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PwC Alert

Of computer software and capital allowance claims

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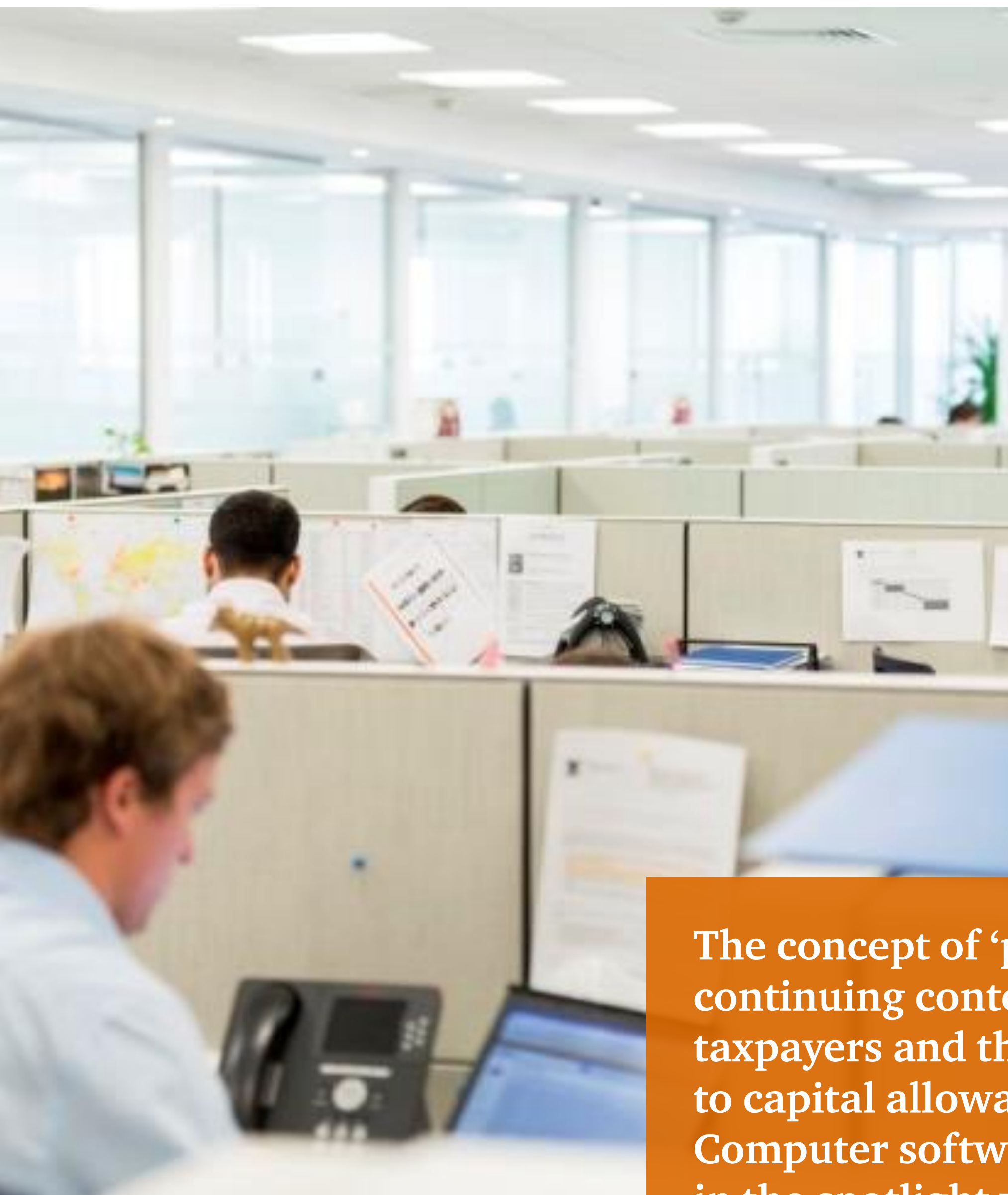


The concept of ‘plant’ is central to the continuing contentions between taxpayers and the taxman with respect to capital allowance (CA) claims. Computer software has recently been in the spotlight with the issuance of *Public Ruling No. 12/2014 – Qualifying Plant and Machinery for Claiming Capital Allowances* by the Inland Revenue Board. This article discusses the key considerations in determining whether computer software qualifies as ‘plant’ for CA purposes.

The basics

Before a particular expenditure qualifies as 'plant' for CA claims, it must first be in respect of a capital expenditure - in the tax parlance, an expenditure which creates an 'enduring benefit'. This refers to expenditure incurred to acquire or to create an asset which lasts for a considerable period of time. In other words, its expected useful life should not be transient. Revenue expenditure on the other hand does not qualify for CA claims. Instead, like all other revenue expenditures, it is eligible for deduction if it is incurred in the production of income unless specifically prohibited by the Income Tax Act 1967 (Act).

Similar to the concept of 'income', the word 'plant' is not defined in the Act. In place of a definition are principles laid out from a body of case laws. The guiding principle of 'plant' can be traced back to the case of *Yarmouth v France* [(1887) 19 QBD 647] where, Lindley L J said: "There is no definition of plant in the Act: but, in its ordinary sense, it includes whatever apparatus *(tool)* is used by a business man for carrying on his business, not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment *(capital expenditure)* in his business…" *[Emphasis added]*. Whether or not a particular capital expenditure incurred in providing for an asset is 'plant' would depend on the application of the above guiding principle to the unique circumstances of each taxpayer's case.

Enhancing the CA scheme for the digital economy

The CA scheme can be tweaked to influence and incentivise targeted types of business expenditure. This can be achieved by widening its scope by prescribing specific expenditures to qualify for CA. Common examples found in the Act include certain types of industrial buildings, agricultural and forestry infrastructure and even renovation expenditure. In addition, the Act also allows the Minister of Finance (Minister) to vary CA claim rates. This has been an avenue used by the Minister to encourage investments in certain types of 'plant' by providing for the cost of such assets which would otherwise take up to 8 years to be fully deductible as CA under general rates, to be claimed at accelerated CA (ACA) rates.

As the importance of computers in business grew during the '90s, the Minister issued successive Accelerated CA Rules (ACA Rules) which provide for ACA claims on the cost to provide for information and communication technology equipment (ICT equipment) to be made over a period of 1-2 years of assessment. However, the ACA Rules are only applicable for the following specified ICT equipment which includes computer software:

- Access control system
- Banking systems
- Barcode equipment
- Bursters/decollators
- Cables and connectors
- Computer Assisted Design (CAD)
- Computer Assisted Manufacturing (CAM)
- Computer Assisted Engineering (CAE)
- Card readers
- Computers and components
- Central Processing Units (CPU)
- Storages
- Screens
- Printers
- Scanners/readers
- Accessories
- Communications and networks
- Software systems or software packages

In December 2014, the IRB issued *Public Ruling No. 12/2014 – Qualifying Plant and Machinery for Claiming Capital Allowances* (PR 12/2014) to explain whether capital expenditure incurred on an asset qualifies as 'plant' for CA purposes. Among others, the IRB attempted to explain its interpretation with respect to computer software in the following paragraphs in PR 12/2014:

Paragraph 8.1

The IRB states that cost of provision of computer software which are "software systems" or "software package" as specified in the ACA Rules are eligible for CA. The IRB goes further to state that software systems or software package means software that is:

- purchased together with the computer equipment from a supplier; or
- purchased separately from a software supplier

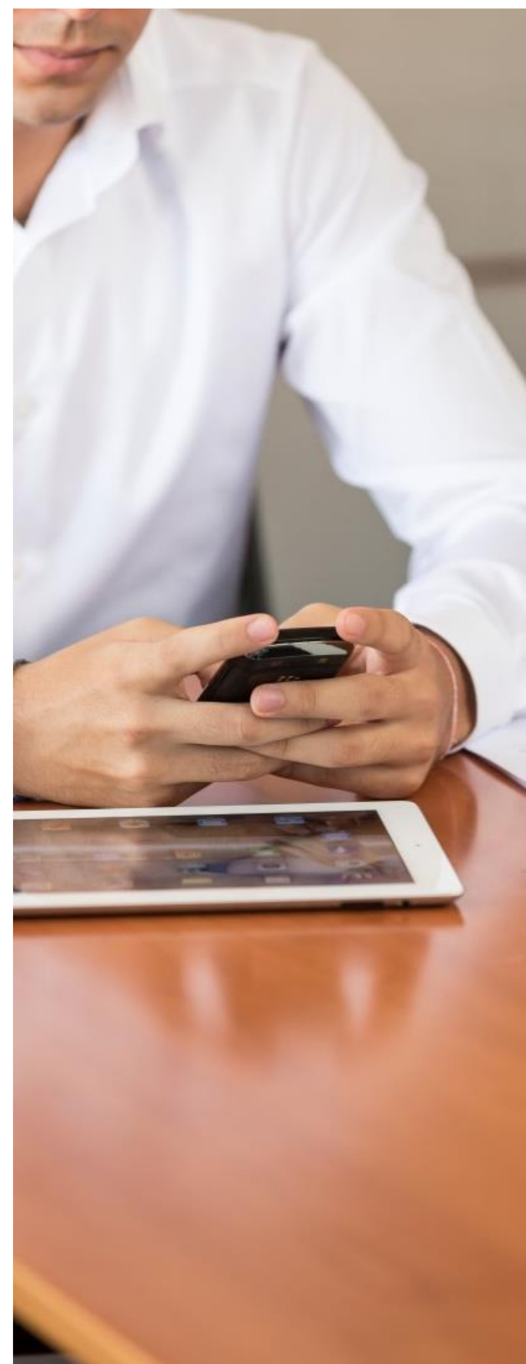
Paragraph 8.2

Payment for developing software such as the following are not part of the cost for the provision of computer software and do not qualify as 'plant':

- consulting fees
- right to use the software such as license fee
- other incidental charges

Paragraph 8.1 read together with paragraph 8.2 immediately creates the following impression:

- Only the types of software stated in the ACA Rules qualify as 'plant'. The basis of restricting it to the types of software stated in the ACA Rules is however, not discussed. This is of particular interest since the ACA Rules merely prescribe ACA rates for certain types of 'plant'; in this case, software systems or software packages.
- There is a distinction between payments for (i) purchased software and (ii) payments for license fees for the rights to use software and by extension, a distinction between (i) purchased software and (ii) developed software. In this context, the former naturally connotes purchase of off-the-shelf software from suppliers and the latter connotes custom-made software by software developers.
- The IRB is of the opinion that only purchases of off-the-shelf software qualify as 'plant' whereas custom-made software does not qualify as 'plant'.



Purchase and development of software, rights to use and license fees – what do they really mean?

When a product is purchased, a simple question to be answered is whether the purchase is for a copyrighted product or is the purchase for the copyright itself. The answer will help to put the issue in perspective as the natural meaning of 'purchase' may connote acquisition of copyright when the term 'license' is juxtaposed with the word 'purchase'.

Although often taken for granted, when software is purchased, especially off-the-shelf software, the purchaser is really paying a license fee to the author of the software for a right to use that software. The right could be for either an indefinite period or a periodical subscription based right. The copyright to the software and its source code remains and belongs to the author of the software, at least, in most cases. Otherwise, the purchaser is free to modify, reproduce or distribute copies of the software as he/she deems fit.

Then we have cases involving the development of customised software by third-party software developers. Whether or not the copyright to the software would be assigned to the client or retained by the software developer would depend on the software development agreement and prevailing laws. Say in most cases, third party software developers only grant their clients the license to use the developed albeit customised software, the fee charged will similarly be a license for the rights to use the customised software. This is really not different from license fees for purchase of software as set out in paragraph 8.1 of PR 12/2014.

The basic principles in determining whether capital expenditure for a particular asset qualifies as 'plant' would depend on whether the asset functions as the taxpayer's business tool. This would require determination based on the facts of each case. The question that we are left to ponder is this – does the software purchase or development agreement which determines whether the taxpayer has limited right (license to use) or unrestricted right (absolute ownership) affect how the software is used in the taxpayer's business? It would be helpful had the IRB discussed this matter before stating its position in paragraphs 8.1 and 8.2 of PR 12/2014.

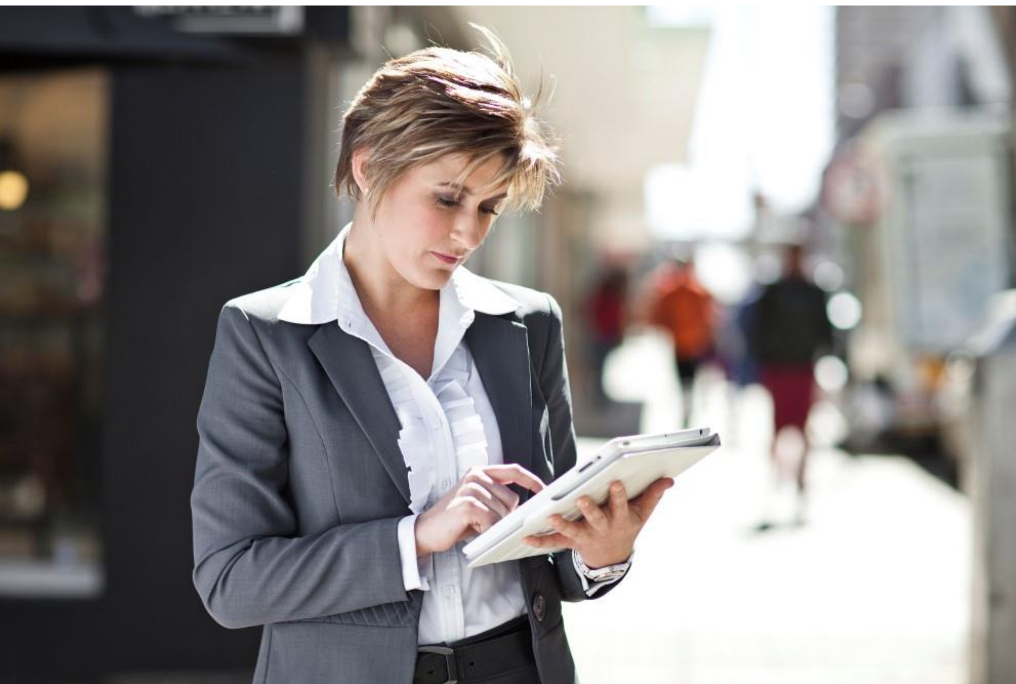
The question of complete legal ownership which may be a reason for the IRB to distinguish license fees from outright purchase (which may or may not be different) should not arise. This is because the ownership test is satisfied so long as the person who incurs the cost is the beneficial owner of the asset.

Ultimately, the IRB's position on the different treatments in regards to how software is acquired in paragraphs 8.1 and 8.2 can be unsettling to readers who try to reconcile them to the general principles on 'plant'. The spectre of exorbitant penalties in the Act for adopting a treatment which differs from the IRB's interpretation may result in taxpayers conceding to these positions notwithstanding. On one extreme, those who could not differentiate the positions from paragraphs 8.1 and 8.2 may voluntarily deny themselves the CA claim on their computer software.

The capital and revenue divide

What if the cost incurred is for short-term subscription based software? Would the subscription be treated any different than other types of periodical revenue expenditure incurred during the production of income? The capital and revenue divide involving software may be further obscured in cases involving renewal fees for access to support and/or updates from software developers given today's rapid pace of software evolution. Also, it can be difficult to distinguish between updates and upgrades.

The situation could be further exacerbated if the fees are in a lump sum (an all-inclusive fee) for say a specified period of subscription. Identifying the capital and revenue elements from such cases would depend on the facts and degree of each case and will most likely involve a close scrutiny of the software development/purchase/license agreement.



Taxed by law or by administrative concession?

Whilst public rulings have the benefit of providing certainty, it may also inherently present the following challenges:

- The IRB's positions are insufficiently explained, making its application challenging.
- The IRB's positions cannot be applied wholesale to all situations.
- Taxpayers cannot agree with the IRB's position.

Should taxpayers compute their taxes based on the law and legal precedents or accept the IRB's position as the de-facto law? Increasingly, this will be a choice that taxpayers have to make given the plethora of public rulings that will be in issue.

Learning from the practical approaches adopted by other countries

Looking at these complexities resulting from the various ways in which each taxpayer acquires its computer software, taxpayers could end up spending an inordinate amount of time to determine and decide the tax treatment for computer software.

In the UK, computer software is specifically deemed as 'plant' in the statute. In addition, the HM Revenue and Customs (HMRC) has issued Business Income Manuals for the subject matter which states that tax treatments for software acquired outright and those developed follow the same tax treatment. It also states that the HMRC will accept expenditure for software which is expected to have an economic life of less than 2 years as revenue expenditure.

The Inland Revenue Authority of Singapore has also provided guidance on the tax treatment of software as follows:

- Payment for license fees for rights to use software – eligible for CA over 1 year
- Software acquired with full legal and economic ownership – eligible for CA over 5 years
- Custom-developed software – where the taxpayer possesses all rights, and is assigned the necessary interests and benefits, the expenditure incurred is accorded specified deductions, otherwise it is eligible for CA claims over 1 year.

These are perhaps some examples of approaches that the IRB can look into to provide clarity and simplify the tax treatment of computer software.

Let's talk

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