ST-24-0006-GIL 02/07/2024 COMPUTER SOFTWARE

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

February 7, 2024

NAME
TAXPAYER REPRESENTATIVE
ADDRESS

Dear NAME:

This letter is in response to your letter dated December 11, 2023, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings, and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

To Whom it May Concern:

We respectfully request the issuance of formal written guidance on behalf of COMPANY for the issues described below based on the facts contained herein. The Company is located in CITY, COUNTRY.

Facts

The Taxpayer is a foreign-based company whose headquarters are located outside of the United States and whose software is hosted on servers located outside the state of Illinois. The Taxpayer sells subscriptions to access information hosted in the cloud through a web portal or by a downloaded application onto mobile cell phones (i.e., iPhones and Android phones), or other electronic mobile devices (i.e., iPads or tablets), to customers ("Members") in the United States. The Taxpayer engages in providing a health coaching ecosystem through customized health, fitness, mental wellness, and nutrition services ("Services"). The Taxpayer provides access to body data insights, personal health coaching, workouts, meal plans, and progress tracking. The Taxpayer also has a Corporate Wellness Program with weekly statistics and detailed data reports, group challenges, and various self-awareness programs.

The Taxpayer offers these Services to Members along with some limited services available to non-members free of charge. To become a Member, a new customer can: 1) create an account on the Taxpayer's website and sign up through a subscription charge or 2) download the free Taxpayer's application ("App") via application marketplaces, such as the COMPANY1 or COMPANY2 (collectively referred to as the "App Store") and sign up through a subscription charge. With the initiation of the subscription charge, the Taxpayer grants to the Member a non-transferable, non-exclusive, license (without the right to sublicense) to use the Services, solely for the Member's personal use. With either option, the frequency of the subscription charge is selected by the Member. If the subscription expires, the Member loses access to the purchased Services. The Services are fundamentally Software as a Service, and the majority of Services are unattainable without access to the Internet. There are limited functions available in offline mode such as the ability to use various health trackers and to download pre-recorded exercise videos. However, most of the offline functions are available in the App for free to anyone who has downloaded it, whether they are Members or not.

Regardless of the method selected to become a Member, the Member is prompted to answer a series of questions around their current health/fitness status and their desired future health/fitness goals. These answers supplied by the Members are utilized by an algorithm to provide customized and detailed health and fitness solutions. The health and fitness solutions provided to a Member are solely determined and delivered by the algorithm and not done with any human interaction, direction, or involvement. The Services include compilations (such as access to hundreds of articles that include tips and tricks on weight loss and dieting) (collectively referred to hereafter as "Content") and access to prerecorded video workouts. Additional Content includes meal plans, progress tracking, and holistic guidance catered to the Customer's fitness, nutritional, and mental health needs. The Content is proprietary to the Taxpayer or to third parties. The information may be individualized to the Customer and the Customer receives a personalized daily exercise routine and user-friendly graph to measure their progress. There is also personalized nutrition and diet information that may be digitally supplied to the Member. For an additional fee, Members may obtain personal health coaching with certified professionals that provide expert feedback, 24/7 support, regular check-ins, and progress evaluations. Certified coaches assist members with fitness plans that were initially generated by the algorithm.

As previously indicated, the services provided are primarily Software-as-a-Service, requiring an Internet connection for most of the App's Content and functionalities with some features available offline. These features are available to Member and non-members free of charge and include a fasting tracker, water/hydration tracker, fitness tracker, and non-personalized, pre-recorded workout videos, which can be downloaded. The fasting tracker allows customers to log their fasting progress and view automatically compiled statistics, available free of charge for all iOS and Android users. However, Android users may incur a charge if they choose to access app-recommended training activities.

Similarly, the water tracker enables customers to record their hydration and view online and offline statistics. This feature is free during a trial period on iOS, but a Membership is required thereafter. In contrast, Android users can use the water tracker free of charge and would only pay to access the recommended training activities. The fitness tracker, which collects physical activity data from the user's phone, electronic device, or wearable wristband via Bluetooth, also functions without an Internet connection. The fitness tracker records users' physical activities and provides statistics, accessible offline for both Members and non-members using iOS or Android. Finally, the App also offers non-personalized, pre-recorded workout videos that are free and can be downloaded for offline viewing.

Issues

Would Illinois impose sales tax on the subscription charges for the customized digital content and subscription service delivered by the Taxpayer through the Taxpayer's App on the customer's device and website?

Analysis Supporting Taxpayer's Views

Due to the nature of the personalized health content sold by the Taxpayer and the delivery of the content through a web browser or App, the associated subscription fee and resulting content should be characterized as Software as a Service ("SaaS") or an electronically delivered information service. Below we examine the taxability of the Services under Illinois law.

Illinois imposes a Retailers' Occupation Tax and Service Occupation Tax on persons engaged in the business of selling tangible personal property, including computer software, at retail[1] and on the transfer of tangible personal property by a service person in connection with the rendered services.[2] For the purposes of the Retailers' Occupation Tax, prewritten computer software is recognized as tangible personal property.[3]

Electronically Delivered Information Service

In Illinois, the downloading of information electronically is not seen as the transfer of tangible personal property. The state's stance, as previously expressed, is that the downloading of digital media (including videos) is considered an intangible transfer and does not fall under the Retailers' Occupation and Use Tax.[4]

Software-as-a-Service

Illinois imposes Retailers' Occupation and use tax on the sale, lease, or license of prewritten computer software with limited exemption for software licenses which meet certain criterion. Prewritten computer software, or "Canned software" is considered

[1] 35 ILCS 120/2a
[2] 35 ILCS 115/3
[3] 35 ILCS 120.2-25
[4] Illinois General Information Letter ST 06-0071-GIL

tangible personal property regardless of the form in which it is transferred or transmitted, including by electronic means. The sale at retail or transfer of canned software intended for general or repeated use is also considered taxable.[5]

The Illinois Department of Revenue ("The Department") has previously advised it does not view software accessed via a cloud-based system, where such software is never downloaded, as a taxable transfer of tangible personal property. It was also advised that "*if an Illinois customer downloads computer software for free from an out-of-state retailer's website or server that is also located out-of-state, the retailer, even though it is donating tangible personal property to the customer, has exercised no power or control over the property in Illinois*."[6] Therefore the customer would incur no use tax liability for the retailer to collect.

Furthermore, The Department has stated that information or data which is electronically delivered or downloaded is not considered a taxable transfer of tangible personal property in the state. Illinois has previously declined to provide additional guidance regarding transactions involving computer software Application Service Providers (ASPs), software hosting and web-based software, citing these topics as being reviewed for administrative rule.[7]

Existing Internal Revenue Service Regulations, § 1.861-18[8], provides [sic] rules for classifying transactions involving computer programs. For this purpose, § 1.861-18(a)(3) defines a computer program as "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result" and includes "any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program." Furthermore, Section 1.861-18 generally does not provide a comprehensive basis for categorizing many common transactions involving what is commonly referred to as "cloud computing," which typically is characterized by on-demand network access to computing resources, such as networks, servers, storage, and software. Cloud computing transactions typically are described for non-tax purposes as following one or more of the following three models: Software as a Service ("SaaS"); Platform as a Service ("PaaS"); and Infrastructure as a Service ("IaaS"). SaaS allows customers to access applications on a provider's cloud infrastructure through an interface such as a web browser.[9] Other transactions exist that are not solely related to computing but still involve on-demand network access to technological resources (these transactions and cloud computing transactions are collectively referred to herein as "cloud transactions"). These transactions have increased in frequency over time and share similarities with the three cloud computing models described above. Examples include streaming music and video, transactions involving mobile device applications ("apps"), and access to data through remotely hosted software.

[5] Ill. Admin. Code tit. 86, § 130.1935(a)
[6] Illinois General Information Letter ST 20-0018-GIL
[7] Illinois General Information Letter ST 10-0113-GIL
[8] Internal Revenue Code § 1.861-18
[9] National Institute of Standards and Technology, Special Publication 500-322 (February 2018)("NIST Report")

Since the user of the Services can get more than just information services (i.e., meal plan, health plan, workout plan), the state may classify the Service as Software as a Service ("SaaS"). For instance, the user can get their heart rate, steps, and other body metrics if they are using a connected device, all of which is available to members and non-members. It is reasonable to conclude that based on Illinois law, the subscription should not be subject to tax as it is not prewritten computer software. Specifically, the subscription is predominantly for the purchase of the meal and health plan, workout plan, and workout videos, which are nontaxable electronically delivered information services.[10] However, should the subscription be classified as software, it is also nontaxable as it is a SaaS solution. Specifically, the customer does not pay for the downloaded App, the Company and servers are located out-of-state, subscriptions are nontaxable, and the content is generally only accessible via the Internet, which is clearly nontaxable pursuant to Illinois General Information Letter ST 20-0018-GIL. Further, this classification aligns with the IRS regulations outlined above whereby applications that are only functional with the Internet are treated as SaaS by the IRS. For these reasons, we believe the subscription fee is not taxable in Illinois.

Analysis Contrary to Taxpayer's Views

There are no statues, regulations, rulings or other state provided guidance which specifically addresses the presented facts.

Conclusion

Based on the foregoing, the Services should be characterized as an Information Service or Software as a Service. Regardless of such classification, the Taxpayer's Services are ultimately Software as a Service or an Information Service, neither of which are taxable in the state when the hosted software is accessed on servers located outside of Illinois.

The above relates to tax periods May 2020 to present. To the best of the Taxpayer's knowledge and ours, the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor. Additionally, neither the Taxpayer nor its representatives have previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

As you review the above request for guidance, please do not hesitate to reach out to me with any questions at PHONE or EMAIL. We kindly request an opportunity to have a conference call to discuss the above request prior to the Department issuing the formal ruling.

DEPARTMENT'S RESPONSE:

Retailers' Occupation Tax

[10] 86 Ill. Adm. Code 130.2105(a)(3)

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. 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. 35 ILCS 105/3; 86 Ill. Adm. Code 150.101. These two taxes comprise what is commonly known as "sales tax" in Illinois. *Kean v. Wal-Mart Stores, Inc.*, 235 Ill. 2d 351, 362 (2009). If the purchases occur in Illinois, the purchasers must pay the Use Tax to the retailer at the time of purchase. 35 ILCS 105/3-45; 86 Ill. Adm. Code 150.401. The retailers are then allowed to retain the amount of Use Tax paid to reimburse themselves for their Retailers' Occupation Tax liability incurred on those sales. 86 Ill. Adm. Code 150.130(b). If the purchases occur outside Illinois, purchasers must self-assess their Use Tax liability and remit it directly to the Department. 35 ILCS 105/3-45; 86 Ill. Adm. Code 150.701(a).

Service Occupation Tax

Retailers' Occupation Tax and Use Tax do not apply to sales of service. See 35 ILCS 120/2; 35 ILCS 105/3. 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. 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 of tangible personal property transferred incident to service; (2) 50% of the serviceman's entire bill; (3) Service Occupation Tax on the serviceman's cost price if the serviceman is a registered de minimis serviceman; or (4) Use Tax on the serviceman's cost price if the serviceman is de minimis and is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. 86 Ill. Adm. Code Sections 140.106; 140.108; and 140.109.

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. See 86 Ill. Adm. Code 140.106.

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). 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. See 86 Ill. Adm. Code 140.109.

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 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. 86 Ill. Adm. Code 140.108.

If an entity 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.

Information services

In Illinois, information or data that is electronically transferred or downloaded is not considered the transfer of tangible personal property in this State. 86 Ill. Adm. Code 130.2105(a)(3). However, canned computer software is considered taxable tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means, or other media. 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 (*e.g.*, medical records delivered to a customer in a hardcopy version, rather than sent electronically), such service transactions are generally subject to tax liability.

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. Computer software includes all types of software including operational, applicational, utilities, compliers, templates, shells, and all other forms. 86 Ill. Adm. Code 130.1935(a).

Generally, sales or transfers of "canned" computer software intended for general or repeated use are taxable retail sales in Illinois. 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 or transfer by a retailer of computer software which is subject to manufacturer licenses restricting the use or reproduction of the software is also taxable. 86 Ill. Adm. Code 130.1935(a). However, if all of the criteria provided in subsection (a)(1) of Section 130.1935 are met, then neither the sale or transfer of the software nor the subsequent software updates are subject to Retailers' Occupation Tax. Specifically, a license of software is not a taxable retail sale if:

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 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 forth in the license agreement.

86 Ill. Adm. Code 130.1935(a)(1). If a license of canned computer software does not meet all the criteria, the software is taxable.

Please note that it is very common for software to be licensed over the internet and the customer to check a box that states that he or she accepts the license terms. Acceptance in this manner does not constitute a written agreement signed by the licensor and the customer for purposes of subsection (a)(1)(A) of Section 130.1935. To meet the signature requirement for an exempt software license, the agreement must contain the written signature of the licensor and customer.

A provider of software as a service is acting as a serviceman. As a serviceman, the seller does not incur Retailers' Occupation Tax. Service Occupation Tax is imposed upon all persons engaged in the business of making sales of service on all tangible personal property transferred incident to a sale of service, including computer software, and is calculated as explained above.

Computer software is defined broadly in the Retailers' Occupation Tax Act and Service Occupation Tax. 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 App, 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.

If an Illinois customer downloads computer software for free from an out-of-State retailer's web site or server that is also located out of State, the retailer, even though it is donating tangible personal property to the customer, has exercised no power or control over the property in Illinois. In this instance, the donor would not have made any taxable use of the property in Illinois. The customer, the donee, would incur no Use Tax liability as the customer did not acquire the software from a retail transaction. Illinois generally does not tax subscriptions.

Moreover, sales of custom computer programs prepared to the special order of the customer may not be a taxable sale. 86 Ill. Adm. Code 130.1935(c)(1). Custom software means the software which results from real and substantial changes to the operational coding of canned or pre-written software in order to meet the specific individualized requirements of the purchaser for his limited or particular use. 86 Ill. Adm. Code 130.1935(c)(2). Custom computer software is not subject to the Retailers' Occupation Tax, Use Tax, Service Occupation Tax or Service Use Tax if the following elements are present:

1. Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and

2. The program requires adaptation by the vendor to be used in a specific work environment, *e.g.*, a particular make and model of a computer using a specified input or output device. 86 Ill. Adm. Code 130.1935(c)(1).

If modified software is held for general or repeated sale or lease, it is canned software. 86 Ill. Adm. Code 130.1935(c)(2). 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. 86 Ill. Adm. Code 130.1935(c)(3). Computer software that is not custom software is considered to be canned computer software. See 86 Ill. Adm. Code 130.1935.

The Department is unable to provide the Company with a private letter ruling based on the limited facts presented in your letter. Your letter states that customers may download an application to enable them to obtain online and offline services. The majority of the services may require access to the Internet, but some services are provided without Internet access, which means some services are not provided through SaaS. Customers obtain services through subscription charges, but there are additional charges for some services provided by the Company.

Your letter states that most of the offline functions available in the App are free, but not all of them. You do not explain how the offline functions are acquired, how they are paid for by customers, and why the transactions are not subject to Retailers' Occupation Tax and Use Tax.

In Illinois, information or data that is electronically transferred or downloaded is not considered the transfer of tangible personal property in this State. However, canned computer software is considered taxable tangible personal property. Computer software includes all types of software, including operational, applicational, utilities, compliers, templates, shells, and all other forms. 86 Ill. Adm. Code 130.1935(a). Based on the information provided, it is not possible for the Department to determine whether some of the services the Company provides for an additional charge are computer software or information services.

If an Illinois customer downloads computer software for free (such as an App, API, applet, desktop agent, or remote access agent) from an out-of-State serviceman's web site or server that is also located out of State, the serviceman, even though it is donating tangible personal property to the customer, has exercised no power or control over the property in Illinois, and the donor would not have made any taxable use of the property in Illinois.

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,

Alexis K. Overstreet
Deputy General Counsel

AKO:RSW:rn