

The Taxman never sleeps – He just stays on his computer

A large part of the 21st century business world is the information-based service economy. Business communications and business transactions move at Mach speed in our computer-based service economy. Unfortunately, the taxman is not traveling far behind. Computer software is but the latest technology from which the taxman desires to take his, or her, piece of the action. “Computer software” has become a taxable asset to the taxman when a business is up for sale. My comments in this article focus on the tax implications of New York business transfer sales tax, and not on retail sales tax liability. As Albert Einstein said, “bureaucracy is the death of all sound work.” New York business transfer tax law places the taxability of computer software in two categories: prewritten software and custom designed software. In New York State, the sale of prewritten software is subject to bulk sales tax, while the sale of custom designed software is exempt from taxation. The only software that is considered custom software is “software designed and developed to the specifications of a *specific purchaser*.”

In a so-called bulk sale transaction, a business’ general assets will be subject to taxation by the state. The taxman’s determination of a taxable asset is ever expanding as more of a company’s intangible assets become subject to tax liability. The value of a company’s software can comprise a large portion of a company’s monetary worth. Determining the taxability, and the value, of software involved in a sale often makes the difference in hundreds of thousands of dollars in taxes. Tax planning before any transaction is essential.

Even those aware of the modern limits in characterizing “custom computer software” may be surprised at just how expansive this term really is to the taxman. An incorrect assumption by a business purchaser that software was “custom” recently cost a business in New York Tax Court more than half a million dollars. In the sale, the buyer purchased all of the seller’s assets including the software. The seller had previously designed and developed software for its own use and never sold or attempted to sell it prior to the sale of its entire operations. The tax court found that since this software was developed internally by the seller, it was not “designed and developed to the specifications of a purchaser.” The court held that the previously written custom software was to be classified as prewritten software and therefore taxable upon transfer.

If a company’s computer software was originally considered *custom software*, it could lose that tax-exempt status when the company later sold it as part of an asset sale. Custom software sold to any party for whom it was not *specifically designed* becomes prewritten software. Even if “prewritten software” is custom modified for a new purchaser, the software is subject to tax. Only the actual cost of customizing the prewritten software would be tax exempt.

Under New York tax law, the definition of software is evolving in a bad direction. Computer “source code,” not traditionally considered computer software, can be taxed as software. Source code is a computer program in its original programming language. Source code needs to be converted into “object code” by a compiler before a computer can read it. Yet as far as the taxman is concerned, “source code” is synonymous with prewritten software. A recent New York court

decision did not consider the sale of source code as an exempt transfer of intellectual property, but rather a taxable transfer of tangible personal property.

What about a computer source code used to *create* custom made software? New York Tax Court determined this was also prewritten software. The business purchased source code to make custom designed software, they did not purchase custom designed software itself. Conveniently, this transaction also falls outside of another New York State tax law exemption. There is an exemption for the purchases of “machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property for sale, by manufacturing processing, generating, assembling . . .” The court had determined the source code was “equipment” for tax purposes and the company was using this equipment to “produce” software. But, the exemption was still denied because the source code was producing “custom software,” which is not tangible personal property and therefore not subject to this exemption. The taxman always finds a way. This mistake recently cost a business six figures in taxes. The taxman always rings twice.

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