ST-23-0022-GIL 07/12/2023 COMPUTER SOFTWARE

This letter discusses computer software. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

July 12, 2023

NAME
COMPANY
ADDRESS

Dear NAME:

This letter is in response to your letter received May 12, 2023, 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.

In your previous letter dated March 27, 2023, you stated and made inquiry as follows:

> We at COMPANY1 (COMPANY1) have a "manufacturers rep" type relationship with a COUNTRY company called COMPANY2. Through COMPANY1, COMPANY2 sells wellness providers a combination of hardware and software to initiate the relationship. This program allows the wellness provider to offer a hair follicle test that provides their client a nutritional assessment. We understand that this sale is sale of a tangible product and we are required to collect sales taxes on this transaction.
>
> However, if the purchasing wellness provider continues to utilize the tool with their customers (of which they charge a fee), they will be required to purchase additional report credits from COMPANY1 on behalf of COMPANY2. These credits will populate the providers software program and allow them to offer additional nutritional assessment reports to their clients.
>
> The question is will this sale of credits be considered an intangible or tangible product for sales tax purposes. I spoke to NAME on the Illinois Taxpayer Support line and he shared that the application he thought was

the closest to this was offering a gift certificate that is redeemed at a later date by the user. He indicated that this did not seem to be a tangible product and was, therefore, a non-taxable transaction. However, he was clear that his interpretations were not binding by the state of Illinois. He then instructed me to draft this communication to you and ask for a Private Letter Ruling.

I appreciate you reviewing this situation and providing us guidance so we can operate within the rules and regulations of the state. Naturally, we would like to have an answer as quickly as possible so we can operate in a complaint [sic] fashion. Please email me at E-MAIL or call me at PHONE if you have further questions.

The Department responded by general information letter dated April 20, 2023.

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.

Computer software is considered tangible personal property in Illinois. 35 ILCS 120/2-25.

‘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. Charges for updates of canned

software are considered to be sales of software. 86 Ill. Adm. Code 130.1935(b). 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 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.

Your letter does not discuss whether the wellness provider receives a license of software that meets the criteria provided in Section 130.1935(a)(1). It is unclear from your letter what, if any, benefits the customer receives from payment of the credits beyond the ability to offer additional nutritional assessment reports. Does the wellness provider continue to receive the use and benefits of the software without purchasing additional credits? Does the purchase of additional credits include any updates to the software? Does the purchase of additional credits include maintenance of the hardware or software? How are the credits applied or transferred to the wellness providers? Without a more thorough explanation of the credits the Department is unable to provide a binding private letter ruling.

Your subsequent inquiry received May 12, 2023, provides additional information and contains additional inquiries related to the Department's April 20, 2023, response. Once again, we must respond with a general information letter because your previous letter and recent inquiries do not comply with the procedures for obtaining a binding private letter ruling found in the Department's regulations at 2 Ill. Adm. Code 1200.110.

ATTORNEY, thanks for the response to our initial inquiry about discerning if the sale of additional report credits would be considered a tangible or intangible product for sales tax purposes. Allow me to respond to your assorted points:

*you indicate we must have a written "signed" agreement in place to comply with the requirements of Section 130.193S(a)(l). We can certainly institute this procedure but my question is you indicate this agreement is between the licensor and the customer. We at COMPANY1 are not the licensor of the technology, we simply represent them here in the US (they are COUNTRY based). Can COMPANY1, acting as their contractual distributor, witness that agreement of [sic] must it be the licensor? We can facilitate either situation.

*you address a question in your letter "it is unclear if there are any benefits the customer receives from the payment of the credits beyond the ability to offer additional nutritional assessments. Does the wellness provider continue to receive the use and benefits of the software without purchasing additional credits". The answer is the only function of this software is to allow the provider to produce nutritional assessments for their clients. The software does not perform any other function.

*you address a question "does the purchase of additional credits include any updates to the software? Does the purchase of additional credits include maintenance of the hardware of software?" The licensor does provide ongoing maintenance of the software but that is unrelated to the purchase of credits. The ongoing maintenance is to the software program itself and that is provided as part of the purchase price of the unit. As we agreed in the first correspondence, the purchase of the program we all agree is a tangible sale and sales taxes will be associated with that purchase/sale.

*you address a question "how are credits applied or transferred to the wellness providers?" The answer is they make a purchase of the credits via a shopping cart/ecommerce site on their credit card. Upon purchase, their software credits their account with the credits they purchase. Thus, why the help support line said this seemed to be like issuing a gift certificate.

Thank you for the continued dialogue, we look forward to input so we can resolve this issue and move forward with our commercial opportunity.

DEPARTMENT'S RESPONSE:

Both your initial inquiry and recent inquiry express the opinion that the sale of the software is a sale of tangible personal property and subject to sales tax. However, you also inquiry whether a written agreement should be signed by COMPANY1 or COMPANY2. As explained in the Department's previous response, if a transaction for the licensing of computer software meets all 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. As to your inquiry regarding who should sign a licensing agreement, the agreement should be signed by the licensor.

Your remaining questions are also dependent on whether the license agreement meets all the criteria provided in subsection (a)(1) of Section 130.1935. If the license agreement does not meet criteria, based on the information you have provided, the credits would be taxable at the time of purchase as additional computer software.

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.

If all the criteria listed in subsection (a)(1) of Section 130.1935 are met, then neither a transaction involving the licensing of computer software nor the subsequent software updates will be considered a taxable retail sale subject to Retailers' Occupation and Use Tax. See 86 Ill. Adm. Code 130.1935(a)(1)(A)-(E).

Assuming a license of software meets the requirements of subsection (a)(1) of 86 Ill. Adm. Code 1935, any charges for support, maintenance or updates of the licensed software provided pursuant to the qualified license agreement would not be subject to Retailer's Occupation Tax, whether or not the charges for support, maintenance or updates of the licensed software are billed pursuant to the terms of the license agreement or the terms of a separate agreement.

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,

Richard S. Wolters
Associate Counsel

RSW