

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. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

December 10, 2008

Dear Xxxx:

This letter is in response to your letter dated May 8, 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](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:

The purpose of this letter is to request a General Information Letter ruling pursuant to 2 Ill. Adm. Code Sec. 1200.120. as to whether certain software agreements should be subject to Illinois Retailers' Occupation Tax.

#### **FACTS**

One of our clients is in the business of licensing computer software to end users in Illinois. Due to technological advancement, software that used to be transferred on hard disks can now be accessed by customers over the Internet.

Our client has entered into agreements with end users that govern the use of its software accessed via the Internet.

These agreements contain provisions that restrict the customer's ability to duplicate and use the software, and prohibit the customer from transferring, licensing, or sublicensing the software to a third party without the permission of our client. Additionally, there is a written agreement signed by our client and the customer.

Upon execution of the license agreement, the customer receives access to software located on the client's servers in another state. The software is not downloaded to the customer's computer. The license agreement does not contain language that allows the licensee to maintain an archival copy, or provides that the customer will receive a replacement hard copy at little or no charge, as there is no possibility that the software could be damaged or lost in the hands of the customer. In the event that the master copy of the software that resides on the client's servers is damaged or lost, the client will reinstate a working copy of the software using its backup procedures.

The license agreements have limited duration, and expire when not renewed. When a customer signs an extension of the software license, continued access to the software is provided. If the software license agreement is not renewed, continued access to the software is denied (access codes are needed to use the software). The license agreement does not contain a provision requiring that the software be returned or destroyed at the end of the license term. Such a provision is not necessary because the software remains on the client's servers at all times.

### **RULING REQUESTED**

We request a ruling as to whether a license of computer software is subject to tax in Illinois, where: 1) the license agreement meets sections (a)(1), (a)(2), and (a)(3) of 86 Ill. Adm. Code Sec. 130.1935, 2) the Client's software is not transferred to the customer, but instead remains on the Client's servers at all times, and thus there are no provisions or policies concerning replacement of lost or damaged software, and 3) the agreement is silent to what happens to the software at the end of the license period, because again the customer never takes possession of the software, and the customer cannot access the software at the end of the license term.

### **AUTHORITY**

Illinois Regulation, 86 Ill. Adm. Code Sec. 130.1935(a) states that:

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 third 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 of 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.

### **ANALYSIS**

While we are uncertain as to how the Illinois Department of Revenue will rule on this matter, we assert the following in support of the argument that client's software should be considered a nontaxable license.

Regulation 130.1935 explains when a license of software will not constitute a sale. Essentially, these provisions establish the difference between a license, which is essentially a right to use software on terms controlled by a licensor, and a sale, where a customer has full rights to use the software in any manner.

Subsection D of Regulation 130.1935 states that the licensor must provide a backup, or allow the customer to create a backup, of the software at little or no cost. This is consistent with the notion that the customer is purchasing the right to use the software, and is guaranteed usage of the software, in comparison to a sale of software (or some other product) where, after the initial transaction (and warranty period), the vendor generally has no responsibility to the customer. In this instance, the client continues to have the responsibility to provide customer with access to working software, but instead of transferring the software to customer's computers, client maintains the software on its own server. Since the software remains on the client's computers, there is no risk that customer will lose or damage the software, and thus the need for replacement software is eliminated.

Subsection E of Regulation 130.1935 states that a customer must destroy or return the software to the licensor at the end of the license period. Again, this section helps establish the difference between a license, where the licensee's rights to use the software is limited to the terms established by the licensor, and a sale, where the customer is not subject to such limitations on usage. In this instance, the client simply no longer provides access to the software at the end of the license period, by disabling the customer's access. Since the software remains on the client's computers, there is no need for a provision concerning the return or destruction at the end of the license term, because the customer has no software to use or access at the end of the license term.

Letter rulings were issued, and then Regulation 130.1935(a) was amended to date, that in the case of a perpetual license, Subsection E is deemed to be met, even if language about destruction or return of software at the end of the license period was not present. This allowance was granted to recognize the superfluousness of requiring such language in a contract where it had no relevance due to the nature of the agreement. Requiring language in a license contract regarding backup copies and destruction and return of software would be similarly needless when the customer never downloads the software in the underlying transaction.

Therefore, while Client's license agreement does not meet the letter of Regulation 130.1935 due to advancements in technology that no longer require that software be delivered to the customer, the spirit of the nontaxable license definition is met, and thus this transaction should be deemed not subject to tax.

Thank you for your time and consideration. If you have any questions or require any further information regarding the above transaction, please contact me.

#### **DEPARTMENT'S RESPONSE:**

Generally, sales of "canned" computer software are taxable retail sales in Illinois. Sales of canned software are taxable regardless of the means of delivery. For instance, the transfer or sale of canned computer software downloaded electronically would be taxable.

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.

Your letter request indicates that the customer is not required to destroy or return all copies of the software at the end of the license period. In addition, we have found no evidence that the license agreement grants a perpetual license to the customer. In fact, you state that the license agreements have limited duration, and expire when not renewed. A license of canned software is subject to Retailers' Occupation Tax liability if all of the criteria set out in 86 Ill. Adm. Code 130.1935(a)(1) are not met.

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 dispositive of the subject of your request, as are several PLRs and GILs that the Department has issued which can be found on the Department's website.

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.

Very truly yours,

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