

The Department's regulation "Public Information, Rulemaking and Organization" provides that "[w]hether 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). (This is a GIL.)

November 24, 2008

Dear Xxxxx:

This letter is in response to your letter dated July 8, 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 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 December 17, 2007, we submitted a private letter ruling request on behalf of COMPANY an STATE Corporation (**'COMPANY'**) regarding the proper Illinois sales and use tax treatment of the transactions described below.¹ On May 12, 2008, we had a conference call with yourself regarding COMPANY's letter ruling request. You expressed concern that due to other pending software issues, the Department may be unwilling to issue COMPANY a private letter ruling. You also suggested that we review certain technical aspects of COMPANY's service to see if we could avoid certain software issues preventing issuance of a letter ruling. We have reviewed the technical aspects of COMPANY's service and discovered that some of our factual assumptions were not technically correct. Herein, we supplement and replace our previous letter ruling. To the extent they are inconsistent with this letter, disregard our factual representations and legal arguments in our prior letter.

As indicated in our prior letter, COMPANY is not under audit by the Audit Bureau of the Department of Revenue, is not under investigation by the Investigations and Prosecutions Bureau of the Department of Revenue, and does not anticipate litigation with respect to its sales and use tax liabilities.

We have provided our analysis of relevant legal authorities and request that you confirm our conclusions. We have been unable to locate authorities suggesting a result contrary to our conclusions. To the best of our and COMPANY's knowledge the Illinois Department of Revenue has not previously ruled on the same or similar issues to those discussed herein.

I. FACTS

COMPANY provides an 'SERVICE' service which enables physicians to use personal digital assistants ('PDAs') or Internet browsers on personal computers to electronically submit patient prescriptions to pharmacies over COMPANY's secure SERVICE (the '**SERVICE**'). Because the Service may be accessed and used with a mobile PDA platform or an Internet browser on a personal computer, physicians may use the SERVICE to prescribe medications at a variety of point-of-care locations, such as exam rooms, hospitals, offices, or at home.

With the SERVICE, a physician may prepare and submit a patient's prescription by following a few simple steps. First, the physician uses a wireless-enabled PDA or an Internet browser to access, via the Internet, the patient's insurance eligibility, drug formulary (how the patient is billed for certain types of medications), and medical information stored on COMPANY's secure servers. After reviewing the patient's information, the physician selects and electronically submits a proposed prescription to the SERVICE system. The SERVICE system cross-checks the prescription for possible adverse reactions to the patient's allergies or previously prescribed medications. After receiving verification that the medication will not cause an adverse reaction, the physician prepares the prescription on the PDA or in the Internet browser and electronically submits the prescription to a pharmacy over the secure SERVICE system. After the prescription is submitted to a pharmacy, the SERVICE monitors the prescription's status and adds the prescription to the patient's medical history maintained on COMPANY's servers.

Physicians' use of the SERVICE results in significant cost savings to healthcare institutions (e.g., insurance companies and HMOs) due to improved formulary compliance, generic drug prescribing, reduced staffing, and increased patient safety. To encourage physicians to use the SERVICE, health care institutions ('**Sponsors**') enter into '**Sponsorship Agreements**' with COMPANY, under which Sponsors pay COMPANY to provide the SERVICE directly to the Sponsors' associated physicians ('**Providers**') (see a sample Sponsorship Agreement attached as **Exhibit A** to our prior letter). Under the Sponsorship Agreements, Sponsors pay COMPANY an '**Initiation Fee**' for each Provider, and COMPANY provides each Provider with a one-year SERVICE Subscription together with hardware, software, and related services necessary to access and use the SERVICE. COMPANY negotiates the sales price of hardware separately from its charges for services and separately states charges for hardware on its invoices to Sponsors.² After SERVICE subscription terms expire, Sponsors or Providers may pay a '**Renewal Fee**' to renew their SERVICE Subscription (which includes ongoing training and technical support services).

In addition to Initiation and Renewal Fees, Sponsors pay COMPANY a small fee for each prescription written by Providers that meets certain criteria ('**Script Fees**'), COMPANY receives a portion of each Script Fee as compensation for use of the SERVICE. A second portion of each Script Fee is treated as prepayment towards the writing Provider's Renewal Fee (i.e., payment of Script Fees reduces, and possibly

eliminates Renewal Fees). A third portion of each Script Fee is treated as prepayment towards an Initiation Fee for an additional Provider (*i.e.*, when sufficient Script Fees allocated towards an Initiation Fee have been paid, Sponsors are entitled to an SERVOCE Subscription and related hardware for an additional Provider).

COMPANY generally equips each provider with a specially configured wireless-enabled PDA and, if necessary, installs wireless access points and related hardware at the Provider's facilities (collectively '**Hardware**'). Title to Hardware passes to Sponsor or Providers and they are not prohibited from using the Hardware for other uses. If a Provider does not use the SERVICE with sufficient frequency, Sponsors may request that COMPANY, for a small fee, transfer that Provider's SERVICE subscription and Hardware to a different Provider. COMPANY procures Hardware from various manufacturers/distributors located in various states. At the time COMPANY enters into Sponsorship Agreements, Hardware is located at COMPANY's Texas facilities.

COMPANY configures PDAs with an access control agent ('**Agent**'). The Agent acts as a unique identifier of the PDA, much like a WEP key (an algorithm protecting wireless networks), and authorizes the PDA to communicate with COMPANY's secure servers. The Agent does not contain business logic, data, or cookies, and has no cache options. The Agent contains minimal display logic which displays information received from COMPANY (*i.e.*, the Agent displays certain pixels on the PDA screen based on data received from COMPANY).

COMPANY maintains various software applications on its servers which it uses to retrieve requested data from its databases, process retrieved information (*i.e.*, perform insurance and safety cross-checks and compile reports), and securely transmit patient information to Providers and pharmacies. COMPANY, however, does not download software to Physicians PDAs at any point in the process.

Apart from its function of authorizing PDAs to connect to the SERVICE system, the Agent serves no other function and has no commercial value. COMPANY does not sell the Agent to nonsubscribers and does not charge Sponsors for the Agent. The Agent is an ancillary, invisible (to Sponsors and Providers), enabling component of the SERVICE. Although COMPANY does not charge Sponsors/Providers for the Agent, it requires Providers to sign license agreements. COMPANY requires Providers to sign license agreement solely to protect its intellectual property from appropriation by Providers. For example, the licenses restrict Providers from reverse engineering the Agent.

Providers who use personal computers to access the SERVICE do not use the Agent. Instead, Providers access the SERVICE by entering a URL into a common, commercially available Internet browser. COMPANY does not provide personal computer equipment or maintenance.

COMPANY performs several services during Providers' initial set-up process and throughout SERVICE subscription terms. During set-up, COMPANY uploads Providers' patient information to its secure servers. COMPANY also installs hardware necessary for PDAs to wirelessly access the SERVICE (*i.e.*, wireless access points and cables) ('**Installation Services**') and trains Providers on how to access and use the SERVICE. Throughout the SERVICE subscription term, COMPANY offers training and technical support (collectively '**Support Services**') with respect to the SERVICE. Support Services may periodically address hardware issues as they relate to accessing and

using the SERVICE. COMPANY, however, does not repair hardware and does not enter into maintenance contracts with Sponsors or Providers. COMPANY does not charge extra (outside of Initiation and Renewal Fees) to provide Support Services or Installation Services; rather, COMPANY provides Support Services and Installation Services as part of the SERVICE subscription package to ensure that Providers actual use SERVICES. By ensuring that Providers use SERVICES, COMPANY increases the likelihood that Sponsors will renew or expand their Sponsorship Agreements and increases the amount of Script Fees paid by Sponsors.

II. TAXPAYER'S REQUESTED RULINGS

We respectfully request that you issue a private letter ruling confirming that:

(i) because SERVICES and Support Services do not involve transfers of tangible personal property or the delivery of a taxable service, they should not be subject to sales or use taxes; (ii) because COMPANY and Sponsors agree to the sales price of Hardware separately from Installation Services, Installation Services are not subject to sales or use tax; (iii) because COMPANY provides the Agent to Providers as an ancillary enabling component of the SERVICE and does not charge for its use, Sponsors' should not be treated as acquiring the Agent in a retail sale and should not be subject to sales or use tax thereon; (iv) COMPANY should not collect sales or use tax from Sponsors on Scrip Fee payments; (v) Hardware is subject to sales or use tax and not service occupation tax or service use tax; and (vi) COMPANY should collect use tax on Hardware delivered to Sponsors/Providers (after receiving full prepayment of applicable Initiation Fees through receipt of sufficient Script Fees) at the time Hardware is delivered by COMPANY.

III. AUTHORITIES

Illinois imposes retailers' occupation tax (sales tax) on the sale tangible personal property in Illinois. § 120/2.³ Illinois also imposes use tax on the privilege of using in Illinois tangible personal property purchased at retail. § 105/3. If retailer's occupation tax is imposed on a sale of tangible personal property, use tax will not be imposed on the property's use. Unless otherwise indicated, references to 'sales and/or use tax', refer to both the retailers' occupation tax and the use tax.

As explained below, sales and use taxes do not apply to sales of services. However, if tangible personal property is transferred incidentally to sales of services, Illinois generally will impose either service occupation tax on incidentally transferred property or service use tax on the use of incidentally transferred property. §115/3; § 110/3. For tangible personal property to be treated as transferred incidentally to a service (and therefore subject to service occupation tax or service use tax instead of sales or use tax), the tangible personal property acquired must have no value to the purchaser except as a result of services rendered by the vendor. See *Spagat v. Mahin, Director of Revenue*, 277 N.E. 2d 834 (Ill. 1971) (Taxpayer purchased carpet and installation services. The Illinois Supreme Court held that the carpet had value apart from the installation services and therefore the carpet purchase was subject to use tax and not service use tax).

Computer software is considered tangible personal property regardless of the form in which it is transferred or transmitted. § 105/3; 86 Ill. Admin. Code 130.1935. Computer

software includes all types of software including operational, applicational, utilities, compilers, templates, shells and all other forms. *Id.*

Many service providers, especially those who provide services over the Internet, provide free software to their customers to enable the customers to access and use their service. In those situations, the customers are not treated as purchasing the software at retail and are not subject to sales or use tax on their acquisition or use of the free software. See 86 Ill. Admin. Code 150.305(a). The service provider, however, is treated as using the software in providing its service, and is therefore subject to use tax on its purchase of software provided free of charge to its customers. 86 Ill. Admin. Code 150.305(c).

For example, in Illinois General Information Letter ST 06-0087-GIL (4/20/2006), a taxpayer provided an online sales/use tax database information service. The taxpayer's customers submitted transaction data over the Internet to the taxpayer's servers which calculated the appropriate sales tax. To enable its customers to electronically submit transaction data and to receive sales tax calculations, the taxpayer provided its customers with software. The taxpayer, however, did not charge its customers for the software.

In the letter, the Department indicated that when property is transferred without charge (such as the software), the donor should be treated as the end user and should be subject to use tax. The donee, however, should not be treated as the end user and should not be subject to sales or use tax.

Illinois imposes sales and use tax only on the use of tangible personal property and not on the provision of services. § 105/3; § 110/3, ST 07-0119-GIL (8/15/2007) (your previous letter). In certain circumstances, retailer's charges to install tangible personal property sold to a customer may be included in the tangible personal property's sales price, and therefore subject to sales and use taxes. However, if a seller and a buyer agree upon installation charges separately from the tangible personal property's selling price, the installation charges are not treated as part of the tangible personal property's selling price, and therefore, as a service are not subject to sales or use tax. 86 Ill. Admin. Code 130.450(b).

DISCUSSION

Hardware constitutes tangible personal property. Therefore, COMPANY's Hardware sales to Sponsors/Providers for use in Illinois should be subject to use tax. Further, because Hardware may be used for purposes other than SERVICES, Hardware sales should not be treated as transferred incidentally [sic] to SERVICES and therefore should not be subject to service occupation or service use tax. At this time, COMPANY does not intend to register as a de minimis serviceman.

Illinois sales and use taxes only apply to sales or use of tangible personal property purchased at retail (and not services). Therefore, as a service, SERVICES are not subject to sales and use taxes. For the same reason Support Services (which do not involve transfers of tangible personal property) are not subject to sales and use taxes.

As explained, COMPANY and Sponsors agree upon Hardware's sales price separately from the portion of the Initiation Fee allocable to services (*i.e.*, SERVICES, Support Services, and Installation Services). Therefore charges allocable to Installation Services

should not be included in Hardware's sales price, and should not be subject to sales or use tax.

It is not entirely clear whether the Agent constitutes software. However, even if it is software, Providers' free use of the Agent in connection with the SERVICE should not be subject to sales or use tax. Providers do not purchase the Agent - COMPANY provides it free of charge to enable Providers to access the SERVICE. Accordingly, under 86 Ill. Admin. Code 150.305(a) and (c), Providers' acquisition or use of the Agent should not be subject to sales or use tax. Instead, COMPANY should be treated as using the Agent in providing SERVICES.⁴ The fact that COMPANY requires Providers to sign a license to limit Providers' rights to use the Agent should not change this analysis. The license does not signify that Providers purchase the Agent; it is purely a protective measure.⁵

Similarly, even though by accessing the SERVICE, Providers cause COMPANY's software located on its servers to operate, Providers are not making a taxable use of software. They are simply accessing databases, requesting information and reports, and directing COMPANY to electronically submit prescriptions. Providers are not consumers of software in any meaningful sense. By analogy, when a person enters a search request in a search engine, it causes the search engine software to operate. However, for tax purposes, the person would not be treated as using the search engine owner's software.

Because SERVICES, Support Services, Installation Services, and the Agent are not subject to sales or use tax, Initiation Fees (except for separately stated portions relating to Hardware) and Renewal Fees should not be subject to sales or use tax. Also fees to transfer an SERVICE subscription to another Provider should not be subject to sales or use tax.

The portion of Script Fees allocable to payment for using SERVICES should not be subject to sales or use tax because, as explained above, SERVICES are not subject to sales or use tax. Similarly, because SERVICES, Support Services and the Agent received upon payment of Renewal Fees are not subject to sales or use tax, the portion of Script fees allocable to prepayment of Renewal Fees should not be subject to sales or use tax.

After sufficient Script Fees have been paid to cover an Initiation Fee, Sponsors are entitled to receive Hardware (in addition to an SERVICE subscription) for an additional Provider. However, Hardware is not delivered to Providers in Illinois until after sufficient Script Fees have been paid to cover an entire Initiation Fee. Because Sponsors/Providers do not receive Hardware at the time Script Fees are paid, Sponsors will not have made a taxable Hardware use at the time Script Fees are paid. Therefore, at the time Script Fees are paid, Sponsors/Providers will not have incurred use tax liability upon which COMPANY may legally collect use tax. COMPANY should invoice Sponsors for use tax with respect to Hardware delivered into Illinois pursuant to Script Fee payments at the time the Hardware is delivered.

In light of the facts and authorities discussed above, we respectfully request that you issue a private letter ruling confirming our analysis.

* * * *

Thank you for your consideration. If you need additional information, or should you have any questions, please call me. If you anticipate that a response to this letter might reach a different result from that suggested above, we respectfully request an opportunity for an informal conference to discuss this matter prior to the issuance of such response.

DEPARTMENT'S RESPONSE:

The Department's regulation "Public Information, Rulemaking and Organization" provides that "[w]hether 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). As we advised during our telephone conversation, after reviewing the nature of your inquiry and because of the limited facts and information on the software being provided as part of the service, it was the Department's position that we must decline to issue a Private Letter Ruling. The latest letter you sent to the Department has not changed our position.

Your letter dated May 22, 2007, and responded to by the Department on August 15, 2007 (ST 07-0119 GIL), stated that "[t]he initial deployment of services is billed as a bundled package of hardware, software and service subscription and is one single line item on an invoice." In your latest letter, at page 2, you state that the Company "negotiates the sales price of hardware separately from its charges for services and separately states charges for hardware on its invoices to Sponsors." You also state that the Company "intends to format its invoices for Illinois sales similarly to Exhibit B." The Department has reviewed Exhibit B; and, as we discussed during our conversation, the Department does not believe that the sample invoice properly reflects a separate charge for the hardware.

You advised the Department during our conversation that the Company does not sell hardware, routers and cable to persons who do not purchase the SERVICE from the Company. If this is the case, the Department believes the sales of hardware, routers and cable would generally be incident to the sale of service and subject to tax under one of the four methods described in the Department's earlier response.

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

RSW:msk

¹ References to sales and use taxes are to Retailers' Occupation Tax, Use Tax, Service Occupation Tax, and Service Use Tax collectively, unless the context indicates otherwise.

² Prior to determining that it was responsible for collecting Illinois use tax, COMPANY did not separately state Hardware charges on invoices and did not collect use tax thereon. Representatives of the Audit Bureau have informed us that in its voluntary disclosure self-assessment, COMPANY may establish by proper documentation the portion of invoice charges allocable to Hardware. On future

invoices, COMPANY intends to separately state Hardware charges. We have attached an invoice relating to sales in another state in which COMPANY has separately stated Hardware charges. (See **Exhibit B** attached to our prior letter). Prospective, COMPANY intends to format its invoices for Illinois sales similarly to Exhibit B.

³ All section references are to Chapter 35 of the Illinois Compiled Statutes unless otherwise indicated.

⁴ COMPANY developed the Agent in-house. Because COMPANY did not acquire the Agent at retail, under 86 Ill. Admin. Code 150.305(a), its use should not be subject to use tax.

⁵ COMPANY's software licenses do not meet the requirements of 86 Ill. Admin. Code 130.1935(a)(1).