

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-15**

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 the sale of shop drawings for [TYPE OF ITEM].

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 his detriment.

FACTS

[TAXPAYER] is a Tennessee [TYPE OF ENTITY] that is in the business of creating and selling customized detailed shop drawings for [TYPE OF ITEM] to customers in Tennessee as well as in other states. The Taxpayer's [OWNER(S)] is not an architect, engineer, landscape architect, or interior designer. [TYPE OF ITEMS] are typically found in [REDACTED].

A general contractor or concrete subcontractor, when awarded a project, sends the Taxpayer the [TYPE OF] plans for the project. The Taxpayer then produces a shop drawing of each individual

[ITEM]. The shop drawing details the width and height of each individual [ITEM] and shows the location of all [ITEMS]. The shop drawings are specific to each [ITEM] for which the Taxpayer has been provided plans, and cannot be used for other [ITEMS]. The shop drawings are then transferred to the customer in the form of a booklet. However, the Taxpayer has indicated that it currently is implementing a system that will enable it to transfer the shop drawings electronically. It plans to utilize this system in the near future in at least some instances.

QUESTION

Is the sale of the shop drawings provided by the Taxpayer subject to the Tennessee sales and use tax?

RULING

Yes. The sale of the Taxpayer's shop drawings is subject to the Tennessee sales and use tax if the shop drawings are transferred to the customer via a tangible medium. However, if the shop drawings are transferred solely in electronic form, then the sale is not subject to the Tennessee sales and use tax.

ANALYSIS

Retail sales of tangible personal property and specifically enumerated services in Tennessee are subject to sales and use tax under TENN. CODE ANN. § 67-6-101 *et seq.*, unless specifically exempted from taxation. 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 part as "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."¹ TENN. CODE ANN. § 67-6-102(81)(A).

The Tennessee sales and use tax applies to the entire fee for design services if the shop drawings are transferred to the customer via a tangible medium (*e.g.*, in a booklet). If the shop drawings are transferred to the customer solely via electronic means, however, the fee for design services is not subject to the Tennessee sales and use tax.

Application of the Tennessee sales and use tax if the shop drawings are transferred via a tangible medium

When the Taxpayer transfers shop drawings to a customer in the form of a booklet, or via any other tangible medium, the sale of the shop drawings is subject to the Tennessee sales and use tax.

As noted above, the retail sale of tangible personal property and specifically enumerated services in Tennessee is subject to the Tennessee sales and use tax. TENN. CODE ANN. § 67-6-102(81)(A) defines a "sale" in part as "any transfer of title or possession, or both, exchange, barter, lease or

¹ TENN. CODE ANN. § 67-6-102(92)(A) defines "tangible personal property" as "personal property that can be seen, weighed, measured, felt, or touched."

rental, conditional or otherwise, in any manner or by any means whatsoever of *tangible personal property* for a consideration.” (Emphasis added.) The sale of *intangible* intellectual property, on the other hand, is not subject to the Tennessee sales and use tax.²

The requirement that there be consideration is clearly met in the Taxpayer’s case, because the Taxpayer transfers ownership and possession of the shop drawings to its customers for a fee. Thus, if the transaction is characterized as a sale of tangible personal property under the Tennessee sales and use tax laws, then the transfer of the shop drawings will be subject to the sales and use tax. However, if the transaction is characterized under the Tennessee sales and use tax laws as a sale of a service or a sale of intangible intellectual property, to which the Taxpayer’s shop drawings are merely incidental, then the transfer will not be subject to the sales and use tax. The issue then is whether the transaction in question constitutes a sale of tangible personal property or whether it constitutes a sale of services or intangible intellectual property to which the shop drawings are merely incidental.

The Tennessee Supreme Court addressed this issue in *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621 (Tenn. 1987). In that case, the taxpayer commissioned an advertising firm for the creation and development of design ideas for the marketing of the taxpayer’s publications. As part of the design ideas, the firm created advertising design models of promotional material, which it transferred to the taxpayer in tangible form. The state maintained that the transaction was taxable because a transfer of tangible personal property had occurred. The taxpayer argued that the models were incidental to the creative services that it received and therefore were nontaxable. *Id.* at 623. The court rejected the taxpayer’s argument and held that the advertising design models were not merely incidental to the services provided, but rather were a “crucial element” of the transaction. *Id.* at 624. Thus, the court found that the models were subject to the Tennessee sales and use tax.

The Tennessee Supreme Court emphasized the necessity of the models in conveying the design ideas, observing that if a model was destroyed, “the commissioned idea literally physically vanished.” *Id.* The court compared the design models to film reels in *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27 (Tenn. 1948). In that case, the Tennessee Supreme Court held that the rental of a motion picture contained on a film reel was the rental of tangible personal property and subject to the Tennessee sales and use tax. *Id.* at 29. The court stated that the intangible license to the motion picture separate and apart from the tangible film reel was without value because the taxpayer would have been unable to exhibit the movie without the film reel. *Id.* at 28.

However, the *Thomas Nelson* court distinguished the design models from magnetic tapes and punch cards containing software in *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (Tenn. 1976). In *Commerce Union*, the Tennessee Supreme Court found that the sale of software contained on magnetic tapes and punch cards did not constitute a sale of tangible personal property.³ The court stated that although the software was contained on tangible magnetic tapes and punch cards, such tangible transfer media were “merely incidental” to the sale of intangible

² As noted, specifically enumerated services are also subject to Tennessee sales and use tax under TENN. CODE ANN. § 67-6-205 (Supp. 2010). However, design services such as those offered by the Taxpayer are not one of the enumerated services.

³ The Tennessee legislature has since amended the definition of “tangible personal property” to include prewritten computer software. *See* TENN. CODE ANN. § 67-6-102(92)(A).

property. *Id.* at 408. Unlike the motion picture in *Crescent Amusement* and the design ideas in *Thomas Nelson*, neither of which could be utilized apart from the tangible media in which they were embodied, the software, once downloaded onto a computer, retained its value even when the magnetic tapes and punch cards were destroyed. *Id.* The court elaborated on this idea by pointing out that the software as contained on the tapes and punch cards was actually not ready to be used until it was downloaded onto a computer, and that the tapes and punch cards were therefore valueless once the software was downloaded. *Id.*

Much like the design models in *Thomas Nelson* and the film reels in *Crescent Amusement*, the Taxpayer's shop drawings are a crucial element of the transaction, rather than merely incidental to the design process. The Taxpayer's customers need the drawings in order to build the [TYPE OF ITEM]. Like the design models, if the shop drawings were destroyed, the Taxpayer's ideas would "physically vanish;" the design ideas cannot exist independently of the shop drawings. In fact, without the transfer of the shop drawings, the Taxpayer's services would be useless. Furthermore, unlike the software in *Commerce Union*, the shop drawings are ready to be used upon transfer to the customer and need no further processing.

In fact, the Taxpayer, in creating its shop drawings, is using [TYPE OF] plans that have been previously created by an architect or other licensed professional. In other words, the Taxpayer is basically producing a tangible product based on an intangible concept created by someone else; no new intangible intellectual property is being created.

Therefore, the transfer of the Taxpayer's shop drawings in the form of a booklet or other tangible medium constitutes a transfer of tangible personal property, rather than a transfer of intangible intellectual property, for the purposes of the Tennessee sales and use tax.⁴

The sales price of the shop drawings equals the fee charged for the entire project, including any charges for design services. Design services such as those offered by the Taxpayer are not a specifically enumerated service listed under TENN. CODE ANN. § 67-6-205 (Supp. 2010), and thus are not subject to sales and use taxation. However, when a sale of tangible personal property takes place in conjunction with the provision of services, the sales price of the tangible personal property includes any charges for related services. The definition of "sales price" under TENN. CODE ANN. § 67-6-102(82)(A) "applies to the measure subject to sales tax" and is defined in pertinent part as "the *total amount* of consideration ... for which personal property" is sold. (Emphasis added.) No deduction is permitted for the seller's cost of the property sold, labor costs, charges for services necessary to complete the sale, delivery charges, and so on. *Id.* Thus, charges for design services that lead to the development and creation of tangible personal property for retail sale to a customer are taxable as part of the sale of tangible personal property and cannot be separated out from the charges for the tangible personal property. See *Rivergate Toyota, Inc. v. Huddleston*, No. 01A01-9602-CH-00053, 1998 WL 83720 (Tenn. Ct. App.

⁴ Note that the Taxpayer's shop drawings are not exempt from the Tennessee sales and use tax under TENN. CODE ANN. § 67-6-354 (2006), which provides an exemption from the Tennessee sales and use tax for "any concept sketch, drawing, or model by an *architect, engineer, landscape architect or interior designer* that is used in the development of a *prototype* for manufacture or production." (Emphasis added.) First, the exemption applies only to drawings used to develop prototypes, and not to drawings used in producing the final, completed building. The Taxpayer's drawings are used to manufacture the actual [TYPE OF ITEM] themselves, not prototypes of the [TYPE OF ITEMS]. Second, the Taxpayer is not an architect, engineer, landscape architect, or interior designer, as required by the exemption. Therefore, the Taxpayer's shop drawings are not exempt from sales and use taxation under TENN. CODE ANN. § 67-6-354.

February 27, 1998) (holding that the taxpayer was liable for use tax on the “entire cost of the transaction,” which included costs allocable to labor, services, and other expenses). Therefore, the sales price of the shop drawings equals the fee charged for the entire project, including any charges for design services.

Accordingly, when the Taxpayer transfers shop drawings to a customer in the form of a booklet, or via any other tangible medium, the sale of the shop drawings is subject to the Tennessee sales and use tax.

Application of the Tennessee sales and use tax if the shop drawings are transferred solely via electronic means

When the Taxpayer transfers shop drawings to a customer solely via electronic means, the sale of the shop drawings is not subject to the Tennessee sales and use tax.

As noted above, the Tennessee sales and use tax is imposed on the retail sale of tangible personal property in Tennessee. TENN. CODE ANN. § 67-6-102(81)(A) defines the term “sale” in part as “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.” (Emphasis added.) In the case of the electronic transmission of the shop drawings, no transfer of tangible personal property occurs between the Taxpayer and its customer.

However, certain electronically transferred products are subject to the sales and use tax. TENN. CODE ANN. § 67-6-233 (Supp. 2010) imposes a tax on the sale, lease, license, or use of “specified digital products.” “Specified digital products” are defined to mean “electronically transferred digital audio-visual works, digital audio works, and digital books.” TENN. CODE ANN. § 67-6-102(89). Electronically transferred shop drawings do not come within the scope of this definition and are therefore not considered specified digital products that are subject to taxation.

Accordingly, no sale of tangible personal property takes place for purposes of the Tennessee sales and use tax when the Taxpayer transfers shop drawings to the customer solely in electronic form. Note, however, that the transaction is subject to the Tennessee sales and use tax if at any time possession of the shop drawings is transferred by the Taxpayer to its customer in tangible form, regardless of whether the customer also receives the shop drawings via electronic means.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: June 6, 2011