client's servers, and, the establishment of domain names for each of the Taxpayer's customers.

14. The Taxpayer's charges to its Tennessee customers for the sale or rental of tangible personal property, and charges for the installation of tangible personal property which remains tangible personal property after installation, would be subject to Tennessee sales tax.

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