

This letter discusses the taxability of computer software licenses. See 86 Ill. Adm. Code 130.1935.
(This is a PLR.)

July 24, 2014

Dear Xxxx:

This letter is in response to your letter dated May 2, 2014, 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.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY, Inc for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY, nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

On behalf of our client COMPANY, (hereafter referred to as “COMPANY” or “client”), we are requesting a private letter ruling pertaining to the sales and use taxability of certain software products. Our client is requesting this opinion from you in order to better comply with your jurisdiction’s tax collection and reporting requirements. We are providing the following facts in regards to our client company and some of its software products.

Company Description

Our client helps companies develop and deliver mobile and web apps rapidly and with quality. Our client provides an end-to-end solution that includes software and services to help companies confront the development and operations collaboration challenges posed by rapid development and delivery of new apps.

PHP is a widely-used open source general-purpose scripting language that is used for web development. Our client uses this open source technology that can be found for free and added value with development tools to run and manage the PHP applications. The product values are found in both these development tools and the PHP support services that are provided with the software on a subscription basis.

It is important to note that COMPANY was founded by [xxxx] and they promote the open source PHP community. As an active contributor to the open source PHP community, our client offers free solutions to customers. A customer can download the free version and create a developer environment for running applications. They can use the COMPANY forums to discuss and troubleshoot their project with other PHP developers.

And with our client's integrated solutions, developers can rapidly build, deploy, and sustain best-in-class applications for web, mobile, and cloud environments. Using our client's products, development and operations teams can work collaboratively and support faster release cycles for these types of applications.

COMPANY Software Products

Some of our client's most common software products and subscriptions include the following:

PRODUCT A: PRODUCT A is an enterprise-ready platform for deploying, running, and managing mobile and web apps. PRODUCT A equips development and operations teams with the software and infrastructure to support application releases, and it provides PHP applications with a high level of reliability, performance, and security, both on-premise and in the cloud.

PRODUCT B: The community edition of PRODUCT A is a free, complete PHP version that is suited for developing PHP applications or running non-critical applications in production. This is the free version and does not include the added value functionality and support for PRODUCT A.

PRODUCT C: PRODUCT C gives professional PHP developers the tools to write and maintain PHP code faster, solve problems more quickly, develop in the cloud, and improve team collaboration.

PRODUCT D: PRODUCT D is a PHP encoding and obfuscation product on the market that protects the company's application from unlicensed use and reverse engineering.

PRODUCT E: With the PRODUCT E Subscription, a company will get the right to use our client's software solutions on an unlimited number of servers for developing, running, and managing PHP web applications:

- PRODUCT A
- PRODUCT C
- Technical Support

PRODUCT F: PRODUCT F combines PRODUCT C IDE for writing PHP and JavaScript code and PRODUCT A Development License for running, optimizing, and troubleshooting the company's applications, and is backed up by a Service Level Agreement (SLA) from COMPANY Support, ensuring that the company's development process is always performing at maximum capacity.

Written Agreement Signed by Both Parties

When a company is interested in purchasing our client's software products and/or subscriptions, the parties will enter into an agreement as evidenced in writing that is signed by both parties. The written agreement will typically include the product names, price, terms and conditions, and any additional notes and/or information. For PRODUCT A and PRODUCT E products, the license usage conditions are included that specify restrictions on licensing, sublicensing, and transferring the software to third parties.

End-User License Agreement

A copy of the End-User License Agreement ("EULA") for the various COMPANY software products is available at the following web link:

XXXXXXXXXXXXXXXXXXXXXXXXXX

Since COMPANY products are used to run critical applications in production, each license includes an additional version of the free, open source PHP. If a license is not renewed, the customer's production applications will revert to the free, unsupported version. They will lose the added-value development tools and support but their applications will continue to run. The EULA is written to support both COMPANY product licenses and the open source version.

The relevant provisions of the EULA are as follows:

1.1. Grant of License. COMPANY hereby grants to you, and you accept, a limited, nonexclusive, non-transferable license to use the Software in machine-readable, object code form only, and the user manuals accompanying the Software (the "Documentation"), only as authorized in this Agreement, and subject to compliance with the terms of this Agreement, and payment of all applicable license fees....

1.3. Restrictions, Copies and Modifications. You may not reverse engineer, decompile, disassemble, or otherwise translate the Software or any license keys you have obtained. You may not modify or adapt the Software or any license keys that you have obtained in any way. You may make one copy of the Software, the Documentation, and any license keys that you have obtained, solely for backup or archival purposes. Any such copies of the Software, Documentation, or license keys shall include any copyright or other proprietary notices that were included on such materials when you first received them. Except as authorized in this Section, no copies of the Software, Documentation, or license keys, or any portions thereof, may be made or distributed by you or any person under your authority or control. You may not allow third party use of the Software or use of the Software as a service bureau.

1.4. Assignment of Rights. You will not sublicense, lease, rent, or lend your rights in the Software, Documentation, or license keys, as granted by this Agreement, to any party without prior written consent of COMPANY.

1.5. Product Specific Special Terms. The provisions of this Section are applicable to the specific product mentioned and are exceptions to other provisions of this Agreement, and serve to modify such provisions only to the extent such provisions relate to these products.

PRODUCT A – Notwithstanding anything to the contrary set forth in this Agreement, you are permitted to duplicate and distribute the PRODUCT A product, on a standalone basis or combined with other products, provided (i) you do not make any modifications to PRODUCT A and distribute the entire PRODUCT A product, (ii) you do not modify or remove any proprietary rights notices or markings, or remove or modify this Agreement as included in any such distribution, (iii) you clearly indicate that PRODUCT A is included in your distribution, (iv) you do not use COMPANY's name, logos or trademarks or the name, logos and trademarks of any included third party software in any way that might state or imply COMPANY's or third party's endorsement of your product, and **(v) you do not transfer with any such copy any license keys for PRODUCT A. PRODUCT A distributed without a license key will operate with only reduced functionality and if a license key for PRODUCT A expires and is not renewed, it will continue to operate with only reduced functionality. This reduced functionality version is licensed on a perpetual basis, without charge, subject to compliance with the terms of this Agreement....** (Emphasis added.)

PRODUCT C – PRODUCT C is not available for you to distribute. If the license key for PRODUCT C expires and is not renewed for a subscription or limited term license, PRODUCT C will continue to operate with only reduced functionality. This reduced functionality version is licensed on a perpetual basis, without charge, subject to compliance with the terms of this Agreement.

PRODUCT D – PRODUCT D is not available for you to distribute. However, you may distribute COMPANY Optimizer and PRODUCT D Loader (the runtime c components for encoded files) to your end customers, provided that your end user customers enter into an end user agreement that contains at a minimum the following provisions covering the COMPANY embedded components: (i) prohibits reverse compilation and/or reverse assembly, (ii) disclaims all warranties, and (iii) disclaims liability for any indirect, incidental or consequential damages....

2.3. Proprietary Rights to Software and Trademarks. ...This Agreement does not grant you any ownership interest in or to the Software or the Documentation,

but only a limited right of use that is revocable in accordance with the terms of this Agreement....

2.4. Confidentiality. You shall permit only authorized users, who possess rightfully obtained license keys, to use the Software or to view the Documentation. Except as expressly authorized by this Agreement, you shall not make available the Software, Documentation, or any license key to any third party. You will use your best efforts to cooperate with and assist COMPANY in identifying and preventing any unauthorized use, copying, or disclosure of the Software, Documentation, or any portion thereof....

5. Term and Termination

...You may terminate this Agreement at any time by: (i) providing written notice of your decision to terminate the Agreement to COMPANY and (ii) either returning the Software, Documentation, all copies, thereof, and all license keys that you have obtained to COMPANY or destroying all such materials and providing written verification of such destruction to COMPANY.... Upon termination of this Agreement, you agree to either return to COMPANY the Software, Documentation, all copies thereof, and all license keys that you have obtained, or to destroy all such materials and provide written verification of such destruction to COMPANY.

Questions

1. Are sales of PRODUCT A subject to Illinois sales and use taxes?
2. Are sales of PRODUCT C subject to Illinois sales and use taxes?
3. Are sales of PRODUCT E Subscription subject to Illinois sales and use taxes?

Proposed Responses

1. We hereby propose that sales of PRODUCT A are not subject to Illinois sales and use tax based on Ill. Admin. Code 86 §130.1935(a)(1).
2. We hereby propose that sales of PRODUCT C are not subject to Illinois sales and use tax rate based on Ill. Admin. Code 86 §130.1935(a)(1).
3. We hereby propose that sales of PRODUCT E Subscription are not subject to Illinois sales and use tax rate based on Ill. Admin. Code 86 §130.1935(a)(1).

Discussions – PRODUCT A

We believe that PRODUCT A qualifies for the non-taxable treatment under Ill. Admin. Code 86 §130.1935(a)(1) because it meets all 5 conditions listed in the Illinois regulations. The Illinois regulations provide that the software license is not a taxable retail sale if:

1. It is evidenced by a written agreement signed by the licensor and the customer;
2. It restricts the customer's duplication and use of the software;
3. It prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;
4. The licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and
5. The customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

The first condition is met because when a company is interested in purchasing our client's software products and/or subscriptions, the parties will enter into an agreement as evidenced in writing that is signed by both parties. The written agreement will typically include the product names, price, terms and conditions, and any additional notes and/or information. For PRODUCT A and PRODUCT E products, the license usage conditions are included that specify restrictions on licensing, sublicensing, and transferring the software to third parties.

The second condition is met based on Sections 1.3, 1.4, and 2.3 of EULA;

1.3. Restrictions, Copies and Modifications. You may not reverse engineer, decompile, disassemble, or otherwise translate the Software or any license keys you have obtained. You may not modify or adapt the Software or any license keys that you have obtained in any way. You may make one copy of the Software, the Documentation, and any license keys that you have obtained, solely for back up or archival purposes. Any such copies of the Software, Documentation or license keys shall include any copyright or other proprietary notices that were included on such materials when you first received them. Except as authorized in this Section, no copies of the Software, Documentation, or license keys, or any portions thereof, may be made or distributed by you or any person under your authority or control. You may not allow third party use of the Software or use of the Software as a service bureau.

1.4. Assignment of Rights. You will not sublicense, lease, rent, or lend your rights in the Software, Documentation, or license keys, as granted by this Agreement, to any party without prior written consent of COMPANY....

2.3. Proprietary Rights of Software and Trademarks. ...This Agreement does not grant you any ownership interest in or to the Software or the Documentation, but only a limited right of use that is revocable in accordance with the terms of this Agreement....

The third condition is met based on Sections 1.1, 1.3, 1.4, 1.5 and 2.4 of EULA:

1.1. Grant of License. COMPANY hereby grants to you, and you accept, a limited, nonexclusive, non-transferable license to use the Software in machine-readable, object code form only, and the user manuals accompanying the Software (the "Documentation"), only as authorized in this Agreement, and subject to compliance with the terms of this Agreement, and payment of all applicable license fees....

1.3. Restrictions, Copies and Modifications. ...Except as authorized in this Section, no copies of the Software, Documentation, or license keys or any portions thereof, may be made or distributed by you or any person under your authority or control. You may not allow third party use of the Software or use of the Software as a service bureau.

1.4. Assignment of Rights. You will not sublicense, lease, rent, or lend your rights in the Software, Documentation, or license keys, as granted by this Agreement, to any party without prior written consent of COMPANY.

1.5. Product Specific Special Terms. The provisions of this Section are applicable to the specific product mentioned and are exceptions to other provisions of this Agreement, and serve to modify such provisions only to the extent such provisions relate to these products.

PRODUCT A – Notwithstanding anything to the contrary set forth in this Agreement, you are permitted to duplicate and distribute the *PRODUCT A* product, on a standalone basis or combined with other products, provided (i) you do not make any modifications to *PRODUCT A* and distribute the entire *PRODUCT A* product, (ii) you do not modify or remove any proprietary rights notices or markings, or remove or modify this Agreement as included in any such distribution, (iii) you clearly indicate that *PRODUCT A* is included in your distribution, (iv) you do not use COMPANY's name, logos or trademarks for the name, logos and trademarks of any included third party software in any way that might state or imply COMPANY's or a third party's endorsement of your product, and (v) you do not transfer with any such copy any license keys for *PRODUCT A*. *PRODUCT A* distributed without a license key will operate with only reduced functionality and if a license key for *PRODUCT A* expires and is not renewed, it will continue to operate with only reduced functionality. This reduced functionality version is licensed on a perpetual basis, without charge, subject to compliance with the terms of this Agreement....

2.4. Confidentiality. You shall permit only authorized users, who possess rightfully obtained license keys, to use the Software or to view the Documentation. Except as expressly authorized by this Agreement, you shall not make available the Software, Documentation, or any license key to any third party. You will use your best efforts to cooperate with and assist COMPANY in identifying and preventing any unauthorized use, copying, or disclosure of the Software, Documentation, or any portion thereof.

The fourth condition is met based on Section 1.3 of EULA:

1.3. Restrictions, Copies and Modifications. ...You may make one copy of the Software, the Documentation, and any license keys that you have obtained, solely for backup or archival purposes. Any such copies of the Software,

Documentation, or license keys shall include any copyright or other proprietary notices that were included on such materials when you first received them....

The fifth condition is met based on Section 5 of EULA:

5. Term and Termination

...You may terminate this Agreement at any time by: (i) providing written notice of your decision to terminate the Agreement to COMPANY and (ii) either returning the Software, Documentation, all copies thereof, and all license keys that you have obtained to COMPANY or destroying all such materials and providing written verification of such destruction to COMPANY.... Upon termination of this Agreement, you agree to either return to COMPANY the Software, Documentation, all copies thereof, and all license keys that you have obtained, or to destroy all such materials and provide written verification of such destruction to COMPANY.

Please note, however, that for PRODUCT A, there are more complexities involved in determining whether it meets the third condition of Ill. Admin. Code 86 §130.1935(a)(1) since the EULA is written for both the PRODUCT A and the PRODUCT B. Specifically, Section 1.5 of EULA provides the following:

1.5. Product Specific Special Terms. The provisions of this Section are applicable to the specific product mentioned and are exceptions to other provisions of this Agreement, and serve to modify such provisions only to the extent such provisions relate to these products.

PRODUCT A – Notwithstanding anything to the contrary set forth in this Agreement, you are permitted to duplicate and distribute the PRODUCT A product, on a standalone basis or combined with other products, provided (i) you do not make any modifications to PRODUCT A and distribute the entire PRODUCT A product, (ii) you do not modify or remove any proprietary rights notices or markings, or remove or modify this Agreement as included in any such distribution, (iii) you clearly indicate that PRODUCT A is included in your distribution, (iv) you do not use COMPANY's name, logos or trademarks or the name, logos and trademarks of any included third party software in any way that might state or imply COMPANY's or a third party's endorsement of your product, and (v) you do not transfer with any such copy any license keys for PRODUCT A. PRODUCT A distributed without a license key will operate with only reduced functionality and if a license key for PRODUCT A expires and is not renewed, it will continue to operate with only reduced functionality. This reduced functionality version is licensed on a perpetual basis, without charge, subject to compliance with the terms of this Agreement.

COMPANY explicitly allows its customers to duplicate and distribute PRODUCT A (either on a standalone basis or combined with other products) provided that its customers follow the additional restrictions/conditions imposed by COMPANY. However, the license key contains coded security features that will not permit the fully functioning version of PRODUCT A to be transferred. In addition, the license key is connected to

the customers support contract, so any transfer to a third party, or expiration of the security key, results in no customer support by our client.

We strongly believe that PRODUCT A meets the third condition set out in the Illinois regulations. (1) PRODUCT A prohibits the customer from licensing sublicensing or transferring the software to a third party without the permission of the licensor, and such permission is given as an exception in accordance to Section 1.5 of EULA. (2) And when such permission is given, the licensor remains to have certain continuing control of the software license, as it places additional restrictions/conditions on Section 1.5 of EULA. (3) Most importantly, PRODUCT A distributed without a license key can only operate with only reduced functionality, and if a license key for PRODUCT A expires and is not renewed, it will continue to operate with only reduced functionality. The software product will revert to the open source development version, and the end-user will lose a lot of the functionality. Operating the software with reduced functionality could very well mean that the software may be inoperable for the end-users (or at least not operating as intended by the end-users).

Discussions – PRODUCT C Subscription

PRODUCT C gives professional PHP developers the tools to write and maintain PHP code faster, solve problems more quickly, develop in the cloud, and improve team collaboration.

We believe that any standalone sale of PRODUCT C would be non-taxable as it meets all 5 conditions listed in Ill. Adm. Code 86 §130.1935(a)(1). The same analysis already outlined above would apply to PRODUCT C, except that the third condition is easily met based on Section 1.5 of EULA:

1.5. Product Specific Special Terms. The provisions of this Section are applicable to the specific product mentioned and are exceptions to other provisions of this Agreement, and serve to modify such provisions only to the extent such provisions related to these products.

....
PRODUCT C – PRODUCT C is not available for you to distribute....

Discussions – PRODUCT E Subscription

With PRODUCT E Subscription, a company will get the right to use our software solutions on an unlimited number of their servers for developing, running, and managing PHP web applications:

- PRODUCT A
- PRODUCT C
- Technical Support

We believe that any standalone technical support service would be non-taxable in the state of Illinois.

If the Department decides to rule that both PRODUCT A and PRODUCT C are not taxable based on Ill. Adm. Code 86 §130.1935(a)(1), then all three components of the PRODUCT E Subscription would not be subject to Illinois sales and uses taxes.

If, however, the Department decides to rule that PRODUCT A or PRODUCT C is taxable because it does not meet all 5 conditions listed in Ill. Admin. Code 86 §130.1935(a)(1), then only two of the three components of the PRODUCT E Subscription would be non-taxable. Then the issue is whether PRODUCT E Subscription would be taxable or not when the entire subscription is bundled and sold as one price.

We strongly believe that PRODUCT E Subscription should be non-taxable even if the Department decides to rule that PRODUCT A or PRODUCT C is subject to tax. (1) If at least two of the three components of the PRODUCT E Subscription are not taxable, it would then appear that the predominant nature of the transaction would be the non-taxable components of the subscription. (2) And even if the Department decides to rule that PRODUCT A is taxable, PRODUCT A at most only fails one of the 5 conditions set out in Ill. Admin. Code 86 §130.1935(a)(1). In other words, sales of PRODUCT A would be “almost” treated as non-taxable sales. So if two of the three components are non-taxable, and the other component would be “almost” treated as non-taxable, then it appears that the predominant nature of the transaction would be non-taxable.

Thank you in advance for your timely response to this private letter ruling request. Please provide any statutory or regulatory guidance related to your ruling where applicable. We also request this private letter ruling not to be published or otherwise make available to the general public if possible.

DEPARTMENT’S RESPONSE:

The Department does not typically issue private letter rulings regarding the taxability of specific licenses of prewritten (canned) software. It is the Department’s position that its regulation at 86 Ill. Adm. Code 130.1935 is sufficiently clear for a licensee or licensor to determine whether a specific license of prewritten computer software meets the requirements of subsection (a)(1) of that rule. The Department has reviewed the information and the license agreement that you have provided. Your letter presents a unique, fact-specific scenario which requires more guidance. Based on our understanding of the terms of the licensing agreement, it is the opinion of the Department that sales of PRODUCT A, PRODUCT C, and PRODUCT E Subscription are not taxable retail sales.

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

COMPANY

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I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, 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
Chairman, Private Letter Ruling Committee

RSW:CB:ikm