ST 15-0006-GIL 01/12/2015 COMPUTER SOFTWARE
This letter discusses the taxability of computer software licenses. *See* 86 Ill. Adm. Code 130.1935. (This is a GIL.)

January 12, 2015

Dear XXXX:

This letter is in response to your letter dated May 13, 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:

In accordance with the provisions of Illinois Administrative Code ("ILAC") title 2 section 1200.110, we request that the Illinois Department of Revenue ("Department") confirm our understanding as to the items outlined below.

This ruling request is being made on behalf of our client, COMPANY ("COMPANY"). To the best of our knowledge, the issues or COMPANY have not been and are not currently under audit or appeal, under consideration for a refund, or otherwise under specific investigation or review by any division of the Department. To the best of our, and COMPANY'S knowledge, the Department has not previously ruled on the same issue outlined below for the client or a predecessor, and neither our client nor our client's prior representatives have previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

FACTS

COMPANY develops and distributes information technology automation software ("software") that gives system administrators the ability to automate repetitive tasks,

quickly deploy critical applications, and proactively manage infrastructure changes. COMPANY also provides support and maintenance packages for their software products. COMPANY charges for its software licenses per each "node," or each computer or server, on which software is installed. Ten nodes may be downloaded and installed for free by the general public. (Exhibit G).

Agreement A

COMPANY and Customer A entered into a "Master Software License Agreement" as well as a Supplement and Amendment, attached to this letter as Exhibits A, B and C, respectively, and referred to collectively as "Agreement A." Agreement A is evidenced in writing and signed by both parties. Agreement A provides for an "irrevocable non-exclusive and non-transferable" license of the Software. (Exhibit A, section 2.a). Agreement A is a term agreement, lasting for one year and renewable by mutual agreement of the parties.[1] (Exhibit B, section 3). Pursuant to Agreement A, Customer A is "prohibited from licensing, sublicensing or transferring the Software to a third party, except to a related party." (Exhibit A, section 2.a). In the event that Customer A loses or damages the Software, COMPANY agrees to provide them with an additional copy of the software at no charge. (Exhibit A, section 2.f).

Section 2.f of Exhibit A states that COMPANY grants Customer A "the right to copy the Software in nonprinted, machine readable form in whole or in part as necessary for [Customer A's] own back-up and/or archival use. Such copies may exist beyond the termination of [Agreement A] as needed for other than routine business purposes." However, in April 2014, COMPANY and Customer A executed the Amendment to the Master Services Licensing Agreement, clarifying that Customer A must destroy all copies of the software upon termination of the license term. (Exhibit C, Section 2.h).

Agreement B

COMPANY and Customer B entered into a "Master Business Agreement" ("MBA") as well as a "Software Licensing Attachment to the MBA," attached to this letter as Exhibits D and E, respectively, and referred to collectively as "Agreement B." Agreement B is evidenced in writing and signed by both parties. Pursuant to Agreement B, Customer B may not duplicate the Software for any purpose other than those expressly granted. (Exhibit E, Section 2.2). Customer B may also generate a "reasonable number of copies of the [Software] and install them as may be necessary for disaster recovery and back up purposes." (Exhibit E, Section 2.1.2). Customer B may provide third parties access to the software "for the purpose of performing and/or exercising any applicable [Customer B] rights with respect to the [Software] granted" in Agreement B. (Exhibit E, Section 2.1.3).

During the warranty period, COMPANY will make all "necessary repairs and/or adjustments to the [Software] to make it perform" correctly. (Exhibit E, Section 3.1.1). COMPANY has a policy of providing copies of the Software at no cost in the case of loss or damage.

[1] The Master Software License Agreement (Exhibit A) incorrectly states the agreement was a perpetual license. The Supplement (Exhibit B) amends the Master Software License Agreement to properly state that Agreement A was a term license.

Agreement B states that "[u]pon expiration or termination of [Agreement B], [Customer B] shall uninstall the Vendor Product from its computer systems except for 10 nodes for which [Customer B] may continue to use in accordance with the license terms herein." (Exhibit E, Section 9.1). COMPANY allows for the download and management of 10 nodes for free. (Exhibit G). Customer B purchased 5000 nodes under the perpetual license. (Exhibit F). The 10 free nodes are unrelated to the 5000 purchased nodes.

COMPANY has asked us to request a ruling to determine whether the two agreements are software licenses and not taxable retail sales under ILAC title 86 section 130.1935(a)(1).

ISSUES

1. Does Agreement A meet the requirements of ILAC tit. 86 sec. 130.1935(a)(1) making it a nontaxable sale of a license?
2. Does Agreement B meet the requirements of ILAC tit. 86 sec. 130.1935(a)(1) making it a nontaxable sale of a license?

CONCLUSIONS

1. Yes, Agreement A meets the requirements of ILAC tit. 86 sec. 130.1935(a)(1) making it a nontaxable sale of a license as discussed further below.
2. Yes, Agreement B meets the requirements of ILAC tit. 86 sec. 130.1935(a)(1) making it a nontaxable sale of a license as discussed further below.

AUTHORITY AND DISCUSSION

ILAC title 86 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 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 per jury 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.

<u>Agreement A</u>

Agreement A meets all of the above requirements, as follows: (A) it is a written contract signed by both parties as evidenced in Exhibits A and B, (B) that restricts duplication to archival uses only as evidenced by Exhibit A, Section 2.f., (C) and prohibits licensing and/or transferring of the software as evidenced by Exhibit A, Section 2.a., (D) with a

policy of providing copies of the software at no cost in the case of loss or damage as evidenced by Exhibit A, Section 2.f., and (E) the Amendment, as evidenced in Exhibit C, does not allow for copies to exist beyond the termination of the agreement. Therefore, subsection (E) is met as all copies must be destroyed at the end of the lease term.

Agreement B

Agreement B meets all the above requirements as follows: (A) it is a written contract signed by both parties as evidenced in Exhibit E, (B) restricts duplication for any for any [sic] purpose other than those expressly granted as evidenced by Section 2.2., (C) prohibits transfer of the software as evidenced by Sections 2.2., (D) with a policy of allowing copies of the software for disaster recovery as evidenced by Section 2.1.2, and (E) is a perpetual license thereby implied that all copies are destroyed or returned at the termination of the agreement. The agreement does allow for 10 copies to be retained without technical support. Those 10 nodes are available for the download and use by anyone, as evidenced in Exhibit G. The 10 nodes available for free are separate and distinct from the nodes that are subject to the terms of Agreement B. Therefore, subsection (E) is still met as the agreement is perpetual and all copies of the software must be uninstalled, except for the 10 nodes that are available for free to the general public and unrelated to the actual software license. The law states that by merely being a perpetual license, the destruction of the software is deemed met without being stated.

Accordingly, both Agreement A and Agreement B meet the [sic] all of the requirements under ILAC title 86 section 130.1935(a)(1) and should be considered a license of software not subject to retail sales tax.

We request that the Department confirm our understanding as to the above issues and conclusions.

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In the event that this letter does not provide sufficient information to support our conclusions, we request a verbal hearing to more fully state our position with respect to the foregoing.

Thank you for your consideration in this matter. If you require additional information or would like to discuss this request further, please contact me at [XXX-XXX-XXXX].

DEPARTMENT'S RESPONSE:

The Department's regulation entitled "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 generally does not issue private letter rulings regarding the taxability of specific licenses of prewritten (canned) software. 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. Therefore, the Department declines to issue a Private Letter Ruling in response to your request. We hope however, the following General Information Letter will be helpful in addressing your questions.

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. The tax is measured by the seller's gross receipts from retail sales made in the course of such business. "Gross receipts" means the total selling price or the amount of such sales. The retailer must pay Retailers' Occupation Tax to the Department based upon its gross receipts, or actual amount received, from the sale of the tangible personal property.

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. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. 86 Ill. Adm. Code 130.1935. Computer software that is not custom software is considered to be canned computer software, whether it is "stand-alone" or not. 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 Section 130.1935(c)(3).

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.

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 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.

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

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