

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-29**

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

The application of the Tennessee sales and use tax to software configuration 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 retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] is [REDACTED INFORMATION].

[REDACTED INFORMATION], the Taxpayer has for [TIME PERIOD] been in the process of consolidating its various [REDACTED] systems into a single centralized system at its [LOCATION IN TENNESSEE]. This centralization of functions involves the [SYSTEM] offered by [COMPANY]. The initial necessary [COMPANY] software was purchased by the Taxpayer in [REDACTED]; the software is located on the Taxpayer's servers in Tennessee. The Taxpayer paid

Tennessee sales tax on the purchase and installation of this software. Repair, maintenance, and installation of the software is covered by the [COMPANY] software license agreement.

The Taxpayer also purchases a significant amount of software consulting services in order to maintain an optimal level of functionality. Consultants working with the Taxpayer assist in utilizing the functionalities in the software to best meet a particular business unit's needs. The consultants also input data and access capabilities present within the software that are most advantageous to the Taxpayer's business requirements in general.

The software configuration services are purchased by the Taxpayer from many vendors, including [COMPANY]. When purchased from [COMPANY], the software configuration services are acquired at the Taxpayer's option, separate and apart from software licenses or maintenance agreements. The [COMPANY] license agreement contains no provision regarding the furnishing of software configuration services to the Taxpayer.

Professional service agreements are generally entered into at the outset of the Taxpayer's relationship with a vendor and cover statements of work for various services as well as schedules of deliverables. Multiple statements of work for services or other deliverables may be executed under a single professional service agreement. Each statement of work operates independently and separately from other statements of work under a single professional service agreement. Each statement of work is invoiced separately.

Many of the Taxpayer's software consulting contracts are related to [REDACTED]. The Taxpayer contracts with two categories of consultants to work on this project.

The first category of consultants, custom [SOFTWARE] development consultants, includes those individuals with authority to develop additional code complimentary to the [COMPANY] standard delivered software.¹ These consultants work during the development phase of a project to create or customize programming to fit the Taxpayer's particular needs. The taxability of software development services provided by the custom [SOFTWARE] development consultants is not at issue in this letter ruling.

The second category of consultants, software configuration consultants, is comprised of persons who do not have the authority to create new code or to amend or alter existing code. Software configuration [REDACTED], which some software services contracts may refer to as "customizing," is the act of setting pre-defined software toggles or switches or building tables that give direction within the standard delivered application software. Software configuration consultants do not develop, modify, or create software code. In addition, the software configuration services include troubleshooting and resolving customer issues, as well as coordinating discussions between [COMPANY] and the Taxpayer's customers to help resolve product issues.

Persons who are authorized to perform software configuration services are not authorized to perform custom [SOFTWARE] development work. The Taxpayer has imposed security authorizations to control this distinction. Furthermore, from an organization viewpoint, one technology management group controls software configuration work, and a separate group controls software development work.

¹ [REDACTED].

QUESTIONS

1. Are the services provided by the software configuration consultants subject to the Tennessee sales and use tax?
2. To the extent the Taxpayer and its vendors are able to separate nontaxable services from taxable services purchased, is the vendor permitted to charge Tennessee sales and use tax on the portion of the sales attributable to the nontaxable services?
3. If a vendor has incorrectly charged Tennessee sales and use tax on previous sales of nontaxable services, what procedures must be employed in the event that the Taxpayer requests a refund of sales taxes previously paid?

RULINGS

1. No. The services provided by the software configuration consultants as described herein are not subject to the Tennessee sales and use tax.
2. No. If a vendor sells an optional nontaxable service independent of the sale of taxable goods or services and separately charges for the various goods and services sold, the vendor may not charge sales tax with respect to the independent nontaxable service.
3. In the event that the Taxpayer requests a refund of sales taxes previously paid with respect to nontaxable services, the Taxpayer's vendors must follow the procedure for claiming refunds set forth under TENN. CODE ANN. § 67-1-1802 (Supp. 2010).

ANALYSIS

1. Services provided by the software configuration consultants

The services provided by the software configuration consultants as described herein are not subject to the Tennessee sales and use tax.

For the reasons discussed below, to be subject to the Tennessee sales and use tax, the services provided by the software configuration consultants must constitute: 1) a sale of prewritten or custom computer software; 2) services involving the fabrication of, or customized modifications or enhancements to, computer software; 3) services sold as part of the sale of computer software; and/or 4) services involving the repair, maintenance, or installation of computer software.

Retail sales of tangible personal property in Tennessee are subject to the sales and use tax under the Retailers' Sales Tax Act, TENN. CODE ANN. § 67-6-101 *et seq.* TENN. CODE ANN. § 67-6-102(79) (Supp. 2010) defines a "retail sale" as any "sale, lease, or rental for any purpose other than for resale, sublease, or subrent." The term "sale" is defined under the Tennessee sales and use tax laws in pertinent part as "any transfer of title or possession, or both . . . of tangible personal property for a consideration." TENN. CODE ANN. § 67-6-102(81)(A). TENN. CODE ANN. § 67-6-102(92)(A) defines "tangible personal property" in pertinent part as "personal property that can be seen, weighed,

measured, felt, or touched,” and specifically includes prewritten computer software.² Additionally, TENN. CODE ANN. § 67-6-231(a) (Supp. 2010) specifically provides that the “retail sale, lease, licensing or use of computer software in this state, including prewritten and custom computer software,” is subject to the sales and use tax, “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.” Finally, 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.³ See *Creasy Sys. Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 36 (Tenn. 1986).

The Retailers’ Sales Tax Act also imposes the sales tax on certain services. The sales tax does not apply to all services; rather, it only applies to retail sales of those services specifically enumerated by the statute. *Ryder Truck Rental, Inc. v. Huddleston*, 1994 WL 420911 (Tenn. Ct. App. Aug. 12, 1994). Even if a service is not specifically enumerated by the statute, however, the service may be subject to the sales tax where charges for the service are included in the sales price of a taxable good or service. Specifically, TENN. CODE ANN. § 67-6-102(82)(A) provides that the sales price of a good or service equals the “total amount of consideration . . . for which personal property or services are sold.” Thus, when the sale of a non-enumerated service is part of the sale of a taxable good or service, the charges for the non-enumerated service are included in the sales price of the taxable good or service and as such are subject to taxation.

With respect to particular enumerated services, TENN. CODE ANN. § 67-6-205(c)(4) (Supp. 2010) imposes the sales tax on the service of repairing tangible personal property. Similarly, TENN. CODE ANN. § 67-6-205(c)(6) imposes the sales tax on the service of installing tangible personal property that remains tangible personal property following installation. Accordingly, the repair or installation of software is a taxable service for purposes of the Tennessee sales and use tax. While consulting services are not enumerated under the Retailers’ Sales Tax Act and are generally not subject to the sales tax, the consulting services will nevertheless be subject to taxation if the services involve the repair, upgrade, maintenance, or installation of computer software. Additionally, as explained above, charges for consulting services will be subject to taxation when the sale of the services is part of the sale of computer software.

In summary, to be subject to the Tennessee sales and use tax, the services provided by the software configuration consultants must constitute: 1) a sale of prewritten or custom computer software; 2) services involving the fabrication of, or customized modifications or enhancements to, computer software; 3) services sold as part of the sale of computer software; and/or 4) services involving the repair, maintenance, or installation of computer software. In the Taxpayer’s case, none of these requirements is met.

First, the services provided by the software configuration consultants do not constitute the sale of prewritten or custom computer software to the Taxpayer. [COMPANY] is the only party that makes sales of software to the Taxpayer.

² “Prewritten computer software” is “computer software . . . that is not designed and developed by the author or other creator to the specifications of a specific purchaser” and includes prewritten upgrades. TENN. CODE ANN. § 67-6-102(71).

³ Note that TENN. CODE ANN. § 67-6-387 (Supp. 2010) exempts from the Tennessee use tax the fabrication of computer software by a person for that person’s own use and consumption.

Second, the software configuration consultants do not create or otherwise fabricate computer software for the Taxpayer, nor do they perform customized modifications or enhancements to the [COMPANY] software. Rather, the consultants set pre-defined software toggles or switches and build tables that give direction within the [COMPANY] application software. Significantly, these activities do not involve the modification or enhancement of software code; the consultants simply activate features already coded within the existing software, configuring the software to optimize its functionality.

Third, the services provided by the software configuration consultants are not purchased as part of the sale of a software product or license. This is obviously the case when the software configuration consultant is employed by a vendor that does not sell software to the Taxpayer. *See Austin Co. v. Woods*, 620 S.W.2d 73, 76 (Tenn. 1981) (holding that sales price of tangible personal property does not include related services provided by third party). Under the facts provided, this conclusion is likewise applicable in instances where the software configuration consultant is employed by a vendor that also makes sales of software to the Taxpayer. The sale of software may occur when [COMPANY] sells its prewritten software to the Taxpayer or when custom [SOFTWARE] development consultants develop additional code complimentary to [COMPANY] prewritten software.

In the case of [COMPANY], the software configuration services are acquired at the Taxpayer's option, separate and apart from [COMPANY]'s software licenses or maintenance agreements. The [COMPANY] license agreement in fact makes no mention of software configuration services. Rather, the Taxpayer and [COMPANY] enter into a separate agreement for the purchase of services; specific orders for services are made pursuant to individual statements of work. Importantly, each statement of work operates independently and separately from the others under the service agreement. The sale of software configuration services is therefore not dependent upon, or otherwise connected with, the sale of other types of services, some of which may involve the sale of software. Additionally, the Taxpayer may, and in fact does, opt to acquire software configuration services from a vendor other than [COMPANY]; this fact further indicates that [COMPANY]'s sale of software and [COMPANY]'s sale of configuration services are separate and distinct transactions.

In the case of other vendors, as with [COMPANY], a professional service agreement is generally entered into at the outset of the Taxpayer's relationship with the vendor. The professional service agreement covers statements of work for various services as well as schedules of deliverables. Multiple statements of work for different services may be executed under a single professional service agreement. Thus, a single vendor may provide software configuration services pursuant to one statement of work and custom [SOFTWARE] development services pursuant to another. Importantly, each statement of work operates independently and separately from the others under the professional service agreement; the sale of software configuration services is therefore not dependent upon or otherwise connected with the sale of custom [SOFTWARE] development services. The vendor's sale of software (in the form of custom [SOFTWARE] development services) and the vendor's sale of configuration services are thus properly characterized as separate and distinct transactions.

The distinctness of the sales is further underscored by the fact that a single person will never perform both custom [SOFTWARE] development services and software configuration services. Persons who are authorized to perform software configuration services are not authorized to perform custom [SOFTWARE] development work. Similarly, from an organization viewpoint, one technology management group controls software configuration work, and a separate group controls software

development work. There is therefore no overlap of software development services and software configuration services.

Fourth, the software configuration consultants do not repair, maintain, or install the [COMPANY] software for the Taxpayer. Repair, maintenance, and installation of the [COMPANY] software is covered by the [COMPANY] software license agreement.

Accordingly, the services provided by the software configuration consultants are not subject to the Tennessee sales and use tax. Note, however, that if a statement of work were to include both software configuration services and custom [SOFTWARE] development services (or any other service that involves the creation, fabrication, installation, upgrade, or repair of software), the software configuration services would be subject to taxation as part of the sale of software.

2. Charges for services

The Retailers' Sales Tax Act, TENN. CODE ANN. § 67-6-101 *et seq.*, imposes the sales tax on the sales price of certain services enumerated by the statute. *Ryder Truck Rental, Inc. v. Huddleston*, 1994 WL 420911 (Tenn. Ct. App. Aug. 12, 1994). Charges for a service that is not enumerated by the statute may nevertheless be subject to the sales tax if such charges are included in the sales price of taxable services or tangible personal property. TENN. CODE ANN. § 67-6-102(82)(A) provides in pertinent part that the "sales price" of taxable services or tangible personal property is the "total amount of consideration . . . for which personal property or services are sold," including any services necessary to complete the sale, with no deduction for the seller's costs, labor, and so on.

Thus, if the seller charges a lump sum for all the goods and services sold, the sales price of the taxable goods and services will be the total amount of consideration paid. However, when the vendor sells an optional nontaxable service independent of the sale of taxable goods or services and separately charges for the various goods and services sold, the seller may not charge sales tax with respect to the independent nontaxable service.

Accordingly, in the Taxpayer's case, if a vendor separately charges for the software configuration services, the software configuration services are optional and sold independent of any taxable goods or services, and the software configuration services are not subject to taxation for the reasons set forth in the response to Question #1, the vendor may not charge Tennessee sales and use tax with respect to those services.

3. Procedure for claiming refunds of Tennessee sales tax paid

In the event that the Taxpayer desires a refund of sales taxes previously paid with respect to the services provided by the software configuration consultants, the Taxpayer's vendor must follow the procedure for claiming refunds set forth under TENN. CODE ANN. § 67-1-1802 (Supp. 2010).

With respect to a refund of sales taxes paid, TENN. CODE ANN. § 67-1-1802(a)(1) requires that the vendor first refund or credit the sales tax to its customer (in this case, the Taxpayer). TENN. CODE ANN. § 67-1-1802(a)(1) also requires that the vendor submit its claim for refund within three years from December 31 of the year in which the tax payment was made. The claim must set forth each ground upon which a refund is claimed, the amount of such refund, the tax period, the tax type, and any other information reasonably sufficient to apprise the Commissioner of Revenue of the general

basis for the refund claim.⁴ It is recommended that the vendor include a copy of this letter ruling with any claims for refund of sales taxes paid with respect to the services provided by the software configuration consultants.

If a claim is not determined within the six-month period following receipt of the claim by the Commissioner, the claim shall be deemed denied for the purpose of filing suit in chancery court. TENN. CODE ANN. § 67-1-1802(b)(2). The vendor must file suit on a denied refund claim in the appropriate Tennessee chancery court within one year from the date that the refund claim was filed with the Department. TENN. CODE ANN. § 67-1-1802(b)(1).

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: 06/23/2011

⁴ A Tennessee sales and use tax refund claim form is available on the Department's website at <http://state.tn.us/revenue/forms/sales/f1403301.pdf>.