North Carolina Department of Revenue

Pat McCrory
Governor

Lyons Gray
Secretary

November 5, 2013

<u>MEMORANDUM</u>

To: County Assessors

From: David B. Baker, Director
         Local Government Division

Re: Senate Bill 490 – Customized Software

Senate Bill 490 passed the 2013 session of the General Assembly. This bill excludes customized software from property tax by adding the phrase below to G.S. 105-275(40)

> The foregoing does not include development of software or any modifications to software, whether done internally by the taxpayer or externally by a third party, to meet the customer's specified needs.

What has not changed?

Software that is not capitalized on the accounting records of the owner or is purchased or licensed from a related entity would still be excluded from property tax as it was before S490 passed.

Embedded software is still taxable and defined as: ….computer instructions, known as microcode, that reside permanently in the internal memory of a computer system or other equipment and are not intended to be removed without terminating the operation of the computer system or equipment and removing a computer chip, a circuit, or another mechanical device.

What has changed?

The requirements for software to be taxable are:

> It is purchased or licensed from a person who is unrelated to the taxpayer and it is capitalized on the books of the taxpayer in accordance with generally accepted accounting principles, including financial accounting standards issued by the Financial Accounting Standards Board. A person is unrelated to a taxpayer if (i) the taxpayer and the person are not subject to any common ownership, either directly or

indirectly, and (ii) neither the taxpayer nor the person has any ownership interest, either directly or indirectly, in the other

Software that meets the above requirements is now excluded under the new amendment if the software is developed from scratch to meet the specified needs of the taxpayer whether done internally by the taxpayer or externally by a third party.

What about software that is purchased by the taxpayer and then modified for the taxpayer's specified needs? In this case the purchased software is taxable if it meets the requirements of 105-275(40), but the modifications would be excluded. For example, a software package that is purchased or licensed from an unrelated entity for $100,000 and is capitalized on the taxpayer's books would still be taxable. However, the software cannot be utilized by the owner in its current state, and it must be modified for the owner's use. The owner hires additional full-time employees and also pays outside (unrelated to the owner) consultants to modify and install the software so the owner can use it for their specified needs. The amendment above excludes the additional costs needed to put "the software" in its usable state for the customer's specified needs. In this example, "the software" is taxable and the modifications are excluded from property tax.

This change is effective for tax years which begin on or after July 1, 2014. It does not matter in which year the software was acquired; all customized software is excluded and should not be listed by the owner starting in January 1, 2014.

What about tax years prior to January 1, 2014?

If software is deemed to be taxable under the previous statute then it is still taxable for those years.

Please do not hesitate to contact our office at 919-814-1129 if we can be of any assistance.