

This letter discusses the taxability of computer software licenses and maintenance agreements. See 86 Ill. Adm. Code 130.1935 and 86 Ill. Adm. Code 140.301. (This is a GIL.)

April 4, 2014

Dear Xxxxx:

This letter is in response to your letter dated January 24, 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.

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:

We have recently undergone a State of Illinois sales tax audit and the auditor involved found that our maintenance agreements were tax exempt. However, we think it advisable to have a letter from the Department validating that finding before announcing the taxability of maintenance agreements to our clients in Illinois.

Therefore, we would like to request a Letter of Ruling regarding Illinois Sales and Use Tax on Computer Software and Hardware Maintenance agreements to Credit Unions. We are a value added reseller of technology-related equipment, software, etc. We also sell maintenance agreements for the products we sell and maintain staff in Indiana to provide service and support on those products.

In reviewing the Illinois regulations regarding sales tax on maintenance agreements, we were left unclear about exactly whether or not our maintenance agreements are subject to sales tax. We found 5 criteria that we understand to be used to determine whether or not computer maintenance agreements are taxable and we cite areas in our purchase agreements that we believe fulfill these criteria for tax exemption:

- A)** it is evidenced by a written agreement signed by the licensor and the customer;
 - We have this with every customer.

- B)** it restricts the customer's duplication and use of the software;
 - we are covered here by this provision.

7.1 **Software Products, Enhancements and New Products.** Customer agrees that COMPANY owns the exclusive proprietary rights in the Software Products, Service Bureau, Enhancements and New Products. Customer agrees to avoid any action which might diminish the proprietary rights of COMPANY in the Software Products, Service Bureau, Enhancements and New Products. **Without limiting the foregoing, Customer agrees that it will not make or have made any copies of the Software Products, Enhancements for New Products, or any part thereof, except as necessary for its own internal use.** Customer shall cause all such copies to bear affixed copyright or other proprietary notices.

C) 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;*
- we are covered here by this provision.

3.1 **License.** During the term of this Agreement, COMPANY grants to Customer and Customer accepts from COMPANY, **a non-exclusive, nontransferable, license** to use the Software Products and Enhancements at the Installation Site and on the Equipment.

D) 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
- we are covered her by this provision.

7.1 **Software Products, Enhancements and New Products.** Customer agrees that COMPANY owns the exclusive proprietary rights in the Software Products, Service Bureau, Enhancements and New Products. Customer agrees to avoid any action which might diminish the proprietary rights of COMPANY in the Software Products, Service Bureau, Enhancements and New Products. Without limiting the foregoing, Customer agrees that it will not make or have made any copies of the Software Products, Enhancements for New Products, or any part thereof, except as necessary for its own internal use. Customer shall cause all such copies to bear affixed copyright or other proprietary notices.

E) the customer must destroy or return all copies of the software to the licensor at the end of the license period. The provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

- we are covered here by this provision.

3.4 **Termination of License.** The License granted by this Agreement shall terminate simultaneously with this Agreement. Upon termination of the License, Customer agrees:

3.4.1 **to destroy the Software Products (and any permitted internal use copies)** and certify to COMPANY in writing that such destruction has taken place; and

We appreciate your time and assistance.

DEPARTMENT'S RESPONSE:

The Illinois Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. The tax is measured by the seller's gross receipts from retail sales made in the course of such business. "Gross receipts" means the total selling price or the amount of such sales. The retailer must pay Retailers' Occupation Tax to the Department based upon its gross receipts, or actual amount received, from the sale of the tangible personal property.

Generally, sales of "canned" computer software are taxable retail sales in Illinois. Canned computer software is considered to be tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means, or other media. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. 86 Ill. Adm. Code 130.1935. Computer software that is not custom software is considered to be canned computer software, whether it is "stand-alone" or not. Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3). The criteria you reference in your letter is evaluated to determine whether a computer software license is taxable. It is not necessarily indicative of the taxability of maintenance agreements.

If transactions for the licensing of computer software meet all of the criteria provided in subsection (a)(1) of Section 130.1935, neither the transfer of the software nor the subsequent software updates will be subject to Retailers' Occupation Tax. A license of software is not a taxable retail sale if:

- A) It is evidenced by a written agreement signed by the licensor and the customer;
- B) It restricts the customer's duplication and use of the software;
- C) 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;
- D) The licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or 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

- E) 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.

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.

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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,

Cara Bishop
Associate Counsel

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