ATO issues Draft Ruling regarding deductibility of website expenditure

8 April 2016

In brief

On 6 April 2016, the ATO published a draft tax ruling outlining its views on the tax treatment of expenditure on commercial websites. In this draft ruling, the Commissioner set out a number of broad principles that can be applied in determining whether website costs are revenue or capital in nature, and if the latter, whether they may be considered 'in-house software', or whether some other residual approach applies, such as capital gains tax (CGT) or black hole cost treatment.

This is a somewhat difficult area, given the subjectivity in application of the capital/revenue analysis to an area of business which is subject to increasing rates of change.

The essence of the draft is that website expenditure may be capital in nature where it results in a change or improvement to the profit-yielding structure of the business. Capital treatment is expected to follow where there is enhanced or upgraded functionality of the website, or creation of a structural advantage which is significant or material to the business. Conversely, revenue treatment may follow where there are piecemeal or routine modifications resulting in minor enhancements.

The Commissioner has accepted that expenditure on websites, where it is capital in nature, may satisfy the definition of 'in-house software' and so is a depreciating asset under Division 40 ITAA 1997.

The draft will be of interest to a wide range of taxpayers, whose websites are key to their business or require ongoing maintenance and development.

The R&D provisions are not considered in the draft and so taxpayers' claims for R&D deductions should not be directly impacted.

It is noted that exposure draft legislation was released on 1 April 2016 which, if enacted, will allow taxpayers to self-assess effective lives of intangible depreciating assets, including in-house software. This may allow for more appropriate outcomes for some taxpayers.

The draft ruling is also of interest as it provides some broader insight into the Commissioner's views around the revenue vs capital distinction.

In detail

In conjunction with several of its clients, PwC Australia initiated dialogue with the Australian Taxation Office (ATO) around two years ago, during which we sought guidance regarding income tax treatment of website expenditure, given the absence of ATO interpretive material since the 2009 repeal of TR 2001/6. Given the increasing significance of websites and online businesses (and the growing quantum of spend for some businesses), it was important for taxpayers to obtain clarity around the Commissioner's views regarding treatment of such expenditure.

Following the dialogue, on 6 April 2016, the ATO issued draft Taxation Ruling TR 2016/D1 *Income Tax: deductibility of expenditure on a commercial website* (the Draft Ruling). In the Draft Ruling, the Commissioner has sought to apply existing concepts of capital and revenue to characterise the different types of costs that may be involved in development and maintaining a website.

Capital vs revenue characterisation

The Commissioner considers that website expenditure may be capital where it results in a change or improvement to the profit-yielding structure of the business. Capital treatment is expected to follow where there is enhanced or upgraded functionality of the website, or creation of a structural advantage which is significant or material to the business. Conversely, revenue treatment may follow where there are piecemeal or routine modifications resulting in minor enhancements. The table below provides a brief summary of types of spend that the Commissioner considers can be categorised as either capital or revenue.

Capital	**Revenue**
Labour costs that are directly referable to the enhancement of the profit yielding structure of the business	Expenditure on 'off-the-shelf' software that is licenced periodically
'Off-the-shelf' software products where the product provides an enhancement of the profit yielding structure of the business	Periodic operating, registration and licensing fees
Expenditure incurred in acquiring or developing a commercial website for a new or existing business	Expenditure incurred in maintaining a website
Expenditure that adds new functionality or materially expands existing functionality	Expenditure on modifications to a website that add minor functionality or make minor enhancements to existing functionality
Content migration as part of establishing a new website	Expenditure incurred in maintaining a social media presence and updating content
An amount paid once-and-for-all to secure the right to use a domain name	Periodic registration fees for domain names

The approach taken in the Draft Ruling is to provide some broad principles that can be applied when determining whether website costs are capital or revenue in nature. The Draft Ruling emphasises that characterisation is a matter of fact and degree. This approach, however, leaves taxpayers with the challenge of applying somewhat subjective analysis to potential assets which, by their nature, are often changeable and constantly evolving.

The Commissioner considers the key question in determining whether an amount is capital to be: *to what extent does the expenditure enhance or augment the profit-yielding structure of the business?* The Commissioner considers the degree of 'enduring benefit' to be secondary.

The Commissioner notes that factors to be taken into account in making this assessment include the following:

- The role of the website in the business
- The nature of the modification to the website
- The size and extent of the modification
- The degree of planning and level of resources employed in effecting the modification
- The level of approval required for the modification
- The expected useful life of the modification.

As noted above, these factors are quite broad, and the challenge will be the judgment required in applying them to the relevant facts.

Synthesizing the Commissioner's comments and the discussion in its 21 examples, the ATO considers the following are likely to give rise to capital treatment:

- Extended or new functionality
- Upgrades
- Modifications resulting in structural advantage
- Replacement of a material part of the commercial website is a structural advantage
- Piecemeal modifications that are part of a program of work
- Creation of a business asset or advantage that is distinct from the website

The Commissioner notes that in assessing the advantage obtained, consideration needs to be given to the 'significance' or 'materiality' of the advantage or the size of spend, and this judgment needs to be made from a practical and business perspective.

In-house software

The Commissioner has agreed that, to the extent expenditure is considered to be capital in nature, website expenditure may fall within the definition of in-house software. 'In-house software' is defined in s995-1 ITAA 1997 as follows:

"in-house software " *is computer software, or a * right to use computer software, that you acquire, develop or have another entity develop:*

1. *that is mainly for you to use in performing the functions for which the software was developed; and*
2. *for which you cannot deduct amounts under a provision of this Act outside Divisions 40 and 328.*

“Software” is not defined in the tax law and so takes its ordinary meaning. The Commissioner’s view is that, *“software is, functionally, anything that instructs another part of the computer system; more generally, it is a digital system made up of programs, data and associated documentation. It may include data and website content.”*

Accordingly, it appears from the Draft Ruling that the Commissioner agrees that websites typically fall within the concept of software and in-house software. It is noted that in-house software does not include application software made available to download for offline use. This could be a fine distinction, as the Commissioner notes that software provided on a commercial website for installation on the user’s device is nonetheless in-house software provided it has a purpose solely to provide a user interface for interacting with the business.

The Commissioner confirms in one of the examples (in the section of the Draft Ruling that will be binding) that a mobile banking app is in-house software, because it facilitates interaction between the customer and the bank, notwithstanding that it is downloaded onto the user’s device.

The Commissioner notes in the Draft Ruling that other provisions may apply to the extent s8-1 or the in-house software provisions are not applicable. CGT treatment and s40-880 are referred to, but not covered in significant detail.

In total, the Commissioner has provided 21 examples in the Draft Ruling, to help illustrate the application of the principles outlined in the Draft Ruling. Whilst these examples are useful in understanding the Commissioner’s view, they also highlight some of the challenges involved in categorising website expenditure. For example, the Draft Ruling includes several welcome examples of website modifications that are considered to be “minor” and hence revenue in nature, including upgrades to user-monitoring software to better understand the visitor profile and use of its website, and the addition of a new payment option to an online sales facility. These can be contrasted with an example of back-end upgrades to website architecture which, in those examples, are considered to be a structural enhancement to the business. One of the distinguishing features between these examples appears to be the expectation of the need for further enhancements to the website within the short term (12-18 months) or the long term (more than 2 years). Given the pace of change in this area, it may be difficult to distinguish between minor and major website upgrades in this way. The Commissioner also has taken the view that regular updates resulting in gradual improvements are capital in nature where they are part of a broader program which can be considered to be an ‘upgrade as a whole’. We expect this to be difficult for some taxpayers, given the fact that websites require ongoing improvement just to remain functional and relevant in the market, and the question of whether discreet updates should be considered to be separate or part of an overall program presents similar challenges to the ‘functional unit’ analysis in the context of websites.

Another example in the Draft Ruling highlights modifications to a website for mobile devices, and draws a distinction between adapting the existing website to display content in a smart phone friendly layout (an ordinary business expense that is deductible) and creating a separate website exclusively for mobile device access to which mobile device browsers will be automatically redirected (capital in nature). This highlights the subtlety of interpretation and the difference in outcomes that can arise where facts are changed in an arguably fairly minor way.

The Draft Ruling, once finalised, is intended to apply both before and after its date of issue.

Comments on the Draft Ruling can be made until Friday 20 May 2016.

The takeaway

The Draft Ruling, if finalised, will provide some welcome clarification regarding the Commissioner's views. It is positive that the Commissioner has agreed that expenditure which is not revenue in nature may in many cases constitute in-house software, which in our view is the most reasonable interpretation of the legislation and the underlying policy intent. It is also positive to have guidance confirming that operating or maintenance-type activities can be revenue in nature.

The challenges, as noted above, are likely to arise from the breadth and subjectivity of the indicia put forward in the Draft Ruling (for example, the use of undefined terms such as *material*, *significant*, and *minor*, *piecemeal*) and these concepts will need to be considered in the context of the business and the role the website plays within it. Our experience in practice is that websites are often constantly evolving and may be updated regularly, sometimes daily or more, and a website may dramatically change over the course of one to two years, but the changes may be made through numerous incremental updates or releases, each of which (of itself) may be insignificant. Overlaying the concepts of the Draft Ruling in such circumstances could be challenging. Taxpayers will need to ensure they have appropriately assessed their facts and documented their positions.

Again, it is relevant to note that on 1 April 2016, the Australian Treasury released Exposure Draft legislation which, if enacted, will allow taxpayers the option to self-assess effective lives of intangible assets, so that in-house software may be assessed to have a life other than 5 years, for assets an entity starts to hold from on or after 1 July 2016. This means that more appropriate outcomes can be achieved for taxpayers where their website expenditure is capital and they are able to align their effective lives with the reality of their websites.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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