ST 16-0003-PLR 03/26/16 COMPUTER SOFTWARE

This letter discusses the taxability of computer software. See 86 Ill. Adm. Code 130.1935. (This is a PLR.)

March 23, 2016

Dear XXXXX:

This letter is in response to your letter dated December 30, 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.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Admin. Code § 1200.110, governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

> RE: Private Letter Ruling Request on behalf of COMPANY [1]
>
> Pursuant to 2 Ill. Adm. Code 1200.110, I am requesting a Private Letter ruling ("PLR") on behalf of COMPANY , pertaining to COMPANY's liabilities under the Illinois Retailers Occupation Tax ("ROT"). COMPANY requests that the Department of Revenue (Department) issue a PLR regarding whether the one-time prepaid software license fees and related monthly license and support fees described herein are exempt from ROT pursuant to 86 Ill. Adm. Code 130.1935(a)(1). This request contains all information

[1] The business activities currently conducted by COMPANY that give rise to this ruling request were formerly conducted by a business known as "ABC." Prior to DATE, ABC was a division of DEF. On DATE the ABC division was separately incorporated as DEF. On DATE DEF. was spun off and became COMPANY, although it continued to use the same EIN that had been used by DEF. For ease, all references to these entities in this submission will be to "COMPANY." All material facts asserted as to COMPANY are also true as to DEF, Inc. and ABC, during the respective time periods that those entities owned the licensed software described in this submission, unless explicitly stated otherwise.

required by 2 Ill. Adm. Code 1200.110(b)(a)-(8). A Power of Attorney authorizing my representation of COMPANY has previously been provided to the Department, and copy is enclosed.

This PLR request relates to all ROT periods that are currently open for a refund pursuant to the applicable statute of limitations as well as all prospective periods (the "Periods at Issue"). There is currently no audit or litigation pending with the Department regarding COMPANY's Illinois ROT liability for the Periods at Issue. There is also no audit and/or litigation currently pending with the Department for COMPANY involving any other tax type or tax periods.

Statement of Material Facts

COMPANY is located at ADDRESS, CITY, IL, XXXXX, FID: XX-XXXXX. COMPANY sells computer systems, which include computer hardware consisting of central processing units and peripheral equipment. COMPANY also licenses various industry-specific computer software applications to automobile, truck and motorcycle dealers. The separate software applications are standard (canned) applications which are offered to all clients and range from back-office accounting and inventory control applications to front–office showroom traffic tracking and vehicle financing applications. The software is offered in both an on-premise format and in a remotely-accessed ASP Hosted software format in which the customer accesses the software via the Internet. COMPANY offers approximately 50 of these standard prewritten software applications. A large multi-franchise dealer licenses an average of 20 applications, while single-franchise dealers license an average of 9 applications. COMPANY has approximately 1,000 to 1,500 clients located in Illinois.

Each of the approximately 50 software applications represents standard software offered universally to all clients. The average term of a software license agreement is five to seven years. For each software application licensed by the client, there is a one-time prepaid software license fee that ranges from $$$ to $$$, depending on the software application selected. The average prepaid software license fee is approximately $$$. There is also a monthly license and support fee. For any single software application, the list price fee is the same from client to client since the software applications licensed are the same from client to client. The monthly license and support fee is a bundled charge which includes a monthly software license fee, telephone support services and upgrades to the software being licensed. The monthly license and support fee is not optional for the client.

The license granted by COMPANY to its customers is evidenced by a written agreement. (Copies of Master Services Agreements[2] ["MSAs"] attached as **Exhibits A, B and C)**. The agreements provide, *inter alia*, that: (1) the customer's rights to duplicate and use the software is restricted; (2) the customer may not license, sublicense or transfer the software to third parties with the permission and continued control of CDK, (3) the licensee may make and keep an archival copy, and (4) the

[2] The MSA's attached hereto as Exhibits A, B and C are representative of all agreements entered into between COMPANY and its customers in Illinois, and all provisions material to the legal analysis in this submission appear in all agreements the COMPANY enters into with all customers.

customer must destroy or return all copies of the software to COMPANY at the end of the license period.

Required Disclosure

Pursuant to 2 Ill. Adm. Code 1200.110(b)(4), COMPANY states that the department has previously ruled on a similar issue for a predecessor of CDK. *See Private Letter Ruling No ST99-0036-PLR (Ill. Dep't of Revenue Nov. 2, 1999*.) (Copy attached as **Exhibit D**) ("1999PLR"). However, as described in greater detail below, the relevant regulation, 86 Ill. Adm. Code 130.1935(a)(1) was amended on October 2, 2000. This amendment materially impacted the analysis in the 1999 PLR, and COMPANY now believes that its software license agreements are exempt from Illinois ROT. As a result of this amendment, the 1999 PLR no longer binds the Department or COMPANY. *Private Letter Ruling No. ST99-0036-PLR (Ill. Dep't of Revenue November 2 1999*. ("This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules, or in the material facts recited this ruling")(paraphrasing 2 Ill. Adm. Code1200.110(d)). In any event, the 1999 PLR was revoked by operation of law on November 2, 2009. See 2 Ill. Adm. Code 1200.110(e) ("Beginning July 1, 2002 every letter ruling is revoked on the date that is 10 years after the date of issuance of the ruling or July 1, 2002 whichever is later").

Law and Analysis

Prior to October 2, 2000, and at the time that the Department issued the 1999 PLR, 86 Ill. Adm. Code 130.1935(a)(1) provided in relevant part,

> a) Computer software means all types of software including operational, applicational, utilities, compilers, templates, shells and all other forms. Canned 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. The sale at retail, or transfer, of canned software intended for general or repeated use is taxable, including the sale by a retailer of software which is subject to manufacturer licenses restricting the use or reproduction of the software.
>
> 1) 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);
>
> D) the vendor will provide another copy at minimal or no charge if the customer loses or damages the software;

E) the customer must destroy or return all copies of the software to the vendor at the end of the license period.

Effective October 2, 2000, 86 Ill. Adm. Code 130.1935(a)(1) was amended. Section (a)(1) of the regulation remained nearly identical to the previous version in all material respects, except for subsection (D), which now provided,

> 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 perjury by the licensor**

(emphasis supplied)

Prior to the amendment, the 1999 PLR concluded that the 1999 MSA met the requirements of 86 Ill. Adm. Code 1935(a)(1)(A), (B), (C), and (E). The MSA attached to this PLR request, which are identical in all material respects to the 1999 MSA, also meet the requirements of 86 Ill. Adm. Code 1935(a)(1)(A), (B), (C) and (E).

- The software license is evidenced by a written agreement signed by the licensor and the customer **(Exhibit A; Exhibit B, Exhibit C)**.

- The agreement restricts the customer's duplication and use of the software **(Exhibit A, ¶¶6.B, C; Exhibit B, ¶¶ 6.B,C; Exhibit C, ¶¶ 6.B, C)**;

- The agreement prohibits the customer from licensing, sublicensing or transferring the software to third parties (except to a related party) **(Exhibit A ¶¶4.C, 6.B; Exhibit B, ¶¶4.C, 6.B; Exhibit C, ¶¶4.C, 6.B)**;

- The customer must destroy or return all copies of the software to the vendor at the end of the license period **(Exhibit A, ¶¶ 4.D, 6.D; Exhibit B, ¶¶4.D, 6.D; Exhibit C, ¶¶ 4.D, 6.D)**.

The 1999 MSA had been found not to meet the requirements of former subsection (D) because the MSA did not contain a provision that the vendor would provide an additional copy of the software at minimal or no charge if the customer lost or damaged the software. However, as a result of the October 2, 2000 amendment, a license agreement meets the requirements of subparagraph (D) if it *either* provides a copy at minimal or no charge *or* "if it permits the licensee to make and keep an archival copy, and such policy is…stated in the license agreement." 86 Ill. Adm. Code 130.1935(a)(1). Paragraph 6.C of the MSAs at Exhibits A, B and C provides explicitly that "[c]lient shall not copy, in whole or in part, the ADP products related documentation….**provided, however, that Client may make an appropriate number copies of the ADP Products[3] for back-up purposes only.** (**Exhibits A, B and C at ¶6.C**) (emphasis

[3] Paragraph 6.C of Exhibits B and C refers to "COMPANY," not "DEF" This change reflects the ownership changes described above in footnote1.

supplied). Thus, as a result of the regulatory change to subparagraph (D), the MSAs attached at Exhibits A, B and C meet all five requirements set forth in 86 Ill. Adm. Code

130.1935(a)(1) to qualify as exempt from Illinois ROT.[4]

Ruling Requested

COMPANY requests that the Department issue a PLR concluding that all sales of software licenses to COMPANY customers pursuant to the attached MSAs (and all sales pursuant to MSAs that are identical in all material respects to the attached MSA) are exempt from Illinois ROT because they meet the requirements of 86 Ill. Adm. Code 130.1935(a)(1), regardless of whether the software is on-premise or accessed electronically via the internet.

There is no specific trade secret information in either this letter or the attached exhibits that must be redacted prior to public dissemination. The only redactions are those that will be made by the Department pursuant to 2. Ill. Adm. Code 120.110(c), including the name and address of COMPANY and COMPANY representative. Although there is no specific trade secret information, COMPANY respectfully requests that the department not include any portion of Exhibits A, B and C in the publicly disseminated version of the PLR, other that the quoted provisions above which are necessary for the Department's legal analysis.

Thank you for your consideration of COMPANY's Request. If the department requires any additional information to conduct its analysis, please do not hesitate to contact me.

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.

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

[4] 2Ill. Adm. Code 1200.110(B)(6) requires a statement of authorities contrary to the taxpayer's views" In addition, if "the taxpayer determines that there are no authorities contrary to his or her views, or taxpayer is unable to locate such authority, the request must contain a statement to the effect." 2Ill. Am. Code 1200.110(b)(6). COMPANY 1 has been unable to locate any other contrary authority that present sufficiently similar facts and a legal conclusion which would be dispositive of the issues presented in this letter, and contrary to the ruling requested by COMPANY 1.

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.

We have reviewed the license agreements that you provided with your letter. Based on these agreements, it is the Department's opinion that the software license fees are exempt from Illinois Retailers' Occupation Tax as they meet all of the criteria provided in subsection (a)(1) of Section 130.1935. Because the software license fees are nontaxable, the related support fees which you mention in your letter are also considered nontaxable.

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, 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
Chairman, Private Letter Ruling Committee

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