

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

September 11, 2024

NAME  
TITLE  
COMPANY  
ADDRESS

Dear NAME:

This letter is in response to your letter dated August 14, 2024, 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 <https://tax.illinois.gov/> to review regulations, letter rulings and other types of information relevant to your inquiry.

Whether to issue a private letter ruling in response to a letter ruling request is within the discretion of the Department. The Department will respond to all requests for private letter rulings either by issuance of a ruling or by a letter explaining that the request for ruling will not be honored. 2 Ill. Adm. Code 1200.110(a)(4). A request for a private letter ruling must be made by, or on behalf of, an identified taxpayer. The Department will not issue letter rulings to taxpayer representatives for anonymous or unidentified taxpayers. 2 Ill. Adm. Code 200.110(a)(1). If there is case law or there are regulations dispositive of the subject of the request, the Department will also decline to issue a private letter ruling on the subject. 2 Ill. Adm. Code 200.110(a)(3)(D). There is also certain information that must be included in each request for a private letter ruling as provided in 2 Ill. Adm. Code 200.110(b)(1)-(8). The Department determined not to issue a Private Letter Ruling in response to your request. However, the Department is issuing a General Information Letter to help address your question. In your letter you have stated and made inquiry as follows:

Pursuant to 2 Ill. Adm. Code 1200.110, COMPANY (“**COMPANY**”, “**Taxpayer**”, or the “**Company**”) hereby requests a Private Letter Ruling from the Illinois Department of Revenue (the “**Department**”) regarding the application of Illinois sales tax to our enterprise on-premises software sales.

## **I. Factual Background**

COMPANY, a STATE corporation, is a provider of enterprise cybersecurity software solutions, which specifically include, for the purposes of this letter request, on-premises software products. Our on-premises software is sold to business customers, including those located in the State of Illinois, pursuant to written license agreements consisting of a Master Solutions Agreement (“MSA”), Supplemental Terms for On-Premises Software (“**Supplemental Terms**”), and an Order Form. The Order Form is executed by COMPANY and the customer, incorporates the MSA and Supplemental Terms, and sets forth the specific on-premises software and license period. COMPANY does not provide perpetual licenses for its software. Upon execution, the customer may download the on-premises software via electronic means provided by the Company; the Company does not provide its software through a tangible medium.

Relevant to this letter request, the Company does not have a formal or informal policy of providing replacement copies of its software to customers who may lose or damage their licensed copy of the software originally provided via electronic means. The absence of such a policy is not a deliberate decision, but rather a consequence of not needing such a policy up to this point.

Based on our understanding of Illinois tax law and guidance from our tax compliance software, we have been charging and remitting sales tax on these on-premises software transactions to the Illinois Department of Revenue. We now seek clarification on whether the sale of our enterprise on-premises software qualifies for exemption from Illinois sales tax under 86 Ill. Adm. Code 130.1935.

## **II. Relevant Authorities**

In the State of Illinois, the Retailers’ Occupation Tax Act imposes a tax upon persons who are engaged in the business of selling tangible personal property at retail to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. Use Tax is imposed on the privilege of using, in the State of Illinois, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as “sales tax” in Illinois.

Under 35 ILCS 120/2-25, “computer software” is defined as “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 that is held for repeated sale or lease...”

Generally, sales of “canned” computer software intended for general or repeated use are taxable retail sales in Illinois. Canned computer software is considered tangible personal property regardless of the form in which it is transferred or transmitted, “...including tape, disc, card, electronic means, or other media.” See 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs or software are prepared to the special order of the customer. Computer software that is not custom software is considered to be canned computer software. *Id.*

However, if all of the criteria provided in subsection (a)(1) of Section 130.1935 are met, then neither the sale or transfer of canned software, nor any subsequent software updates to the canned software, are subject to Retailers’ Occupation Tax. Specifically, 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.

86 Ill. Adm. Code 130. 1935(a)(1). If a license of canned computer software does not meet all the criteria, then the software is taxable.

### **III. Analysis**

Though we have been treating our on-premises software sales as taxable, for the period beginning October 2021 through the current date, we have received inquiries from customers suggesting that this software may meet the criteria for tax exemption under 86 Ill. Adm. Code 130.1935. Our analysis of the five-part test outlined in this code section is as follows:

- A. Written Agreement: Our MSA, Supplemental Terms, and Order Form constitute a written agreement signed by both parties. Section 16.13 of our MSA allows for electronic execution.
- B. Restricted Use: Section 4.3 of our MSA explicitly restricts the customer's duplication and use of the software.
- C. Prohibition on Transfer: Section 4.3 of our MSA prohibits the customer from licensing, sublicensing, or transferring the software to any third party.
- D. Replacement Policy: Our current agreements do not state an obligation to provide replacement copies at little or no charge if the customer loses or damages the software, nor do they permit customers to keep an archival copy once their license expires. We do not have a policy internally for the provision of replacement copies in the event a customer loses or damages the software, as this situation has not previously arisen. However, if a customer is in compliance with the license terms set forth in the customer's written agreement, the Supplemental Terms state that the Company may provide updates and bug fixes for its on-premises software, and a customer could theoretically be given access to redownload the latest version of the on-premises software via electronic means.
- E. Return or Destruction: Section 14.1 of our MSA requires the customer to cease using, uninstall, and destroy or return all copies of the software upon termination or expiration of the agreement.

While our enterprise software appears to meet requirement (A), (B), (C), and (E) under 86 Ill. Adm. Code 130.1935, we are uncertain about the applicability of requirement (D) to our software given that our contracts do not contemplate the replacement of lost or damaged software. And as we have thus far never been presented with a situation where a customer has lost or damaged its on-premises software and have no formal policy regarding replacement of software in such situations, we are unclear whether our current practices satisfy the replacement policy requirement under (a)(1)(D) of the five-part test.

#### **IV. Request for Ruling**

Based on the facts presented, we respectfully request a ruling on whether our enterprise on-premises software sales are exempt from Illinois sales tax under 86 Ill. Adm. Code 130.1935.

#### **V. Statements Relating to Request**

Pursuant to Ill. Admin. Code 2 §1200.110(b), the Company makes the following representations:

- To the best of the Company's knowledge, the Department has not previously ruled on the same or similar issue for the Company or a predecessor, nor has the Company submitted the same or similar issue but withdrawn it before a letter ruling was issued.
- The Company has no pending audits, litigation, or administrative proceedings regarding this issue.
- This request is duly signed by the Company.

#### **VI. Statement of Confidentiality Request**

Pursuant to 2 Ill. Adm. Code 1200.110(d), we request that all identifying details be deleted from the ruling prior to publication.

### **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. 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 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" 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.

Please note that it is very common for software to be licensed over the internet and for the customer to check a box that states that the customer 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. An electronic agreement in which the customer accepts the license by means of an electronic signature that is

verifiable and can be authenticated and is attached to or made part of the license will comply with this requirement. 86 Ill. Adm. Code 130.1935(a)(1)(A).

A provision in the license agreement that states the licensor shall permit the licensee to download a copy of the computer software at minimal or no charge if the customer loses or damages the software will meet the requirements of subsection (a)(1)(D).

Computer software is defined broadly in the Retailers' Occupation Tax and Service Occupation Tax Acts. 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.

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 for the retailer to collect and remit to Illinois. Illinois generally does not tax software-as-a-service 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:

- A) preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and
- B) 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

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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 canned computer software. See 86 Ill. Adm. Code 130.1935.

I hope this information is helpful. If you have further questions related to the Illinois sales tax laws, please visit our website at <https://tax.illinois.gov/> or contact the Department's Taxpayer Information Division at (800) 732-8866.

Very truly yours,

Richard S. Wolters  
Associate Attorney

RSW:sce