

This letter concerns tangible personal property transferred incident to sales of service. See 86 Ill. Adm. Code Part 140. (This is a GIL.)

July 23, 2008

Dear Xxxxx:

This letter is in response to your letter received in this office on October 18, 2007, 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:

Our company provides a multi-tier service agreement (UMAs) to our customers. This service agreement covers hardware with software installed. The agreement covers services for maintenance and repairs as well as future upgrades.

We believe, based on our research, that this service agreement would not be taxable. I am outlining the details of the agreement below and am requesting confirmation on the initial determination that this service agreement would be nontaxable.

The service agreement covers 24 months and is payable in 2 equal annual installments.

During this 24 month period our company provides support and maintenance to both the computer hardware and the installed software. This would include repair/replacement of parts.

Once the full agreement has been paid, the customer will be provided with a free of charge upgrade. The customer will send back the original system (hardware with software installed) and we will send them a new upgraded system (hardware with software installed).

We are allocating the service agreement costs at 30% to maintenance and 70% to future upgrade systems.

Is the service agreement taxable - if so, what portion is taxable and when are the taxes applicable.

DEPARTMENT'S RESPONSE:

We hope the following information is helpful to you in determining your Company's tax obligations.

SERVICE OCCUPATION TAX

Illinois Retailers' Occupation and Use Taxes do not apply to sales of service that do not involve the transfer of tangible personal property to customers. However, if tangible personal property is transferred incident to sales of service, this will result in either Service Occupation Tax liability or Use Tax liability for the servicemen depending upon his activities. For your general information see of 86 Ill. Adm. Code 140.101 through 140.109 regarding sales of service and Service Occupation Tax.

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. See 86 Ill. Adm. Code 140.101. The purchase of tangible personal property that is transferred to the service customer may result in either Service Occupation Tax liability or Use Tax liability for the servicemen depending upon his activities. The serviceman's liability may be calculated 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 a de minimis serviceman and is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of the sale of service. The tax is then calculated on the separately-stated selling price of the tangible personal property transferred. If the servicemen do not separately state the selling price of the tangible personal property transferred, they must use 50% of the entire bill to the service customer as the tax base. Both of the above methods provide that in no event may the tax base be less than the servicemen's cost price of the tangible personal property transferred. 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. See 86 Ill. Adm. Code 140.109. Servicemen may qualify as de minimis if they determine that the annual aggregate cost price of tangible personal property transferred as an incident of the sale of service is less than 35% of the total annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphics arts production). Servicemen no longer have the option of determining whether they are de minimis using a transaction by transaction basis. Registered de minimis servicemen are authorized to pay Service Occupation Tax (which includes local taxes) based upon their cost price of tangible personal property transferred incident to the sale of service. Such servicemen should give suppliers resale certificates and remit Service Occupation Tax using the Service Occupation Tax rates for their locations. Such servicemen also collect a corresponding amount of Service Use Tax from their customers, absent an exemption.

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. 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 to be 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. See 86 Ill. Adm. Code 140.108.

SOFTWARE

Information or data that is electronically transferred or downloaded is not considered the transfer of tangible personal property in this State. See 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. See 86 Ill. Adm. Code 130.1935. If the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c). If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935(a)(1), neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax.

MAINTENANCE AGREEMENTS

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 maintenance agreements depends upon if 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.

If maintenance agreements are sold separately from tangible personal property, sales of the agreements are not taxable transactions. However, when maintenance services or parts are provided under the maintenance 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).

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 taxability of maintenance agreements depends upon whether the 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 this case, no tax would be incurred on the maintenance services or parts when the repair or servicing is performed.

Except as discussed in the following paragraph, if a maintenance agreement is sold separately from tangible personal property, the sale of the agreement is not a taxable transaction. However, when maintenance services or parts are provided under the maintenance agreement, the service or repair company is acting as a service provider 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). If, under the terms of a maintenance agreement, 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 this paragraph.

In contrast to a patch or bug fix, if a maintenance agreement offered 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 selling price for warranty repairs, training, telephone assistance, installation, consultation, or other charges, then the whole agreement is taxable as a sale of canned software.

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. If you are not under audit and you wish to obtain a binding PLR regarding your factual situation, please submit a request conforming to the requirements of 2 Ill. Adm. Code 1200.110 (b).

Very truly yours,

Richard S. Wolters
Associate Counsel

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