REVISED INFORMATION BULLETIN

NONPOSSESSORY COMPUTER LEASES

In November 2015, the Department of Finance issued an Information Bulletin concerning nonpossessory computer leases. The full text of the Information Bulletin is set forth below. The one revision is to Q&A # 14, concerning the application of the lease for re-lease exemption. The revision to Q&A # 14 will apply effective July 1, 2020.

This Information Bulletin ("Bulletin") provides further guidance on the application of the City of Chicago's Personal Property Lease Transaction Tax ("Lease Tax" or "Tax"), Chapter 3-32 of the Municipal Code of Chicago ("Code"), to various forms of nonpossessory computer leases. The publication of Personal Property Lease Transaction Tax Ruling #12 ("Ruling #12" or "Ruling") has been widely reported, and the Department of Finance ("Department") has received a number of requests for further guidance. In response to such requests, the Department prepared this Bulletin.

In addition, on October 28, 2015, the Chicago City Council enacted certain amendments to the Lease Tax Ordinance that are discussed herein. These include, among other things, an exemption for certain small new businesses and a lower rate for certain "cloud" products, both of which will be effective January 1, 2016.

Please note that any previously issued private letter rulings, general information letters or other communications containing advice that is inconsistent with Ruling #12 are superseded by the Ruling and should not be relied upon.

General

The Lease Tax first went into effect in 1974, and it has at all times applied to "leased time for use of . . . computers . . . ." It was retitled the Chicago Personal Property Lease Transaction Tax in 1992 and was restated in its current form in 1994, at which time a definition was added for the term "nonpossessory computer lease" (see below). In a number of rulings from as early as 1985, the Department has applied the Lease Tax to payments for remote uses of computers and software where such use was accessed from Chicago.

The term "nonpossessory computer lease," added to the Ordinance in 1994, is broadly defined to cover any payments for which "the customer obtains access to the provider's computer and uses the computer and its software to input, modify or retrieve data or information . . . [and includes] time sharing or time or other use of a computer with other users." Code Section 3-32-020(I).

It is worth restating several key and longstanding principles from the Lease Tax Ordinance:

- Location of Customer Use is Key. Liability for the Tax is triggered when a customer in Chicago makes remote use of a provider's computer or software, even if the provider's computer or software is located outside of the City.

- Obligation to Collect. A provider of nonpossessory computer usage may have an obligation to collect and remit the Tax depending on the provider's locations and operations. This involves issues of federal and state law, and the Ruling does not address those issues.

- Labels Not Relevant. The use is taxable whether the agreement governing the use is framed as a "lease, rental, license, or by some other term . . . ". See Code Section 3-32-020(I).

- Payment Triggers Tax. The Lease Tax is imposed on payment for use – if the customer's use is free, no Tax is due.

The Lease Tax Ordinance provides a number of specific exemptions:

- Securities Trading. An exemption applies where the use is to "effectuate the execution, clearing, processing, matching or recording of a trade" of securities or commodities (Code Section 3-32-050(9) or "Exemption 9").

- Accessing and Managing Financial Accounts. An exemption applies where the use is to "effectuate the deposit, withdrawal, transfer or loan of money or securities, including any related review of accounts or investment options by the account owner" (Code Section 3-32-050(10) or "Exemption 10").

- Minimal Use of Computer. An exemption applies where the use is "de minimis and the related charge is predominantly for the information transferred to the customer rather than for the customer's use or control of the computer, such as the nonpossessory lease of a computer to receive either current price quotations or other information having a fleeting or transitory nature" (Code Section 3-32-050(11) or "Exemption 11").

- Re-leases. An exemption applies to a lease of property where the customer will in turn "act as a lessor of the same property" (Code Section 3-32-060 or "Lease for re-lease exemption").

- Small New Businesses. Effective January 1, 2016, there will be an exemption for certain small new businesses, both providers and customers. Details are discussed later in this Bulletin.

The City has also recognized certain exclusions inherent to the Lease Tax; for example, payments for services, including software that is custom designed for the customer.

Lower Rate. In addition, effective January 1, 2016, there will be a lower rate of 5.25% (rather than the full rate of 9%) for certain "cloud" products. Here again, details are discussed later in this Bulletin.

Changes in Technology

While the plain language of the Lease Tax Ordinance has remained the same for decades, the means by which use takes place has undergone significant transformation, with advances in computing, connectivity and other technology. Software and capacity that were once located on the customer's premises are now more often hosted remotely. Businesses are increasingly making use of arrangements commonly referred to as Platform as a Service (PaaS), Infrastructure as a Service (IaaS), and Software as a Service (Saas), where the customer pays for a shared platform, infrastructure or software. This evolution in the access to or delivery of "usage" does not put usage (or access to usage) in Chicago beyond the scope (and plain language) of the Lease Tax Ordinance.

While many businesses, prior to the issuance of Ruling #12, paid the Lease Tax for a variety of digital uses, including PaaS, IaaS and SaaS, the Department understands that other companies, particularly early stage companies, may not have been aware of the scope of the Tax.

In addition, the Department has, for a number of years, received regular requests from lessors (providers) and lessees (customers), and from the accounting firms and law firms advising them, for guidance on the application of the Lease Tax to various products and situations that have developed since the Tax was first enacted, including inquires through the voluntary disclosure process.

Ruling #12 was issued so that taxpayers that had not been aware of the issues it addresses could be brought into compliance and so that, as a matter of fairness, taxpayers that had been compliant would be assured that similarly situated taxpayers would be treated similarly.

The Department recognizes that Ruling #12 represents a change, in certain situations, from its prior interpretation of Exemption 11. In the past, the Department had generally interpreted the reference to "fleeting and transitory" information as exempting certain products that provide financial market data. Ruling #12 clarified that such uses are exempt only if the receipt (and any usage) is simply the passive receipt of information. Thus, the Ruling stated: "As a general rule, this means that a subscription to an interactive web site will be subject to the lease tax, and will not be exempt, even if most or all of the information available on the web site is fleeting or transitory. This would include, for example, a web site that provides financial research, information and analytical tools." Ruling ¶ 11.

Recent Amendments

1. The Small New Business Exemption - Code Section 3-32-050(A)(13) - reads as follows:

In accordance with the terms of this subsection, and pursuant to procedures to be established by the comptroller, the nonpossessory lease of a computer, where the lessor or lessee is a small new business, as the term "small new business" is defined in this subsection.

(a) For purposes of this subsection, the term "small new business" shall mean a business that (i) holds a valid and current business license issued by the City or another jurisdiction, (ii) during the most recent full calendar year prior to the annual tax year for which the exemption provided by this subsection is sought had under $25 million in gross receipts or sales, as the term "gross receipts or sales" is defined for federal income tax purposes, and (iii) has been in operation for fewer than 60 months. For the purpose of calculating the $25 million limit, gross receipts or sales will be combined if they are received by members of a single unitary business group. For purposes of this subsection, the term "unitary business group" is as defined for Illinois income tax purposes. For the purpose of calculating the 60 month limit, time in operation will be deemed to have begun during the first calendar month in which the business seeking the exemption first received any gross receipts or sales. Also for the purpose of calculating the 60 month limit, time in operation will include any earlier time during which any of the following businesses were in operation (i) another existing business, if that business is a member of the same unitary business group as the business seeking the exemption, (ii) a business that is no longer in operation, but that would be a member of the same unitary business group as the business seeking the exemption, if it were still in operation; (iii) a business whose liabilities would be liabilities of the business seeking the exemption, pursuant to Illinois law concerning successor liability; or (iv) any other business that is reasonably determined by the Comptroller to be substantially similar or a predecessor to the one seeking the exemption, based on factors including, but not limited to, common ownership, management, employees, assets, line of business and location.

(b) A small new business that is the lessor of a nonpossessory computer lease shall not be required to collect tax on its charges for such nonpossessory computer lease.

(c) A small new business that is the lessee of a nonpossessory computer lease shall not be required to pay tax on its charges for such nonpossessory computer lease. To document this exemption, the lessor must obtain from the lessee and retain in its business records a copy of the lessee's lease tax exemption certificate, in a form to be provided by the Comptroller.

The Department is preparing exemption certificate forms that will be available on its web site. Providers or customers with questions should contact the Department.

2. The Lower Rate Provision - Code Section 3-32-030(B.1) - reads as follows:

> In the case of the nonpossessory lease of a computer primarily for the purpose of allowing the customer to use the provider's computer and software to input, modify or retrieve data or information that is supplied by the customer, the rate of the tax imposed by this chapter shall be 5.25 percent of the lease or rental price.

In general, this means that the lower rate will apply to "cloud" products such as PaaS, IaaS and SaaS (where the nonpossessory lease is primarily for the purpose of allowing the customer to use the provider's computer and software to input, modify or retrieve data or information that is supplied by the customer), but not to "database" products (where the nonpossessory lease is primarily for the purpose of allowing the customer to use the provider's computer and software to input, modify or retrieve data or information that is supplied by the provider). Here again, providers or customers with questions should contact the Department.

Effective Date

There have been a number of questions raised concerning the effective date of Ruling #12. The reference to the effective date was intended to apply only to changes in the Department's official interpretation of the Lease Tax Ordinance. Thus, any changes would be applied prospectively, meaning that they would apply only to periods beginning on or after September 1, 2015 (the original effective date, which has now been moved to January 1, 2016). As discussed above, the Department recognizes that its interpretation of Exemption 11 represented a change - see discussion above on "fleeting and transitory" information.

Other portions of Ruling #12 were simply restatements of existing law - for example, the statements that "charges incurred ... to perform legal research or similar on-line database searches" are taxable (¶ 6), that "[i]f a customer pays a provider to write a report ..., the charge is for the service of writing the report ... and is not subject to lease tax" (¶ 7), and that "charges for storing a customer's data on the provider's computer are not subject to lease tax if the provider's computer is outside of the City, so long as the charges are solely for storage" (¶ 8). To the extent that Ruling #12 simply restates existing law, that law applied before the effective date of the Ruling, and it would have continued to apply even if the Ruling had never been issued. Thus, as to products that were clearly taxable before the issuance of the Ruling, the Department did not intend the effective date of the Ruling to mean the release of liability for periods before that date.

Nevertheless, given the number of providers and customers that were unaware of the Lease Tax, or of the scope of its application, the Department has decided to extend the offer discussed in the next section of this Bulletin.

Voluntary Disclosure Offer

Code Section 3-4-265 provides:

> A. The comptroller shall issue written guidelines setting forth the terms and conditions applicable to the department's voluntary disclosure program, which permits eligible taxpayers and tax collectors to self-assess and pay their outstanding tax liabilities and interest in exchange for the waiver of all penalties. The guidelines, which may be amended from time to time, may permit eligible taxpayers and tax collectors to pay interest at a rate less than the amount set forth in Section 3-4-190 of this chapter and to pay not more than those liabilities arising during the four-year period immediately prior to the date on which a taxpayer or tax collector applies to participate in the program.
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> B. The guidelines may prohibit any taxpayer or tax collector that has received a written notice of tax audit or tax investigation to participate in the voluntary disclosure program with respect to the tax or taxes identified in the notice. The terms and conditions of the program shall be approved by the corporation counsel and shall apply to all taxpayers and tax collectors.

In addition, Code Section 3-4-150 provides:

> G. The comptroller, with the approval of the corporation counsel, may compromise all disputes in connection with any tax or interest due or any tax, interest or penalty assessed.

In accordance with these provisions, the Department, with the approval of the Department of Law, makes the following offer:

> Any provider or customer that files a voluntary disclosure application by January 1, 2016, and that qualifies for the City's standard voluntary disclosure program (e.g., has not received a written notice of tax audit or tax investigation) will receive the following terms, provided that it comes into compliance with the Lease Tax Ordinance and Ruling #12 by January 1, 2016 (or such later date that the Department may agree to for good cause):
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> 1. As to charges for nonpossessory computer leases that qualified for Exemption 11 under the Department's interpretation of the exemption before the issuance of Ruling #12, no liability for Tax, interest or penalties based on those charges for any periods ending before January 1, 2016.
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> 2. As to charges for other nonpossessory computer leases (i.e., charges for nonpossessory computer leases that do not meet the requirements of paragraph 1 above), payment of Tax for the period of January 1, 2015 through December 31, 2015 (one year), and no liability for interest or penalties.

3. As to any other taxes owed (in other words, Lease Tax based on leases other than nonpossessory computer leases, or taxes other than Lease Tax), the terms of the City's standard voluntary disclosure program will apply. Thus, for those other tax liabilities, penalties will be waived, and there will be no more than four years of liability for tax and interest.

Pursuant to Code Section 3-4-280, any Lease Tax already collected by any provider is held in trust for the City and must be remitted to the Department.

Any provider or customer who wishes to accept the Department's offer should send an email indicating such to taxpolicy@cityofchicago.org with their business name, taxpayer contact name, and telephone number. Questions may also be directed to taxpolicy@cityofchicago.org or the Department's Customer Service line at 312-747-4747.

FAQ

1. **Q: Who pays the Lease Tax?**

   A: The Tax is imposed on the customer (the lessee), but the provider (the lessor) is required to collect it. If the provider does not collect the Tax, the customer is still liable to pay it.

   The Department does not require providers to collect the Lease Tax unless they have sufficient contacts with the City – sometimes called nexus. If the provider does not have nexus, the customer is required to pay the Tax directly to the City. Taxpayers can download a copy of the annual Lease Tax form at:

   http://www.cityofchicago.org/city/en/depts/fin/supp_info/revenue/tax_form_list.html

2. **Q: How do I know if a customer is a Chicago customer?**

   A: Where the customer's location is not otherwise clear, the Department will utilize the rules set forth in the Mobile Telecommunications Sourcing Conformity Act, 35 ILCS 638. See Ruling #12 ¶ 16; Code Section 3-32-020(I). This is the same set of rules used by telecommunications companies for sourcing mobile telecommunications. In general, it means that the Lease Tax will apply to customers whose residential street address or primary business street address is in Chicago, as reflected by their credit card billing address, zip code or other reliable information.

   If a provider has no information to indicate that any of its customer's use will take place in Chicago, then the provider will not be required to collect the Lease Tax from its customer. If a provider has information to indicate that some of its customer's use will take place in Chicago but no information of its own that allows it to perform a

reasonable apportionment between the customer's Chicago use and non-Chicago use, then the provider may rely on actual data or estimates provided by the customer, or in certain situations the provider may accept a "direct pay" certification from the customer. See Ruling #12 ¶¶ 18 - 19. The Department is preparing apportionment and direct pay certification forms that will be available on its web site.

3. Q: If there is a single payment for uses within and without Chicago, how does a taxpayer determine its liability with respect to Chicago use?

A: Where a customer has some employees or other individuals who use the provider's computer from terminals or devices located in Chicago, and some employees or other individuals who use the provider's computer from terminals or devices located outside of Chicago, a charge that covers both the Chicago use and the non-Chicago use should be apportioned. For any given individual assigned an access code, seat, license or other ability to use the provider's computer, all of that individual's use will be presumed to take place at the individual's principal office location. However, where supported by books and records, the Department will accept any reasonable basis for apportioning Chicago and non-Chicago use. See Ruling #12 ¶ 17.

4. **Q: Does the Ruling change the rules for determining nexus?**

A: The Department's enforcement practice (for providers) has historically been predicated on nexus, and the Ruling does not change that - in fact, the Ruling specifically says it does not address the issue. As noted above, this involves issues of federal and state law. Providers must rely on their own attorneys to advise them on the application of the law to their particular facts. As noted in Ruling #12, however, the Department will, in conjunction with the Department of Law, attempt to assist where appropriate on a case-by-case basis.

5. Q: What types of digital uses are covered by the Lease Tax?

A: The Lease Tax applies to any usage of remote computing or software, including but not limited to SaaS, IaaS and PaaS, such as (a) automated deployment of servers, processing power and networking, (b) software applications accessed remotely such as office suite software, project management software and customer relationship management (CRM) software, (c) web hosting, and (d) database search products. Customer support for any taxable usage does not transform such usage into exempt services.

6. **Q: If services are not subject to the Lease Tax, why does the tax apply to SaaS, IaaS, and PaaS?**

   A: The Lease Tax does not apply to services (for example, custom software made for hire). However, simply because a product is described as a "service" or has the word "service" in its title does not mean that it would be treated as a service for purposes of the Lease Tax (or other taxes). For a discussion of bundled charges, see Question #13 below.

7. **Q: Are charges to facilitate a purchase subject to the Lease Tax?**

   A: Payments made for completing a purchase are generally not subject to the Lease Tax. For example, if a company charges a fee to execute an order with a restaurant for food delivery, the use in that case should be integrated with the transaction and, therefore, not subject to Lease Tax. However, if a subsequent transaction is too attenuated from the search itself – such as a charge to search a database of home listings for sale where the actual purchase takes place outside of the platform – payment for the search would be subject to Lease Tax.

8. **Q: Regarding storage, Ruling #12 quotes from Ruling # 5, which states that storing a customer's data on the provider's computer is not a nonpossessory computer lease so long as the related charges are solely for storage.**

   1) **What if additional customer data is sent to the provider's computer for storage on a regular basis?**

   2) **What if the customer eventually has to retrieve data from the provider's computer as part of a disaster recovery?**

   A:

   1) Sending additional data to the provider's computer does not make the charge taxable. The charge is for storing the data. The fact that the customer sends additional data for storage on a regular basis does not mean that the charge is to input, modify or retrieve the data.

   2) Retrieving the data as part of a disaster recovery does not create a taxable charge. In that case, the recovery is incidental to the storage, which is intended to provide recovery in case of disaster.

9. **Q: There is an exemption for usage that is de minimis where the charge is predominantly for information rather than usage (Exemption 11). What is this exemption for, what does de minimis mean, and how does a taxpayer determine whether the charge is predominantly for information?**

A: The exemption, as set forth in the Ordinance, is narrowly defined and was intended to exempt from the Lease Tax only the passive receipt of information, such as a stock ticker.

"De minimis" – As discussed in Ruling #12, de minimis usage means that the information is delivered passively, with a minimum of search or other functionality, except in certain circumstances where the information is predominantly (i.e., primarily) proprietary (see Question #10 below).

"Predominantly" – Determining whether a charge is predominantly for information, or whether the information is predominately proprietary, is necessarily a fact and circumstances test, and it requires an assessment of the relative value of the information versus the search or other functionality. In most cases, information that is in the public domain will not have a sufficient independent value to meet this test whereas, as explained in Ruling #12 and Question #10, proprietary information will.

10. Q: How does a taxpayer determine if the charge paid by the customer is primarily for proprietary information?

A: Examples of proprietary information include copyrighted newspapers, newsletters or magazines that the subscriber would have to purchase if the materials were acquired or accessed through other means, such as a purchase at a "bricks and mortar" store. The fact that the design and features of a web site may be proprietary does not mean that the information on the web site is proprietary. Likewise, the fact that the procedures and systems used to create and maintain the database may be proprietary does not mean that the information on the web site is proprietary. Also, the fact that some information on the web site may be proprietary (such as notes or commentary), does not mean that the charge paid by the customer is primarily for proprietary information. If any taxpayer has a question on the application of these rules to a particular situation, please contact the Department for further guidance.

11. Q: Does the Lease Tax apply to "free trial periods"?

A: If there are no payments made for the use, then no Tax is payable.

12. Q: Are payments for advertising subject to the Tax?

A: No - advertising is a service.

13. **Q: Where there are bundled payments made for taxable uses and non-taxable uses, how does a taxpayer apply the Lease Tax to such payments?**

    A: Where taxable uses are bundled with storage or services (such as application support) and the provider does not separate the taxable and nontaxable charges, the entire fee will be subject to the Lease Tax unless the taxpayer can prove that 50% or more of the charge is for non-taxable items. A separate charge will be recognized as separate only if the charge is optional, in form and in substance.

14. **Q: How does the Lease for re-lease exemption work? My company pays for IaaS, and the software we develop is then available as a web app on the hosted infrastructure with a subscription fee.**

    A: To the extent that you incorporate into your product certain products that are leased to you by your IaaS provider (or a provider of SaaS, PaaS or similar products), the lease for re-lease exemption may apply. In general, the Department will utilize the rules that apply to the sale for re-sale exemption in the State sales tax statutes, as reflected in regulations and private letter rulings issued by the Illinois Department of Revenue. These include 86 Ill. Adm. Code 130.1935, which states: "Value-added resellers who acquire software for relicensing or transfer to consumers after modification or adaptation of the software may acquire the software as a sale for resale by presenting their suppliers with valid certificates ..."

15. **Q: What is the relationship between Ruling #12 and Amended Ruling #5 (effective September 1, 2013)?**

    A: Ruling #12 concerns nonpossessory computer leases, meaning leases "in which the customer obtains access to the provider's computer and uses the computer and its software to input, modify or retrieve data or information." Code Section 3-32-020(I). Amended Ruling #5 concerns primarily the issue of whether certain "perpetual software license agreements" will be treated as sales of software (not subject to the Lease Tax) or leases of software (subject to the Lease Tax). In general, Ruling #12 will apply where a customer is granted remote access to software belonging to a provider, and installed on the provider's computer, whereas Amended Ruling #5 will apply where a customer installs a provider's software on the customer's own computer.

For Additional Guidance:

Pursuant to Uniform Revenue Procedures Ordinance Ruling #3 (June 1, 2004), companies may seek an individual private letter ruling from the Department by contacting the Department's Tax Division or the Department of Law's Revenue Litigation Division. Contact information is available through the City's web site, www.cityofchicago.org.