ST 15-0069-GIL 10/26/2015 COMPUTER SOFTWARE

This letter discusses the taxability of computer software and charges related to the sale of software. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

October 26, 2015

Dear Xxxxx:

This letter is in response to your letter dated June 26, 2015, 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:

> For quite some time, our company has been registered with your state for sales/use tax purposes. At the time of registration, we obtained information from your office about the taxability of our sales. Since then, we have relied on regulation updates from the state and the customers we have there, to make any necessary changes.
>
> However, technological advancements over the years have caused many states to revise their tax codes to accommodate the changes, such as electronic transmission/delivery of information previously sent on some form of media. For this reason, I would like to revisit the taxability of sales in your state, to be certain that we are still collecting the proper amount of tax.
>
> Enclosed is a summary of our business and the billing procedures used, as well as examples of the most common charges. Please provide a written response to the summary that addresses each individual category; whether it is subject to

sales tax, and if the full amount of tax is charged or only a percentage, along with references to the corresponding regulations.

Thank you in advance to your prompt attention to this matter. If you have any questions, or need additional information, please contact me directly.

Sales and Billing Procedures

Computer Systems

Systems are generally sold as "all inclusive" with Hardware, Software, Configuration and Training being charges as a single amount

Software

This may be the full business management software or optional, add-on modules, such as General Ledger, a single price includes any labor charges for configuration of the system as well as customer support required to activate the software and train the customer on its use

Hardware

Server, workstations (PC), monitors, printers, scanner guns, etc.

Labor Charges

Minor on-site installation or configuration of networks and communications. Customer generally contracts with a local IT provider for installation and networking of the hardware, although when our employees arrive to conduct training, oftentimes they must complete the work or troubleshoot and correct any problems that prevent the system from operating properly

On-site training with customer on system operation

In-house (CITY, STATE) repairs to systems and/or components

Software Maintenance

Customers enter into an agreement for Software Maintenance; for a fee, ABC provides unlimited phone support for the system, as well as all revisions, updates and enhancements, at no additional cost

Updates are transmitted over the internet into the customer's system

Manufacturer Price Updates

When a dealer/distributor purchases a computer system, we provide current manufacturer pricing information, e.g. Part Number, Suggested Retail, and Cost information for the product lines he/she represents at no additional cost; these are loaded onto the server before it is shipped to the customer's site

After the initial sale, ABC will provide updated pricing information at a cost of $50 - $75 per update per manufacturer. Updates are generally transmitted over the internet, directly into the customer's system; although, for a very few older systems, we must send the information on some form of media

Supplies

We maintain a complete inventory of statement forms, invoices, shop work orders, paper, ribbons, etc. that may be purchased by customers; additionally, they may also need custom check forms or rental contracts

Freight Charges

Shipments of equipment and supplies are handled through UPS, Fedex and USPS. Freight charges include a 15% markup that is included in the total and not separately identified on the invoice

DEPARTMENT'S RESPONSE:

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.

Software and Maintenance Agreements

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 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.

Labor Charges

The Retailers' Occupation Tax is imposed upon persons engaged in this State in the business of selling tangible personal property for use or consumption. Retailers' Occupation Tax is based upon the "selling price" of the tangible personal property sold. Section 1 of the Retailers' Occupation Tax Act defines the term, "selling price," as the "consideration for a sale valued in money … and shall be determined without any deduction on account of the cost of the property sold, the cost of materials used, labor or service cost or any other expense whatsoever…." See 35 ILCS 120/1. As indicated by this definition, a retailer's cost of doing business is not deductible from his or her gross receipts. This principle is articulated in Section 130.410 of the Department's rules. 86 Ill. Adm. Code 130.410. This rule states that in calculating Retailers' Occupation Tax liability, "labor or service costs" . . . "overhead costs" . . . "or any other expenses whatsoever" are not deductible from gross receipts. The rule provides that these costs of doing business are an element of the retailers' gross receipts subject to tax even if separately stated on the bill to the customer. Note, incoming freight is always a cost of doing business subject to Retailers' Occupation Tax. Thus, for deliveries made from one company's facilities to another of its facilities for the purpose of consolidating a customer's order and subsequently redelivered to the customer, tax liability will be measured on the cost of the delivery from the one facility to the other facility. This delivery is a transportation cost that is treated exclusively as a retailer's cost of doing business.

Transportation and Delivery Charges

The Department's regulation regarding transportation and delivery charges, 86 Ill. Adm. Code 130.415, is under review in light of the decision in *Kean v. Wal-Mart Stores, Inc.*, 235 Ill. 2d 351, 919 N.E.2d 926 (2009). At issue in *Kean* was whether shipping charges for certain Internet purchases of tangible personal property were subject to Illinois sales tax. The court found that an "inseparable link" existed between the sale and delivery of the merchandise plaintiffs purchased from Wal-Mart's Internet store. Thus, the court in *Kean* concluded that the outgoing transportation and delivery charges were part of the gross receipts subject to the Retailers' Occupation Tax.

An inseparable link exists when (a) the transportation and delivery charges are not separately identified to the purchaser on the contract or invoice or (b) the transportation and delivery charges are separately identified to the purchaser on the contract or invoice, but the seller does not offer the purchaser the option to receive the property in any manner except by delivery from the seller (i.e., no pick-up option). In contrast, if the tangible personal property that the customer agreed to buy can be sold to the customer without the retailer rendering the delivery service, then an inseparable link does not exist and the delivery charges should not be included in the selling price of the sale of tangible personal property. *Kean*, 235 Ill. 2d at 375.

Thus, when charges for outgoing transportation and delivery are separately identified and the purchaser has the option to pick up the tangible personal property, outgoing transportation and delivery is considered a service separate and distinct from the sale of tangible personal property that is being transported or delivered and charges for such services should be excluded from the gross receipts subject to the Retailers' Occupation Tax. When a seller offers the purchaser the option to pick up the property at the seller's location, the seller must maintain documentation which demonstrates that the purchaser had that option.

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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