ST 99-0037-GIL 01/12/1999 SERVICE OCCUPATION TAX

Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. See 86 Ill. Adm. Code 140.101. (This is a GIL.)

January 12, 1999

Dear Mr. Xxxxx:

This letter is in response to your letter dated December 2, 1998. The nature of your letter and the information you have provided require that we respond with a General Information Letter which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter, you have stated and made inquiry as follows:

We are requesting information regarding the taxability of the below items.

Business Overview -- We operate retail stores in your state and in addition we have a mail-order business that is based in STATE.

1. **Mail Order Catalogs** -Our mail order catalogs are manufactured outside of your state and we only pay sales tax on those catalogs shipped within the state where manufactured. The out of state manufacturer then mails a portion of these catalogs to our customers in your state. We never have control or receive possession of these catalogs.

= Are we liable for use tax on the manufacturing of these catalogs?

= Are we liable for use tax on the cost of renting mailing lists from other companies? Does it matter if the list is of a proprietary nature?

= Are we liable for use tax on the cost of having our mailing list maintained (adding new customers and address change) by an outside company? Does it matter if the list resides and is maintained outside of your state?

= Is advertising space that we sell in our catalog a taxable sale?

Internet Application -- We sell access to an interactive application that resides on our web page. Purchasers receive an access code and a user manual. We are not selling a program but access to information. Users answer various questions posed by the application regarding the specifics of a particular scenario and the application gives information in return.

= What are the tax consequences of this transaction?

= Who pays tax on the manual?

3. Business Association Membership -- Memberships cost $50.00 per year or $30 for a renewal and the benefits are as follows:

= Accreditation Program - For a $75 fee we mail out a test for the customer to complete and return to us for grading. Re-take exams cost $25. For a $10 fee along with the completion of an advanced training class, participants can apply for higher levels of accreditation. Upon successful completion of the test and other applicable requirements, participants receive an award plaque (we pay tax when purchased), permission to use an association logo as well as become eligible to purchase exclusive association products. Are the above fees taxable sales?

= Liability Insurance available for an additional charge.

= Trade Journal -- Members receive a trade journal 8 times a year. Assuming these publications are manufactured in and mailed from another state and no sales tax was paid to the manufacturer; are we liable for use tax? Is the sale of advertising space in this journal taxable?

= Special Pricing -- Members' trade journal includes four pages of members' only discounts.

= Exclusive Designs -- Members have access to proprietary designs not available to the general public.

= Exclusive Accessory Products -- Members have access to accessory products not available to the general public.

= Discounts on Car Rental & Hotels

= Miscellaneous -- New members receive a membership certificate, shop apron and cap. Are we liable for use tax on the cost of these items?

= Invitation to Annual Conference -- Members receive special hotel rates.

In addition to the specific questions regarding the above membership items, is the sale of the membership itself as outlined above taxable?

4. Magazines -- Are general circulation magazines, such as 'Field & Stream', sold at retail taxable?

5. Shipping & Handling -- Is shipping along taxable? Is a charge for shipping and handling combined into one amount taxable? Our catalog states all orders are shipped FOB shipping point.

However, in the event of damages or lost orders our customers contact us and we replace the order and file any insurance claims on our own behalf.

6. **Instruction/Lessons** -- We offer instruction in various sports activities as well as in business management. Are these taxable sales?

7. **Shopping Bags** -- When a customer makes a retail purchase we generally place the merchandise in a plastic bag for the customer's convenience. Can a retail store purchase retail-shopping bags tax exempt? That is, is the purchase of these bags considered a sale for resale?

8. **Repair of Tangible Personal Property** -- Is repair labor on tangible personal property taxable?

If further information is needed, I can be reached at ####.

When a company contracts for the production of custom printed marketing literature, a special order printing situation exists and liability is incurred under the Service Occupation Tax Act. See 86 Ill. Adm. Code 130.2000 and 140.101, enclosed.

Retailers' Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. For your general information we are enclosing a copy of 86 Ill. Adm. Code 140.101 regarding sales of service and Service Occupation Tax.

The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or, (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under the Retailers' Occupation Tax Act.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of sales of service. The tax is based on the separately stated selling price of the tangible personal property transferred. If servicemen do not wish to separately state the selling price of the tangible personal property transferred, those servicemen must use 50% of the entire bill to their service customers as the tax base. Both of the above methods provide that in no event may the tax base be less than the cost price of the tangible personal property transferred. Under these methods, servicemen may provide their suppliers with Certificates of Resale when purchasing the tangible personal property to be transferred as a part of the sales of service.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). See, 86 Ill. Adm. Code 140.101(f) enclosed. This class of registered de minimis servicemen is authorized to pay Service Occupation Tax (which includes local taxes) based upon the cost price of tangible personal property transferred incident to sales of service. They remit the tax to the Department by filing returns and do not pay tax to suppliers. They provide suppliers with Certificates of Resale for the property transferred to service customers.

The final method of determining tax liability may be used by de minimis servicemen that are not otherwise required to be registered under the Retailers' Occupation Tax Act. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). Such de minimis servicemen may pay Use Tax to their suppliers or may self-assess and remit Use Tax to the Department when making purchases from unregistered out-of-State suppliers. Those servicemen are not authorized to collect "tax" from their service customers, nor are they liable for Service Occupation Tax. It should be noted that servicemen no longer have the option of determining whether they are de minimis using a transaction by transaction basis.

Generally, when companies provide their customers with mailing lists on either magnetic tape or computer disk for use, for a fee, they make sales of computer software. Section 2-25 of the Retailers' Occupation Tax provides in relevant part that "computer software means a set of statements, data, or instructions to be used directly or indirectly in a computer in order to bring about a certain result in any form in which those statements, data, or instructions may be embodied, transmitted, or fixed, by any method now known or hereafter developed, regardless of whether the statements, data, or instructions are capable of being perceived by or communicated to humans and includes prewritten or canned software that is held for repeated sales or lease...."

Sales of "canned" computer software are generally taxable retail sales in Illinois. See the enclosed copy of 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c).

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).

If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935(a)(1), neither the transfer of the software or 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);

D) the vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and

E) the customer must destroy or return all copies of the software to the vendor at the end of the license period.

As stated above, licenses of computer software are not taxable if they meet all of the criteria listed in Section 130.1935(a)(1). However, item (D) of that part requires the license to contain a provision requiring the vendor to provide another copy at minimal or no charge if the customer loses or damages the software. The Department has deemed software license agreements to have met this criteria if the agreements do not contain a provision about the loss or damage of the software, but the vendors' records reflect that they have a policy of providing copies of software at minimal or no cost if the customers lose or destroy the software.

Item (E) of this part also requires a license to require a customer to destroy or return all copies of the software to the vendor at the end of the license period. The Department has also deemed perpetual license agreements to qualify for this criteria even though no provision is included in the agreements that requires the return or the destruction of the software.

Please note that transfers of tangible personal property such as manuals are generally subject to Retailers' Occupation Tax.

The Telecommunications Excise Tax Act imposes a tax on the act or privilege of originating or receiving intrastate or interstate telecommunications by persons in Illinois at the rate of 7% of the gross charges for such telecommunications purchased at retail from retailers by such persons, 35 ILCS 630/3 and 4. The Act defines gross charges as including amounts paid for the act or privilege of originating or receiving telecommunications in this State and for all services and equipment provided in connection therewith by retailers, 35 ILCS 630/2(a).

The taxability of charges for internet access or usage is fact specific. Section 2(c) of the Telecommunications Excise Tax Act defines "telecommunications" and states that this term does not include "value added services in which computer processing applications are used to act on the form,

content, code and protocol of the information for purposes other than transmission." For example, the charges for computer data, protocol conversions which permit computers to exchange data, no matter which languages or protocols a computer's output may be in, and packet-switching, which groups data into packets for efficiency of transmission, would be exempt. See 86 Ill. Adm. Code 495.100(d).

Persons that provide customers access to the Internet and who do not, as part of that service, charge customers for the line or other transmission charges which are used to obtain access to the Internet, are not considered to be telecommunications retailers for providing such access. However, if fees for Internet access or usage include a component for line charges, such fees will be subject to the tax and providers will have to register as telecommunications retailers. If retailers charge for the transmission of data, as well as for the data itself, Section 495.100(c) of the Telecommunications Excise Tax regulations provides that charges for the data processing or inquiry would not be subject to tax, but charges for transmission of the data would be taxable, so long as the charges for each is disaggregated and separately identified in the books and records of the retailer. If these charges for transmission and data services are not thus disaggregated, the entire charge is taxable as a sale of telecommunications.

The Illinois Retailers' Occupation Tax Act, 35 ILCS 120/1 et seq., and the Use Tax Act, 35 ILCS 105/1 et seq., apply to the retail sale of tangible personal property. Generally, the Department does not consider receipts from the sale of club membership fees to be gross receipts from the sale of tangible personal property. Rather, a membership fee is considered an intangible, which is not subject to Retailers' Occupation Tax or Use Tax liability. This is the case when the sale of membership rights does not include the transfer of tangible personal property.

If the organizations give items to their members in Illinois, such as membership cards, pins, or patches, those organizations owe Use Tax on the cost price of those items. Newsletters are treated in a similar manner unless they qualify as a magazine as described in the next paragraph. Please note that the use in Illinois of tangible personal property that is purchased for advertising purposes, such as a poster, is subject to Use Tax liability. See the enclosed copy of 86 Ill. Adm. Code 130.410.

Enclosed is a copy of 86 Ill. Adm. Code 130.2105 concerning Sellers of Newspapers, Magazines, Books, Sheet Music and Phonograph Records, and their suppliers. Please note sales of magazines are not subject to sales tax, Section 130.2105(a)(2).

In making determinations on whether publications such as newsletters qualify as magazines for purposes of exemption from tax, there is one test that must be met and several other factors to be considered. The test that must be met in order for publications to qualify as magazines is that they must be published periodically, that is, they must be published at least two times per year. They must also possess certain characteristics of magazines. Such characteristics include whether the publications can be subscribed to, whether they contain articles on subjects of general interest, whether they contain general advertising, and whether they have the format of magazines such as soft covers,

individual pages, and indexed articles. This means newsletters that are published on a monthly basis and possess some of these characteristics can qualify for the exemption from Illinois sales tax. See Moody's Investors Service, Inc. v. Department of Revenue, 101 Ill.2d 284 (1984).

As a technical proposition, handling charges represent a retailer's cost of doing business, and are consequently always includable in gross charges subject to tax. See, 86 Ill. Adm. Code 130.410. However, such charges are often stated in combination with shipping charges. In this case, charges designated as "shipping and handling," as well as delivery or transportation charges in general, are not taxable if it can be shown that they are both separately contracted for and that such charges are actually reflective of the costs of shipping. To the extent that shipping and handling charges exceed the costs of shipping, the charges are subject to tax. As indicated above, charges termed "delivery" or "transportation" charges follow the same principle.

The best evidence that shipping and handling or delivery charges have been contracted for separately by purchasers and retailers are separate contracts for shipping and handling or delivery. However, documentation that demonstrates that purchasers had the option of taking delivery of the property, at the sellers' location for the agreed purchase price, plus an ascertained or ascertainable delivery charge, will suffice. If retailers charge customers shipping and handling or delivery charges that exceed the retailers' cost of providing the transportation or delivery, the excess amount is subject to tax.

Mail order delivery charges are deemed to be agreed upon separately from the selling price of the tangible personal property being sold so long as the mail order form requires a separate charge for delivery and so long as the charges designated as transportation or delivery or shipping and handling are actually reflective of the costs of such shipping, transportation or delivery. See subsection (d) of Section 130.415. If the retailer charges a customer shipping and handling or delivery charges that exceed the retailer's cost of providing the transportation or delivery, the excess amount is subject to tax.

Enclosed is a copy of Section 130.2070 of the Department's regulations governing "Sales of Containers, Wrapping and Packing Materials and Related Products." As subsection (b) indicates, Retailers' Occupation Tax does not apply to the sale of bags if the purchaser of the bags transfers the ownership of the bags to his customers together with the ownership of the tangible personal property contained in the bag. Under these circumstances, the purchaser is considered to be buying the bag for resale.

When purchasing items for resale, purchasers must provide their suppliers with properly executed Certificates of Resale. The requirements for Certificates of Resale are explained in the enclosed copy of Section 130.1405.

I hope this information is helpful. The Department of Revenue maintains a Web site which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Melanie A. Jarvis
Associate Counsel

MAJ:msk
Enc.