Software Developer Classification Discussion

Virginia Association of Local Tax Auditors

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Code of Virginia, § 58.1-3703 (B):

- **§ 58.1-3703 (B). Counties, cities and towns may impose local license taxes and fees; limitation of authority.**

"B. Any county, city or town by ordinance may exempt in whole or in part from the license tax (i) the **design, development or other creation of computer software for lease, sale or license** and (ii) private businesses and industries entering into agreements for the establishment, installation, renovation, remodeling, or construction of satellite classrooms for grades kindergarten through three on a site owned by the business or industry and leased to the school board at no costs pursuant to § 22.1-26.1."

****Caveat: Historically, Virginia business centered on agriculture, famous for Virginia Ham and Tobacco. In the 1990's, the US information technology industry was emerging and there was a shift both economically and politically in Virginia to attract technology industry to the Commonwealth of Virginia. As a result, the BPOL exclusion of software development (creation of an intellectual property) evolved.**

How to identify a Software Developer for classification or exclusion purposes:

- Who is a Software Developer (in general)?

  Much of the actual creation of software happens through the writing of computer code. A software developer will analyze the needs of the user (client) then create, test and develop a software program (<u>product</u>) that will solve a problem, provide entertainment or simply make life easier for the target market.

- The software development lifecycle (SDLC) is essentially a series of steps that provide a model for the development and lifecycle management of a piece of software, "a product." (It describes the planning, designing, coding, and testing of a software system, as well as the method in which these steps are implemented.)

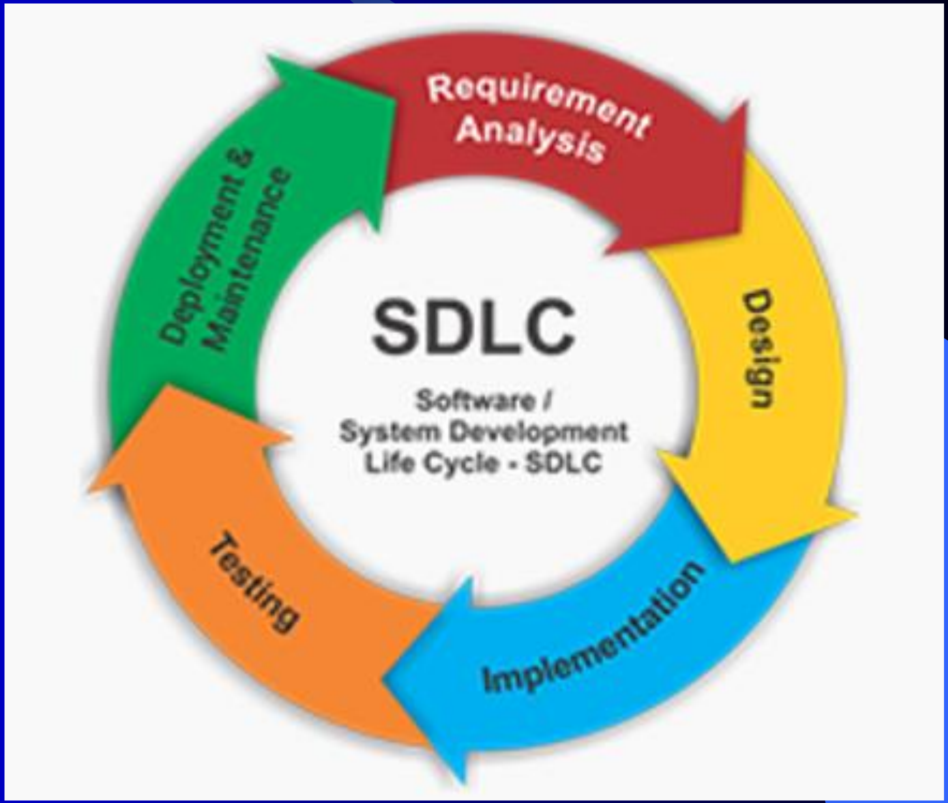
***Caveat: <u>Every person that is involved in the SDLC at any phase is a developer!</u>**

****For BPOL purposes, beware that we must filter classification of Software Developer through § 58.1-3703 (B) of the Virginia State Code of Taxation and our own locality Code of Ordinances.****

The Software Development Lifecycle (SDLC) and Methodologies

- The SDLC consists of the following six phases in every Software development life cycle model :

  1. Requirement gathering and analysis
  2. Design
  3. Implementation or coding
  4. Testing
  5. Deployment
  6. Maintenance



- SDLC Development Methodologies:
  (Service Delivery Methods)

  1.Waterfall-Traditional
  2.Agile
  3.Rapid Application

Software Development Lifecycle (SDLC)…

1. Requirement gathering and analysis

During this phase, all relevant information is gathered from the customer to develop a product per customer expectation. Any ambiguities need to be resolved in this phase. Meeting is set up with customer to gather all the information like what the customer wants to build, who will be the end user, what is the purpose of the software. Once the requirement gathering is done, an analysis is done to check the feasibility of the development of software product. Once the requirement is clearly understood, a Software Requirement(s) Specification (SRS) document is created.

2. Design

This is the phase of system designing based on the requirement(s) and detailed analysis of the new system. It is the most crucial phase in the development of a system. In this phase the SDLC process moves from the what questions of the analysis phase to the how.

3. Implementation or Coding

In this phase the code is produced, the work is divided in modules/units and actual coding is started. Since the code is produced in this phase, it is the main focus for the developer. This is the longest phase of the SDLC.

Software Development Lifecycle (SDLC) continued…

4. Testing

After code is developed, it is tested thoroughly against the requirements to make sure that the software product is solving the needs identified during the requirement(s) phase. Any defects found are assigned to developer to get them fixed. Retesting, regression testing is done till the software meets customer's expectation.

5. Deployment

After successful testing , software is deployed in the production environment or first User Acceptance Testing (UAT) is done depending on customer expectation. If customer finds the software application expectable, then sign off is provided by customer to go-live. Software product is complete! *At this phase customer usually takes ownership of the software; the sale of the software is complete.

*This is very important and especially true if customer is a government entity (i.e. the US Government takes ownership of the software from the developer as required by the Federal Acquisition Regulation, (FAR). Most enterprise businesses and other government agencies own rather than lease or license software product.

6. Maintenance

After software product is deployed on the production environment (the fully functional software product is in use by customer), any issues that arise and need to be addressed/fixed, or any enhancements that are to be done are taken care of by the developer. This phase is the operational maintenance phase.

*Note: Operational and Maintenance (O&M) phase contracts are separate from the software development process. No new software creation is being conducted.

Why is it important to understand the SDLC for Local BPOL Tax Purposes:

- The SDLC provides guidelines as to the process of developing a software product, an intellectual property (IP).
- The SDLC details the process phases that result in creating a software product.
- The SDLC helps define who essentially developed the software product.

****For BPOL purposes, it is important to know who developed and who owns the software product, the intellectual property (IP).****

Intellectual Property Product (IP) Vs. Information Technology Service (IT) Service

- **Intellectual Property (IP): The <u>Software Product</u>**

  Is a work or invention that is the result of creativity, such as a design, including **<u>intangible creation of the mind, to which one has rights and for which one may apply for a patent, copyright, or trademark</u>. <u>IP is protected in law by patents, copyrights and trademarks</u>, which enable people to earn recognition and financial benefit from what they invented or created.**

  Below are links to the US Dept. of Commerce agencies that can be searched to verify registration and ownership information:

  https://www.copyright.gov/

  https://www.uspto.gov/

- **Information Technology Service (IT Service): <u>Service</u>**

  Information technology services provide technology-oriented solutions by combining the processes and functions of software, hardware, networks, telecommunications and electronics.

  <u>Services may include up-grading, up-dating, or modifying software created by another company</u>

Qualifying Software development businesses meet the following criteria:

1) A ***software product*** was created by the business.

a. Not allowed for receipts attributed to up-grading, up-dating, or modifying software created by another company.

b. Software development under a 3rd party or subcontract agreement does not qualify (lack of ownership — ownership usually retained by the primary contractor, or by the one initially contracting the development service.)

2) Creator/Developer retains all ownership rights **and is receiving receipts from the sale, license, or lease of the software product that it has developed**.

a. Rights retained by the developer/licensor:

i. ownership/title/interest

ii. intellectual property or proprietary rights

iii. trademarks, trade secrets, copyrights, & patents

b. Rights prohibited by the user after/licensee:

i. sell, license, lease, or otherwise distribute/market the software;

ii. copy, reproduce, decompile, reverse engineer, or modify the software

iii. obtain/utilize source code from the software

iv. sublet the software to third parties

c. License agreement limits the number of copies a user may make of the software to a set number as needed for use.

d. If software is created under a government contract, obtain evidence of waiver of the ownership clause. Software produced under a government contract can qualify if a waiver is supplied indicating the developer is allowed to commercially market the resulting software provided the developer does so under its own name, risk, liability, and warranty.

Determining Eligibility/Verification

Supporting Documentation Requirements:

- Copies of the licenses and/or contracts detailing the lease, license, or sale of the software product developed.
- Information on copyrights, trademarks, patents are also found at these US Dept. of Commerce agencies links:

  https://www.copyright.gov/

  https://www.uspto.gov/
- Description of any/all business activities conducted or controlled in your locality.
- Copies of complete Federal and state tax returns.
- Detailed financial statements that identify both the company's total gross receipts and those receipts directly attributed to the lease, sale, or license of its software. Statement of accounts, showing: i.e.: License fees, Maintenance fees, Update/Upgrade fees, Training, Consulting, etc. (only certain fees are excludable).
- Brief description of the nature of business. If company has a web site, request that they provide the web page address.
- List of software products developed. Request copies of promotional literature for each product.

Code of Virginia, Public Documents (PDs) :

- **§ 58.1-3703 (B). Counties, cities and towns may impose local license taxes and fees; limitation of authority.**

  “B. Any county, city or town by ordinance may exempt in whole or in part from the license tax (i) the **design, development or other creation of computer software for lease, sale or license** and (ii) private businesses and industries entering into agreements for the establishment, installation, renovation, remodeling, or construction of satellite classrooms for grades kindergarten through three on a site owned by the business or industry and leased to the school board at no costs pursuant to § 22.1-26.1.“

BPOL Regulations

- BPOL Tax Local Taxes 2000 BPOL Guidelines link:

  https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/00-3

- Under Title 23 VAC 10-500-500, "computer and systems development services" are classified as "business services" and may be subject to the BPOL tax as set forth in *Va. Code* § 58.1-3706 A 4.

Examples of Allowed & Disallowed Software Developer **Exclusions**

Software Exclusion could be claimed under Consultant/Special Occupation Ordinance, and/or Business Service Ordinance(s). Business Service classification is spelled out in the Code of Virginia; the 2000 BPOL Guidelines, and Public Documents (PDs). In the 1990s there were IT Consultants, businesses' that were primarily involved with needs analysis of the their clients. Today, almost all businesses are involved with all aspects of SDLC, therefore, for BPOL purposes IT Businesses are be classified as Business Service.

Determination – The software developer exclusions **were NOT allowed** for the following Reason(s):

a) Review of contracts submitted to the County in support of the software developer exclusion instead evidenced that the taxpayer was providing Information Technology (IT) services to clients, including requirements gathering and analysis; design; implementation; testing; deployment ; maintenance and documentation, business services; rather than receiving revenues from the sale, lease, or license of a software product, as the exclusion allows.

b) No design, development or other creation of a software product (IP), rather taxpayer was involved in updating, upgrading, enhancing or customizing an existing software product, to meet requirements, their client's needs. No license fees, lease or sale will be generated from this business activity.

c) They have no Copyrights, trademarks, or patents of the software products. Therefore, they have NO ownership rights to the Intellectual Property (IP) software to be able to license, lease, or sell.

Examples of Allowed & Disallowed Software Developer **Exclusions** (Cont'd)

d) They are contracted by an agency agreement to sell software that is not their own. They are selling other companies products and services, and did not design, develop or create. They do not own any patents, trademarks, copyrights, they have no intellectual property rights.

e) In case software is created under a government contract, it behooves us to obtain evidence of waiver of the ownership clause that is part and parcel of the Federal Acquisition Regulation (FAR). Software produced under a government contract can qualify for exclusion if a waiver is supplied indicating the developer is allowed to commercially market the resulting software provided the developer does so under its own name, risk, liability, and warranty.

***Caveat: In contracts, beware of the indemnity clause, this does not provide ownership rights; but rather it identifies liability, the liable party, should anything go wrong with the software product.**

Determination – The software developer exclusions **were allowed** for the following Reason(s):

The Taxpayer is exempt from the BPOL gross receipts attributable to the **design, development or other creation of computer software product for lease, sale or license**.

****For BPOL purposes it is important to keep in mind who developed and who owns the software product, the intellectual property (IP).****

Code of Virginia, Related PD(s):

- *Related PD's: Rulings of the Tax Commissioner Link:*
  https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/14-117
  https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/99-296
  https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/18-30

- Excerpt from P.D. 99-296 states "Business…would be classified as a business service under the provisions of the BPOL Guidelines, which state: "engineering, design, research and development and computer software development typically are not manufacturing." Page 3 of Appendix B. Rather, data processing, computer and systems development services are typically classified as "business services," and may be subject to the BPOL tax as outlined in Code of Virginia § 58.1-3706(A)(4). BPOL guidelines, page 121…"

Fairfax County and Fairfax County Code of Ordinances:

Fairfax County Code of Ordinances: Software developers [4-7.2-1(b)(1)Z]

Effective January 1, 1999, gross receipts derived solely from the design, development or other creation of computer software for lease, sale or license shall be subject to an exclusion in the amount set forth in the table below. This exclusion shall apply only to those receipts attributed to computer software design, development or creation activities actually performed at a definite place of business within Fairfax County as specified by Section 4-7.2-6.

Link to Fairfax County Code of Ordinances:
https://library.municode.com/va/fairfax_county/codes/code_of_ordinances?nodeId=FACOCO_CH4TAFI_ART7.2BUPROCLITA

Fairfax County Exclusion Worksheet:

"The software product(s) must be developed at a definite place of business in Fairfax County. Qualified developers originate and retain the ownership rights (intellectual/propriety) of the developed software to include the exclusive right to license, sell, or lease the software. Receipts derived from computer related activities such as systems analysis, systems integration, and/or training on the software are not part of this exclusion. Receipts attributed to maintenance contracts may be excluded if maintenance includes automatic updates, fixes, and upgrades to qualifying software products. Software development activities conducted on behalf of another party are not eligible for this exclusion."

Link to Fairfax County Exclusion Worksheet:
https://www.fairfaxcounty.gov/taxes/sites/taxes/files/assets/documents/pdf/business/2018-bpol-exclusion-worksheet.pdf

Questions??