

Charges for updates of canned software are fully taxable as sales of software under Section 130.1935(b) of the Department's rules. If a maintenance agreement provides for updates of canned software (other than "patches" or "bug fixes"), and the charges for those updates are not separately stated and taxed, then the whole agreement is taxable as a sale of canned software. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

January 16, 2009

Dear Xxxxx:

This letter is in response to your letter dated April 1, 2008, 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](http://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 whose commercial domicile is in Illinois ('Licensee') and who has licensed software and purchased optional maintenance agreements for use in Illinois from both in-state and out-of-state software companies ('Licensors'), we are seeking a written interpretation how optional maintenance agreements for the licensed software should or should not be taxed under Illinois law. Licensee is seeking a definitive ruling to clarify Illinois' taxation and exemption of the software updates provided under the terms of the Licensee's optional maintenance services it purchases. Due to Illinois' unique distinction and treatment of licensed software, software updates and the various maintenance services available for purchase, it is Licensee's experience that out-of-state Licensors do not understand Illinois law and are charging the Licensee Illinois tax on products the Licensee believes should be exempt from Illinois' retailer's occupation tax ("ROT") or taxed under Illinois' service occupation tax ("SOT").

### **FACTS**

Licensee is a manufacturer, wholesaler and distributor of products with its headquarters located in Illinois. For its business operations, Licensee licenses a variety of software from various licensors. These licenses generally include an option to purchase software maintenance agreements ('Maintenance Agreements') that are separate and distinct

from the software license itself. Software license agreements generally are issued for an annual period or other set period of time which can be renewed annually or at the end of the set period. *Maintenance Agreement* is an all-inclusive term for a product and related services that may or may not include separate and distinct components such as:

- documentation of the licensed software,
- periodic updates or upgrades to the software under license, e.g. storage media on which program improvements and error corrections are recorded for transfer to the licensee,
- installation assistance,
- access to technical support services via:
  - the telephone,
  - the Internet, or
  - by e-mail,
- maintenance updates, fixes and patches (i.e. debugging),
- on-line and/or on-site training,
- other maintenance services (e.g. consultations on how to use software), and
- other miscellaneous consulting services related to the licensed software.

Optional maintenance agreements (i.e. not mandatory with the purchase of the original license of software) are offered in various forms depending on the Licensor and its products. Due to the optional nature of the Maintenance Agreements, the products and services provided under the terms of the Maintenance Agreements are separate and distinct from the original license of software and should be taxed independently of the licensed software. Generally speaking, Licensee has purchased optional maintenance agreements in the following three forms that include shipping charges where applicable:

- an all-or-nothing bundled package of services and software updates for a single price generally billed as an annual fixed-fee lump sum which may be renewed annually at the same price for a fixed number of years,
- a package of services and software updates for one price that itemizes the components included in the particular maintenance agreement purchased to arrive at the Licensee's charge for the agreement, and
- an itemized package of services and software updates that the Licensee pays for after picking and choosing the items it wants from a list of products and services with individual prices, that the Licensor has to offer.

In general, Licensee's software agreements meet the conditions of 86 Ill. Adm. Code 130.1935(a) that exempts such licenses from Illinois' ROT.

## **ISSUE**

Whether the Licensee's optional maintenance agreements or its components as described and related shipping charges are subject to Illinois' ROT and/or SOT.

## **APPLICABLE LAW**

In general, sales of pre-written or canned programs are retail sales subject to Illinois' ROT regardless of the form in which it is transferred. 86 Ill. Adm. Code 130.1935(a). Thus, a retail sale of canned computer software transmitted over the Internet would be subject to the Illinois' ROT under 86 Ill. Adm. Code 130.1935(a). Custom computer

programs, prepared to the special order of the customer, are not subject to ROT under 86 Ill. Adm. Code 130.1935(c)(1).

The licensing of software, however, is not a retail sale under 86 Ill. Adm. Code 130.1935(a)(1)(A through E) if:

- (1) it is evidenced by written agreement,
- (2) it restricts the customer's duplication and use,
- (3) it prohibits the customer from licensing, sublicensing, or transferring the software to third parties,
- (4) the vendor will provide another copy free or at minimal charge if the software is lost or damaged, and
- (5) the customer must destroy or return all copies to the vendor at the end of the license period.

In *Private Letter Ruling* ST 00-0031-PLR, Illinois Department of Revenue, November 30, 2000, the Department ruled that if transactions for the licensing of computer software meet all the criteria provided in the Regulation 130.1935 then the transfer of the software is not taxable.

Under 86 Ill. Adm. Code 130.1935(b), charges for updates of canned software are considered to be sales of software. In addition, the regulation states that training, telephone assistance, installation and consultation are exempt if they are separately stated from the selling price of canned software.

A third point in the regulation states that maintenance agreements for software will be treated in the same manner as other maintenance agreements. Thus, consulting services and maintenance agreements for software will not be subject to ROT or Use Tax since these services do not constitute tangible personal property. Sellers of maintenance agreements, however, must pay tax on their cost price of the materials transferred incident to the completion of a maintenance agreement under the general rule outlined 86 Ill. Adm. Code 140.301(b)(3).

## **OUR ANALYSIS**

To properly determine what tax Licensee owes on items received under their License agreement and optional service agreements, each potentially taxable item must be identified and then examined closely to determine which of the two signed agreements between the Licensee and the Licensor, the License agreement or the optional maintenance agreement, establishes the legal obligation for the Licensor. In addition to this consideration, the itemization of the Licensee's bill may also be a determinative factor of how much tax a Licensor should charge the Licensee. Basing the tax owed on only one of these three parts of the transaction without considering the other two, may result in an incorrect determination of whether any tax is owed and/or whether ROT or SOT is owed, if the item is taxable. The following analysis will show how all three factors must be considered to arrive at the correct determination of tax.

The analysis immediately following is for the situation where the Licensee picks and chooses the components of its Maintenance Agreement and those Maintenance Agreements that are a package of services and updates which are itemized on the Licensor's invoice to the Licensor. The taxation of the bundled package will be discussed separately after this analysis.

Software Updates/Upgrades – All of Licensee's software purchases are canned software which generally are **taxable**, including any software updates if provided directly under the terms of a canned software purchase. However, Licensee's software license is non-taxable under 86 Ill. Adm. Code 130.1935(a)(1) thus all software updates, under the License agreement are also **non-taxable** because the License itself is exempt from tax. Software updates provided under obligations established under the optional maintenance agreement are treated as **taxable** items because they are not provided under the terms of the exempt License agreement, but, instead, are provided under the terms of the optional maintenance agreement which does not meet the requirements for exemption requirements under 86 Ill. Adm. Code 130.1935(a)(1). Because the software updates are provided for under the terms of a maintenance agreement the general rule applicable to maintenance service providers outlined 86 Ill. Adm. Code 140.301(b)(3) applies thus characterizing the tax owed as SOT payable to the state by the Licensor and not ROT since the taxable software is deemed to be materials transferred incident to the completion of a maintenance agreement and not a retail sale.

This application highlights how a determination of whether Illinois ROT and SOT tax is owed on an item purchased depends not only on the product itself, but also on the legal obligation being fulfilled by the Licensor. To summarize, the Licensee's software updates can either be: (1) subject to ROT if purchased directly as canned software, (2) exempt from ROT if provided under a non-taxable license agreement, or (3) subject to SOT if provided under an optional maintenance agreement, as materials transferred by a Licensor incident to the completion of its legal obligations under a maintenance agreement.

Maintenance Updates, Fixes and Patches – Although these items are software, they are provided by the Licensor under the terms of the maintenance agreement, thus, SOT is the applicable tax payable by the Licensor as materials transferred by a Licensor incident to a maintenance agreement.

Documentation of Licensed Software – These items are tangible personal property provided by the Licensor under the terms of the maintenance agreement, thus, SOT is the applicable tax payable by the Licensor as materials transferred by Licensor incident to a maintenance agreement.

Installation Services and All Technical Support Services – These items are maintenance services that do not constitute tangible personal property, thus, are not subject to ROT or Use Tax. SOT is applicable tax payable by the Licensor on any materials transferred by a Licensor incident to providing these services.

On-line and On-Site Training – These items also are maintenance services that do not constitute tangible personal property, thus, are not subject to ROT or Use Tax. SOT is applicable tax payable by the Licensor on any materials transferred by a Licensor incident to providing these services.

Maintenance Services and Other Consulting Services – These items also are services that do not constitute tangible personal property, thus, are not subject to ROT or Use Tax. SOT is the applicable tax payable by the Licensor on materials transferred by a Licensor incident to a maintenance agreement.

Shipping Charges – For Use Tax and SOT situations, 86 Ill. Adm. Code 140.301(b)(1)(B) states that whether a Licensor's shipping charges are taxable or not depends upon the method used by the Licensor to calculate his tax liability. Delivery charges made by a de minimis Licensor paying either Use Tax or SOT on his cost price are not taxable, since tax in these instances is incurred only on the cost price of the tangible personal property transferred to the service customer incident to a sale of service.

If, however, a Licensor remits SOT on his selling price, delivery charges made to his customer may be taxable. If the Licensor calculates his tax liability on the basis of the separately stated selling price of tangible personal property transferred to service customers, such delivery charges are not taxable. However, if the Licensor does not separately state the selling price and calculates his liability on 50% of the entire service bill, delivery charges become part of the tax base.

For ROT purposes, transportation and delivery charges by a Licensor for delivering property to the customer are not subject to ROT if the seller and buyer separately contracted for the transportation or delivery charges and did not include such charges in the selling price of the item sold. (86 Ill. Adm. Code 130.415)

Delivery charges are deemed to be agreed upon separately if the seller requires a separate charge for delivery and if the charges reflect the actual costs incurred by the Licensor. Charges that exceed the costs of shipping, transportation, or delivery are subject to tax. (86 Ill. Adm. Code 130.415)

If transportation or delivery charges are included in the selling price of the item sold, the transportation or delivery expense is an element of cost to the seller and may not be deducted from gross receipts in computing ROT liability. (86 Ill. Adm. Code 130.415)

Bundled Package of Services and Software Updates – As described above, items in a Maintenance Agreement that are itemized and therefore, separately stated on the Licensor's invoice may or may not be taxable depending on the item and whether it is being provided under the License Agreement or the Optional Maintenance Agreement. When the taxable and non-taxable items are bundled by the Licensor into a single package and sold for at a set price, however, the entire package is taxable because the non-taxable services items [sic] are not separately stated as required under Illinois' ROT regulations to maintain their non-taxable nature.

Thank you for your assistance and consideration in this important matter. If you have any questions, please contact me.

We look forward to your prompt response.

## **DEPARTMENT'S RESPONSE:**

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 Sec. 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.

In addition, for your information, the Private Letter Ruling Committee recently determined that it will no longer issue Private Letter Rulings regarding whether a specific license of prewritten (canned) computer software meets the requirements of subsection (a)(1) of 86 Ill. Adm. Code 130.1935. It is the Private Letter Ruling Committee's position that its regulation at 86 Ill. Adm. Code 130.1935 is sufficiently clear for a licensee or licensor to determine whether a specific license of prewritten computer software meets the requirements of subsection (a)(1) of that rule.

I hope this information is helpful. If you require additional information, please visit our website at [www.tax.illinois.gov](http://www.tax.illinois.gov) or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely,

Samuel J. Moore  
Associate Counsel

SJM:msk