Chapter 7

Internet

1. Introduction

1.1 Overview

Most businesses of any size will now have a presence on the internet, either in the form of their own website or as an entry on the website of a collective body such as a trade association. A commercial website can have many functions from a simple advertising medium to an online catalogue or the means through which most of the company's sales are made. Larger companies also use restricted access webpages to communicate with their workers and suppliers. **7–001**

1.2 Scope of this chapter

This chapter is divided into three parts, which examine the tax implications of using the internet for the following business purposes: **7–002**

1. **Part 1: Setting up a website**;
2. **Part 2: E-commerce** (trading over the internet); and
3. **Part 3: Workers and the internet** (providing workers with internet access and email).

Precedents relevant to all of these aspects of internet use can be found in Chapter I of *Practical Commercial Precedents* (see section **5.5**). The tax issues are discussed in outline with practical points and danger areas highlighted. The warnings are designed to alert you to situations where expert tax advice may be required. Each part concludes with some key questions to help guide the areas of advice which may be requested from tax or accounts specialists. The chapter concludes with directions to further information to be found in other reference books and on the internet.

1.3 Key fact-finding questions

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	Questions	See para
1.3.1	**Who owns the domain names which include the company's trading names?**	**2.2**
	Having control of the domain names is a prerequisite to establishing an effective web presence.	
1.3.2	**Where is the business resident and in which other countries does it have a physical presence?**	**3.2.1**
	Whether the business has a permanent establishment in a country will affect the tax payable on profits made from sales in that country.	
1.3.3	**Where are the servers located that host the company's website?**	**3.2.3**
	The physical location of a server can create a permanent establishment for the business in certain countries.	
1.3.4	**What functions does the company's website perform?**	**2.3**
	The principle functions of the website can determine whether the costs of developing the website are immediately tax deductible.	
1.3.5	**Does the company sell to businesses, private individuals, or both?**	**3.3.3**
	Whether the business sells to VAT-registered or non-VAT-registered customers can effect whether it must register for VAT in certain countries.	
1.3.6	**What is the company policy on employees working remotely or at home?**	**4.1.1**
	Having a written policy can be crucial for the taxation of the individual employees.	

Part 1

2. Setting up a website

2.1 Prerequisites

7–004 For any business to have a website presence on the internet it is necessary to have a website, but before it can set up a website it must first acquire a domain name (see section **2.2**).

This is necessary whether or not the company will own and operate the computers (know as servers) on which the website will be hosted (i.e. where the computer code that runs the website will be held). In many cases the internet service provider (ISP), which provides the company with access to the internet, will offer to host a website for a nominal fee, subject to certain restrictions on the size of website and the amount of traffic it is able to process. In this case the website will be hosted on the ISP's servers at a site remote from the company's premises. However, as the website grows in importance, perhaps providing the means through which many sales are concluded, the company may wish to have more control over the servers. The physical location of the servers can be important where the company conducts e-commerce through websites based on those servers (see section **3.2.3**).

Unless the company has a high level of programming skills among its workers, it will normally commission a third-party supplier to create its website. This website developer will write the computer mark-up and scripting language code which perform the functions of the website, i.e. display pictures, arrange text, provide search facilities, etc. The contract with the website developer may be ongoing as most websites require some form of maintenance, if only to refresh text as it becomes out of date (see section **2.4**). It is important to determine who owns the intellectual property rights attached to the materials used on the website: words, pictures and possibly mechanisms that allow users to move around the website and purchase goods and services.

2.2 Domain names

2.2.1 What is a domain name?

Domain names provide easily memorable names to stand in for numeric internet protocol (IP) addresses. Domain names are sometimes incorrectly known as web addresses, but this colloquial expression is more akin to the URL (uniform resource locator). The difference between a URL and domain name is illustrated as follows: **7–005**

- URL: *http://www.example.com*;
- Domain name: *example.com*.

A website found at *http://www.example.com* will often be advertised without the "http://", and can sometimes be reached by just entering "example" (depending on browser versions and configuration settings).

The domain name allows any service to move to a different location in the topology of the internet, which would then have a different IP address. Also, since more than one domain name can be assigned to an IP address, users may be directed to one website by using a variety of domain names. For example, a company that owns a number of brand names may want the consumers of all those bands to be directed to the main website of the organisation, which can be done if the company holds the rights to all of the appropriate domain names.

A domain name is 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 phase to be registered using a particular top-level domain such as. com,. org,. biz, or a country-specific top-level domain such as. uk, or. nl. 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 as they are easy for potential customers to remember, increasing the probability that they become repeat customers or regular clients.

2.2.2 Selling a domain name

7–006 The person who holds the rights to a domain name may also acquire three types of asset with potential for exploitation:

1. the contract with the registration authority which gives the applicant the right to use that domain name;
2. goodwill which the name may generate; and
3. a registered trademark in respect of the name.

Asset 1. is a contractual right between the registrant and the registrar and does not strictly contain any intellectual property rights as such.

Assets 2. and 3. are dependent on there 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 domain name as a trading name or trademark. Those words may already be registered as a trademark, or used as a trading or brand name by someone else.

> **ⓘ Practical point**
>
> If the trader is creating a completely new business with a fresh trading name, it makes sense to not only check that the trading name chosen is not already registered as a trademark by another business, but that the domain name is also free to purchase.

The sale or assignment of the rights to use any of these assets by an individual 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 (£8,800 for 2006/07) and no tax will be due if no other capital gains are made in the same tax year.

Where a company disposes of one of the above assets, which has been created or acquired since April 1, 2002, the disposal will fall under the regime for intangible assets (FA 2002 Sch.29) and the profit is taxed as part of the company's trading profits. For further discussion of the tax aspects of selling intangible assets such as goodwill and trademarks see Chapter **5: Intellectual property**.

2.2.3 Trading in domain names

A business may trade in domain names by registering many names for small sums, and then sell on the right to use each name to organisations, companies or individuals. This trade is a supply of electronically supplied services and falls under the provisions in VATA 1994 s.3A and Sch.2B (see section **3.3.1**). **7–007**

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

For further discussion of the VAT reverse-charge rules see Chapter **10: Supply of goods and services**.

2.3 Website development

2.3.1 Accounting treatment of costs

To establish the correct tax treatment of the costs of a website, one must first analyse whether, in accounting terms, the costs represent capital or revenue expenditure. The accounting treatment is found through the application of accounting standards and other supplementary announcements made by the Accounting Standards Board (ASB), which together are known as Generally Accepted Accounting Practice (GAAP). **7–008**

The tax treatment of the website development costs must follow GAAP as, in accordance with FA 1998 s.42(1), all UK businesses must calculate their profits according to GAAP. Expenditure that is capital in nature does not receive tax relief unless the particular asset acquired qualifies for capital allowances, or it can be classified as an intangible asset created or acquired by a company since April 1, 2002. Expenditure that is revenue in nature will receive tax relief by being charged against the profits of the business as it is incurred.

The question of how to treat website development costs was addressed in the ASB publication Urgent Issues Task Force Abstract 29 (UITF 29), effective from March 23, 2001 (see section **5.1**). This document addresses four elements of website development costs.

2.3.1.1 Planning costs

7–009 This includes 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.

2.3.1.2 Application and infrastructure development costs

7–010 This covers the costs of obtaining and registering a domain name, of buying or developing hardware and operating software that relate to the functionality of the site. 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.

2.3.1.3 Design costs

7–011 This includes expenditure to develop the design and appearance of the individual website pages, including the creation of graphics.

2.3.1.4 Content costs

7–012 This includes 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 UIFT 29 paper 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 in section **2.3.1.1** 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 costs in sections 2.3.1.2 to 2.3.1.4 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 which only acts as an online brochure should not be capitalised.

2.3.2 HMRC approach

7–013 This approach is not reflected by the view expressed in the HMRC *Business Income Manual* at para.BIM35870 which says;

> "The cost of a web site 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".

> ⓘ **Practical point**
>
> The opinions expressed in the HMRC *Business Income Manual* are HMRC's view; they do not have the force of law. If the client is refused tax relief for the cost of developing a website based on the views expressed in the HMRC manual he should appeal quoting the requirements of UITF 29.

2.3.3 Capital allowance treatment

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. Capital allowances may be due on the cost of the software developed under CAA 2001 s.45 Class C. However, HMRC are not willing to treat the cost of the domain name as a tangible asset. The HMRC view is that the domain name is an intangible asset and the cost is not eligible for capital allowances. **7–014**

2.3.4 International

All UK-quoted companies have to comply with 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 March 25, 2002. The conclusions of SIC 32 are much the same as UITF 29 except that when 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. The tax treatment of intangible assets largely follows the accounts treatment. So if the intangible asset is depreciated, those depreciation costs will achieve a tax deduction. **7–015**

2.4. Website maintenance

The maintenance of a website is a revenue cost as 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. **7–016**

2.5. Questions for the tax or accounting specialist

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	Questions	**See section**
2.5.1	**Has VAT been correctly accounted for on the acquisition of the domain name?**	**2.2.3**
	The VAT reverse-charge rules may apply where the registration agent belongs outside of the EU.	

2.5.2	**Have the costs of creating the website been correctly treated in the accounts reflecting the requirements of UITF 29?**	**2.3.1**
	Unless the website creates an enduring asset for the business the costs should be set against income as they occur.	

Part 2

3. E-commerce

3.1. Definition of e-commerce

7–018 E-commerce or online businesses largely consists of indirect sales and purchases; the electronic ordering of tangible goods. As such, the trade is similar in principal to traditional mail-order sales, and the tax issues will be the same as addressed in Chapter **10: Supply of goods and services**. However, a growing section of e-commerce involves both the electronic ordering and delivery of services supplied online, such as the supply of music, software and other information-based services. As these transactions can easily stretch over international borders, this creates new tax and law challenges, which are addressed in this section.

Although the e-commerce business may perceive no physical or geographical barriers to its trade, its operations in certain countries may be restrained by governments who wish to protect their citizens by, say, restricting access to information, or from buying unlicensed products. The e-commence business must therefore be aware of such legal restrictions and of the international tax problems that can arise. These generally fall into two areas:

1. taxes on business profits based on a presence in the country; and
2. sales taxes such as VAT.

3.2. Tax on profits

7–019 A company that is not resident in the UK may be treated as trading in the UK if it sells goods or services over the internet to UK customers. However, such a non-resident company will only have its profits from that trade subject to corporation tax in the UK if it carries on a trade through a *permanent establishment* in the UK (ICTA 1988 s.11(1)).

3.2.1 Permanent establishment

"Permanent establishment" is a key term for international tax, as under the Organisation for Economic Cooperation and Development (OECD) model tax treaty a non-resident business is only taxable in a foreign country to the extent that it is carrying on a business there through a permanent establishment. In the UK tax code "permanent establishment" is defined in FA 2003 s.148(1) as: **7–020**

"A company has a permanent establishment in a territory if, and only if:

a) It has a fixed place of business there through which the business of the company is wholly or partly carried on, or
b) An agent acting on the behalf of the company has and habitually exercises the authority to do business on behalf of the company".

Having an agent does not necessarily mean the business has a permanent establishment, as FA 2003 s.148(3) says that a company will not have a permanent establishment in the UK simply by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of his business.

3.2.2 Fixed place of business

A fixed place of business is defined in FA 2003 s.148(2) as including: **7–021**

- a place of management;
- a branch;
- an office;
- a factory; or
- a workshop.

It does not mention websites or the servers that host the websites.

3.2.3 Location of servers

The HMRC view on whether the location of a server gives rise to a permanent establishment was given in a press release on April 11, 2000: **7–022**

"In the UK, we take the view that a website of itself is not a permanent establishment. And we take the view that a server is insufficient of itself to constitute a permanent establishment of a business that is conducting e-commerce through a website on the server. We take this view regardless of whether the server is owned, rented or otherwise at the disposal of the business."