



North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

David W. Hoyle
Secretary

July 21, 2011

Memorandum

To: County Assessors

From: David B. Baker, MPA, PPS *DBB*
Director, Local Government Division

Re: Assessment of Software

The assessment of software presents several unique challenges. This memorandum will address the taxability and exclusion of software under North Carolina law and some issues regarding the proper assessment of software. This memorandum does not address the issue of situs, that is, where the property is treated as being located for property tax purposes.

Software is personal property, and to maintain equity with the assessment of other personal property, software must be treated like other personal property to the extent possible. If we are to rely on the cost approach for the appraisal of personal property, all costs included in the installation of software should be listed. This includes all costs necessary to achieve the normal operation of the software. This position rests both on principles of equitable treatment and sound appraisal principles. In the assessment of personal property, assessors do not tax individual cost components of the property, such as installation costs, by themselves. For example, engineering cost is not taxable by itself. However, if engineering costs, development costs, or any other costs are part of the overall cost of putting personal property in place and in operation, then those costs become part of the cost of the taxable **property**.

Per G.S. 105-274(a), "All **property**, real and personal, within the jurisdiction of the State shall be subject to taxation unless it is..." exempted or excluded. [Emphasis added.] Clearly, we are required to assess **property**, not individual costs.

Assessors do use those costs to determine the value of the property. Perhaps the most equitable way to determine if a particular cost is part of the cost of the property is by verification of the taxpayer's accounting records. If a cost is part of the capitalized cost of any asset, whether software or any other personal property, it should certainly be considered part of the cost of the asset. The taxpayer has considered that cost as part of the depreciable cost of the asset, thereby gaining an income tax depreciation advantage, and it should also be considered a cost applicable to the property for property tax purposes.

The position above relates to software in a unique way. Because of the exclusion statute in G.S. 105-275(40), assessors can neither assess software that is purchased or licensed from a related entity nor can they assess software that is expensed. It is our position that this exclusion is clearly only applicable to the software property, and not to modification costs or installation costs of the software property itself. Therefore, once software property has been determined to be excluded, modifications or additions to that property are also excluded. Conversely, once software property has been determined to be taxable, modifications or additions to that property are also taxable. The modifications or additions do not stand by themselves as separate property subject to a separate determination of exclusion under G.S. 105-275(40).

For example, a software package is purchased or licensed from an unrelated entity for \$100,000 and is capitalized on the taxpayer's books. This can be called "the software". The software is 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 its intended purpose. It is our position that the additional costs needed to put "the software" in its usable state are similar to installation costs of other personal property, and that those additional costs become part of the cost of the taxable software, regardless of whether the additional costs were paid to related or unrelated parties. In this example, "the software" is taxable and, therefore, the modifications are also taxable.

One of the requirements for taxation is that the software must be purchased or licensed from a person who is unrelated to the taxpayer. Per G.S. 105-275(40)(b), "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." Additionally, when an owner uses its employees or contract employees to develop software, it may be necessary to determine if those persons are unrelated to the owner. If wages paid to a person are reported using IRS Form W-2, we consider that person as being "related". If wages paid to a person are reported using IRS Form 1099, we consider that person as being "unrelated".

In conclusion, our position is that software property is either taxable or excluded. This position is consistent with the similar treatment of other personal property. We do not hold the position that parts of the software cost can be taxable while other parts of the software cost can be excluded. In North Carolina, property is taxable, not costs.

Please do not hesitate to contact our office at 919-733-7711 if we can be of any assistance.