ST 13-0076-GIL 11/26/2013 COMPUTER SOFTWARE
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. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

November 26, 2013

Dear Xxxxx:

This letter is in response to your letter dated November 6, 2013, 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:

> The above named Taxpayer requests guidance and confirmation from the Illinois Department of Revenue regarding the application of the Illinois Retailers' Occupation Tax with reference to the sale of licensed software and services pursuant to the transactions described below:
>
> 1. COMPANY 1 (The Company) sells Software as follows:
>
>   a. COMPANY 1 is a reseller of software created by COMPANY 2. The software provides customers communication solutions for call centers including call recording, workforce scheduling, quality management and other workforce management tools.
>
> 2. The Company performs value added services including system integration, training and maintenance services as follows:
>
>   a. System Integration Services consist of installing the software on the customers server(s), interfacing the database of outside systems with the database of the solution and the installation of software for the end-user in order to access the system;
>
>   b. Training Services consist of instruction and training of the Customer relating to the software's operation;

c. Maintenance Services consist of answering customer questions on functionality, insuring the database to database interchange is functional and installing upgrades to the software provided by COMPANY 2 for improved functionality and/or software bug fixes;

d. At no point does The Company make changes to the underlying software or codes.

3. The Company sells its software and value added services under the following terms:

a. The term of the software license is perpetual but each license requires an annual maintenance agreement for customer service, repair and upgrades;

b. The software license(s) and service agreement(s) is evidenced by a written agreement signed by The Company (Licensor) and the Customer;

c. The software license(s) and service agreement(s) restrict the Customer's duplication and use of the software;

d. The software license(s) and service agreement(s) 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;

e. The Company (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.

f. The Customer must destroy or return all copies of the software to the licensor at the end of the license period.

APPLICABLE LAW:

TITLE 86: REVENUE, PART 130 RETAILERS' OCCUPATION TAX Section 130.1935

Section 130.1935(a) (1) states that:

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 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

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.

Section 130.1935(a) states in its last sentence "The sale at retail, or transfer, of canned software intended for general or repeated use is taxable, including the transfer by a retailer of software which is subject to manufacture licenses restricting the use or reproduction of the software".

Information Bulletin FY90-7, September 1989 states effective October 1, 1989, all prewritten or "canned" computer software will be taxable under both the state sales tax and all local sales taxes.

DISCUSSION:

The Company received a correspondence from a Customer claiming, after their analysis of the law, that The Company's sale of licensed software and value added services were exempt from Illinois Retailers' Occupation Tax. The Customer claims that since the Section 130.1935(1) (A) through (G) have been complied with the sale is not subject to Illinois Retailers' Occupation Tax. To support their position the Customer provided a copy of a Private letter Ruling dated May 29, 2001 relating to software sold by Oracle Corporation (copy attached). The ruling exempts the subject sale of software from Illinois Retailers' Occupation Tax.

The Company has contacted the Illinois Department of Revenue on several occasions inquiring whether the sale of their software and value added services are subject to

Illinois Retailers' Occupation Tax. The Company has received conflicting opinions as the application of Illinois Retailers' Occupation Tax to their sales.

ISSUES:

1. Whether The Company's sale of license of software is subject to the Illinois Retailers' Occupation Tax;

2. Whether The Company's sale of value added services (system integration, training and maintenance services) are subject to Illinois Retailers' Occupation Tax;

3. Whether The Company's sale of a license of software is the sale of "canned software" within the definition of Section 130.1935 (a) and Information Bulletin FY90-7, September 1989 making the exempting provisions of Section 130.1935 (a)(1)(A)-(E) inapplicable.

Enclosed is the following:

1. TITLE 86: REVENUE, PART 130 RETAILERS' OCCUPATION TAX Section 130.1935 – Computer Software

2. Information Bulletin FY90-7, September 1989
3. Private letter Ruling dated May 29, 2001

Thank you for your consideration in this matter.

DEPARTMENT'S RESPONSE:

Retailers' Occupation Tax

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. In Illinois, Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as "sales" tax in Illinois.

Service Occupation Tax

Illinois Retailers' Occupation and Use Taxes do not apply to sales of service that do not involve the transfer of tangible personal property to customers. However, if tangible personal property is transferred incident to sales of service, this will result in either Service Occupation Tax liability or Use Tax liability for the serviceman depending upon his activities. For your general information see of 86 Ill. Adm. Code 140.101 through 140.109 regarding sales of service and Service Occupation Tax.

Under the Service Occupation Tax Act, businesses providing services (*i.e*. servicemen) are taxed on tangible personal property transferred as an incident to sales of service. See 86 Ill. Adm. Code 140.101. The purchase of tangible personal property that is transferred to the service customer may result in either Service Occupation Tax liability or Use Tax liability for the servicemen depending upon his activities. The serviceman's liability may be calculated in one of four ways: (1) separately-stated selling price of tangible personal property transferred incident to service; (2) 50% of the serviceman's entire bill; (3) Service Occupation Tax on the serviceman's cost price if the serviceman is a registered de minimis serviceman; or (4) Use Tax on the serviceman's cost price if the serviceman is a de minimis serviceman and is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act.

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. See 86 Ill. Adm. Code 140.106.

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. 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). Servicemen cannot determine whether they are de minimis on a transaction-by-transaction basis. 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 also 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. Servicemen may qualify as de minimis if they determine that the annual aggregate cost price of tangible personal property transferred as an incident of sales of service is less than 35% of the servicemen's annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). 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.

The provision of professional or consulting services that do not include the transfer of tangible personal property with the provision of such services does not result in Service Occupation Tax or Use Tax liability. The transfer of any tangible personal property such as

written reports, tangible media (CDs) and training manuals incident to a sale of service would result in Service Occupation Tax liability or Use Tax liability. See 86 Ill. Adm. Code 140.01 *et seq.*

Computer Software

The Department no longer issues letter rulings regarding whether a specific license of prewritten (canned) computer software meets the requirements of subsection (a)(1) of 86 Ill. Adm. Code 130.1935. 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. Although we cannot provide answers to your specific questions, we hope the following general information will be of assistance.

Generally, retail sales or transfers of "canned" computer software are taxable in Illinois regardless of the means of delivery. For instance, the sale or transfer of canned computer software downloaded electronically would be taxable. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See 86 Ill. Adm. Code 130.1935(c). Custom computer programs or software must be prepared to the special order of the customer.

Charges for updates of canned software are fully taxable pursuant to Section 130.1935. If the updates qualify as custom software under Section 130.1935(c), they may not be taxable. 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.

Please note that it is very common for software to be licensed over the internet and the customer to check a box that states that they accept the license terms. Acceptance in this manner does not constitute a written agreement signed by the licensor and the customer for purposes of subsection (a)(1)(A) of Section 130.1935. To meet the signature requirement for an exempt software license, the agreement must contain the written signature of the licensor and customer.

A license of canned software is subject to Retailers' Occupation Tax liability if all of the criteria set out in 86 Ill. Adm. Code 130.1935(a)(1) are not met.

Maintenance Agreements

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 Sec. 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,

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