

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-34**

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 applicability of the Tennessee sales and use tax single article cap to the sale and licensing of bundled software products.

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], [REDACTED], is engaged in the business of licensing prewritten computer software [REDACTED]. The Taxpayer has [NUMBER] primary product families. Each product family has core products and multiple optional products to choose from, and customers have the ability to pick and choose the components that will meet their particular business needs.

The Taxpayer also sells related software implementation services, optional software maintenance contracts, training services, and other professional services related to computer software.

The licensing of the Taxpayer's software is contracted under an end-user license agreement; the license agreement may be updated periodically, if necessary, by amendments to the original agreement. The license agreement grants the licensee a perpetual, nontransferable and nonexclusive license to use the products and related documentation. The agreement contains provisions that, among other things, restrict the licensee's duplication and use of the software. A Product License and Technical Services Order Form ("PTSO") is executed as an appendix to the license agreement; the licensed software is itemized on the PTSO in detail as to the specific product name, operating system, and license metric (as explained below, however, the portion of the sales price that is allocable to each product is not listed separately on the PTSO). There are various categories used to define the license metrics of a software product, including Maximum Measured Service Units ("MSU"). An MSU's rating, which the Taxpayer typically uses as the license metric for its mainframe products, reflects a specific central processing unit's processing capacity and speed.

There are two elements that factor into the determination of the price for the licensed software. The first element consists of the actual software product or products. The second element consists of the license metric granted for the product or products.

The Taxpayer bundles the components of the software license and the maintenance for software components and negotiates a single sales price. The consideration paid for the license and for maintenance of each separate software product is not listed separately on the invoice or on the PTSO. Rather, all software products sold in a single negotiation are totaled and invoiced as a single amount.

However, the cost of each product and the respective maintenance cost are recorded in the Taxpayer's internal billing records, which are not provided to the customer. Records showing the allocated cost of each software product and the maintenance charge for each product can be produced from the Taxpayer's internal billing system. Maintenance charges consist of tangible personal property in the form of updates and upgrades, as well as the intangible service of telephone support. There is no breakdown available in the billing system or anywhere else in the Taxpayer's records that specifies the portion of the maintenance charge that is attributable to the sale of updates and upgrades versus telephone support.

QUESTIONS

1. How is the "single article cap" for Tennessee's local option sales tax applied to the licensing of the Taxpayer's software products?
2. How is the Tennessee "single article" sales tax applied to the licensing of the Taxpayer's software products?

RULINGS

1. The Taxpayer's software products are not subject to the single article cap for purposes of Tennessee's local option sales tax. Therefore, the entire sales price will be subject to the local option sales tax.
2. Because the Taxpayer's software products are not subject to the single article cap for purposes of the local option sales tax, the Taxpayer's software products are not subject to the Tennessee "single article" sales tax.

ANALYSIS

1. The single article cap and the local option sales tax

The Taxpayer's software products are not subject to the single article cap for purposes of Tennessee's local option sales tax. Therefore, the entire sales price will be subject to the local option sales tax.

Under the Retailers' Sales Tax Act, TENN. CODE ANN. § 67-6-101 *et seq.*, retail sales of tangible personal property in Tennessee are subject to sales and use tax. TENN. CODE ANN. § 67-6-102(92)(A) (Supp. 2010) 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.¹ Additionally, TENN. CODE ANN. § 67-6-231(a) (Supp. 2010) specifically provides that the sale or use of computer software is subject to the sales and use tax.²

TENN. CODE ANN. § 67-6-702(a)(1) (Supp. 2010) authorizes counties and incorporated cities to impose an additional tax on the same privileges that are subject to the state sales and use tax (the "local option sales tax"). However, the local option sales tax, when applied to the sale of any single article of tangible personal property, only applies to the first \$1,600 of that sale.³ TENN. CODE ANN. § 67-6-702(d) defines the term "single article" for purposes of the local option sales tax as "that which is regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit or as a common unit of measure, a regular billing or other obligation." Additionally, TENN. CODE ANN. § 67-6-702(d) provides that "[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article."

¹ "Prewritten computer software" is "computer software ... that is not designed and developed by the author or other creator to the specification of a specific purchaser" and includes prewritten upgrades. TENN. CODE ANN. § 67-6-102(71).

² The term "sale" means in pertinent part "any transfer of title or possession, or both, lease or licensing, in any manner or by any means whatsoever of computer software for a consideration, and includes the creation of computer software on the premises of the consumer and any programming, transferring, or loading of computer software into a computer." TENN. CODE ANN. § 67-6-102(81). TENN. CODE ANN. § 67-6-387 (Supp. 2010) provides an exemption for computer software that is designed by a person for the person's own use.

³ The \$1,600 limit is referred to for purposes of this letter ruling as the "single article cap."

The Taxpayer's sales of bundled software constitute taxable sales under Tennessee law, thereby subjecting the sales of software to the local option sales tax. If the Taxpayer's sales are sales of single articles, then the local option sales tax will apply only to the first \$1600 of each sale. But, if the Taxpayer's sales are not sales of single articles, then the local option sales tax will apply to the entire sales price. Therefore, it is necessary to determine under what circumstances packaged or prewritten computer software products are "regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit." TENN. CODE ANN. § 67-6-702(d).

Prewritten computer software, as defined for purposes of the sales and use tax, is commonly understood to be a separate unit. Therefore, the single article cap generally will apply to the sale of prewritten computer software. Similarly, the Department also considers a license agreement that contemplates the transfer of rights to use certain prewritten computer software products to be a single article for purposes of the local option sales tax and the state single article sales tax, provided that the agreement separately itemizes the consideration to be paid for each separate prewritten computer software product and license. *See Honeywell Info. Sys. v. King*, 640 S.W.2d 553 (Tenn. 1982) (stating that taxpayer must treat sales of components as individual sales and not as a packaged sale for each component to be considered a single article).

In *Honeywell Info. Sys.*, 640 S.W.2d at 553, the taxpayer plaintiff leased computer components. The taxpayer's method of marketing, invoicing and record-keeping clearly demonstrated that it did not lease the component units of its computer systems as one single entity. Rather, it invoiced its customer for each of the components, each bearing its own serial number, and a specific monthly rental being charged for each component. The Tennessee Supreme Court held that since the taxpayer did not treat these components as "a single article of personal property" for purposes of its own leasing, invoicing and collections, the Commissioner for the Department of Revenue was likewise justified in treating them separately.

In *Executone of Memphis, Inc. v. Garner*, 650 S.W.2d 734 (Tenn. 1983), the Tennessee Supreme Court clarified that it is the character of each component, not how a taxpayer treats each component, that determines its status as a single article. The court dismissed the plaintiff's argument that the plugs, the switching systems, and the telephone units in a digital telephone switching system were components of a single article because no single component is sufficient on its own. The Court held that:

In applying the considerations set out in Rule 6 to the present case, it requires no distortion to conclude that the plugs, the switching systems, and the telephone units, as they are described here, are "commonly understood" to be separate units. The Plaintiff admits that these articles have unit prices, that they can be put together to meet various office needs, and that if the occasion arose they could be sold separately to one who needs a system alteration. **To conclude that only the system itself constitutes a single unit completely ignores the separate physical character of each component part, both in the design of the system and in the ultimate benefit to the customer.**

Executone of Memphis, 650 S.W. 2d at 737 (emphasis added). Thus, it is the character of each component, not how a taxpayer treats each component, that determines its status as a single article.

However, in *Colemill Enter., Inc. v. Huddleston*, No. 01A01-9605-CH-00218, 1996 WL 693677 (Tenn. Ct. App. Dec. 5, 1996), *rev'd on other grounds*, 967 S.W.2d 753 (Tenn. 1998), the Tennessee Court of Appeals held that the single article cap did not apply to a rebuilt airplane, because the plaintiff did not itemize the individual components and services separately on the invoice, with the result being that the Commissioner of Revenue had no means to determine the price of each individual component. The *Colemill* plaintiff rebuilt airplanes using numerous components, and claimed that the single article cap applied to the sale of the entire rebuilt airplane even though a portion of the sales price included charges for installation services (to which the single article cap does not apply). The Tennessee Court of Appeals rejected this argument, noting that the plaintiff charged one fee for an entire rebuilt airplane. Because the plaintiff did not itemize the individual components and services separately on the invoice, the Commissioner of Revenue had no means to determine the price of each individual component. The court agreed with the Commissioner that assessing tax on the full sales price was the only way the Commissioner could ensure that the full amount of the installation services were taxed, and that the aircraft parts were properly taxed as well. The single article cap therefore did not apply to the rebuilt airplane, and the entire sales price was subject to the local option sales tax.

Under the *Honeywell* and *Executone* analysis, software products are properly characterized as single articles. However, in keeping with the *Colemill* analysis, the sale of more than one of these items together for one price removes the sale from the limitation of the single article cap. Furthermore, consistent with the *Colemill* analysis, TENN. CODE ANN. § 67-6-702(d) provides that “[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article.”

Unlike the plaintiff in *Honeywell Info. Sys.*, the Taxpayer sells everything for a single lump sum price. Specifically, the Taxpayer bundles the components together and negotiates a single sales price with a customer; the consideration paid to license each separate software package is not listed separately on the invoice or on the PTSO. In a similar manner as the plaintiff in *Colemill*, the Taxpayer charges one non-itemized price for the sale of the core or basic software products, together with the optional components and the software maintenance.⁴

As illustrated in the *Colemill* decision and in TENN. CODE ANN. § 67-6-702(d), if a dealer does not allocate or determine a sales price corresponding to each single article, the single article cap generally will not apply, and the full sales price is subject to the local option sales tax. Because the Taxpayer’s sale of the core or basic software products, the optional components, and the software maintenance is not broken down but rather is negotiated with the customer for one single price, the sale will not be treated as the sale of individual single articles. Accordingly, the single article cap will not apply, and the total sales price of the software packages will be subject

⁴ Note that under TENN. CODE ANN. § 67-6-231(b)(1), the sale of a service contract covering the maintenance of computer software is a taxable service, and as such is subject to the local option sales tax. However, the single article cap only applies to the “sale or use of any single article of *personal property*.” TENN. CODE ANN. § 67-6-702(a)(1) (emphasis added). Thus, the sale of computer maintenance services, as a sale of services rather than personal property, is not subject to the single article cap, whether it is separately itemized or not.

to the local option sales tax. As such, the entire price of the sale is subject to the local sales tax. Note that if the Taxpayer itemized the prices for the core or basic software solutions and the optional components on its customers' invoices, each component of the sale would be considered a single article, except for the maintenance services (see footnote #4).

In summary, the Taxpayer's software products and maintenance services, when sold together for one non-itemized price, are not subject to the single article cap for purposes of the local option sales tax. The entire sales price therefore will be subject to the local option sales tax.

2. *The state single article tax*

Because the Taxpayer's software products are not subject to the single article cap for purposes of the local option sales tax, the Taxpayer's software products are not subject to the Tennessee "single article" sales tax.

TENN. CODE ANN. § 67-6-202(a) (Supp. 2010) imposes an additional state tax at the rate of 2.75 percent on the amount over \$1,600, but less than or equal to \$3,200, on the sale or use of any single article, as defined by TENN. CODE ANN. § 67-6-702(d), of tangible personal property (the "state single article sales tax"). As discussed above, the Taxpayer's sales of software products, because they are sold together for one non-itemized price, do not qualify as sales of single articles and as such are not subject to the single article cap. Therefore, it follows that the Taxpayer's sales are also not subject to the state single article tax.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

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