

PUBLICATION

Spotlight on Tennessee: Rulings Highlight Taxable and Non-Taxable Consulting Services

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Two recent letter rulings issued by the Tennessee Department of Revenue (Department) and posted on January 22, 2014 illustrate that nothing should be taken for granted in the sales and transactions taxes area when services are involved. Traditionally, sales, use and other transactions taxes have been imposed on sales of tangible personal property and only certain enumerated services. More recently, states are beginning to broadly expand their sales and other transactions tax bases to a range of services.

Tennessee remains in the traditional camp and subjects specifically-enumerated services to its sales and use tax. Services such as data processing, information services and management consulting services are generally not subject to Tennessee sales or use taxes. Conversely, Tennessee's local gross receipts tax, the business tax, does reach the gross receipts of a business providing management consulting or management services unless a specific exemption applies, such as health services.

In Letter Ruling #13-21, dealing with sales and use taxes, the taxpayer provided technology consulting services to customers using a "virtual lab." While the sale or license of computer software and hardware, as well as installation services related to software and hardware, are subject to Tennessee sales and use taxes, consulting and testing services generally are not. However, when non-taxable services are a necessary part of a sale of a taxable good or service, charges for the non-taxable service are subject to sales or use tax. The taxpayer's "virtual lab" provided software testing and demonstration services. The taxpayer would back up the customer's data, as well as test and demonstrate the functionality of software a customer was considering to purchase or license. Although installation of computer software is a specifically enumerated taxable service, no sale or license of software occurred. Any software installed in the virtual lab was owned or licensed by the taxpayer. If a customer decided to license the software, the taxpayer would remove the software that it had installed in the virtual lab. In short, since the taxpayer did not sell or license any tangible personal property, the Department ruled that its charges for the virtual lab were not taxable.

Conversely in Letter Ruling #13-16, dealing with the business tax, the taxpayer provided a range of management consulting services to health care facilities. Depending on the type of management or administrative service provided, the taxpayer charged a customer either an allocation of the taxpayer's costs or a customer was charged a management consulting fee at cost plus a profit markup. The Tennessee business tax is a local gross receipts tax that is imposed at different rates depending on the "dominant" business classification of a taxpayer. Management services are included in Classification 3, but medical, dental and allied health services to human beings are excepted from taxation. Since the taxpayer did not own health care facilities and did not provide services directly to patients or residents of a health care facility, the Department ruled that the taxpayer could not be considered as exempt from the tax based on the activity of its clients.

Further, and on a separate issue, when services are provided to an affiliated entity, only the profit element of the services charge is subject to the business tax. The taxpayer was a second-tier subsidiary of a sole shareholder. The sole shareholder also owned more than 50 percent of several of the taxpayer's clients. Nonetheless, the Department ruled that the ownership relationship did not satisfy the statutory definition of "affiliated entity" for purposes of the business tax so that the entire services charges, cost allocations and profit elements, were included in the measure of business tax.

Please note that while letter rulings are only applicable to the taxpayer being addressed, these letter rulings illustrate the nuances at play in the analysis of different types of consulting services and the taxability or non-taxability of such services under Tennessee's sales, use and business taxes. If you have questions about the foregoing letter rulings, please contact one of the attorneys in the Firm's Tax Group.