ST 14-0022-GIL 04/08/2014 TELECOMMUNICATIONS EXCISE TAX ACT
This letter provides an overview of items subject to the Telecommunications Excise Tax Act. *See* 35 ILCS 630.
(This is a GIL.)

April 8, 2014

Dear Xxxx:

This letter is in response to your letter dated February 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:

> Please accept this letter as a formal request for a General Information Letter. We are seeking guidance on whether a client's colocation and managed hosting services are subject to taxation in the state of Illinois and whether the manner in which the services are invoiced has any impact on the taxability of the services.
>
> The client operates a colocation and hosting facility in the state of Illinois. The colocation services are comprised of bandwidth, cross connects, power circuits, and, in some cases, direct private lines between the facility and its customers. The end product/service that the customer receives is a place to store its servers that is secure from intruders, the elements, and power and Internet connectivity disruptions. Managed hosting services are comprised of the use of servers owned by the facility, along with other services such as firewall, load balancing, data backups, and intrusion protection.
>
> It is our understanding that the bandwidth is not subject to tax, as it is a means of Internet access and, as such, is barred from taxation per the Internet Tax Freedom Act of 2007. Please confirm that the state does not assess sales tax on bandwidth services.
>
> Cross connects are cables connecting one cabinet to another in instances where customer equipment is located in different places within the facility, or to provide connection to the Internet, or to connect a direct private line that is located elsewhere in the facility to a customer's cabinet. Please verify whether this is considered a rental of tangible personal property or is a supply used by the client to provide its colocation services. Also, would the taxability be impacted if the cost was not separately stated on the face of the sales invoice and instead sold in a lump-sum billing for colocation services?

The client purchases direct private lines from several different telecommunications providers for use in its services, and the costs are passed through at a marked up rate. The lines consist of various types of copper and fiber connections and may be used to transport either voice or Internet services. The client is not privy to what its customers transmit over the circuits. Again, it is unclear as to whether the lines are actually resold to the customers (and subject to tax) or if they are used or consumed in the process of providing the colocation services. If they are deemed to be an item purchased for resale to its customers, are they considered to be an exempt Internet service, a taxable rental of tangible personal property, or a taxable telecommunications service? If they are taxable, is it acceptable for the client to continue to pay sales tax to the vendor and only collect sales tax (or remit consumer's use tax) on the mark-up? Please also address whether it would change the taxability if the client billed its customers in a lump-sum amount for colocation services rather than providing its customers with an itemized invoice.

Lastly, the client uses a number of software programs to allow the customers to remotely manage the servers to which they have subscribed, provide data back-up services, and other functions as part of its managed hosting services. The client only provides the customer a non-exclusive, non-transferable, limited use license to the software program and only to the extent it is needed for the contracted services. The costs are not independent of the hosting services, and are not recovered from the customer in an itemized charge. Does this qualify as a taxable sale? If so, does it make any of the other charges or a lump-sum charge for colocation and/or managed hosting services taxable?

If any additional details are required to provide a determination of taxability, please contact NAME at (xxx) xxx-xxxx. Thank you for your consideration.

DEPARTMENT'S RESPONSE:

Though we cannot determine the exact nature of your client's activities from the limited information provided in your letter, it appears that your client may provide services that permit its customers to originate and terminate telecommunications.

TELECOMMUNICATIONS EXCISE TAX ACT

The Telecommunications Excise Tax Act, 35 ILCS 630/1 *et seq.*, imposes a tax upon the act or privilege of originating or receiving in the State of Illinois interstate or intrastate telecommunications by a person in Illinois at the rate of 7% of the gross charge for such telecommunications purchased at retail from a retailer by such person. Under Section 2(c) of the Act,

"'[t]elecommunications', in addition to the meaning ordinarily and popularly ascribed to it, includes, without limitation, messages or information transmitted through use of local, toll and wide area telephone service; private line services; channel services; telegraph services; teletypewriter; computer exchange services; cellular mobile telecommunications service; specialized mobile radio; stationary two way radio; paging service; or any other form of mobile and portable one-way or two-way

communications; or any other transmission of messages or information by electronic or similar means, between or among points by wire, cable, fiber-optics, laser, microwave, radio, satellite or similar facilities. As used in this Act, 'private line' means a dedicated non-traffic sensitive service for a single customer, that entitles the customer to exclusive or priority use of a communications channel or group of channels, from one or more specified locations to one or more other specified locations. The definition of 'telecommunications' shall 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. 'Telecommunications' shall not include purchases of telecommunications by a telecommunications service provider for use as a component part of the service provided by him to the ultimate retail consumer who originates or terminates the taxable end-to-end communications. Carrier access charges, right of access charges, charges for use of inter-company facilities, and all telecommunications resold in the subsequent provision of, used as a component of, or integrated into end-to-end telecommunications service shall be non-taxable as sales for resale." 35 ILCS 630/2(c).

"'Gross charge' means the amount 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 a retailer, valued in money whether paid in money or otherwise, including cash, credits, services and property of every kind or nature, and shall be determined without any deduction on account of the cost of such telecommunications, the cost of materials used, labor or service costs or any other expense whatsoever.

"Gross charges' does not include charges for customer equipment, including equipment that is leased or rented by the customer from any source, wherein such charges are disaggregated and separately identified from other charges. 'Gross charges' also does not include charges for nontaxable services or telecommunications if (i) those charges are aggregated with other charges for telecommunications that are taxable, (ii) those charges are not separately stated on the customer bill or invoice, and (iii) the retailer can reasonably identify the nontaxable charges on the retailer's books and records kept in the regular course of business. If the nontaxable charges cannot reasonably be identified, the gross charge from the sale of both taxable and nontaxable services or telecommunications billed on a combined basis shall be attributed to the taxable services or telecommunications. The burden of proving nontaxable charges shall be on the retailer of the telecommunications.

INTERNET TAX FREEDOM ACT

The Internet Tax Freedom Act imposes a federal moratorium on state or municipal taxes on Internet access until November 1, 2014. 47 USCA § 151 note; § 1101. "Internet access":

(A) means a service that enables users to connect to the Internet to access content, information, or other services offered over the Internet;

(B) includes the purchase, use or sale of telecommunications by a provider of a service described in subparagraph (A) to the extent such telecommunications are purchased, used or sold-

(i) to provide such service; or
(ii) to otherwise enable users to access content, information or other services offered over the Internet;

(C) includes services that are incidental to the provision of the service described in subparagraph (A) when furnished to users as part of such service, such as a home page, electronic mail and instant messaging (including voice and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity;

(D) does not include voice, audio or video programming, or other products and services (except services described in subparagraph (A), (B), (C), or (E)) that utilize Internet protocol or any successor protocol and for which there is a charge, regardless of whether such charge is separately stated or aggregated with the charge for services described in subparagraph (A), (B), (C), or (E); and

(E) includes a homepage, electronic mail and instant messaging (including voice and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity, that are provided independently or not packaged with Internet access.

Telecommunications that are purchased, used or sold by a provider to enable users to connect to the Internet or to otherwise enable users to access content, information or other services offered over the Internet are subject to the federal moratorium. Thus, not all telecommunications are subject to the moratorium. In addition, paragraph D of the definition of "Internet access" excludes "voice, audio or video programming, or other products and services (except services described in subparagraph (A), (B), (C), or (E)) that utilize Internet protocol or any successor protocol and for which there is a charge, regardless of whether such charge is separately stated or aggregated with the charge for services described in subparagraph (A), (B), (C), or (E)." Therefore, telecommunications, including for example Voice over Internet Protocol (VoIP), that are not purchased, used or sold to a provider to enable users to connect to the Internet or to otherwise enable users to access content, information or other services offered over the Internet, are not subject to the federal moratorium and are subject to the Telecommunications Excise Tax.

Section 1106 of the Internet Tax Freedom Act states:

"If charges for Internet access are aggregated with and not separately stated from charges for telecommunications or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business."

Under the Department's regulations, non-taxable services are not subject to Telecommunications Excise Tax provided that the charges for such services are disaggregated and separately identified from other charges in the books and records of the telecommunications retailer. *See* 86 Ill. Adm. Code 495.100.

COMPUTER SOFTWARE

Your letter mentions that the client allows the customer to manage their services with software programs. 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.

SERVICE OCCUPATION TAX

Please be aware that if your client is transferring tangible personal property incident to providing a service, 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.

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

CB:lkm