

ST 02-0260-GIL 12/06/2002 SERVICE OCCUPATION TAX

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

December 6, 2002

Dear Xxxxx:

This letter is in response to your letter dated July 1, 2002. 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 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at <http://www.revenue.state.il.us/Laws/regs/part1200/>.

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

I am writing to request rulings as to whether the following products sold are taxable in the state of Illinois. AAA is domiciled in the state of STATE. We provide automobile collision repair and medical information in the form of software, books, and electronic commerce.

We are uncertain as to whether the following products would be subject to sales tax to our customer in the state of Illinois.

AAA sells a software program for Insurance Companies, which detects billing and coding errors, enforces coding conventions, applies a benchmark for usual and customary fees on medical bills. This product is billed separately from the products below.

1. We provide a service to customers in the form of medical bill processing. Our Company has a medical bill-processing unit on-site in our CITY/STATE office and can provide customers with data entry or data capture (scanning) assistance. Medical bills are entered into our application software, processed, and an 'explanation of payment' is transferred to the customer either electronically or in hard copy, depending on their needs

Would the charge for bill processing, with the data returned electronically be subject to sales tax?

Would the charge for bill processing, with the data returned on hard copy be subject to sales tax?

2. The other product AAA is requesting a taxability determination is called NAME. This product supports the medical auditing and bill review software. The NAME product is designed for first party automobile medical bills, and reprices them based on discounts off of billed charges or state fee schedules. The product provides a network of certified professional and facility medical providers specifically focused on auto liability.

Our customer's (an insurance company) access the NAME directory through their website or a directory provided by the NAME. They then offer their claimants a list of the medical providers from the directory when seeking medical care. The network has providers that are organized for the property and casualty industry and have all agreed by contract to charge certain fees for certain services. The network consists of high quality providers in all 50 states across numerous specialties.

After the medical services are rendered, our client receives an invoice for these services discounted or re-priced based on our network discount. After the medical services are rendered, our customer obtains an extract from our Medical claims software program. This extract, which contains the medical bills processed and cost savings from using the NAME, is sent to our billing department. We bill our customer a percentage of the savings produced from using the NAME (access fee). In turn AAA will send the NAME a percentage of the savings from the medical bills based on a contractual agreement.

Is the access fee AAA charges to our customer subject to sales tax?

If the extract data is sent to AAA electronically, does this change the taxability status?

Does the fee that AAA pays the NAME subject to sales tax?

3. The third product is our information products which is accessed by our customers through a website called AAA. This site contains many pieces of information, functionality, and processes to facilitate and speed up the automobile claims process. Once the customer signs up and is given a password, no CD-ROMs or tangible property is exchanged. The customer accesses the site through an Internet connection and the server containing the information is located in CITY/STATE.

Depending on whether the customer is an insurance company or collision repair customer, they can handle the claims process on-line, create the estimate, send or receive a digital image of the collision damage, upload the information to our portal site, and have the claim accessed by adjusters and or reviewers.

Please let us know whether the charge to our customers for access this website is taxable in the state.

We are unable to make a binding determination in the context of a General Information Letter. Determinations regarding the subject of nexus are very fact specific and depend upon the amount and nature of activities performed in Illinois. The following information about nexus and Illinois sales is provided for your consideration. We hope it is useful for you in determining your client's Illinois sales tax responsibilities.

An "Illinois Retailer" is one who either accepts purchase orders in the State of Illinois or maintains an inventory in Illinois and fills Illinois orders from that inventory. The Illinois Retailer is then

liable for Retailers' Occupation Tax (sales tax) on gross receipts of sales and must collect the corresponding Use Tax incurred by purchasers. If a vendor attends an Illinois trade show for a few days, and accepts purchase orders at that show, he would be making Illinois retail sales subject to Retailers' Occupation Tax. This would be true even if he later ships the goods from an out-of-State location to the Illinois customers.

Out-of-State sellers who fall under the definition of a "retailer maintaining a place of business in this State" (see 86 Ill. Adm. Code Sec. 150.201(i), enclosed), must register to collect Illinois Use Tax from Illinois customers and remit that tax to the Department. See 86 Ill. Adm. Code Sec. 150.801(c), enclosed. The retailer must collect and remit Use Tax to the State on behalf of his Illinois customers even though the retailer does not incur any Retailers' Occupation Tax liability.

The U.S. Supreme Court in *Quill v. North Dakota*, 112 S. Ct. 1902 (1992) set forth guidelines for determining what nexus requirements must be met before a business is properly subject to a state's tax laws. *Quill* invoked a two-prong analysis consisting of 1) whether the Due Process Clause is satisfied, and 2) whether the Commerce Clause "substantial nexus" test is met before the state can impose tax collection responsibilities.

The due process test will be met if requiring the retailer to collect state sales tax is fundamentally fair to the retailer. If the retailer intentionally avails itself of the benefits of the taxing state's economic market, then due process is satisfied, *Quill* at 1910.

Notwithstanding the fact that due process has been met, a business must also have a physical presence in the taxing state in order for the "substantial nexus" test to be met under the Commerce Clause and before a state can impose tax collection responsibilities on an out-of-State retailer. A physical presence does not mean simply an office or other physical building. Under Illinois tax law, it also includes the presence of any representative or other agent of the seller. The representative need not be a sales representative, and it is immaterial for tax purposes that the representative's presence is temporary.

The final type of retailer is the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax laws. A retailer in this situation does not incur Retailers' Occupation Tax on sales to Illinois and is not required to collect Use Tax on behalf of its Illinois customers. However, the retailer's Illinois customers will still incur Use Tax on their purchase of the tangible personal property and have a duty to self-assess their Use Tax and pay it directly to the Illinois Department of Revenue.

Sales of service in Illinois are not subject to Retailers' Occupation Tax liability. The provision of services as described in your letter, if accompanied by the transfer of tangible personal property to customers in Illinois, would be subject to liability under the Service Occupation Tax Act. Sales of computer software incident to such service are considered taxable in Illinois regardless of the manner of the transfer of the software (electronically for example). See the enclosed copy of 86 Ill. Adm. Code 130.1935. Please note, however, information or data that is downloaded electronically, such as downloaded reports, books, newspapers or magazines, is not taxable because it does not constitute the transfer of tangible personal property but instead represents the transfer of intangibles. Please refer to 86 Ill. Adm. Code 130.2105(a)(3).

Where a business provides services that are accompanied with the transfer of tangible personal property, such transactions are generally subject to tax liability under the Service Occupation Tax Act. See 86 Ill. Adm. Code 140.140(l). Under the Service Occupation Tax Act,

servicemen are taxed on tangible personal property transferred as an incident of their sales of service. Servicemen incur either Service Occupation Tax (SOT) liability or Use Tax liability in these transactions. The tax consequences depend upon the method used to calculate the liability. Servicemen may calculate their tax base in one of four ways: 1. separately stated selling price; 2. 50% of serviceman's entire bill; 3. SOT on his cost price if he is a registered de minimis serviceman; or, 4. Use Tax on his cost price if he is an unregistered de minimis serviceman that is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Please see 86 Ill. Adm. Code 140.101, the Basis and Rate of the Service Occupation Tax.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of the sale of service. The tax is then calculated on the separately stated selling price of the tangible personal property transferred. If the servicemen do not separately state the selling price of the tangible personal property transferred, they must use 50% of the entire bill to the service customer as the tax base. Both of the above methods provide that in no event may the tax base be less than the servicemen's cost price of the tangible personal property transferred. A serviceman who incurs Service Occupation Tax on his selling price should provide Certificates of Resale to his suppliers when purchasing tangible personal property that will be transferred to service customers. Please refer to 86 Ill. Adm. Code 140.106, enclosed.

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. See 86 Ill. Adm. Code 140.109, enclosed. Servicemen may qualify as de minimis if they determine that the annual aggregate cost price of tangible personal property transferred as an incident of the sale of service is less than 35% of the total annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphics arts production). Registered de minimis servicemen are authorized to pay Service Occupation Tax (which includes local taxes) based upon their cost price of tangible personal property transferred incident to the sale of service. Such servicemen should give suppliers resale certificates and remit Service Occupation Tax using the Service Occupation Tax rates for their locations. Such servicemen collect a corresponding amount of Service Use Tax from their customers, absent an exemption.

The final method of determining tax liability may be used by de minimis servicemen that are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Such de minimis servicemen handle their tax liability by paying Use Tax to their suppliers. If their suppliers are not registered to collect and remit tax, the servicemen must register, self-assess and remit Use Tax to the Department. The servicemen are considered to be the end-users of the tangible personal property transferred incident to service. Consequently, they are not authorized to collect a "tax" from the service customers. See 86 Ill. Adm. Code 140.108, enclosed. These de minimis servicemen do not provide Certificates of Resale to suppliers.

It appears that your sales of service may be occurring outside Illinois; consequently we doubt that there is any Service Occupation Tax liability. If you qualify as an unregistered de minimis serviceman, then there is no tax liability on the part of your customers in Illinois.

In regard to software, sales of "canned" computer software are considered taxable retail sales in Illinois regardless of the manner of the transfer of that software (electronically for example). 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 subsection (c) of Section 130.1935.

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 subsection (c)(3) of Section 130.1935. If transactions for the licensing of computer software meet all of the criteria provided in (a)(1) of Section 130.1935, neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax.

Charges for updates of canned software are fully taxable pursuant to Section 130.1935. If the updates qualify as custom software under subsection (c) of Section 130.1935, they may not be taxable. But, if maintenance agreements provide for updates of canned software, and the charges for those updates are not separately stated and taxed, then the whole agreement would be taxable as sales of canned software.

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 Section 1200.110(b).

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk
Enc.