Refund Opportunity: Tennessee Court Says "Control Yourself, Or Pay Sales Tax"

Scott Siekierski
Dallas

In *Teksystems*, [1] the Tennessee Chancery Court ruled that the cost of temporary information technology workers provided by a third-party service company was not subject to sales tax because the client's control over the workers rendered the workers agents of the client. Tennessee Code Ann. § 67-6-102(34)(F), in effect during the audit period (1998-2000), imposed sales tax on the transfer, installation, maintenance, or repair of computer software by a third party. Code § 67-6-102(36)(b), in effect during the audit period, also contained an "inhouse created software" exemption to the sales tax, traditionally used to exempt software developed by a company's own employees from sales tax. The *Teksystems* decision is the first Tennessee decision to extend this exemption to projects performed by contract workers supplied by a temporary employment agency.

Teksystems (the taxpayer) was in the business of furnishing temporary information technology workers to supplement its client's IT departments for both short-term and long-term projects. The taxpayer argued that the inhouse-created software exemption applied to its services because the client exerted a sufficient degree of control over the contract workers to render the workers agents of the client—therefore the clients (via the contract workers) were creating software for their own use. After the Court affirmed that the central question was whether the contract employees were agents of the client, it distinguished between the level of control exerted over an independent contractor (control of the end result, but not the means) and an agent (control over both the end result and the means of reaching that result).

The Court then examined the relationship between the contract workers and the client. The Court found that the contract workers operated as agents because the client had sufficient control over the end result and the means the contract workers used to obtain the results. Specifically, the Court noted the client determined, assigned, oversaw, and directed each contract worker's specific tasks and projects. The Court also found that the contract workers worked side-by-side with full time employees, the contract workers only supplemented an existing IT department, the client made the decision whether to hire each contract worker, and the client negotiated vacation days, sick days, and personal days with each contract worker.

---

[1] *Teksystems v. Loren Chumley*, No. 06-177-III (Tenn. Ch. Ct. June 3, 2008).

The Department of Revenue enumerated a list of differences between the contract workers and full time employees, including differences in hiring procedures and standards, hourly versus salaried pay, and that the contract workers were not invited to the client's Christmas Party. The Court recognized that differences between the client's internal employees and the contract workers precluded their status as *de facto* employees of the client, but that such a relationship was not necessary to trigger the inhouse created software exception. Instead, the finding that the contract workers were agents of the client was sufficient. Teksystems had met its burden to show that the inhouse created software exemption applied.

Although the Court reached the correct result, its analysis may cause confusion because of its failure to distinguish a tax-exempt taxpayer from a tax-exempt transaction. The Court stated that the present case involved the doctrine that "a taxpayer can claim the *tax exempt status* of its client if the taxpayer is the agent of the client."[2] This concept stems from the U.S. Supreme Court's decision in *United States v. Boyd*,[3] where a contractor for the federal government asserted immunity from sales tax based upon its contention that it served as an agent of the federal government. The Tennessee court applied this doctrine in *Edwin B. Raskin Co. v. Ruth E. Johnson*[4] when it held the taxpayer exempt from sales tax because it operated a golf course as the agent for a tax exempt municipality. Subsequently, in *Sodexho Management, Inc. v. Johnson*,[5] the court held a supplier of food services for a university was not exempt from use tax because it was deemed an independent contractor, not an agent, of the university. The Tennessee Chancery Court in *Teksystems* stated that the theory in these cases was that the taxpayer "steps into the shoes of its tax-exempt client when it is the servant of that client."[6]

But unlike *Boyd*, *Raskin*, and *Sodexho*, Teksystems' argument was not contingent upon the tax-exempt status of its client. Teksystems' clients were not tax exempt. Teksystems' argument was instead based on the statutory definition of the taxable transaction, which expressly exempts "the fabrication of software by a person for such person's own use or consumption." In order for the court to determine whether the facts of the case fit this definition, the Court had to determine whether the contract workers functioned as agents of the client. However, the Court added confusion by implying that its agency analysis related to whether the taxpayer "steps into the shoes of a tax exempt client."[7] Any taxpayer, exempt or not, has the ability to argue that the transaction that took place is not taxable under the statutes imposing the tax.

---

[2] *Teksystems*, No. 06-177-III (Tenn. Ch. Ct. June 3, 2008) (emphasis added).

[3] 378 U.S. 39 (1964).

[4] No. 01-A-01-9708-CH-00392, 1998 WL (Tenn. Ct. App. May 15, 1998).

[5] 174 S.W.3d 174 (Tenn. Ct. App. 2004).

[6] *Teksystems*, No. 06-177-III (Tenn. Ch. Ct. June 3, 2008).

[7] *Teksystems*, No. 06-177-III (Tenn. Ch. Ct. June 3, 2008).

Corporations should be aware that Tennessee has modified its sales tax code numerous times since the 1998-2000 audit period at issue in *Teksystems*. Effective January 1, 2008, the computer software provisions of the Tennessee tax code had been repealed and replaced with Tenn. Code Ann. § 67-6-231 (2008), which states "The sale or use of computer software, including prewritten computer software, shall be subject to the tax levied by this chapter, regardless of whether such software is delivered electronically, by use of tangible storage media, or otherwise." Despite the fact that the express exemption for a "person's own use" was repealed, the agency theory espoused by the Court in *Teksystems* may still be a viable argument against the imposition of sales tax in a similar fact situation.