

This letter concerns computer software maintenance agreements. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

May 26, 2011

Dear Xxxxx:

This letter is in response to your letter dated May 11, 2011, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

My client, hereafter referred to as 'Company', will be entering into contracts with customers. The contracts are for the licensing of prewritten software which qualifies as a non-taxable [sic] license of software under Illinois Department of Revenue (IL-DOR) Regulation § 130-1935 a) 1). In addition, the Company sells maintenance contracts which provide technical support services and software updates, corrections and upgrades (updates). The software maintenance contracts are sold separately from the software license and it is not mandatory that the customers purchase a maintenance contract. The selling price of the services and the software updates are not separately priced. Customers purchasing the optional maintenance contracts are entitled to services and software updates, corrections and upgrades for a lump sum price for a specific and limited time period.

The IL-DOR Regulation § 130-1935 is very specific regarding the any [sic] charges for software updates and states in § 130-1935 b):

Charges for updates of canned software are considered to be sales of software. Charges for training, telephone assistance, installation and consultation are exempt if they are separately stated from the selling price of canned software.

We have a question as to whether or not the Company's sales of maintenance contracts [sic] are subject to sales tax in Illinois. The maintenance contracts include software updates and the charges for services are not separately stated. However, the software license is not subject to tax.

Under the circumstances described above and subject to the assumption that the software license qualifies as non-taxable [sic] under § 130.1935 a) 1): are sales of maintenance contracts in support of the licensed software subject to tax when the services and software updates are delivered in Illinois?

Please provide a written response. If you have any questions, please call me.

DEPARTMENT'S RESPONSE:

In general, maintenance agreements that cover computer software are treated the same as maintenance agreements for other types of tangible personal property. See 86 Ill. Adm. Code 130.1935(b). The taxation of maintenance agreements is discussed in subsection (b)(3) of Section 140.301 of the Department's administrative rules under the Service Occupation Tax Act. See 86 Ill. Adm. Code Sec. 140.301(b)(3). The taxability of agreements for the repair or maintenance of tangible personal property depends upon whether charges for the agreements are included in the selling price of the tangible personal property. If the charges for the agreements are included in the selling price of the tangible personal property, those charges are part of the gross receipts of the retail transaction and are subject to tax. In those instances, no tax is incurred on the maintenance services or parts when the repair or servicing is performed. A manufacturer's warranty that is provided without additional cost to a purchaser of a new item is an example of an agreement that is included in the selling price of the tangible personal property.

If agreements for the repair or maintenance of tangible personal property are sold separately from tangible personal property, sales of those agreements are not taxable transactions. However, when maintenance or repair services or parts are provided under those agreements, the service or repair companies will be acting as service providers under provisions of the Service Occupation Tax Act that provide that when service providers enter into agreements to provide maintenance services for particular pieces of equipment for stated periods of time at predetermined fees, the service providers incur Use Tax based on their cost price of tangible personal property transferred to customers incident to the completion of the maintenance service. See 86 Ill. Adm. Code 140.301(b)(3). The sale of an optional maintenance agreement or extended warranty is an example of an agreement that is not generally a taxable transaction.

If, under the terms of a maintenance agreement involving computer software, a software provider provides a piece of object code ("patch" or "bug fix") to be inserted into an executable program that is a current or prior release or version of its software product to correct an error or defect in software or hardware that causes the program to malfunction, the tangible personal property transferred incident to providing the patch or bug fix is taxed in accordance with the provisions discussed above.

In contrast to a patch or bug fix, if the sale of a maintenance agreement by a software provider includes charges for updates of canned software, which consist of new releases or new versions of the computer software designed to replace an older version of the same product and which include product enhancements and improvements, the general rules governing taxability of maintenance agreements do not apply. This is because charges for updates of canned software are fully taxable

as sales of software under Section 130.1935(b). (Please note that if the updates qualify as custom software under Section 130.1935(c) they may not be taxable). Therefore, if a maintenance agreement provides for updates of canned software, and the charges for those updates are not separately stated and taxed from the charges for training, telephone assistance, installation, consultation, or other maintenance agreement charges, then the whole agreement is taxable as a sale of canned software.

If all the criteria listed in subsection (a)(1) of Section 130.1935 are met, then neither a transaction involving the licensing of that computer software nor the subsequent software updates for that software will be considered a taxable retail sale subject to Retailers' Occupation and Use Tax. See 86 Ill. Adm. Code 130.1935(a)(1)(A)-(E).

Assuming a license of software meets the requirements of subsection (a)(1) of 86 Ill. Adm. Code 1935, any charges for support, maintenance or updates of the licensed software provided pursuant to the qualified license agreement would not be subject to Retailer's Occupation Tax, whether or not the charges for support, maintenance or updates of the licensed software are billed pursuant to the terms of the license agreement or the terms of a separate agreement as long as the software updates are subject to the provisions of the qualified license agreement.

I hope this information is helpful. If you require additional information, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Associate Counsel

RSW:mzk