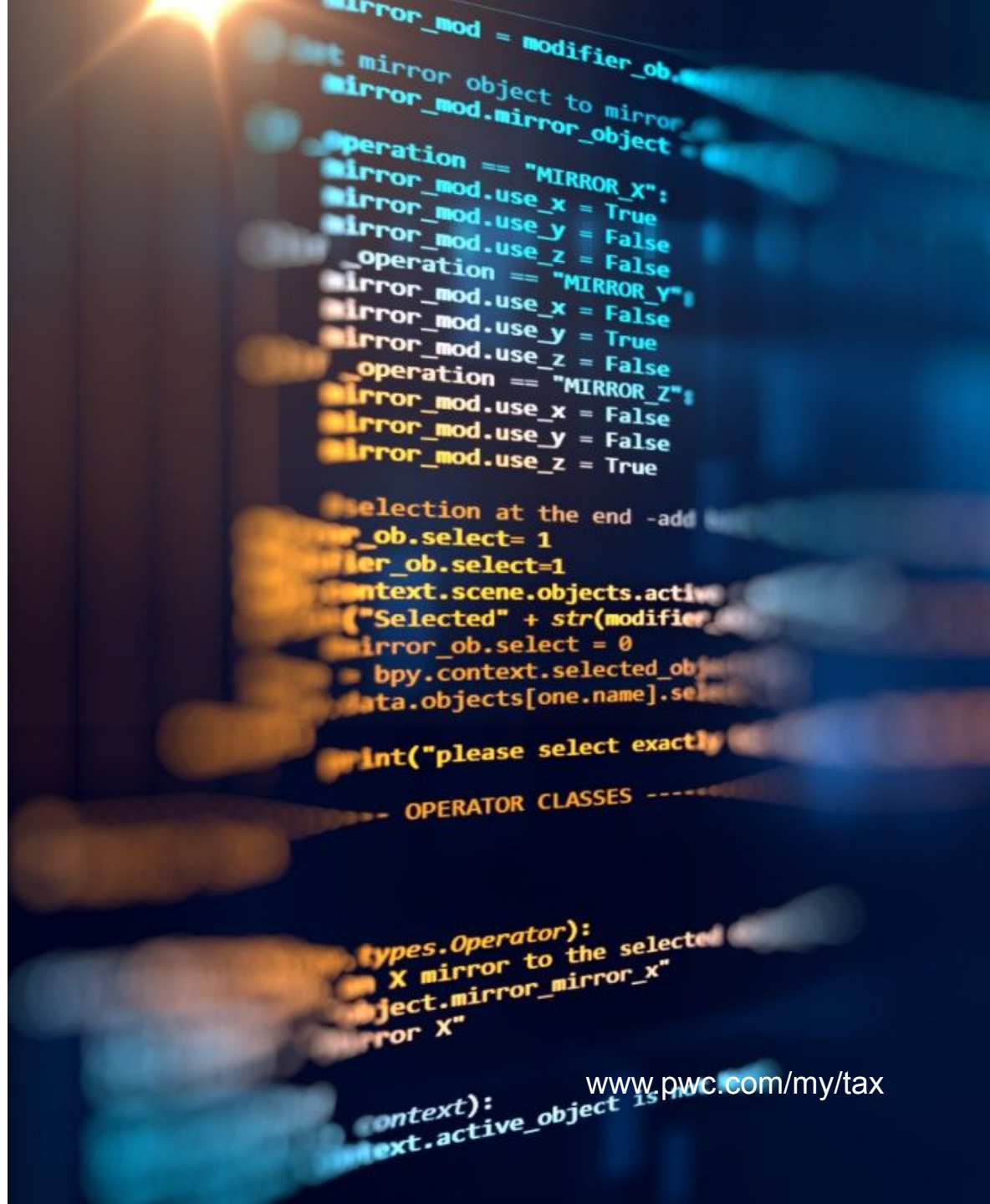




TaXavvy

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Practice Note 2/2020 - Capital Allowance for Development Cost for Customised Computer Software



Following the issuance of the Income Tax (Capital Allowance) (Development Cost for Customised Computer Software) Rules 2019 (“Customised Software Rules”), the Inland Revenue Board has issued Practice Note 2/2020 dated 16 March 2020 on capital allowance for development cost for customised computer software (“Practice Note 2/2020”).

Practice Note 2/2020 provides guidance on the Customised Software Rules, in particular further explanation on the definition of development cost for customised computer software.

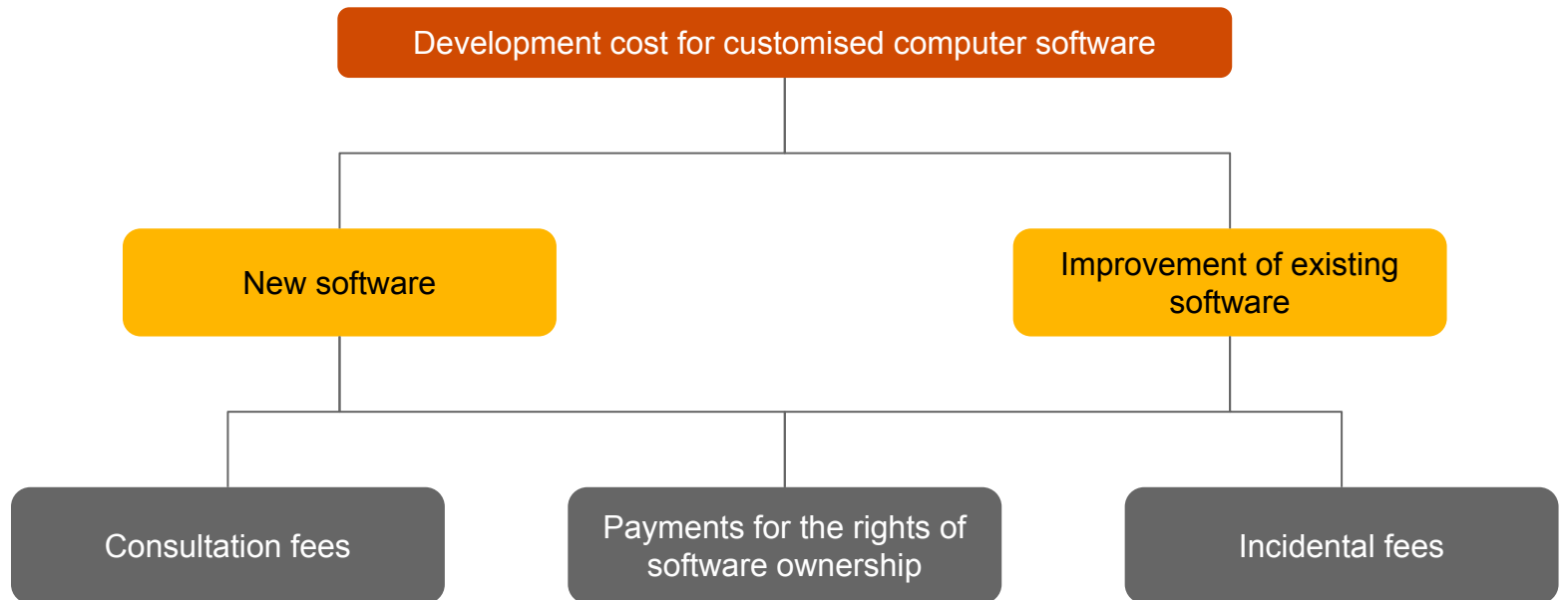
With effect from the year of assessment (YA) 2018, capital allowance is given for the development costs for customised computer software at the following rates:

- Initial allowance - 20%
- Annual allowance - 20%

Practice Note 2/2020 explains the scope of expenditure which is considered as “development costs of customised computer software”.

Development cost for customised computer software

This includes expenditure incurred in the production of *new* software or *improvement of existing* software and comprises *consultation fee, payment for rights of software ownership and incidental fee* relating to the development of customised computer software.



Consultation fees

This include fees for the development of the software specifically for the purpose of developing a new software system, modification or modernisation of the existing software, but **exclude** consultation fees related to **initial** procedure or planning stage such as feasibility study or preliminary study.

Our comments

IRB has adopted a narrower interpretation of consultation fees by excluding initial costs. The wordings under Rule 2 of the Customised Software Rules are arguably broader because the rule refers to “consultation fee ... in relation to the development of customised computer software”.

Payments for the rights of software ownership

This refer to payment for the right to use the software **exclusively**.

Our comments

Restricting capital allowance (CA) claims on license fees only to those which relate to exclusive license will significantly limit taxpayer’s CA claims on the overall software development costs as exclusive software licenses are generally rare.

Incidental fees

These are costs incurred which enable the use of the software in a business and are capitalized (e.g. cost due to change of requirement of the software).

Our comments

This seems to suggest that the incidental fees should be capitalised in the accounts. Accounting treatment may be an indicator of the nature of an expense (capital or revenue) but is not the sole criteria to determine whether the expense is capital in nature for CA claims purposes. Accounting treatment is not a requirement under the Customised Software Rules.

Withholding (WHT) tax obligations

Practice Note 2/2020 also points out that payment for capital expenditure in relation to development cost for customised computer software that is made to non-residents is subject to WHT, where applicable under:

- Section 109 - Royalty
- Section 109B - Advice, assistance or services under Section 4A of the Income Tax Act 1967

Effective date and timing of claim

The Customised Software Rules provide:

- The Rules apply to development cost for customised computer software incurred in the basis period from YA 2018
- The cost is *deemed* to be incurred when the customised software is capable of being used for the purposes of the business

The following examples are set out in Practice Note 2/2020 to illustrate the IRB's position with respect to the above.

	YA development cost is incurred	YA customised software capable of being used in business	Tax treatment	
1	2018, 2019 & 2020	2020	QCE*: CA claim:	Cost from YA 2018 onwards From YA 2020 onwards
2	2017, 2018 & 2019	2019	QCE*: CA claim:	Cost from YA 2018 onwards (YA 2017 cost does not qualify) From YA 2019 onwards
3	2017 & 2018	2018	QCE*: CA claim:	Cost from YA 2018 (YA 2017 cost does not qualify) From YA 2018 onwards

* QCE = Qualifying capital expenditure

Our comments

From the examples given, we observe that the IRB takes the following interpretation:

- Capital expenditure that is incurred before YA 2018 would fall outside the Customised Software Rules (refer scenarios 2 and 3 where the capital expenditure incurred in YA 2017 is excluded)
- The *deemed* incurrence provision (when capable of being used for purpose of the business) would only apply to determine the year when the CA is claimable

This interpretation is arguable. In scenarios 2 and 3, the deemed incurrence provision should arguably be extended to the costs incurred in YA 2017 and hence those costs are deemed to be incurred in YA 2019 and YA 2018 respectively when the software is capable of being used.

The IRB is known to be firm on its position.

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