



The Tax Man Never Sleeps He Just Stays awake at his Computer

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David L. Ganje is founder of the Ganje Law Office, which has earned a reputation for quality in the areas of Business and Corporate law as well as Commercial law. In this capacity, David Ganje has been admitted to practice in the United States Tax Court. Mr. Ganje has been named an Upstate New York Super Lawyer for 2007, 2008, 2009, and 2010 and is a member of the Capital Area Technology Association and the Business Law Section of the New York State Bar Association.

Knowledgeable and effective tax planning is more important than ever in today's information-based service economy. Computer software is but the latest technology into which the Taxman seeks to sink his teeth. "Computer software" has become a taxable asset to the taxman when a business is sold. Important decisions based on the value of assets in purchasing negotiations need to be made as early as possible before the Taxman cometh. New York business transfer tax law places two important distinctions on the taxability of computer software: 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 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. A business in this industry must evaluate its assets far in advance to minimize the Taxman's wrath.

Custom software is "software designed and developed to the specifications of a *specific purchaser*." Even those aware of the modern limits in characterizing "custom computer software" may be surprised at just how narrow 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 that case, a buyer purchased all of the seller's assets including software that had previously been designed and developed for the seller's own use. The Court found, that this software did not fall under the custom software exception because it had been developed and used internally by the seller, not "designed and developed to the specifications of a purchaser."

How did the Court come to its ruling and what are its implications? Basically, if a company's computer software was at one time *originally* considered *custom software*, it could lose that tax-exempt status when the company later sells it as part of an asset sale. What was once "custom," or "unique" will be considered by the Taxman to be secondhand and fully taxable even though the software's purpose remains the same after it changes hands with the rest of a company's assets.

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The software was not *specifically designed* for the new buyers, and the Taxman will come right for it. Even if “prewritten software” is custom modified for a new purchaser, the software is still subject to the 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,” that was not traditionally considered computer software, can now be taxed as software. Source code is a computer program in its original programming language that needs to be converted (and customized!) into “object code” by a compiler before a computer can read it. Yet as far as the Taxman is concerned, “source code” is just another form of prewritten software. A recent New York court decision renders the sale of source code a taxable transfer of tangible personal property without exemption.

All of this now begs the question: What about computer source code used to *create* custom made software? The New York Tax Court determined that this was also prewritten software. In another recent case, a business purchased source code to make custom designed software, but did not purchase custom designed software itself. Conveniently, this transaction also falls outside of another New York State Tax law exemption. This exemption for the purchases of equipment for use in the production of tangible personal property for sale, by manufacturing processing, generating, assembling, etc... The Court had in fact determined that source code was “equipment” for tax purposes and that the company was using this equipment to “produce” software. However, the court made a work-around and the “custom” exemption was still denied because the source code was producing intangible “custom software,” which is not personal property that you can physically touch and therefore not subject to this exemption.

The lesson here is the 5P's: "Proper Planning Prevents Poor Performance." The poor performance to be avoided here is letting the Taxman take a 6-digit bite out of your assets without warning.