ST 11-0005-GIL 01/11/2011 COMPUTER SOFTWARE

This letter concerns computer software maintenance agreements. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

January 11, 2011

Dear Xxxxx:

This letter is in response to your letter dated April 1, 2010, 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:

> On behalf of our client, FIRM respectfully requests a Private Letter Ruling under Illinois Regulation 1200.110 as to the proper application of Illinois retail [sic] occupation (ROT) and use tax (UT) concerning optional and mandatory maintenance contracts as detailed below where the price for each type of agreement is separately stated and both types of agreements pertain and relate to the licensing of computer software which is exempt pursuant to 86 III Adm. Code 130. 1935 (a).
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> STATEMENT OF FACTS
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> CLIENT, an out of state entity, which currently files Illinois retail [sic] occupation and use tax returns, is in the business of licensing computer software. In conjunction with the licensing of computer software, CLIENT offers the sale of two types of maintenance contracts in connection with the licensing of computer software both of which are separately stated on the invoice to the customer(s). The first type of maintenance agreement is optional and is not required to be purchased as part of the licensing of the software. As noted above, customers who purchase this optional maintenance agreement, receive an invoice in which the price for this maintenance contract is separately stated. The second of [sic] maintenance agreement is required to be purchased as part of the licensing of the software, but the customers still receive an invoice in which the price for this maintenance contract is separately stated.

ISSUE(S) FOR RULING

The above taxpayer seeks the Department's guidance on the taxability of the following two maintenance agreements which are illustrated by Exhibits A and B, respectively:

a) A maintenance agreement which is separately stated on invoices to customer(s) and which is not required to be purchased as part of the licensing of the software; and
b) A maintenance agreement which is separately stated on invoices to customer(s) and which is required to be purchased as part of the licensing of the software

ANALYSIS

By way of background, the underlying license of software, to which the above two maintenance agreements pertain, are exempt. Specifically, pursuant to 86 III Adm. Code 130. 1935(a), the licensing of software in Illinois is not considered a 'retail sale' if it meets the following requirements: (1) if it is evidenced by a written agreement, (2) if it restricts the customer's duplication and use, (3) if it prohibits the customer from licensing, sublicensing, or transferring the software to third parties, (4) the vendor will provide another copy free or of minimal charge if the software is lost or damaged, and (5) the customer must destroy or return all copies to the vendor at the end of the license period. Thus, if transactions involving licensing of computer software meet the requirements mentioned above, the transfer of software is deemed nontaxable. According to the applicable authority CLIENT meets the requirement of 86 III Adm. Code 130.1935 (a) and; therefore, is exempt from the retail [sic] occupation tax on the licensing of computer software. Again, for the purposes of this ruling request, the taxpayer is not questioning and/or seeking a ruling concerning the taxability of software licenses as denoted above. Rather, the taxpayer is seeking a ruling on the maintenance agreements associated with the licensing of computer software (an exempt transaction).

With respect to software maintenance agreements, the taxability of maintenance agreements is dependent upon whether or not the charge for the agreement is included in the taxable selling price. If the charge for a maintenance agreement is included in the taxable selling price, then that charge is considered part of the gross receipts of the retail transaction and consequently subject to sales tax (ROT). If maintenance agreements are sold separately, then the sale is not a taxable transaction, but rather the company providing the maintenance or repair will be acting as a service provider under the service occupation tax act (SOT). See 86 ILL ADM. CODE 130.1935(b) and 86 ILL. ADM. CODE 140.301(b)(3).

In the instance case, it appears clear that the sale of optional maintenance contracts associated with the licensing of computer software, with the price of the maintenance contract being separately stated (Exhibit A), would not be taxable pursuant to 86 ILL ADM. CODE 130.1935(b) and 86 ILL. ADM. CODE 140.301(b)(3). Similarly, since the underlying license of software is exempt, a maintenance agreement which is separately stated on invoices to customer(s) and which is required to be purchased as part of the licensing of the software, should also be exempt. See 86 ILL ADM. CODE 130.1935(b) and 86 ILL. ADM. CODE 140.301(b)(3).

REQUESTED RULING

CLIENT seeks guidance confirming its position that the sale of both optional and mandatory maintenance agreements sold in connection with the licensing of business software, wherein the price of both types of said maintenance agreements are separately stated, are nontaxable.

If the Department has any questions or requires any additional information from CLIENT in order to determine Illinois Retailers Occupational [sic] (sales and use) tax consequences of the two types of maintenance contracts denoted above please contact INDIVIDUAL. Thank you in advance for your cooperation and attention to this matter.

DEPARTMENT'S RESPONSE:

The Department's regulation "Public Information, Rulemaking and Organization" provides that "[w]hether to issue a private letter ruling in response to a letter ruling request is within the discretion of the Department. The Department will respond to all requests for private letter rulings either by issuance of a ruling or by a letter explaining that the request for ruling will not be honored." 2 Ill. Adm. Code 1200.110(a)(4). The Department has decided that it will not issue a Private Letter Ruling in regards to your request. Although we cannot provide you with a Private Letter Ruling, we hope the following general information will be of assistance.

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 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 computer software nor the subsequent software updates 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.

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,

Richard S. Wolters
Associate Counsel

RSW:msk