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TAXATION TREATMENT OF Y2K COMPUTER-RELATED AND SOFTWARE EXPENDITURES

The Government has announced in the 1998-99 Budget several measures concerning the taxation treatment of Year 2000 (Y2K) compliance and software expenditures.

Year 2000 Compliance Expenditure

Draft Taxation Ruling TR 98/D5

Simultaneously to the delivery of the Budget the Commissioner of Taxation is releasing draft taxation Ruling TR 98/D5 on the deductibility of Year 2000 (Millennium Bug) expenses.

The effect of the ruling is as follows:

- Expenditure incurred in initial diagnosis work on computer software to determine the extent to which it is not Y2K compliant will be on revenue account, even if no further work is necessary.

- Expenditure incurred in modifying (and subsequently testing) computer software to make it Y2K compliant will be on revenue account, even if it also provides minor improvements to the software.

  — Where expenditure incurred in modifying (and subsequently testing) computer software also involves substantial improvements not related to making the software Y2K compliant it will be necessary to apportion the expenditure between the expenditure related to Y2K compliance which will be immediately deductible and the improvement expenditure which will be deductible over time.

- Expenditure incurred in modifying or completely replacing a computer chip or firmware to make computer hardware or computer operated equipment Y2K compliant is on revenue account. This includes the modification or complete replacement of software embedded in firmware.

  — However, Y2K compliance expenditure that involves replacement of the whole or substantially the whole of the unit of hardware or equipment containing the computer chip or firmware is of a capital nature.

Government Response to TR 98/D5 and Announcement

The Government accepts the effect of the Commissioner’s ruling but will legislate (with effect from the withdrawal of Taxation Ruling IT26 — see below) to extend the class of expenditures immediately deductible to also include:

- expenditure on acquiring new software (including upgrades) or substantially rebuilding current software which has the predominant nature of ensuring Y2K compliance, provided that such expenditure is incurred up to 31 December 1999.

The Government believes this announcement will address uncertainty concerning the treatment of Millennium bug expenses and ensure that the taxation arrangements are consistent with the Government's desire to encourage businesses to achieve Y2K compliance.

Software in General

Withdrawal of Taxation Ruling IT26

On 11 May 1998 the Commissioner of Taxation withdrew Taxation Ruling IT26 which deals with the taxation treatment of software expenditure.

The Commissioner concluded that IT26 no longer reflects the correct application of the existing law in relation to software.

The Commissioner has advised that without a legislative response the withdrawal of IT26 would mean that systems and application software would generally not be subject to amortisation, or, at best, would be amortised over 25 years.

Government Response to the Withdrawal of IT26 and Announcement

The Government will legislate with effect from 10 am AEST, 11 May 1998 (the time of withdrawal of IT26) to provide for systems and application software to be amortised at 40 per cent per year (that is, over 2½ years).

The new arrangements apply to expenditure incurred in relation to contracts entered into to acquire software after the withdrawal of IT26. It will also apply to expenditures on specifically commissioned and in-house development of software commenced after that time. Expenditures on in-house development, or commissioned software commenced or contracts entered into up to that time will continue to receive the previous treatment until 30 June 1999. Thereafter any such expenditure will be treated under the new provisions that are described below:

- all software purchases will be eligible for taxation amortisation over 2½ years at 40 per cent per year. However, the following exemptions will apply:
  - if the (non-renewable) license period is shorter than 2½ years then taxpayers will be allowed to amortise their expenditure over this shorter period;
  - taxpayers who stop using software within 2½ years of acquisition will be allowed an immediate deduction of the unrecouped expenditure at that time;
  - software purchases up to $300 will be immediately expensed. Bulk purchases of software packages summing to more than $300, but individually valued at up to $300, will be covered by the new amortisation provisions;
- the cost of commissioning software or developing it in-house for own use will be capitalised until the project is completed. At that point, it may be amortised in line with the new provisions. This will ensure neutrality with purchased software. Should the commissioned or developed software be disbanded, capitalised costs will be deductible at that time; and
- the treatment of upgrades and maintenance will be in line with the existing application of the law for determining capital and revenue expenses. Broadly, expenditure on enhancing or

upgrading the functional capacity of computer software should be treated on capital account. Expenditure that does not enhance functionality, such as maintenance, testing, code reviews, minor alterations/modifications and remedying defects should continue to be treated on revenue account.

Moreover, systems software that had previously been written off as part of the computer hardware (over 3.7 years under accelerated depreciation) will now be amortised over 2½ years.

The taxation treatment of software that attracts concessions under other parts of the law will remain unchanged.

The write-off rate of 2½ years strikes an appropriate balance between considerations that software is a capital asset — expenditure on which should be amortised for taxation purposes — and the relatively short expected effective life of software arising from rapid developments in the information technology industry.

The proposed arrangements for software are broadly more generous than those applying in comparable overseas taxation jurisdictions. For example, New Zealand allows software purchases to be depreciated at 30 per cent straight line or 40 per cent diminishing value (equivalent to 3.3 years), the United Kingdom provides depreciation of 25 per cent diminishing value (equivalent to a 6-year write off). In Canada systems software receives either a 5 or 8 write off period (depending on the industry it is used in) while application software is depreciated at 100 per cent (which effectively results in a 2-year write off period due to Canada's "half year rule"). The United States provides a 3-year write off for newly purchased software unless the taxpayer can show a shorter write off is appropriate.

Examples

The Attachment sets out examples of how software expenditures will be treated for taxation purposes under the new arrangements.

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CANBERRA

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ATTACHMENT

EXAMPLES OF INTENDED TAX TREATMENT OF Y2K EXPENDITURES

The Commissioner of Taxation outlined the taxation treatment of Y2K expenditures under the current law in Draft Ruling 98/D5. Taxpayers should refer to that ruling for detailed guidance. The Government has decided to amend the taxation law in an important respect to ensure expenditure on new software (including upgrades) or substantially rebuilding current software which has the predominant nature of ensuring Y2K compliance will qualify for an immediate deduction, provided that such expenditure is incurred up to 31 December 1999.

Example 1: – *Y2K Compliance*

Bankcom is a large financial corporation, with multiple branches. It has a centralised mainframe connected via a wide area network (WAN) to each of its branches, as well as a network of Automatic Teller Machines (ATMs). The desktop computers that compose its WAN are also used for a variety of business applications, such as word processing and spreadsheets.

In order to become Y2K compliant, Bankcom engages Bug Compliance Inc (BCI) to undertake a Y2K compliance assessment of all its computer systems. The costs of this assessment are revenue in nature. BCI identifies the need for rectification work to achieve Y2K compliance. Bankcom decides upon the following strategies to deal with the problem, with corresponding tax consequences.

(a) The COBOL accounting software running on the mainframe contains numerous two-digit data fields which will cause a failure if not corrected. The source code for this software is no longer available and will need to be decompiled or re-engineered. Bankcom decides to re-engineer the source code to provide the current functionality. The software is tested with copies of both the current data from business transactions and test data containing 21st century dates. The costs of both the re-engineering and the testing are of a revenue nature.

(b) The ATM network uses programmable chips that contain a two-digit date field likely to cause a failure. The contents of these chips are erased and re-written with a four-digit date field. Each ATM is tested onsite as this work is carried out and the entire network is tested periodically during the course of the rectification work. The costs of both the replacement and the testing are revenue in nature.

(c) The recently acquired PCs running the WAN are fully Y2K compliant, but the software running them contains two digit date fields likely to cause a failure. An alternative software program that is Y2K compliant is available and Bankcom decides to acquire it as a cheaper option than attempting to fix the current version. Under the arrangements announced in the 1998-99 Budget this cost will be deductible in full provided it is incurred up to 31 December 1999.

(d) The word processing software used on the PCs is also Y2K compliant, but the spreadsheet software defaults to two digits for the year. Bankcom decides to implement a conversion macro for all spreadsheets, but decides against testing because it regards the risk as low. The cost of the conversion macro is of a revenue nature.

(e) The mainframe hardware contains two digit date fields on its processing chips that need to be replaced before they cause a failure. Bankcom decides to purchase a new Y2K compliant mainframe, which will also provide additional processing efficiency. This hardware is installed in parallel to the current system and testing is conducted. The costs of the replacement mainframe are capital, and are subject to depreciation.

Example 2: *Y2K Replacement Software*

BAL Pty Ltd can ensure Y2K compliance by replacing software at a cost of $1500 with some minor non-Y2K improvements or replacing software at a cost of $4000 with considerable non-Y2K functions. The $1500 purchase would be considered predominantly of a Y2K compliance and could be expensed. The $4000 package would not be considered to have a predominant Y2K nature and the expenditure would be apportioned on a reasonable basis to reflect the Y2K and non-Y2K compliance components. The Y2K compliance component would then be expensed and the non-Y2K compliance component would be amortised over 2½ years.

EXAMPLES OF INTENDED TAX TREATMENT OF COMPUTER SOFTWARE

Software Purchases/Licences

Where software is acquired under licence the treatment of expenditure of this nature depends on the form the consideration for the licence takes. Regular licence payments akin to rental will be treated as revenue payments. Where a lump sum is paid, it will be treated as a capital payment and eligible for taxation amortisation over 2½ years under the new software amortisation provisions. Software purchases of up to $300 will be eligible for an immediate write off. Where more than one copy of a software program is purchased/licensed the aggregate expenditure on such copies will be used in determining whether the purchase price exceeds $300. Where software is disposed of within 2½ years of its acquisition, taxpayers will be allowed to expense the unrecouped balance on disposal.

Treatment of software expenditure that is eligible for specific concessions (such as the R&D concession) will remain unchanged.

Example 3: *Software acquisition amortisation and obsolescence*

Soft-toys Ltd purchases a software package for $1000 on 1 July 1999.

Under the new amortisation arrangements, $400 would be written off in each of the first two income years with the balance of $200 being written off in the third year of income.

However, the package becomes obsolete on 31 December 2000 and is replaced on 1 January 2001 with a new program costing $2000. For the 2000-2001 income year, Soft-toys can claim total deductions of $1000 comprising: $400 (one half of a full year's write off of $800) in taxation amortisation for the new software; and $600 (a half year write off of $200 plus unrecouped expenditure of $400 ($1,000-$400-$200)) for the old software.

Example 4: *Bulk purchase of software*

Cassandra Consulting Pty Ltd enters into a license which gives it the right to use 5 identical copies of a word processing software package for an indefinite period. This costs Cassandra Consulting $1,000.

Cassandra Consulting should capitalise the full cost of the software ($1,000) and write it off over 2½ years. This is despite the fact that, taken separately, the average cost of each software package does not exceed the $300 threshold.

Software Developed In-House For Business Use

Where software is developed in-house for business use, the treatment of development costs follows the same principles as those governing the treatment of purchased/licensed software. Although most of the expenditure here would take the form of recurring items such as salaries paid to in-house computer programmers, that does not stop the expenditure from being capital. Development costs that are of a capital nature are to be capitalised until the project is completed before they can be amortised. Costs of unsuccessful development will be deductible at the time of abandonment.

Example 5: *Software developed in-house*

In year 1 Insurance Company Ltd develops a new information processing software program. On this project it incurs $100,000 on the following types of activities: gathering and analysis of user requirements; systems design; detailed software specification; programme construction; software testing; user or customer testing (acceptance testing); development of manual and training materials; preparation of documents to describe, support, and for on-going maintenance of software product; management review throughout the development phase (e.g. quality assurance); and other overhead costs. The project is completed at the end of year 2.

In the following years, Insurance Company Ltd incurs a further $20,000 per annum on: help desk facilities; fixing minor programme bugs; bringing performance up to specification; and making minor changes such as increasing field sizes.

As the $100,000 represents a capital investment, Insurance Company Ltd capitalises it to a software development account and begins, as from year 3, to amortise it over the following 2½ years. However, the $20,000 per annum represents maintenance expenses and is deductible in the year(s) incurred.

Commissioned Software

Expenditure incurred on externally commissioned software also follows the same principles as those applying to licensed software. Costs associated with any unsuccessful development may also be deductible.

Example 6: *Successful software development*

In Year 1, Glossy Ltd (a magazine publisher) contracts Software Development Ltd to develop a software programme. The contract requires two payments. One up front of $20,000 and one of $70,000 when the project is completed. In Year 1, Glossy Ltd makes the first payment of $20,000 and capitalises that cost for tax purposes. In year 2, the software program is completed and Glossy Ltd makes the second payment of $70,000. Glossy Ltd then adds the second payment to the first and begins to amortise the total amount of $90,000 over 2½ years, as the development has been completed.

Example 7: *Unsuccessful software development*

In Year 1, Customer Ltd contracts with AB Software Consultants to design a computer programme to monitor and analyse production efficiency. Customer Ltd is to make three progress payments during the contract, each being $20,000. At the end of Year 1 the first two payments have been made. These payments have been capitalised for income tax purposes. During Year 2, Customer Ltd varies its requirements and AB is unable to complete the development. Accordingly the project is abandoned by mutual consent without the third payment being made. For income tax purposes Customer Ltd can deduct in its return for Year 2 the amount of the payments capitalised in Year 1 (ie $40,000).

Upgrades and Maintenance

The treatment of upgrades and maintenance will be consistent with the existing application of the law for determining capital and revenue expenses. Expenditure on upgrading the functional capacity of computer software should be treated on capital account. Expenditure that does not enhance functionality, such as maintenance, testing, code reviews, minor alterations/modifications and remedying defects should continue to be treated on revenue account.

Sometimes a payment may cover both maintenance and upgrades (whatever the payment is called). The taxpayer must then apportion the cost between the revenue and capital items.

Example 8: *"Maintenance" fee includes upgrade*

In August 1999 LUV Ltd acquires a software programme (Version 1) from Software Ltd. The two companies also enter into a two year "Programme Maintenance Agreement". Under that agreement Software Ltd receives $3,000 to provide LUV Ltd with:

(a) a telephone hot-line for user inquiries, a 24 hour bug fixing service and adjustments to formatting to meet LUV Ltd's internal documentation; and

(b) an enhanced Version 2 of the software programme when available (costing over $300).

The part of the fee relating to the services in (a) above will be deductible as a maintenance payment (subject to the provisions dealing with deductibility of advanced payments for services which are not to be completed within 13 months). As the part of the fee that relates to the acquisition of version 2 represents expenditure on an upgrade it must be capitalised until that version is acquired and then amortised over 2½ years. Expenditure on Version 1 will continue to be amortised over 2½ years from its date of acquisition (August 1999).

Transitional arrangements

The new arrangements apply to expenditure incurred in relation to contracts entered into to acquire software after withdrawal of IT26. It will also apply to expenditures on specifically commissioned and in-house development of software commenced after that time. Expenditures on in-house development, or commissioned software commenced up to that time will continue to receive the current treatment until 30 June 1999. Thereafter any such expenditure will be treated under the new provisions.

Example 9: *Transitional Arrangements*

In January 1998 Bank XYZ began developing a new telephone banking software programme.

The product is completed in April 2000. The treatment of costs related to this development for the 1998 and 1999 income years is as follows:

(a) Costs incurred before 30 June 1998 - deductible in the year ended 30 June 1998.

(b) Costs incurred from 1 July 1998 to 30 June 1999 - deductible in the year ended 30 June 1999.

(c) Costs incurred from 1 July 1999 to April 2000 – capitalised and then amortised over 2½ years, from when the project is completed in April 2000.