

**Tennessee Court of Appeals Upholds Sales Tax Exemption  
for Staff Augmentation Services – Significant Refund Opportunities Abound**

Like most states seeking to comply with the Streamlined Sales and Use Tax Project, Tennessee imposes a sales tax on the transfer, installation, maintenance or repair of computer software. See Tenn. Code Ann. § 67-6-102(36)(B) (2006); Tenn. Code Ann. § 67-6-231. Tennessee does not, however, impose a tax directly on the sales of staff augmentation services. Further, under a statutorily provided “in-house software exemption,” Tennessee exempts from sales and use tax “the fabrication of computer software by a person for the person’s own use and consumption.” See Tenn. Code Ann. § 67-6-102(36)(B) (2006); Tenn. Code Ann. § 67-6-387. In *TEKsystems, Inc. v. Farr*, No. M2008-01909-COA-R3-CV (Tenn. Ct. App. May 11, 2009), the Tennessee Court of Appeals upheld a trial court’s determination that the “in-house software exemption” applied to exempt from taxation the software-related services performed by temporary employees provided by a staff augmentation business. In doing so, the Court has provided an opportunity for taxpayers who have already paid taxes to Tennessee on similar services to seek significant refunds and has created the possibility that other services performed by the employees of staff augmentation services may also be exempt from sales tax in Tennessee and, in fact, in any other state that does not directly impose a sales tax on such services.

The plaintiff in *TEKsystems* provided temporary employees to work in its clients’ information technology (“IT”) departments. As is typical, each of these client companies had IT departments with significant internal staffing but would, on occasion, have the need for temporary assistance in completing a time sensitive project or rolling out a new software platform. Once assigned to the client companies, these temporary employees worked side-by-side with the clients’ full-time employees as part of the clients’ already existing IT workforce. At all times during their assignment, the temporary employees worked under the direction, supervision, and control of the clients’ internal employees. The clients were also solely responsible for determining and assigning the temporary employees’ specific tasks and projects and for overseeing and facilitating the temporary employees’ day-to-day work on those tasks and projects. As specific examples of the extent of the clients’ control over the temporary employees, the Court noted that the temporary employees worked at the clients’ offices and, often, as part of a larger IT team comprised largely of the clients’ full-time employees. The Court also noted that the clients determined the temporary employees’ hours, vacation days, and sick days and assigned the temporary employees to the location of their workspace and the deadlines for completing their specific tasks or assignments. The temporary employees also attended regular status meetings with the clients’ IT teams and were required to comply with the same dress codes, standards of conduct, and best practices as the client companies’ full-time employees. In contrast, the plaintiff had no control over the day-to-day activities of the temporary employees and, indeed, had very limited contact with the temporary employees once they were assigned to the client companies.

Based on these facts, the Tennessee Court of Appeals found that, during their assignments with client companies, the temporary employees acted as the client companies’ agents, and the services performed by the temporary employees, therefore, qualified for the “in-house software exemption” from Tennessee’s sales tax. In support of this conclusion, the Court found that the facts of the case showed the client companies “not only had the right to control”

the temporary employees, but “did in fact consistently exercise extensive, if not complete, control” over the temporary employees. Accordingly, the Court found that the temporary employees acted as agents of the clients to whom they were assigned, and the services performed by those temporary employees were exempt from sales tax under the “in-house software exemption.”

The Court’s decision in *TEKsystems* has several important implications. The first is the most obvious. Under the Court’s ruling, any staff augmentation business that provides temporary employees to work for its clients on software-related projects is potentially free from sales tax liability with regard to those employees. To qualify for this exemption, a staff augmentation business must show the temporary employees act as the clients’ agents, rather than as independent contractors. Importantly, and as the Court expressly held in its decision, this determination cannot be controlled by simply looking to whether a contract between the parties labels the temporary employees as independent contractors or agents but, instead, must be made by considering the “surrounding facts and circumstances” of a client’s relationship with temporary employees. Considering those “facts and circumstances” under a traditional agency analysis, whether temporary employees are the agents of the clients to whom they are assigned depends on the “extent of the control exercised” over the temporary employees. If clients exercise control only with regard to the end result of temporary employee services – such as is the case when a software deliverable is purchased – a temporary employee is an independent contractor. On the other hand, if a client’s control is over “the means as well as the result” of a temporary employee’s services, there is an agency relationship.

Consequently, software-related services performed by temporary employees of a staff augmentation business qualify for the “in-house software exemption” if the clients control the means and methods the temporary employees use when performing their services. In *TEKsystems*, the Court found that the temporary employees “were not hired to develop a predetermined ‘end product,’” but, rather, “augmented or supplemented the client’s already existing information technology department.” Further, the Court found that the clients “exerted control over both the means and methods of the work” performed by the temporary employees. As a result, the Court held that the temporary employees were the clients’ agents and all software-related services performed by those temporary employees qualified for the “in-house software exemption” from Tennessee sales and use tax. If other staff augmentation businesses can make a similar showing, it is likely that any software fabrication, repair, maintenance, or installation services performed by the temporary employees provided by those businesses during their assignments with client companies will likewise be exempt from Tennessee sales tax under the “in-house software exemption.” Further, any provider of such staff augmentation services that has already paid sales taxes to Tennessee in connection with the sales of those services is entitled to receive a refund of those taxes to the extent allowed under Tennessee’s statute of limitations applicable to claims for refunds, where refunds must be claimed within three years of December 31 of the year in which the taxes were paid. Accordingly, refund claims are currently available for all such taxes paid in the year 2006 or later.

A further possible implication of the *TEKsystems* case is that a traditional agency analysis may provide staff augmentation businesses with an exemption from Tennessee sales tax well beyond the limits of software-related services. In its decision, the Court noted that Tennessee

law has long applied an agency analysis to a wide variety of taxes and in a wide variety of circumstances to determine whether a party that would otherwise be liable for such taxes was, nevertheless, exempt from those taxes due to its business relationship with a tax exempt client. As stated by the Court, the consistent theory in those cases has been that a taxpayer “steps into the shoes of its tax-exempt client” due to an agency relationship with the client. Under this analysis, an agency relationship between temporary employees provided by staff augmentation services and the clients to whom those temporary employees are assigned should prevent sales tax liability from arising regardless of the nature of services provided and even in the absence of specific statutory exemption like the “in-house software exemption.” Because Tennessee does not impose a sales tax directly on the provision of staff augmentation services, sales tax is only imposed on the services provided through staff augmentation businesses if the temporary employees provided by those businesses perform taxable services for the client companies. If the temporary employees are agents of the clients, however, the performance of those services is attributed to the clients themselves and treated no differently than if they had, in fact, been performed by those clients’ internal employees. In those circumstances – when a client performs services for itself – no sales tax liability could possibly arise because there simply has not been any transfer or sale of any good or service.

This logic was implicitly recognized in the *TEKsystems* case because, under the facts of that case, the temporary employees provided by the staff augmentation business performed other potentially taxable services in addition to the software-related services – such as the repair and maintenance of hardware – and yet, because the temporary employees were the client’s agents, those services were not taxable. Accordingly, the *TEKsystems* case can be seen as extending an exemption from Tennessee sales tax to all staff augmentation businesses whenever an agency relationship exists between the temporary employees provided by that business and the clients of the business. Certainly, for those companies that find themselves in circumstances similar to those that existed in *TEKsystems* (which likely includes any company with a significant IT department), immediate attention should be given to the refund opportunities that likely exist for the providers of staff augmentation services that had previously collected sales taxes on such services.

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