



Insights: Publications

Applying the Chicago Lease Transaction Tax to "Cloud" Software Products

September 11, 2019

Written by **Samantha K. Breslow**

This article clarifies the application of the Transaction Tax to “cloud” software products and explores the interplay with the Illinois Retailers' Occupation Tax (“ROT”).

UPDATE: In January 2021, the Department issued an [Information Bulletin](#) (“Nexus Bulletin”) providing guidance on nexus and establishing a prospective “safe harbor” for certain taxes, including nonpossessory computer leases taxed under the Transaction Tax Ordinance. For additional information on this update, read my article [“Chicago Department of Finance Issues Nexus Guidance.”](#)

Expanding the Definition of a Nonpossessory Computer Lease

As explored in my [prior post](#), the Transaction Tax is imposed upon leases or rentals in the City, including “nonpossessory computer leases”.^[1] Although this language was not added to the Chicago Personal Property Lease Transaction Tax Ordinance (“Ordinance”) until 1994, following the Illinois Appellate Court's decision in *Meites v. Chicago*, 184 Ill. App. 3d 887, 888 (1989), the Ordinance has applied the Transaction Tax to “leased time for use of ... computers” since its adoption in 1974.^[2] In the *Meites* decision, the Court determined that charges billed by LexisNexis to a law firm for online database searches were subject to the Transaction Tax as leased time for use of computer software.^[3] At the time of the Court's review, LexisNexis did not provide the online research platform it offers today; rather, users paid for access to a terminal that provided direct access to a database.

In June 2015, the Chicago Department of Finance (“Chicago Department”) issued [Chicago Lease Transaction Tax Ruling No. 12](#) (“Ruling No. 12”), which stated that a “nonpossessory computer lease” includes “cloud computing, cloud services, hosted environment, software as a service, platform as a service, and infrastructure as a service.” Further, in October 2015, the Chicago City Council amended the Ordinance to include a lower Transaction Tax rate of 5.25% for “the nonpossessory computer lease of a computer”, effective January 1, 2016. Due to a substantial number of requests for further guidance by taxpayers and practitioners, the Chicago Department issued an [Informational Bulletin in November 2015](#), conceding that many companies “may not have been aware of the scope of the Tax[,]” and that it had received regular requests for guidance on the application of the Lease Tax to various products developed since the Transaction Tax was first enacted. This ambiguity

resulted in the Chicago Department offering a voluntary disclosure program specifically targeted to “cloud” products in January 2016.

Limiting the Lookback Period

Due to the historical lack of guidance regarding the applicability of the Transaction Tax to cloud computing and software, in audit the Chicago Department frequently seeks apply the Transaction Tax to software in periods prior to 2016 and applies the higher rate of 9 percent applicable to leases of tangible personal property.^[4] If a taxpayer substantially underpays its Transaction Tax liability, meaning tax paid was less than 75% of tax due, or if no tax return ([Form 7550](#)) was filed for that period, the Chicago Department can assess outstanding Transaction Tax for up to six years from the end of that year.^[5]

However, the Chicago Department arguably did not extend the application of the Transaction Tax to “cloud” products until its issuance of Ruling No. 12 and its November 2015 Information Bulletin. As acknowledged by the Chicago Department, there have been significant “advances in computing, connectivity and other technology” since the enactment of the Ordinance.^[6] Accordingly, when the term “nonpossessory computer lease” was added to the Ordinance in 1994, the Chicago City Council could not have intended to apply the Transaction Tax to the numerous software arrangements identified by Ruling No. 12.

Applying the Transaction Tax or ROT – License or Sale of Software?

A significant challenge facing taxpayers is whether to collect the Illinois ROT or Transaction Tax on transactions involving software or digital goods. The Illinois ROT and Chicago Transaction Tax are mutually exclusive taxes, meaning that a taxpayer cannot be subject to both the Illinois ROT as a sale of software and the Lease Transaction Tax as the license or rental of software. Nevertheless, it is not uncommon for both the Illinois Department of Revenue (“Illinois Department”) and Chicago Department to pursue a taxpayer for collection of both taxes.

The Ordinance clearly states that a taxable “lease” or “rental” shall include a transfer of the use of software only if, for purposes of the ROT, the software is not “custom” software and the transfer is an exempt license of software.^[7] By definition, “custom” software is thus exempt from the Transaction Tax. Further, the Chicago Department clarifies in [Chicago Lease Transaction Tax Ruling No. 5](#) that if the transfer of software is a true license, meaning that it meets the five-part test set forth in Illinois Administrative Code Section 130.1935, it is a lease subject to the Transaction Tax.^[8] Therefore, the Transaction Tax only applies when the transfer constitutes a license of canned software pursuant to Illinois' five-part test, which means the transaction is not treated as a sale of software subject to ROT.

Searching for a Nexus Standard – Is there One?

The Chicago Ordinance and rulings currently provide limited guidance as to the applicable nexus standard for the Transaction Tax. Although Ruling No. 12 clarifies that the Transaction Tax applies “whenever the customer's license, rental or use of the provider's computer takes place in Chicago”, it punts as to the issue of nexus, stating that the issue of nexus “is beyond the scope of this ruling” and instead advises taxpayers to seek a

private letter ruling from the Chicago Department. To date, the Chicago Department has not defined a nexus standard for the Transaction Tax.

As a result, taxpayers are left to guess as to the applicable standard. As explained in a [prior post](#), the United States Supreme Court reversed the longstanding physical presence standard for sales tax nexus in June 2018, affirming South Dakota's economic nexus standard.^[9] Like the substantial majority of states, Illinois adopted similar legislation that requires retailers making sales of tangible personal property to purchasers in Illinois remit Use Tax to the state beginning October 1, 2018 if: (1) the cumulative gross receipts from the sales in Illinois are \$100,000 or more; or (2) the retailer enters into 200 or more separate sales of tangible personal property to purchasers in Illinois.^[10] However, unlike the Illinois legislature, the Chicago City Council has not amended the Ordinance to adopt a bright-line economic nexus standard applicable to the Transaction Tax. In Justice Kennedy's majority opinion in *Wayfair*, he emphasizes several features of South Dakota's tax system that indicated the state's assertion of sales tax nexus would survive Commerce Clause scrutiny, including applying a bright-line "safe harbor to those who transact only limited business" in the state.^[11] Because the City lacks this bright-line safe harbor, its ability to assert economic nexus over remote software providers remains in doubt.

Conclusion

Despite a lack of recent guidance further clarifying the applicability of the Transaction Tax to "cloud" or digital products, the Chicago Department has been aggressive in its audit and issuance of Assessments relating to these products.^[12] As a result, taxpayers who license canned software that is accessed by users located in the City of Chicago should review their filing position and consider whether the Transaction Tax should be collected on a go-forward basis.

[Click here for an updated look at the Chicago lease transaction tax rate increase for "cloud" software products, amended on November 16, 2020.](#)

[Please reach out to Samatha K. Breslow with any questions.](#)

^[1] M.C.C. § 3-32-020(I).

^[2] See M.C.C. § 200.1—2A); [Chicago Informational Bulletin \(November 2015\)](#).

^[3] *Meites v. Chicago*, 184 Ill. App. 3d 887, 889 (1989) (citing M.C.C. § 200.1—2A).

^[4] Further explanation of the Chicago audit process is addressed in a [prior post](#) in the Series.

^[5] M.C.C. § 3-4-120(D). For an explanation of return and remittance report filing deadlines, see an earlier [post](#) in the Series.

^[6] [Chicago Informational Bulletin \(November 2015\)](#).

^[7] M.C.C. § 3-32-020(I).

[8] For an explanation of the applicability of the Illinois ROT to software and the State's five-part test for determining whether the transfer of canned software should be treated as a nontaxable license, see my earlier [post](#) in the Series.

[9] *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

[10] 35 ILCS 105/2(9).

[11] *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018).

[12] Further explanation of the procedure to challenge a Chicago Notice of Tax Determination and Assessment ("Assessment") is addressed in a [prior post](#) in the Series.

Related People



Samantha K. Breslow

t 312.606.3206

sbreslow@ktslaw.com