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## ABOUT US

CORPORATE CREATIONS CHICAGO L.L.C. is an Incorporation and Trademark Services firm staffed by experienced attorneys. We have the ability to do filings in all 50 states, as well as the Virgin Islands, Puerto Rico, and the Bahamas. Furthermore, we are educated in Trademark searches and the Federal Application Process at the United States Patent and Trademark Office. With our streamlined business focus, we are able to provide quality and knowledgeable services in an efficient and economical manner.

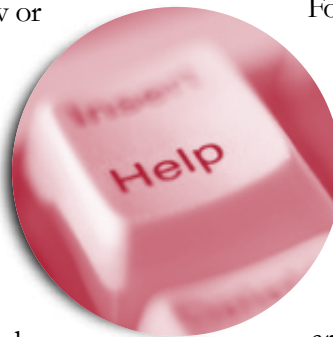
# SOFTWARE: A TAXING SALE

by Meg Cook

The concept of a Sales Tax is not a new or novel notion; it has long been relied upon by states as a substantial source of revenue. It is common knowledge that a Sales Tax applies to goods purchased by a consumer. Specifically, the Illinois statute imposes the Retailers' Occupation Tax (Illinois' version of a Sales Tax) on any tangible goods sold at retail for the purpose of use or consumption. Retailers' Occupation Tax Act, 35 ILCS 120/<sup>1</sup>.

Tangible goods are commonly defined as goods that can be perceived by a person. A tangible good can be specifically identified and appraised for value.

Furthermore, a tangible good is one that can be physically held and touched by a person. On the other hand, intangible goods are not so easily identifiable.



For example, intellectual property (IP) and goodwill are considered intangible goods. A trademark, a form of intellectual property, does not lend itself to physical touch or easy valuation. A company name, logo or slogan is not something that can be picked up and purchased by the consumer in normal everyday circumstances; yet still, intangible goods are sold everyday for large amounts of money.

As the realm of intellectual property continues to expand, the purchasing public and the retail world become familiar and comfortable with some of the older forms of IP. Computer software, for example, would be considered a known form of IP. In fact, the Illinois legislature has established that computer software is a tangible good; thus, the sale of it is subject to a Sales Tax. The Illinois statute specifically states, " a tax is imposed upon persons engaged in the business

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## SOFTWARE: A TAXING SALE

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of selling at retail tangible personal property, including computer software<sup>1</sup> 35 ILCS 120/2. This is easily understood because software is primarily sold via retailers (whether the consumer purchases the item at the retail location or whether he orders the software online and receives the item(s) via delivery). These are obviously tangible goods because they can be perceived and physically touched, specifically identified and valued, and capable of being lifted and/or transported. Computer Software sold at retail stores, both physical and online locations, no longer presents questionable property when it comes to the Sales Tax (although it must have posed such conflict at one point given that the Illinois legislature expressly mentioned computer software as being considered tangible personal property).

Computer software does begin to present a problem when it is no longer sold only at a retail store location. Today, a sizable amount of software is bought over the Internet. Consumers are able to download the software directly from a retailer's website to his/her computer. Consumers are also hiring companies to create software for their personal or business use. Generally, the consumer is purchasing a license to use the software.<sup>2</sup> The consumer rarely has a physical manifestation of that software, such as the set of installation or backup disks sold at retail locations. The rationale behind imposing a Sales Tax on computer software does not apply as convincingly to these types of situations.

To remedy this conflict, the Illinois Department of Revenue has issued several Regulations and Private Letter Rulings discussing when the sale of a computer software license is not taxable as a retail sale. In order for the sale or transfer of a software license to avoid the imposition of sales tax, the sale/transfer must meet five requirements, as stated in the Illinois Department of Revenue Regulations. 86 Ill. Adm. Code 130.1935 (a).

1. The transfer of the software license is evidenced by a written agreement signed by the licensor and the customer.

2. The license restricts the customer's duplication and use of the software.

3. The license prohibits the customer from licensing, sublicensing, or transferring the software to a third party (except a related party) without the permission and continued control of the licensor.

4. The licensor has a policy of either providing a substitute copy of the software at minimal or no charge if the customer loses or damages the software, or a policy of permitting the licensee to make and keep an archival copy of the software. The policy must also be 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.

5. The customer must destroy or return all copies of the software to the licensor at the end of the license period. In the case of a perpetual license, this provision is deemed to be met without being set forth in the license agreement.



If the sale of a software license or a sale of services to create software meets all five of the above criteria, it will not be considered a sale subject to the state sales tax. Furthermore, the Department of Revenue (DOR) has extended the nontaxable status to subsequent updates of the software. Priv. Ltr. Rul 01-0037 (August 30, 2001).<sup>3</sup>

Although the parameters seem fairly square, remember, you must meet all five requirements before the DOR will allow you to treat the software transaction as a nontaxable transfer of software.

1 The Sales Tax only applies to sales at the retail level; sales tax is not imposed on the sale from the wholesaler or manufacturer to the retailer for resale.

2 The license at issue here is not the retail sale of canned software transferred via tape, disc, card, electronic means, or other media. Generally, the sale of canned software intended for general and repeated use is a taxable sale. This includes the sale of software and accompanying licenses that restrict the use and reproduction of the software. 86 Ill. Adm. Code 130.1935. Canned software refers to software that was developed for the general public; it is not customized for any specific individual or company.

3 For analysis of the five criteria, consult General Information Letters (GILs) issued by the Illinois Department of Revenue. The DOR has discussed the requirements at length in multiple GILs.

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# CANNING THE SOFTWARE SALES TAX

by Meg Cook

Generally, retail sales of canned software are subject to the Illinois Retailers' Occupation Tax (Sales Tax). If it is the sale of custom software, the sale might be exempt from imposition of the tax. According to the Illinois Department of Revenue's Regulations, "custom computer programs prepared to the special order of the customer are not subject to tax under the Retailers' Occupation Tax, Use Tax, Service Occupation Tax, or Service Use Tax." 86 Ill. Adm. Code 130.1935(c).

To qualify as exempt custom software, the program must include two elements:

1. Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and
2. The program requires adaptation by the vendor to be used in a specific work environment (e.g. a particular make and model of a computer using a specified input or output device).

Custom software can either be completely original (in which case the consumer is really paying for the vendor's service as a software programmer) or it can result from the modification of canned software.

Canned or prewritten software is completely taxable as a retail sale. Custom software that results from the modification of canned software is subject to sales tax if it is held for general and/or repeated sale or lease. General and/or repeated use transforms the status of custom back to canned software.

In order for modified canned software to become nontaxable custom software, there must be real and substantial changes to the operational code which are made to meet the specific requirements of the customer for his use. 86 Ill. Adm. Code 130.1935(c)(2). Under the regulations, determination of whether sufficient modification of the canned software exists is based on three principles:

1. Individual selection and assembly of multiple prewritten or canned programs or program modules is not considered to be a customized software package (unless substantial changes are made to the operational systems of the individual programs and/or modules).
2. If the prewritten or canned software has been marketed, the new program will qualify as custom if the price of the canned program is 50% or less of the price of the customized program.
3. If the prewritten or canned software has not been marketed, the new program will qualify as custom if the cost of modifying the program is more than 50% of the contract price to the customer.

Before determining whether or not your client has a sale/transfer of software that is subject to sales tax, consider whether or not the software is canned or custom. Although the regulations are still open to interpretation and argument, the DOR has set forth some fairly measurable standards by which to judge the software.

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# WHAT YOU DON'T KNOW CAN HURT YOU: LEGAL AUDITS PROTECT YOUR COMPANY AND SAVE MONEY

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by J. Aaron Ball

Most companies annually engage accounting professionals to conduct an audit of their financial affairs. By contrast, few small and middle market companies seek the periodic review of their affairs by their legal counsel. Failure to review a company's legal affairs can be just as dangerous as ignoring its finances since unknown or ignored legal issues often manifest themselves in the form of costly litigation, fines and penalties. A review of a company's legal affairs, often called a "legal audit," is an important tool to help minimize risk, develop effective business and compliance protocols, and reduce future legal costs.

Legal audits are directed at a broad range of legal issues affecting a company. Generally, legal audits are periodically necessary to prospectively implement new policies or to assure compliance with existing policies due to the changing legal and business environments in which every company is immersed. New business practices, legislation, and court and administrative decisions, as well as rapidly changing legal trends, require that a company's operations be audited periodically to ensure that opportunities are not lost and corporate interests are not jeopardized.

Legal audits may vary depending upon the size of the corporation and the nature of its business. In general, legal audits for small and middle market companies may include investigation of product liability exposure, labor and personnel relations and employment practices, and general business practices. The scope and timing of a legal audit also depends on the nature of the business activities under review.

The process usually begins with an interview of management and document review. Interviews bring management into the process by helping them understand the purpose of the audit and the procedures to be followed, and assists in setting the tone for lower-level management and employees. It also affords top management an opportunity to identify for their counsel areas of concern and business procedures that can be improved.

In conjunction with management interviews, counsel may examine planning, financial, transactional and

operating documents, correspondence and internal communications. Counsel may also review calendars, logs and other records. If a record-retention program is not in place, following document review, counsel should make recommendations regarding the creation and implementation of an appropriate system.

Companies that have only sparingly sought the advice of counsel in the past, or that have recently experienced significant change or growth are good candidates for a legal audit. For example, suppose "Company X" recently hired a number of employees. It may now be subject to Federal laws such as the Family Medical Leave Act ("FMLA") that are triggered based on the number of persons employed by a company. Since failure to understand its obligations under the FMLA (or other applicable laws) could prove costly, Company X should strongly consider retaining experienced corporate counsel to conduct a legal audit to ensure appropriate procedures are in place and management understands the company's responsibilities under the law.

Counsel for small and middle-market companies generally work directly with management. In doing so, they have the unique opportunity to regularly assess management's intentions and to participate in molding corporate strategy. Conducting a legal audit enhances their ability to anticipate legal problems. Companies may also obtain improved quality of legal advice if their lawyer is aware of the "big picture" and can spot significant issues that management may consider irrelevant and avert future problems. After conducting a legal audit, informed counsel need not waste time assembling background information relevant to questions or sudden needs. As a result, legal expenses are also reduced since counsel does not have to engage in fact-finding when a problem arises.

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# CASH OR ACCRUAL ACCOUNTING FOR THE SMALL BUSINESS OWNER?

## THE IRS EXPANDS YOUR OPTIONS

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by **Seth G. Charnes**

Small businesses - and some not so small businesses - recently got an important accounting break from the IRS. Final rules, building on earlier proposed rules, say that more small businesses can use the taxpayer-friendly cash method of accounting.

### **More flexibility**

If you own a small business, you know how much time and expense accounting consumes and how tough the IRS can be. The tax rules say that the IRS can arbitrarily change your method of accounting if it determines that your method fails to clearly reflect your income. Small businesses have always been prime targets.

Traditionally, the IRS frowned on the simple cash method of accounting and switched a lot of small businesses to the more complicated accrual method of accounting. The trigger for this switch was often that the business held items in inventory for sale.

For a long time, the IRS promised to ease the accounting burden of small businesses. Last year, it relaxed the accounting rules for businesses with annual gross receipts of \$1 million or less.

The new regulations go even further. They ease the rules for businesses with annual gross receipts of \$10 million or less. According to the IRS, more than 500,000 businesses will benefit from the new rules.

### **Three options**

If your annual gross receipts are less than \$10 million, you may be able to choose one of three optional methods of accounting:

1. The overall cash method of accounting using inventory accounting;
2. The overall accrual method of accounting with accounting for inventory items as non-incidental supplies; and
3. The overall cash method of accounting with accounting for inventory items as non-incidental supplies.

### **\$10 million threshold**

The test for using the cash method is \$10 million -- or less - in annual gross receipts. You can meet this test by averaging your gross receipts over the past three years if last year's gross receipts were more than \$10 million.

### **Exceptions**

Not every small business can take advantage of the relaxed accounting rules. The exceptions are broad and complex, so you'll need to contact a tax professional to determine if your business can't use the new accounting rules.

Some industries, such as mining or manufacturing, are excluded. IT businesses also may be ineligible. Depending on how your business is structured, part of your business may be able to use the cash method even if another part cannot.

The IRS also may not allow you to change to the cash method if you had previously made a change. Use of the cash method is only available to businesses that have not previously changed - or been required by the IRS to change - to the accrual method.

Because the new rules and exceptions are very complex, please contact our offices to see if you can take advantage of this important shift in IRS policy.

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*The information presented is only of a general nature, may omit many details and special rules, is current only as of its published date, and accordingly cannot be regarded as legal or tax advice.*

