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Clarifying the Cloud: Taxation of Software in Illinois

Please note, that on November 16, 2020, the City Council for the City of Chicago (“City Council”) amended the Chicago Personal Property Lease Transaction Tax Ordinance, eliminating the lower rate of tax on a nonpossessory lease of a computer, which includes “cloud” software products. Read the update here.

Determining whether computer software is taxable is no easy task, especially in light of the changing technological landscape. The Illinois Department of Revenue ("Department") has been asked by taxpayers for a number of years to provide clarification, but until recently has been largely silent on the treatment of sales of computer software. In several non-binding General Information Letters ("GIL") and Private Letter Rulings ("PLR")[1], the Department has recently provided clarification on several key issues, including the taxability of cloud computing.

Canned or Custom Software

As background, whereas the sale of "custom" computer software[2] is not subject to Retailers' Occupation Tax ("ROT"), the transfer of "canned" computer software is generally treated as a taxable retail sale in Illinois. Custom computer programs or software are prepared to the special order of the customer and do not include pre-written or canned programs assembled by vendors into software packages, unless real and substantial changes are made to the programs or creation of program interfacing logic. 86 Ill. Admin. Code Sec. 130.1935(c). The Department's definition of "canned" software offers little insight, merely providing that computer software that is not custom software is considered to be canned computer software. *See* 86 Ill. Admin. Code Sec. 130.1935(c)(2). Regardless of the form in which it is transferred or transmitted, including disc or electronic means, canned software is treated as tangible personal property[3]. 86 Ill. Admin. Code Sec. 130.1935(a).

Even when software is "canned," ROT only applies when an actual sale occurs. Illinois does not tax true licenses. Illinois has historically followed a five-part test for determining whether the transfer of canned software should be treated as the nontaxable license. 86 Ill. Admin. Code Sec. 130.1935(a)(1). Adopted in October of 2000, Section 130.1935(a)(1) provides that a license of software is not a taxable retail sale if the following five requirements are met:

> (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 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.

Although the five-part test is relatively straight-forward in application, due to the advent of cloud computing and internet purchased software, questions have arisen regarding the application of the factors. Specifically, taxpayers have recently asked the Department to clarify the first requirement and whether software that requires a customer to "check a box" that states he or she accepts the license terms qualifies as an "agreement signed by the licensor and the customer". The Department has taken the position that a "shrink wrap" licensing agreement, meaning software licensed over the internet that requires the customer to check a box that states he or she accepts the license terms, does not constitute a written agreement signed by the licensor. PLR ST 18-0003-PLR (2-8-2018); Ill. Dept. of Rev. GIL ST 16-0038-GIL (08-18-2016). However, notably, in February 2018, the Department determined that an electronic license agreement in which the customer accepts the license by means of a signature in electronic form that is attached to or is part of the license, is verifiable, and can be authenticated will comply with the first requirement. Ill. Dept. of Rev. PLR ST 18-0003-PLR (2-8-2018). Additionally, when an order form incorporates terms and conditions from another document, the Department has clarified that it will review both the order form and the document that is incorporated by the order form to determine if the requirements of Section 130.1935(a)(1) are met. *Id*.

Treatment of Cloud Computing

As background, cloud computing providers generally offer their services according to three standard models: (1) Software as a Service ("SaaS"); (2) Infrastructure as a Service ("IaaS"); and (3) Platform as a Service ("PaaS"). Due to the complexity of these services and the inability of state governments to quickly adapt to the evolving technological landscape, the taxation of cloud computing is a topic of significant ambiguity and confusion in many jurisdictions.

In a noteworthy GIL published by the Department in in March 2017, the Department finally addressed the outstanding issue of cloud computing, clarifying that computer software provided through a cloud-based delivery system - a system in which computer software is never downloaded onto a client's computer and is only accessed remotely - is not subject to tax in Illinois. Ill. Dept. of Rev. GIL ST 17-0006-GIL (3-2-2017). If the Department were to change its position on the taxability of cloud-based services, the Department has suggested its decision would only apply prospectively. *Id*. Further, the Department later elaborated that the *ability* to download a PDF or print a document on a user's device does not involve the transfer of any computer software, and therefore is not subject to tax as a cloud-based service. Ill. Dept. of Rev. PLR ST 17-0006-PLR (8-14-2017). Computer software is not downloaded until a user downloads an executable file. *Id*. Nevertheless, despite the clarification provided by these GILs, they are not binding to the Department and Illinois has not adopted specific regulations addressing cloud computing.

Notably, the Department also clarified that because software as a service ("SaaS") is not downloaded, the transfer is not subject to ROT. Instead, SaaS providers are acting as servicemen, and therefore do not incur ROT[4]. Ill. Dept. of Rev. GIL ST 17-0006-GIL (3-2-2017).While there are several ways to calculate the tax liability of a serviceman, such businesses are generally subject to use tax on tangible personal property transferred as an incidence to sales of service, including computer software. 86 Ill. Admin. Code Sec. 140.101.

However, if the purchaser downloads an application programming interface ("API"), applet, desktop agent, or a remote access agent to enable the subscriber to access the provider's network and services,

this transfer may be treated as transaction subject to the ROT. Ill. Dept. of Rev. GIL ST 17-0006-GIL (3-2-2017). The core distinction the Department has drawn with respect to providing an API or other type of access agent is that in the context of true SaaS, the customer is not downloading software, but merely accessing it. If the customer downloads an API or other type of access agent, the Department has taken the position that because the subscriber may be receiving computer software, the transaction may be subject to ROT. Whether such a transaction is subject to the ROT will depend on the five-part test in the Department's regulations. *Id.*

Conclusion

In response to the sustained requests of taxpayers, the Department has recently provided clarification, although not binding, on the taxability of SaaS and cloud computing. However, the area of software development and product offerings is evolving quicker the Department can respond. As a result, while this post highlights significant GILs and PLRs recently published by the Department addressing computer software, it is advisable to seek professional guidance when determining the specific tax treatment of a sophisticated digital product or service.

Please reach out to Samatha K. Breslow with any questions.

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[1] As will be discussed in greater detail in a subsequent post, the Department issues two types of letter rulings: (1) PLRs and (2) GILs. PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of Illinois law to a particular fact situation. In contrast, a GIL more generally directs taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. Whereas PLRs are binding on the Department as to the taxpayer who is the subject of the request for ruling, a GIL is intended to only be instructive and is not binding on the Department. The process of requesting both a GIL and PLR will also be explored in a subsequent post.

[2] "Computer software" means a set of statements, data, or instructions to be used directly or indirectly in a computer in order to bring about a certain result in any form in which those statements, data, or instructions may be embodied, transmitted, or fixed, by any method now known or hereafter developed, regardless of whether the statements, data, or instructions are capable of being perceived by or communicated to humans, and includes prewritten or canned software. 35 ILCS 120/2-25; 35 ILCS 110/3-25; 35 ILCS 115/3-25.

[3] In contrast to software transferred electronically, information or data that is downloaded electronically, such as downloaded books, musical recordings, newspapers or magazines, does not constitute the transfer of tangible personal property. Rather, these transactions represent the transfer of intangibles and are therefore not subject to the ROT and use tax. 86 Ill. Admin. Code Sec. 130.2105(a)(3).

[4] Although this post largely focuses on SaaS, subsequent posts in the Illinois Practitioner Series will further address other cloud computing services, including PaaS and IaaS, on a multijurisdictional basis, including the interplay with the Chicago Personal Property Lease Transaction Tax ("Transaction Tax"). An introduction to the Transaction Tax is available in an earlier post in the Series.