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Taxation of software licenses in Illinois: Is the "click" as mighty as the pen?

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A person's signature, whether inscribed on paper or in electronic format, is first and foremost and at its most basic level a symbol signifying intent, such as a person's intent to be bound to the terms of an agreement or to prove authorship or receipt of a document. As such, a "signature" is commonly defined as "any name, mark or writing used with the intention of authenticating a document."[1] Historically, individuals have signed contracts and other instruments by writing their full names on the document or by placing their initials or some other identifying mark, like an "X," upon the instrument for purposes of authenticating the writing or giving it legal effect. However, with the explosion of the Internet and e-commerce, an increasing number of agreements are now entered into and "signed" electronically. It is against this cyber-backdrop that the Illinois Legislature enacted the Illinois Electronic Commerce Security Act ("ECSA"), which both embraces and regulates the use of electronic commerce in Illinois.

The ECSA

The ECSA became law in 1999, and was enacted by the Illinois Legislature "to move Illinois document laws into the 21st Century" and "to encourage the use of electronic commerce."[2] Less than a year later, Congress passed the Electronic Signatures in Global and National Commerce Act ("E-Sign Act").[3] The E-Sign Act and the ECSA closely resemble each other (and the Uniform Electronic Transactions Act adopted by the majority of other states). If a provision of the ECSA is clearly and materially inconsistent with a provision of the E-Sign Act, the E-Sign Act will likely preempt the ECSA, with respect to that provision, if it concerns a transaction in interstate or foreign commerce. However, since the two acts appear materially consistent, the ECSA is the relevant law in Illinois with respect to electronic records and is therefore the primary focus of this article.

The ECSA provides, in part, that "information, records, and signatures shall not be denied legal effect, validity, or enforceability solely on the grounds that they are in electronic form."[4] The ECSA also provides that "[w]here a rule of law requires information to be 'written' or 'in writing,' or provides for certain consequences if it is not, an electronic record satisfies that rule of law."[5] Further, "[w]here a rule of law requires a signature, or provides for certain consequences if a document is not signed, an electronic signature satisfies that rule of law."[6] An "electronic signature" is "a signature in electronic form attached to or logically associated with an electronic record."[7] The terms "signed" and "signature" are broadly defined by the ECSA to mean "any symbol executed or adopted, or any security procedure employed or adopted, using electronic means or otherwise, by or on behalf of a person with intent to authenticate a record."[8] When enacting the ECSA in 1999, the Legislature also amended Illinois's Statute on Statutes (5 ILCS 70/1 et seq.) to provide that the terms "written" and "in writing" when found in an Illinois statute may include electronic words and letters, but "when the written signature of any person is required by law on any official or public writing or bond, required by law, it shall be (1) the proper handwriting of such person or (2) an electronic signature as defined in the Electronic Commerce Security Act, except as otherwise provided by law,"[9] thereby making an electronic signature generally equal to a handwritten signature under Illinois law.

The ECSA applies to all persons agreeing to "create, store, transmit, accept or otherwise use or communicate information, records, or signatures by electronic means or in electronic form," including all Illinois agencies agreeing to conduct state business electronically.[10] The ECSA, however, does not apply to all electronic records. For instance, as a matter of specific exclusion, the ECSA does not apply if an electronic record would be "clearly inconsistent with" or "repugnant to" the legislative intent of a particular rule of law. However, the mere legal requirement that information be "in writing," "written" or "printed" is not, itself, sufficient evidence that a rule of law is "clearly inconsistent with" or "repugnant to" an electronic record.[11] Additionally, the ECSA expressly provides that it will not apply to wills, trusts, health care powers of attorney, or negotiable instruments or other instruments of title.[12]

The ECSA and licensed software

Software manufacturers usually license their software products to their customers, and such licensing agreements are generally provided to the customer and entered into electronically. These electronic license agreements are commonly referred to as "clickwrap" or "clickthrough" agreements, which reference an online software license agreement in which the licensee consents to the license terms, which appear on the licensee's computer screen or are accessible through

a link, by clicking an icon or checking a box marked "I accept" (or that has a similar term). Usually, the software cannot be used by the customer until the customer registers with the software manufacturer and checks the appropriate icon or box agreeing to the license terms.

The basic tenets of contract law—offer and acceptance—are generally present in such transactions, with the vendor offering to license its software for an agreed upon price and terms (including limitations on the kind of conduct that constitutes acceptance by the licensee), and the consumer agreeing to such price and terms by checking the "I accept" box allowing access to the software. The licensee's agreement to the license terms and the licensee's "signature," in the above instance, are authenticated, since the licensee cannot access the software without first registering with the vendor and checking the box agreeing to the vendor's terms of use.[13] Thus, in such transactions there is often a clear association (and a stored record) between the identity of the customer and the customer's "signature," satisfying the electronic record and signature requirements of the ECSA.[14] Accordingly, a clickwrap agreement similar to the one described above, once accepted (i.e., "checked") by the customer, is most likely a legally enforceable license.[15]

What does the ECSA have to do with the taxation of software licenses in Illinois?

In Illinois, the imposition of sales and use tax is statutorily limited to transfers of "ownership of" or "title to" tangible personal property in a retail transaction.[16] Accordingly, unlike most other states, Illinois does not impose sales or use tax on the rental, lease or license of tangible personal property, since these type of transactions do not convey ownership or title to the property being rented, leased or licensed.[17]

Recognizing that license agreements are not taxable in Illinois, the Illinois Department of Revenue (the "Department") promulgated a regulation which provides that a license of software is not subject to sales or use tax if the license agreement: (1) is evidenced by a written agreement signed by the licensor and the customer; (2) restricts the customer's duplication and use of the software; (3) 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; (4) provides for another copy of the software at minimal or no charge if the software is damaged or lost; and (5) requires the customer to destroy or return all copies of the software to the licensor at the end of the license period.[18]

Based on the above five-part test, the Department takes the position that certain software licenses, such as shrinkwrap software licenses, are subject to Illinois sales and use tax, since such licenses are not signed by the parties to the license agreement.[19] A "shrinkwrap" license refers to the breaking of the shrinkwrap seal that generally encloses the box containing off-the-shelf software. The licensee agrees to the terms of the license by using the software after encountering the license agreement contained in the box. A shrinkwrap license, is a "license,"[20] and a license, by definition, does not include a transfer of ownership of or title to licensed property.[21] Thus, the Department's position regarding shrinkwrap licenses and its software regulation arguably diverges from the statutory definition of a taxable "sale at retail" in Illinois, since the regulation provides for the taxation of certain licensed software—i.e., those licenses (such as shrinkwrap licenses) not meeting the Department's five-part test. Accordingly, the Department's software regulation may be unlawful (by exceeding its legislative scope), since the regulation provides for taxation of software licenses that fail the Department's five-part test, even though the licensees of such taxable software do not receive "ownership of" or "title to" the software being licensed.

The Department's enforcement of its five-part test for licensed software may also violate the ECSA. The first requirement of the Department's five-part test, really the only requirement of consequence for purposes of ESCA, is that the software license must be a "written agreement" and be "signed" by the licensor and the customer.[22] The Department, however, has not followed the ECSA with respect to licensed software. For instance, the Department has issued numerous nonbinding letter rulings, including at least two this year, which generally provide:

> [T]hat it is very common for software to be licensed over the internet and the customer to check a box that states that they accept the license terms. Acceptance in this manner does not constitute a written agreement signed by the licensor and the customer for purposes of subsection (a)(1)(A) of Section 130.1935.[23]

The Department's continued insistence on a signed written agreement most likely runs afoul of the ECSA mandate to recognize electronic signatures. However, such a conclusion also appears out of step with advances in technology and is perhaps contrary to the Department's own efforts to have taxpayers sign and file their Illinois tax returns electronically. Additionally, regardless of legal merit, the Department's position is patently inconsistent with the efforts Congress and the Illinois Legislature have made to facilitate electronic commerce.

The Department has asserted in a few public forums that if a unique digital signature were used on a software licensing agreement (similar to the PIN used to file tax returns electronically in Illinois), the Department would likely accept the digital signature as meeting the first step (i.e., signed) of its software regulation. The Department's acceptance of a digital signature, if formally adopted as Department policy, however, would likely still violate the ECSA, which expressly provides for electronic signatures. More troubling, it would seem that such a policy would likely run afoul of the E-Sign Act, which prohibits states from favoring digital signatures over electronic signatures.[24]

Accordingly, application of the ECSA to a "clickwrap" software license agreement should meet the requirements of a "written" and "signed" software license under the Department's regulation addressing taxation of licensed software. As "clickwrap" agreements become more pervasive and as companies expend more and more money on software licensing, it seems that it will only be a matter of time before an Illinois taxpayer challenges the Department's disinclination to recognize electronic records and signatures for purposes of the Department's five-part test for licensed software.

Faced with such an inevitability, perhaps the only question remaining is: Will the Department act on this issue by reversing its prior rulings regarding taxation of clickwrap software licenses, or will a court make what seems to be an obvious decision—i.e., that an electronic document and signature satisfy a "written" and "signed" document under the Department's five-part test for licensed software? Based on the potential tax dollars involved, this could be a situation where the Department may feel forced to litigate the issue (if for no reason other than to delay refunds and to keep tax revenue coming in to the State while litigation is pending), while at the same time attempt to legislate around

the problem if not successful in court. However, a legislative fix may not be easy in this case, without a fundamental change in the way Illinois taxes rentals, license and leases.[25] ■

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1. Black's Law Dictionary 1507 (Bryan A. Garner, 9th Ed. 2009); *see also* U.C.C. §§ 1-201(37), 3-401(b); 810 ILCS 5/1-201(b)(37), 5/3-401(b).

2. 90TH GEN. ASSEMBLY 106th Legis. Day, 12–13 (daily ed. May 15, 1998) (statement of Sen. Walsh).

3. On June 30, 2000, the E-Sign Act was signed into law as Public Law 106-229.

4. 5 ILCS 175/5-110.

5. *Id*.

6. 5 ILCS 175/1-120.

7. *Id*.

8. 5 ILCS 175/5-105.

9. 5 ILCS 70/1.15.

10. 5 ILCS 175/5-140, 175/25-101.

11. 5 ILCS 175/5-115, 175/5-120.

12. *Id*.

13. 5 ILCS 175/5-120 ("An electronic signature may be proved in any manner, including by showing that a procedure existed by which a party must of necessity have executed a symbol or security procedure for the purpose of verifying that an electronic record is that of such party in order to proceed further with a transaction.").

14. 5 ILCS 175/5-115, 175/5-120.

15. *See, e.g., ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996); *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997); *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010); *Specht v. Netscape Commc'ns Corp.*, 306 F.3d 17 (2d Cir. 2002); *Mortenson Co. v. Timberline Software Corp.*, 998 P.2d 305, 140 Wash. 2d 568 (2000); *Hotmail Corp. v. Van$ Money Pie, Inc.,* 1998 WL 388389 (N.D. Cal. April 16, 1998).

16. 35 ILCS 120/1.

17. *Int'l Bus. Mach. Corp. v. Dep't of Revenue,* 25 Ill. 2d 503; 185 N.E. 2d 257 (1962); *Philco Corp. v. Dep't of Revenue*, 40 Ill. 2d 312, 239 N.E. 2d 805 (1968). *IBM* and *Philco* concern the leasing of tangible personal property; however, for purposes of Illinois sales and use tax, the terms "lease" and "license" are synonymous. *See* 86 Ill. Admin. Code § 130.1310.

18. 86 ILL. ADMIN. CODE § 130.1935(a)(1).

19. In 86 ILL. ADMIN. CODE § 130.1935(a), the Department drafted an example regarding the taxation of shrink-wrapped software. In the example, the Department notes that the customer did not receive title to the computer program, but that the software sale is subject to Illinois sales tax since the license agreement was not signed by the customer.

20. *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996).

21. *Vernor v. Autodesk, Inc.,* 621 F.3d 1102 (9th Cir. 2010) ("first step doctrine" and "essential step defense" do not apply to licenses because the licensee does not receive ownership of the copyrighted material).

22. 86 ILL. ADMIN. CODE § 130.1935(a)(1)(A).

23. Ill. Dep't of Rev. Gen. Info. Ltr. Rul. No. ST 11-0042-GIL, 05/26/ 2011; *see also* Ill. Dep't of Rev. Gen. Info. Ltr. Rul. No. ST 11-00668-GIL, 08/22/2011; Ill. Dep't of Rev. Gen. Info. Ltr. Rul. No. ST 06-0172-GIL 08/14/2006.

24. *See* 15 U.S.C. 7002(a)(2)(A)(ii), which provides that a state statute, regulation or rule may modify, limit or supersede the E-Sign Act, but only if such statute, regulation or rule of law providing for such alternative procedure does not require, or accord greater legal statute or effect to, a specific technology or technical specification for performing the functions of creating storing, generating, receiving, communicating or authenticating electronic records or signatures.

25. In Illinois sales/use tax refunds are often paid by the issuance of credit memoranda. Under this mechanism the Comptroller does not actually issue taxpayers refund checks. The credit memoranda simply reduce the amount of sales/use tax the Department receives in future months. As a result, the state would not have a large payout due to refunds, but fewer tax dollars would be placed into the state's coffers in future periods.