FIRST PRINCIPLES

A website of your own

Do you have a presence on the internet? *Rebecca Cave* reviews the tax implications

Most businesses of any size will now have their own website, or at least an entry on the website of a collective body such as a trade association. A commercial website can perform many functions – from a simple advertising medium to an online shop through which sales are made directly to the final consumers. Larger businesses also use restricted access webpages to communicate with their workers and suppliers. Before the business can set up a website it must first acquire a domain name, and I shall deal here with the tax implications of both acquiring and disposing of a domain name.

Unless the business can rely on a high level of programming skills among its workers, it will normally commission a third-party supplier to create its website. This site developer will write the computer mark-up and scripting language code that perform the functions of the website, ie, display pictures, arrange text, provide search facilities, etc. The contract with the website developer may be ongoing, since most websites require some form of maintenance, if only to refresh text as it becomes out of date.

It is important to determine who owns the intellectual property rights attached to the materials used on the site – words, pictures and possibly mechanisms that allow users to move around the website and purchase goods and services. The web developer is often prepared to transfer those rights to the business that commissioned the website, but this should be allowed for in the contract with the developer.

Website development

To establish the correct tax treatment of a website's costs, one must first analyse whether the costs represent capital or revenue expenditure. This analysis should be done through the prism of accounting treatment as applied by generally accepted accounting practice (GAAP). It is not correct to say that accounting treatment cannot be followed for tax purposes, since under *FA* 1998, s. 42(1), all UK businesses must compute their profits according to GAAP, subject to any adjustment required or authorised by law.

The UK GAAP consists not only of the established accounting standards issued by the Accounting Standards Board (ASB), but also supplementary decisions expressed as Urgent Issues Task Force (UITF) abstracts. The question of how to treat website development costs was addressed in the ASB publication UITF 29, effective from 23 March 2001. This document addresses four elements of website development costs.

1. **Planning costs**
   These include the costs of undertaking feasibility studies, determining the objectives and functionalities of the website, exploring ways of achieving the desired functionalities, identifying appropriate hardware and web applications, and selecting suppliers and consultants.

2. **Application and infrastructure development costs**
   These are the costs of obtaining and registering a domain name, of buying or developing hardware and operating software that relate to the site's functionality. Apart from the cost of registering the domain name, which is likely to be relatively modest, these other costs are unlikely to be incurred by an organisation that engages a third-party supplier to develop and host the website.

3. **Design costs**
   These include expenditure to develop the design and appearance of the individual website pages, including the creation of graphics.

4. **Content costs**
   These include the costs of preparing, accumulating and posting the website content. These may be recurring as well as one-off tasks, so will be generally incurred as maintenance costs.

The UITF 29 abstract recommends that only costs that give rise to a future economic benefit for the business may be capitalised if certain other conditions are met. All other website development costs should be charged against profits as they are incurred.

The planning costs do not by themselves give rise to economic benefits for the business, so should be immediately written off and tax relief obtained at that point.

The development, design and content costs can give rise to future economic benefits for the business. However, UITF 29 requires that these costs should only be capitalised when the website brought into being represents an enduring asset for the business. This will generally only occur when the website is expected to generate sales or other revenues directly, for example by allowing orders or bookings to be placed. Thus the costs of creating a website that merely acts as an online brochure should not be capitalised. These costs should be treated as revenue expenses and set against profits for the period in which they're incurred.

International accounts

All listed companies within the European Union have to produce their consolidated group accounts according to international accounting standards (IAS). The international equivalent to UITF 29 is given in the report of the International Standards Interpretation Committee (SIC) 32: *Intangible Assets – Website Development Costs*, which is effective from 25 March 2002. The conclusions of SIC 32 are much the same as UITF 29, except that where the development costs are capitalised the asset created is required to be treated as an intangible asset, which is subject to the requirements of IAS 38, *Intangible Assets,* rather than a tangible asset.

The tax treatment of intangible assets for corporates under *FA* 2002, Sch 29 largely follows the accounts treatment. If the intangible asset is capitalised in the accounts, the annual tax charge is the depreciation, although the company can elect to deduct a 4% writing-down allowance if it prefers.

HMRC approach

It is unfortunate that the views expressed in the HMRC business income manual about the capital or revenue treatment of website costs do not appear to take into account the official GAAP or IAS position. Instead, the HMRC approach at para BIM35870 is rather basic:

'The cost of a website is analogous to that of a shop window. The cost of constructing the window is capital; the cost of changing the display from time to time is revenue.'

If your client is refused tax relief for the cost of developing a website based on the views expressed in the HMRC business income manual, try quoting the requirements of UITF 29, which establish the accounting treatment as required by *FA* 1998, s. 42(1).

Capital allowances

Where the costs of the website development are capitalised, UITF 29 requires that the asset should be treated as a tangible asset rather than an intangible asset – in which case capital allowances will be due as an item of plant or machinery. Although there is no physical asset, the legislation specifically allows the cost of acquiring and developing software, or the right to use software, be treated as plant and to qualify for capital allowances (*CAA* 2001, s. 71).

The HMRC capital allowance manual at para CA 23410 instructs:

> 'Computer software qualifies for plant and machinery allowances (PMAs) if it is not already plant. Computer software is not defined in the capital allowance legislation. You should treat computer programs of any type and data of any kind as computer software. Computer programs range from operating systems like Windows to games like Solitaire. There may be no physical asset because software is sometimes transferred by electronic means, for example it may be downloaded over the Internet. Software acquired that way is also plant.
>
> 'A person may acquire a right to use or otherwise deal with computer software. If so, the right and the software to which it relates are plant. Treat the person as owning the plant while the person is entitled to the right.'

HMRC are not willing to treat the cost of the domain name as a tangible asset. Their view is that the domain name is an intangible asset and the cost is not eligible for capital allowances. If the business that acquired the domain name is a company, the corporate intangible assets regime (*FA* 2002, Sch. 29) will apply to the cost of the domain name, allowing the tax treatment to follow the accounting treatment, with a deduction for depreciation if appropriate.

Website maintenance

The maintenance of a website is a revenue cost because it does not create an enduring asset, it merely maintains an asset in a useable state. The maintenance costs should therefore be set against profit as they are incurred, and achieve tax relief at that point. However, significant alterations to the website such as adding the capacity to receive payments could be considered to be an improvement to the underlying asset, in which case the capital treatment should apply.

Domain names

Acquiring a domain name

A domain name is normally leased for a period of time, commonly for two- or five-year periods. The organisation or individual interested in the name will apply to a registration agent for the required word or phrase to be registered using a particular top-level domain such as .com, or .org. The cost of registering a domain name may be as little as £10, but the name may become quite valuable within a short period of time. Generic names such as 'books.com' are particularly valuable because they are easy for potential customers to remember, increasing the probability that they will become repeat customers or regular clients.

Where a UK VAT-registered trader acquires a domain name from a supplier based outside the EU, the UK trader will be required to account for VAT on that purchase under the VAT reverse-charge rules.

Selling a domain name

The person who holds the rights to a domain name may also acquire three types of asset with potential for exploitation:

a) the contract with the registration authority, which gives the applicant the right to use that domain name;
b) the goodwill that the name may generate; and
c) a registered trademark in respect of the name.

Asset (a) is a contractual right between the registrant and the registrar and does not strictly contain any intellectual property rights as such. Assets (b) and (c) are dependent on their being a trade or business represented by the words or phrase used in the domain name. Just because the domain name holder has acquired the use of a certain domain name, it does not mean that person has the right to use the words contained in that name as a trading name or trademark. Those words may already be registered as a trademark in the UK or in other countries, or used as a trading or brand name by someone else. Trademarks must generally be registered with the national registry of each country in which they are used.

Where a company disposes of one of the assets (a), (b) or (c), which has been created or acquired since 1 April 2002, the disposal will fall under the corporate regime for intangible assets (*FA* 2002, Sch. 29) and the profit is taxed as part of the company's trading profits.

The sale or assignment of the rights to use any of those assets by an individual or unincorporated business will be a disposal for capital gains tax purposes. In most cases the value received for the asset will be less than the individual's annual capital gains exemption.

Conclusion

The cost of developing and maintaining a website should first be analysed in accounting terms, and the tax treatment should follow that. Do not be brow-beaten by out-of-date views on 'shop windows' expressed in the HMRC manuals.

Rebecca Cave has adapted this article from chapter 7 of her book, Practical Commercial Tax*, published by Sweet & Maxwell*