

This letter discusses computer software. 86 Ill. Adm. Code 130.1935. (This is a GIL.)

November 2, 2023

NAME
COMPANY
ADDRESS

Dear NAME:

This letter is in response to your letter dated October 25, 2023, in which you requested 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:

COMPANY is an IT Corporation that provides IT infrastructure and cloud reseller services, managed services, and managed security services. Included with these services COMPANY will sell IT equipment and licenses that are appropriate for the customer application. Part of these sales can include remotely hosted software (SAAS) by third-party vendors. COMPANY is reselling these SAAS products to its clients and is seeking a private letter ruling on the taxability of these SAAS products.

Illinois taxes the sale of locally hosted software regardless of the method of delivery. However, if the software is subject to a license agreement that meets a five-part test, the transaction is not considered a sale, and Illinois does not tax it. For this to be the case the license agreement:

1. Must be signed by both the licensor and licensee. A click through, check the box, or shrinkwrap license agreement will not meet this test.
2. Must restrict duplication and use (this a broad category, and applies to all license agreements);

3. Must restrict the licensee from transferring or sublicensing the software to any unrelated party without the licensor's permission;
4. Must have a provision that either allows the licensee to make an archival copy in the case of loss or damage, or requires the licensor to provide another copy if necessary; and
5. Must have a provision indicating that at the end of the agreement, the licensee will return or delete/destroy the software. This prong is also met if the license is perpetual.

In the above test, the license is usually between a licensor and licensee, so we (COMPANY.) may not have a copy of the license between licensor and licensee. IE, Microsoft office 365 is a sale between Microsoft and the user (our customer).

We/COMPANY have been informed by sales tax professionals that the state of Illinois does not charge tax on SAAS products. We/COMPANY would like to have confirmation that we do not have to charge taxes on the sale of Microsoft office to our customers.

Examples of the SAAS products can be found here:

<https://www.microsoft.com/en-us/microsoft-365/enterprise/microsoft365-plans-and-pricing>

Thank you in advance for your assistance.

MATERIAL FACTS

COMPANY. sells Microsoft Office 365 to its customers.

COMPANY sales tax software considers the sale of Microsoft Office 365 non-taxable.

The period for these transactions is Q4 2023.

Microsoft Office 365 is a cloud-powered productivity platform.

DEPARTMENT'S RESPONSE:

Retailers' Occupation Tax and Use 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. 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. If the purchases occur in Illinois, the purchasers must pay the Use Tax to the retailer at the time of purchase.

The retailers are then allowed to reduce the amount of Use Tax they must remit by the amount of Retailers' Occupation Tax liability which they are required to and do pay to the Department with respect to the same sales. See 86 Ill. Adm. Code 150.130.

Service Occupation Tax

Retailers' Occupation Tax and Use Tax do not apply to sales of service. See 35 ILCS 120/2; 35 ILCS 105/3. 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 transfer of tangible personal property to service customers may result in either Service Occupation Tax liability or Use Tax liability for servicemen, depending upon which tax base they choose to calculate their liability.

Servicemen may calculate their tax base 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 de minimis and is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. See 86 Ill. Adm. Code Sections 140.106; 140.108; and 140.109.

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 the second method where they will 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 sales of service. They are required to collect the corresponding Service Use Tax from their customers. 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. 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). 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. Servicemen that incur Service Occupation Tax collect the Service Use Tax from their customers. They remit tax to the Department by filing returns and do not pay tax to their suppliers. They provide suppliers with Certificates of Resale for the tangible personal property transferred to service customers. See 86 Ill. Adm. Code 140.109.

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.

If an entity provides services that are accompanied with the transfer of tangible personal property, including computer software, such service transactions are generally subject to tax liability under one of the four methods set forth above. If a transaction does not involve the transfer of any tangible personal property to the customer, then it generally would not be subject to Retailers' Occupation Tax, Use Tax, Service Occupation Tax, or Service Use Tax.

Computer Software

"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." 35 ILCS 120/2-25. 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. 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. 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 86 Ill. Adm. Code 130.1935(c)(3). Computer software that is not custom software is considered to be canned 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. 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.

If a license of canned computer software does not meet all the criteria the software is taxable.

In order to comply with the requirements as set out in Section 130.1935(a)(1), there must be a written "signed" agreement. A license agreement in which the customer electronically accepts the terms by clicking "I agree" does not comply with the requirement of a written agreement signed by the licensor and customer. The Department previously held that an electronic signature did not comply with the requirement of Section 130.1935(a)(1)(A) that the license be evidenced by a written agreement signed by the licensor and the customer. ST 06-0005-PLR (December 16, 2006). In ST 18-0003-PLR (February 8, 2018), the Department decided that an electronic license agreement in which the customer accepts the license by means of a signature in electronic form that is attached to or is part of the license, is verifiable, and can be authenticated will comply with the requirement of a written agreement signed by the licensor and customer. See ST 18-0010-PLR (September 26, 2018) for examples of acceptable written signatures. A license agreement in which the customer electronically accepts the terms by clicking "I agree" remains unacceptable.

A provider of software as a service is acting as a serviceman. As a serviceman, the seller does not incur Retailers' Occupation Tax. Service Occupation Tax is imposed upon all persons engaged in the business of making sales of service on all tangible personal property transferred incident to a sale of service, including computer software (35 ILCS 115/3), and is calculated as explained above.

Computer software is defined broadly in the Retailers' Occupation Tax and Service Occupation Tax Acts. However, computer software provided through a cloud-based delivery system – a system in which computer software is never downloaded onto a client's computer and is only accessed remotely – is not subject to tax. If a provider of a service provides to the subscriber an API, applet, desktop agent, or a remote access agent to enable the subscriber to access the provider's network and services, the subscriber is receiving computer software. Although there may not be a separate charge to the subscriber for the computer software, it is nonetheless subject to tax, unless the transfer qualifies as a non-taxable license of computer software.

If an Illinois customer downloads computer software for free from an out-of-state retailer's web site or server that is also located out of state, the retailer, even though it is donating tangible personal property to the customer, has exercised no power or control over the property in Illinois. In this instance, the donor would not have made any taxable use of the property in Illinois. The customer, the donee, would incur no Use Tax liability for the retailer to collect and remit to Illinois. Illinois generally does not tax subscriptions.

Moreover, sales of custom computer programs prepared to the special order of the customer may not be a taxable sale. 86 Ill. Adm. Code 130.1935(c)(1). Custom software means the software which results from real and substantial changes to the operational coding of canned or pre-written software in order to meet the specific individualized requirements of the purchaser for his limited or particular use. 86 Ill. Adm. Code 130.1935(c)(2). Custom computer software is not subject to the Retailers' Occupation Tax, Use Tax, Service Occupation Tax, or Service Use Tax if the following elements are present:

- A) preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and
- B) the program requires adaptation by the vendor to be used in a specific work environment, e.g., a particular make and model of a computer using a specified input or output device. 86 Ill. Adm. Code 130.1935(c)(1).

If modified software is held for general or repeated sale or lease, it is canned software. 86 Ill. Adm. Code 130.1935(c)(2). 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. 86 Ill. Adm. Code 130.1935(c)(3). Computer software that is not custom software is considered to be canned computer software. See 86 Ill. Adm. Code 130.1935.

Sales for Resale

In order to document the fact that its sale to a purchaser is a sale for resale, a seller must obtain a valid Certificate of Resale from the purchaser. See 86 Ill. Adm. Code 130.1405. A Certificate of Resale is a statement signed by the purchaser that the property purchased by him is purchased for purposes of resale. In addition to the statement that the property is being purchased for resale, a Certificate of Resale must contain:

- 1) The seller's name and address;
- 2) The purchaser's name and address;
- 3) A description of the items being purchased for resale;
- 4) Purchaser's signature, or the signature of an authorized employee or agent of the purchaser, and date of signing; and

- 5) Registration Number, Resale Number, or a statement that the purchaser is an out-of-State purchaser who will sell only to purchasers located outside the State of Illinois.

The Department provides a standard form for documenting sales for resale (Form CRT-61 Certificate of Resale). This form can be obtained from the Department's website.

The obligations of a seller with respect to accepting a Certificate of Resale were addressed in *Rock Island Tobacco and Specialty Company v. Illinois Department of Revenue*, 87 Ill.App.3d 476, 409 N.E.2d 136, 42 Ill. Dec. 641 (3rd Dist. 1980). The *Rock Island* court held that when a retailer obtains a proper Certificate of Resale that contains a registration or resale number that is valid on the date it is given, the retailer's liability is at an end. If the purchaser uses that item himself or herself (i.e., it was not purchased for resale), the Department will proceed against the purchaser, not the retailer, provided the above stated conditions are met. The purchaser's registration or reseller number can be verified at the Department's website by clicking on the "Tax registration inquiry" box.

Failure to present an active registration number or resale number and a certification to the seller that a sale is for resale creates a presumption that a sale is not for resale. This presumption may be rebutted by other evidence that all of the seller's sales are sales for resale or that a particular sale is a sale for resale. For example, other evidence that might be used to document a sale for resale, when a registration number or resale number and certification to the seller are not provided, could include an invoice from the purchaser to his customer showing that the item was actually resold, along with a statement from the purchaser explaining why it had not obtained a resale number and certifying that the purchase was a purchase for resale in Illinois. The risk run by a retailer in accepting such other documentation and the risk run by purchasers in providing such other documentation is that an Illinois auditor is more likely to require that more information be provided as evidence that the sale was, in fact, a sale for resale.

Your letter does not provide sufficient information to enable the Department to provide a binding private letter ruling. It is the Department's understanding that COMPANY resells computer software to end user clients. However, you do not explain the exact arrangement COMPANY has with its supplier, the nature of the software (i.e., canned, custom, or SaaS) being resold, and you do not confirm the license agreement between the owner of the software and the end user meets the license requirements of Section 130.1935(a)(1). You indicate that COMPANY also sells managed services, managed security services and IT equipment but do not fully explain the nature of the services and whether the IT equipment is sold separately or as part of the service. Finally, it is not entirely clear from your letter that Microsoft Office 365 qualifies as SaaS.

If you wish to submit another request for a private letter ruling, please review the requirements to obtain a private letter ruling contained in 2 Ill. Adm. Code 1200.110.

I hope this information is helpful. If you have further questions, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws,

please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Associate Counsel

RSW