ST 20-0009-GIL 06/09/2020 COMPUTER SOFTWARE

This letter discusses open source software. 35 ILCS 120/2-25. (This is a GIL.)

June 9, 2020

**Re: Private Letter Ruling Request – Retailers' Occupation Tax, Use Tax, Service Occupation Tax, Service Use Tax as applied to Open Source Software Licenses and Subscription Services**

Dear Xxxx:

This letter is in response to your letter dated February 19, 2020, 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:

> On behalf of our client, COMPANY, (**FEIN – [XX-XXXXXXX]/ IBT – [XXXX-XXXX]**) (COMPANY or the "Company"), please allow this to serve as a request for a Private Letter Ruling as authorized by the Illinois Department of Revenue (the "Department") per 2 Ill. Admin. Code 1200.110 with respect to the inquiry detailed below. If the Department has any questions relating to the facts described, please contact the undersigned.
>
> The firm of REPRESENTATIVE (the "Representative") is authorized to request the Private Letter Ruling on behalf of the Company. An executed power of attorney is attached. Taxpayer identifying information is set out as follows:
>
> COMPANY
> ADDRESS
>
> **Statement of Facts**
>
> **Taxpayer Information**
>
> This Private Letter Ruling ("PLR") is requested to determine the Retailers' Occupation Tax, Use Tax, Service Use Tax consequences of actual business practices of the Company. The Company is not currently the subject of litigation or audit regarding the matters discussed in this PLR relating to Illinois transactions. To the best of the

knowledge of both the Company and Representative, the Department has not previously ruled on this or a similar issue for the taxpayer or any predecessor. The Company, and any of its representatives, have not previously submitted the same or similar issue to the Department and withdrawn before a letter ruling was issued. The Company is a registered retailer with the Department.

**Description of Company's Business Operations**

The Company is leading global provider of open source software solutions, using a community-powered approach to develop and offer a reliable and high-performing operating system, virtualization, management, middleware, cloud, mobile, and storage software under a subscription model.

The Company employs an open source development model. The open source development model allows the Company to use the collective input, resources, and knowledge of a global community of contributors who collaborate to develop, maintain, and enhance the software. The collaboration is possible because the human-readable source code for that software is publicly available and licenses permit modification.

The Company provides value to its customers through the aggregation, integration, testing, certification, delivery, maintenance, enhancement, and support of software, and by providing a level of performance, scalability, flexibility, reliability, and security for the technologies it packages and distributes.

***Material Facts Relating to PLR request***

**Open Source Software**

To better understand the business model, it is important to define and establish the differences between open source software and proprietary software.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Open source software is software licensed under an open source license as approved by the Open Source Initiative (WEBSITE), which allows software to be freely used, modified, and shared. The distribution terms of open source software must comply with certain criteria: (i) free redistribution, the license shall not require a royalty or other fee for such transaction: (ii) available source code, program must allow distribution in source code which can be compiled; and (iii) other criteria provided by open source community. The relevant common Open Source Initiative "Open Source Definition" provisions are reproduced below:

1. Free Redistribution – The license shall not restrict any party from selling or giving away the software as a component of an aggregate software distribution containing programs from several different sources. The license shall not require a royalty or other fee for such sale.
2. Source Code – The program must include source code and must allow distribution in source code as well as compiled form. Where some form of a

product is not distributed with source code, there must be a well-publicized means of obtaining the source code for no more than a reasonable reproduction cost, preferably downloading via the Internet without charge. The source code must be in the preferred form in which a programmer would modify the program. Deliberately obfuscated source code is not allowed. Intermediate forms such as the output of a preprocessor or translator are not allowed.

3. Derived Works – The license must allow modification and derived works, and must allow them to be distributed under the same terms as the license of the original software.

The Company takes open source software in the form of source code, vets it for security issues, creates machine-readable executable files with Company branding, and tests it with customers and partners. The Company collaborates with a multitude of contributors and projects to produce enterprise-ready, stable products such as COMPANY PRODUCT 1, COMPANY PRODUCT 2 Application Platform, and COMPANY PRODUCT 3 Platform.

The Company distributes its software subject to the original, third-party open source licenses. The most popular open source license, the GNU General Public License ("GPL") is intended to guarantee a user's freedom to share and modify the program and to make sure the software, including modifications, remains free for all its users. These licenses provide broad rights for recipients of the software to use, copy, modify, and redistribute the software without a license fee. These rights afford significant latitude for recipients to inspect, suggest changes to, customized and enhance the software. Through this model, recipients can develop their own programs and solutions.

On the other hand, proprietary software refers to software that is solely owned by the individual or the organization that developed it, who holds the legal property rights, and only the owner or publisher can access the source code. The open source licensing model provides an inherent level of transparency and choice that contrasts with proprietary software licensing models. Under the proprietary software model, a software vendor generally develops the software itself or acquires components from other vendors, without the input from a wider community of participants.

The open source subscription model also contrasts with the typical proprietary software license model from a U.S. GAAP revenue recognition perspective. Under a proprietary software license model, the vendor typically recognizes license revenue in the period that the software is initially licensed. In contrast, under COMPANY's subscription model, it generally defers revenue when it bills the customer and recognizes revenue ratably over the life of the subscription term.

**Subscription Model**

The Company provides its software and support offerings primarily under annual or multi-year subscriptions. Subscriptions are marketed and sold to customers directly and indirectly through business partners. The Company provides a subscriber with the original, perpetual, non-exclusive open source licenses for free. Recipients retain the right to use the software under the applicable license terms. The term of the license is

perpetual; only the subscription is time-based. The Company does not charge a license fee with respect to the Company software but does charge a fee for subscriptions.

Clients pay the Company a fee for the services in the form of a subscription that provides customers with a comprehensive software solution for the duration of the subscription. A subscription generally entitles a customer to a specified level of support, as well as access to the software, software maintenance in the form of security updates, fixes, functionality enhancements, upgrades to the software, on an if and when available basis, and a partner ecosystem of certified, supported hardware and software. A subscription also includes access to the COMPANY Customer Portal, which provides customers with services such as its support knowledge base, product usage documentation, and account management tools. The support knowledge base is the cumulative documentation of support cases over the years that may be searched by customers. The Customer Portal also provides account management tools to assist system administrators with organizational and user-based actions such as adding, changing or deleting organizations (e.g., divisions) as well as individuals users and groups. The Company offers customers subscription options that provide varying levels of customer support, including self-support, standard support, and premium support. Hours of coverage, the available support channel(s), and response times depend upon the level of support purchased.

In addition, the Company's customers are eligible to participate in the CAPITAL program, which provides certain protections in the event of an intellectual property ("IP") infringement claim made against a customer and based on the Company's software offerings. CAPITAL program also provides customers with the Company's obligation during the term of the subscription to: (i) repair or replace the infringing portion of the software; (ii) modify the software so that its use becomes non-infringing; or (iii) obtain the rights necessary for a customer to continue its use of the software.

If a customer already has an open source license for the software, it may still choose to purchase a subscription for the support and added comfort it provides regarding functionality and access to security and bug fixes, in addition to the protection afforded by the PROGRAM Agreement offered only during the term of a subscription. The price of a subscription is the same regardless of whether the customer already has a license.

The Company offers compiled and branded products to subscribers and non-subscribers through an evaluation program that provides access to the software, governed by the open source licenses. Evaluations are not intended for production environments. The Company also maintains an "upstream first" engineering strategy whereby engineers collaborate with the various upstream communities to get source code changes (e.g. features, functions, fixes, patches, etc.) accepted in the applicable open source community before adding such changes to the Company product. Not only does this upstream first engineering approach drive collaboration with other developers, it also makes the source code available to both subscribers and non-subscribers.

**Pricing**

The Company's commercial contracts establish the basis of the fee for the subscription services to be the total number and capacity of units (e.g. physical and virtual instances,

cores, sockets, etc.) and supported use case for each Company product that a customer deploys. This combination of units and use cases is a good indicator of the size, scope and complexity of the anticipated services workload for a given client deployment.

The Company does not allocate any of the transaction price to the functional IP given the relative fair value is effectively zero (that is, it is available for free). Therefore, although the Company deems the delivery of the functional software code a distinct performance obligation within the context of the contract, the estimated relative fair value is deemed to be zero.

**Requested Ruling**

The Company requests that the Department rule on the Company's providing (1) open source software licenses, and (2) subscription services as follows:

1. The Company's providing access to open source software licenses for no consideration is not subject to the Retailers' Occupation Tax. Use Tax may be due on the cost price of the software.

2. The Company's subscription services are non-taxable services and not subject to the Retailers' Occupation Tax. Service Occupation Tax may be due on the cost price of the software or other tangible property transferred as part of the service.

**Statement of Law**

**Statues, Rules, and Rulings:**

**35 ILCS 120/1**
**35 ILCS 120/2**
**35 ILCS 120/2-25**
**35 ILCS 105/2**
**35 ILCS 105/3**
**35 ILCS 105/3-25**
**86 Ill. Admin. Code 130.1935**
**86 Ill. Admin. Code 140.105**
**86 Ill. Admin. Code 140.106**
**86 Ill. Admin. Code 140.108**
**86 Ill. Admin. Code 140.109**
**Illinois Department of Revenue ST 13-0027-(GIL) (May 28, 2013)**

**Law Relevant of Open Source Software**

Illinois generally subjects canned software to Retailers' Occupation Tax ("ROT") and Use Tax ("UT"), while sales of custom software are exempt per 35 ILCS 120/2(a); 35 ILCS 120/2-25; 35 ILCS 105/3; 35 ILCS 105/3-25; and 86 Ill. Admin. Code 130.1935(a), (c)(1). However, a license of software, whether canned or custom, is not a taxable retail sale under ROT or UT if

it meets the Illinois five prong test for a non-taxable software license under 86 Ill. Admin. Code 130.1935(a)(1), if the following conditions are met:

1. It is evidenced by a written agreement signed by the licensor and the customer;
2. It restricts the customer's duplication and use of the software;
3. 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;
4. 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; and
5. 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 for the in the license agreement.

A transfer of ownership or title to tangible personal property, including software, without a charge or other consideration from a retailer to a customer is not subject to ROT or UT per 35 ILCS 120/1 and 35 ILCS 105/2. However, in such a case the would-be retailer is deemed the ultimate purchaser or user of the tangible personal property, including software and must remit UT on the cost price of any property transferred per 35 ILCS 120/1; 35 ILCS 105/2; and 35 ILCS 105/3.

**Law Relevant to Subscription Service**

Illinois generally subjects software maintenance and upgrades sold as part of a software license to tax under ROT and UT as part of the underlying taxable software license per 86 Ill. Admin. Code 130.1935(a), (b). However, separately stated software maintenance including software bug fixes, training, telephone assistance, installation and consultation is a non-taxable service per 86 Ill. Admin. Code 130.1935(b); 86 Ill. Admin. Code 140.301(b)(3); and Illinois Department of Revenue ST 13-0027-GIL (May 28, 2013). As a serviceman, sellers of separately provided software maintenance services must pay the applicable tax on the materials transferred under the maintenance agreement per 86 Ill. Admin. Code 130.1935(b).

Service providers transferring tangible personal property to service customers will incur either Service Occupation Tax ("SOT") or UT liability upon the property transferred. Depending upon whether a service provider is deemed a "serviceman" or "de minimis serviceman," whether the customer separately billed for materials, and whether the service provider is registered to collect ROT or is required to be. Depending upon the aforementioned factors, a service provider may incur tax liability on the material transferred incident to their service in one of four methods.

If a service provider is deemed a "serviceman," it will incur SOT based upon either the separately states [sic] sales price of materials to the customer or based upon 50% of the total lump sum charge for service and materials to the customer depending upon the method of billing. A service provider transferring tangible personal property is considered a "serviceman" if the ratio between the cost of tangible personal property transferred incident to sales of service and the "serviceman's" total annual gross receipts from all sales of service is 35% or

greater per 86 Ill. Admin. Code 140.105(a). If deemed a "serviceman" and the price of materials to the customer is separately stated from the service charges, the SOT liability is based on the sales price of the tangible personal property sold per 86 Ill. Admin. Code 140.106(a)(1). If the "serviceman" does not separately state the price of materials to the customer, the SOT liability is based upon 50% of the entire customer charge per 86 Ill. Admin. Code 140.106(a)(2). The "serviceman" may then bill Service Use Tax ("SUT") to its customer in the amount of the SOT liability to recover the cost of the SOT remitted to Illinois per 86 Ill. Admin. Code 140.106(e).

A service provider transferring tangible personal property is considered a "de minimis serviceman" if the serviceman's cost ratio is less than 35% per 86 Ill. Admin. Code 140.105(b). If a "de minimis serviceman" is required to be registered as a retailer under Section 2a of the Retailers' Occupation Tax Act, the "de minimis serviceman" incurs SOT liability on the cost price materials provided to the customer, and may bill SUT to the customer for this amount to recover the cost of SOT remitted to Illinois per 86. Ill. Admin. Code 140.109(a), (a)(4). However, if a "de minimis serviceman" is not required to be registered as a retailer under Section 2a of the Retailers' Occupation Tax Act, the "de minimis serviceman" incurs UT liability on the cost price of the materials per 86 Ill. Admin. Code 140.108(a), (a)(1).

**Analysis of Grounds for Requested Ruling**

We have examined the relevant statues, regulations, and guidance issued by the Department. Unfortunately, the Department has not issued any letter rulings or guidance on this topic within the last 10 years that the taxpayer or state can rely on.

**Open Source Software**

Generally, Illinois subjects canned software to ROT and UT regardless of the method of delivery. In order to qualify for the license of software retail sale exclusion, the software license must satisfy the five-prong test provided by Illinois regulation. The Company's software licenses are subject to the open source license provisions and are provided at no charge. As the software licenses are distributed under the open source license provisions, the licenses specifically cannot (1) restrict the duplication and use of the software, (2) prohibit the licensing or transfer of software to third-parties, or (3) require the destruction or return of software. Therefore, the license of the Company's software would be a taxable sale at retail since it does not satisfy the second, third, and fifth prongs of the exclusion. However, the Company's software licenses are provided at no charge, and there is no taxable base upon which to impose ROT.

As the Company's software licenses are provided at no charge, the Company is required to accrue UT on the cost of materials relating to the software licenses. However, since the Company's software licenses are provided at no charge there is no taxable base upon which to impose UT.

**Subscription Service**

The Company's subscription service constitutes the sale of non-taxable services. As described above, the subscription services include a number of elements including: (1) access to the software, (2) support services; (3) software maintenance in the form of security updates,

fixes, functionality enhancements, and upgrades; (4) access to the COMPANY Customer portal providing access to a knowledge base and documentation; (5) account management tools; and (6) participation in the CAPITAL Program to provide IP infringement protection.

No portion of the subscription service charge is related to the open source software license. Further, the open source software upgrades and fixes are derivative works and modifications to open source software, which under the aforementioned "Open Source Definition" fall under the original open source software license. Per the Company's Enterprise Agreement, the subscription services are described as a "service offering." As no portion of the subscription services charges relate to the software license, and the software, upgrades and fixes fall under the open source software license, the Company's provision of subscription services are non-taxable services not subject to ROT.

As the Company provides services, it will be considered a service provider under SOT and SUT and may incur tax liability on the materials provided to its customers as part of the subscription services. The Company's cost of materials in providing its services relates to open source software do not include the payment by the Company of any licensee fees for the open source software as the software is freely available from the open source community. Therefore, the cost ratio between the cost of tangible personal property transferred incident to sales of service and compared to the total annual gross receipts from all sales of service is zero and the Company will be considered a "de minimis serviceman." The Company is a registered retailer with the Department, it must incur SOT on the cost price of the tangible personal property transferred incidental to its services. The Company may then bill SUT to its customer in the amount of the SOT liability to recover the cost of the SOT remitted to Illinois. However, as noted above, the Company's cost of materials in providing its services relates to open source software where no fee or royalty was paid by COMPANY, and therefore there is no taxable base upon which to impose SOT.

**Authorities Contrary to Requested Ruling**

As mentions previously, Illinois has not issued any letter ruling or guidance on this topic with the last 10 years that the taxpayer or state can rely on.

**Conclusion**

The Company's providing access to open source software licenses is not subject to ROT as there is no consideration charged for the software. Furthermore, the Company does not owe UT on the cost of the software transferred for no consideration as the software was also acquired by the Company for no consideration under the open source license provisions.

The Company's subscription services are non-taxable services not subject to ROT. While there are software licenses and software upgrades and fixes transferred as part of the subscription, the subscription fee relates to the service component and not to the open source software licenses. Therefore, the charges for the subscription service relates to non-taxable services. Furthermore, the Company does not owe SOT on the cost price of the software transferred as a "de minimis serviceman" as the software was acquired by the Company for no consideration under the open source license provisions.

We respectfully request a letter ruling on the issue presented in this letter. Thank you for your time and consideration in this matter. If you have any questions, or require additional information, please feel free to contact me.

**DEPARTMENT'S RESPONSE:**

Sales 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* 35 ILCS 120/2; 86 Ill. Adm. Code 130.101. In Illinois, 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* 35 ILCS 105/3; 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.

When property is purchased and then given away, the donor has made a taxable use of the property by making such gift. Therefore, it is the donor of the gift who is deemed the end user of the property and who is subject to the Use Tax, rather than the donee. *See* 86 Ill. Adm. Code 150.305(c).

The donor's Use Tax liability is calculated on the cost price of the property given away. When the property is purchased at retail, the base for calculating Use Tax is the purchase price of the property. If, however, the property given away is a finished product produced by the donor, the donor's Use Tax liability is calculated on the donor's cost price of the materials and products purchased and incorporated into the finished product. *See* 86 Ill. Adm. Code Section 150.305(b) and (c).

Service Transactions

Retailers' Occupation Tax and Use Tax do not apply to sales of service. 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; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act.

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.

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). See 86 Ill. Adm. Code 140.101(f). 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.

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.

The Department does not consider the viewing, downloading or electronically transmitting of video, text and other data over the internet to be the transfer of tangible personal property. However, if a company 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.

Computer software is defined broadly in the Retailers' Occupation Tax Act. 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. Illinois generally does not tax subscriptions.

Maintenance Agreements

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.

A company that distributes computer software free of charge that is acquired and transferred subject to original, third-party open source licenses, the GNU General Public License ("GPL"), does not incur Retailers' Occupation Tax liability on the transfer of the software to its customers. If a company obtains open source computer software free of charge, the company does not incur any Use Tax liability.

A company that takes open source software in the form of source code and creates computer software that it subsequently gives to its clients is deemed the end user of the software and incurs Use Tax liability, rather than the client. The company's Use Tax liability is calculated on the cost price of the property given away to the client. The company's Use Tax liability is calculated on the company's cost price of the tangible personal property purchased and incorporated into the finished product.

A fee charged by a company for the services in the form of a subscription that provides customers with support, access to the software, software maintenance in the form of security updates, fixes, functionality enhancements, upgrades to the software, access to services such as its support knowledge base, product usage documentation, and account management tools is not subject to Retailers' Occupation Tax or Service Occupation Tax, as long as any additional software provided pursuant to the subscription is distributed under open source license provisions and is provided at no charge. Service Occupation Tax may be due on any other tangible property transferred as part of the service.

I hope this information is helpful. 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:bkl