ST-22-0023-GIL 10/19/2022 COMPUTER SOFTWARE

This letter discusses the taxability of computer software licenses and maintenance agreements. See 86 Ill. Adm. Code 130.1935 and 86 Ill. Adm. Code 140.301. (This is a GIL.)

October 19, 2022

COMPANY/ADDRESS

Dear XXX:

This letter is in response to your letter dated August 17, 2022, 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:

> We have a question that needs a resolution. I have already called Illinois Department of Revenue and they have directed me to Legal Services. COMPANY has economic nexus in Illinois. We also have a client that claims our invoices are non-taxable. Attached you will find the original agreements, the renewal invoice and product invoice, our current subscription agreement and Reg 130-1935.
>
> **Information concerning items being billed:**
> The invoice is for continued maintenance and access to the software. However, we do have another invoice where they have purchased additional users (separate from the maintenance and access to software invoice).
>
> **Email detail from client:**
> "NAME1 – There is a five part test under REG 130.1935 to determine the taxability of delivered software in Illinois. Those five tests are:

1. Written agreement signed by licensor and customer outlining rights/ restrictions – Yes
2. Restricts duplication and use of software; - Yes
3. Prohibits licensing/transferring software to 3rd party w/o permission/continued control of licensor; - Yes
4. Licensor has policy of providing another copy at minimal or no charge if customer loses/damages the software, or permitting licensee to make a copy; policy is either stated in license agreement, supported by books and records or notarized statement - Yes
5. Customer must destroy/return all copies of software to licensor at the end of the license period; (if perpetual license, this provision is deemed met w/o being set forth in the license agreement) - Perpetual therefore met

   My notes based on our analysis of the contract are above in red. If you meet these five requirements, the product is outside the scope of sales tax in Illinois. Based on our review and the review of TAXPAYER REPRESENTATIVE, this product is not subject to sales tax in Illinois and is therefore subject to personal property lease tax in the CITY. Please clarify based on the attached agreement which one of the 5 parts of this test are not qualified. If someone from your tax department would like to discuss they can reach out to me directly.

   Thanks

NAME2
TITLE
o ###.###.####| c ###.###.####
ADDRESS2*

How the tax is determined:
Currently, we use VENDOR as our sales tax vendor. We are using a code that taxes the attached invoice as Computer software maintenance contracts / agreements – optional – prewritten software (electronically downloaded) for business use only – downloaded updates and support services. When we bill for additional software or users, we use a code that taxes based on Computer software (prewritten/canned) electronically downloaded (business to business).

Question:
Are these invoices taxable or non-taxable? Does Reg 130-1935 apply to these invoices? Can you provide regulation information concerning this determination?

Very truly yours,
NAME1

TITLE2
COMPANY

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. 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). 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.

Please note that 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 the customer. However, an electronic 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 in Section 130.1935(a)(1)(A).

If computer software, including canned software, is licensed and the license agreement meets all of the criteria in subsection (a)(1) of Section 130.1935, the license of the software is not a taxable retail sale. In addition, if the computer software is custom software, as provided in subsection (c) of Section 130.1935, it is exempt from tax under the Retailers' Occupation Tax Act, Use Tax, Service Occupation Tax, and Service Use Tax.

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. Such provisions 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.

Assuming the services provided, such as installation, phone support, training, and seminars, do not require the transfer of tangible personal property to the recipients of those services, charges for such services are exempt if they are separately stated from the selling price of canned software. See Section 130.1935(b). If computer software training or other support services are provided in conjunction with a sale of custom computer software or a license of computer software, the charges for that training are not subject to tax.

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,

Kimberly Rossini
Associate Counsel

KR:dlb