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An analysis of the gap between accounting depreciation and tax capital allowance in Malaysia

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Abstract

Malaysian tax system includes a tax depreciation rule separate from accounting depreciation. This paper is to compares and contrasts the accounting treatment of depreciation and the tax treatment of capital allowance. The gap between the accounting and tax is resulted from different definitions of capital expenditure and qualifying asset and also different deduction rate and useful life used in calculating depreciation. This paper proposes the government to revise the current capital allowance system.

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Keywords: Accounting; taxation; tax depreciation; capital allowance; Malaysia

1. Introduction

In many countries, including Malaysia, their tax system includes a tax depreciation rule separate from accounting depreciation. Tax depreciation in Malaysia, known as capital allowance, offers deduction for amount spent by businesses on acquisition of non-current tangible assets, also known as property, plant and equipment (PPE) in accounting. MFRS 116 (2012) specifies that PPE are resources that have physical substance and are subjected to wear and tear. They are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used in more than one accounting period. The

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purchase of a PPE is a capital expenditure. In accounting, a capital expenditure is shown as an asset owned by the business, while revenue expenditure is written-off as expenses. At the same time, yearly depreciation will be written-off on expenses as an allocation of the asset's depreciable amount over its useful life.

Accounting depreciation is not deductible for tax purpose. A similar scheme is applied in taxation as a replacement, where capital expenditure is not deductible when incurred, but can be recognised over time via capital allowance system. Although the concepts are similar, they serve different purposes. The objective of accounting depreciation is to allocate the cost of an asset throughout its useful life (MFRS 116 BC, 2010), whereas tax capital allowance is given to reflect the reduction in the asset's value caused by natural process of decay or exhaustion by use (Singh & Teoh, 2012). Nevertheless, an identical result could be achieved if the method of calculation and the asset's useful life are the same. However, in most of the time, they are not. As a result, accounting profit has to be adjusted to arrive at taxable income. In certain cases, there are assets that are not eligible for deduction at all.

Several papers have discussed about the vagueness of the tax capital allowance system (Holman, 1940; Edwards, 1976; Stainsby, 1981; Stewart, 2007). No similar paper written on Malaysia's capital allowance has been found. Hence, the objective of this paper is to compare and contrast the accounting treatment of depreciation and the tax treatment of capital allowance. There are three issues considered in this paper. The first is the comparison between the definition of capital expenditure in the accounting and tax approaches. The second issue explores the gap in the definition of qualifying asset, particularly on the definition of 'plant' and eligibility to claim a capital allowance. The third issue explains about the different rates and useful life used in the calculation of depreciation and capital allowance. The final part of the paper provides the overall discussion and policy implication, followed by a concluding remark.

2. Gap in the definition of capital expenditure

Although both accounting and taxation distinguish between capital and revenue expenditure, some items considered as revenue expenditure in accounting are treated as capital expenditure in tax. In accounting, all capital expenditures are subject to depreciation (except for assets that have unlimited useful life such as land). Expenses not qualified as capital expenditure are classified as revenue expenditure; hence written-off in the year incurred. However, some items considered as revenue expenditure in accounting are treated as capital expenditure in tax but are not qualified for capital allowance, hence become permanent losses to the business.

Accounting defines capital expenditure as money spent on the acquisition of PPE or additions to existing assets that will either add to the value or capacity of the asset and will bring future economic benefits to the business. Apart from the cost of the asset, other incidental costs incurred to bring the asset to its useful condition, such as cost of installing machinery, are also deemed capital expenditure. In addition, other factors that can be considered to determine capital expenditure include whether it is a 'once and for all payment' and whether the cost incurred in material enough to be classified as asset.

Malaysia's tax legislation, Income Tax Act 1967 (ITA 1967) does not specify what constitutes capital expenditure. Instead, a series of tests is used to help decide whether an expense is a capital item. They include: (i) *Once and for all test*: A one and for all payment is a capital expenditure, a repeated payment is a revenue expenditure (*Vallambrosa Rubber Co Ltd v Farmer, 1910*); (ii) *Enduring benefit test*: A payment made with a view to bringing into existence an asset or an advantage that can give enduring benefit to the business suggests a capital expenditure (*British Insulated and Helsby Cables Ltd v Atherton, 1925*); (iii) *Identifiable asset test*: A payment is a capital expenditure if the payment made has resulted in the acquisition of assets of capital nature (*Tucker v Granada Motorway Services Limited, 1979*); (iv) *Fixed versus circulating capital*: If the expenditure relates to fixed capital, that is, assets that will be used in business to generate profits, this implies a capital expenditure. But if it relates to circulating capital, that is, inventories, then this implies revenue expenditure (*John Smith & Son v Moore, 1921*); and (v) *Business entity test*: Expenditure that relates to a profit-yielding structure suggests a capital expenditure, whereas expenditure that relates to profit-yielding process suggests revenue expenditure (*Sun Newspapers Ltd v FCT, 1938*).

However, these tests are not based on objective measurements. They are interpretations from judges, developed in early 20th century, to help identify whether an expense is capital or revenue expenditure (Singh, 2013).

Nevertheless, it should be noted that these tests are merely guidelines; the fact of each case and the judicial interpretation will determine whether an expense is of a capital or revenue nature. In addition, recent Malaysian tax cases have utilised a few other tests in deciding the nature of an expense: (i) *Common sense test*. There is no single rule in determining a capital or revenue expenditure. It depends on the circumstances of the case (*KPHDN v Shell Refining Company (FOM) Bhd, 2013*); and (ii) Cost of bringing an asset into working condition is a capital expenditure (*KPHDN v Hicom-Suzuki Manufacturing (M) Sdn Bhd, 2012*). Not many cases can be found in Malaysia. Perhaps due to the fact that the issue has been decided by courts, it is regarded as settled and is accepted as it is.

Despite several similarities between the characteristics of capital expenditure in accounting and tax, some expenses are treated differently by these two systems. For example, in the case of *CH & Co (Perak) Sdn Bhd v DGIR (1989)*, the court held that compensation paid to a tenant for termination of tenancy is capital expenditure for tax purposes on the basis that it is a once and for all payment on an identifiable asset, and the payment was made with the intention to make the asset more advantageous and beneficial. In contrast, accounting will treat this expense as revenue expenditure as it does not add value or capacity to the building.

The gap between accounting and tax law can also be seen in the treatment of assets of small value. In accounting, the initial purchase and subsequent replacement acquisitions may be treated as revenue expenditure based on the principle of materiality. Under the principle of materiality, information can be omitted if its omission does not affect users' decision making. There is no specified material value. As such, businesses commonly set a minimum material value for an asset to be recognised as PPE. For instance, if the minimum value is set at MYR3,000, all assets that cost less than this amount can be treated as revenue expenditure and thus written off in the income statement regardless of their expected life, since the cost to provide for depreciation of these assets outweighs the benefit of presenting accurate assets value (given the small value of assets, hence there is only a minimal impact to financial statements). In contrast, under tax practice, these are capital assets and the cost can only be recognised via the capital allowance system, provided they fall into the definition of plant and machinery. But the recent legislative changes have moved the tax regime closer to accounting practice in this area. Since 2006, ITA 1967 allows taxpayers to deduct the full acquisition price of plant and machinery that cost less than MYR1,000, subject to a maximum of MYR10,000 per year. While accounting materiality value is set by the business itself, the tax rule specifies assets valued at less than MYR1,000 as not material and which therefore can be expensed immediately.

The immediate expensing rule in tax has limitations. The Inland Revenue Board of Malaysia (IRBM) has issued *Public Ruling No 1/2008 Special Allowance for Small Value Assets* explaining that neither the new rules nor the general capital allowance rules apply to the initial acquisition of low value items with an expected life of under two years. As a result, the rule in *Public Ruling No 2/2001 Computation of Initial and Annual Allowances in Respect of Plant and Machinery* applies. It states that the initial cost of acquiring these items cannot be recognised for tax purposes but any subsequent cost of replacement assets is revenue expenditure may be deducted. Therefore, the initial acquisition cost incurred is a permanent loss to a business.

3. Gap in the definition of qualifying asset

The second gap relating to depreciation of non-current tangible assets is in respect of assets or benefits that fall outside the narrow definition of qualifying assets in the capital allowance regime. This problem has its genesis in the development of the income tax system in Britain in the 19th Century, when deductions given to capital expenditures were viewed as a mere "concession", as a compensation for the wear and tear of an asset, rather than a right for businesses (Edwards, 1976). The capital allowance is often referred to as 'relief' for capital expenditures. The legislature has the power to decide which capital expenditures can receive the concession. As a consequence, the judiciary takes the view that capital expenditure is not recognised at all unless it is by way of a concession. In addition, some depreciable assets fall outside the capital allowance regime and hence are never recognised for tax purposes. Further, the period of measurement for some assets is substantially out of line with their actual effective life.

MFRS 116 (2012) allows the depreciable amount of PPE to be deducted as depreciation in the income statement over the asset's useful life. However, land is not depreciated as it has an unlimited useful life, with the exception of land of wasting character, for example, quarries that extract stones such as marble and granite, and gold mines. These types of land will have their value dropped when the minerals and metals contained within the land have been completely extracted.

ITA 1967 provides a similar deduction scheme for wasting assets. This capital allowance scheme is available to all businesses for qualifying expenditure incurred. In brief, the Malaysian capital allowance system consists of capital allowance for machinery or plant (for machinery and plant used in the business), industrial building allowance (for construction or purchase of an industrial building), mining allowance (for assets and capital expenditure incurred in mining operations), prospecting expenditure (for capital expenditure incurred in searching for and winning access to minerals), agriculture allowance (for capital expenditure incurred in agricultural activities, which include clearing and preparation of land, plantation and construction of basic infrastructure on the farm), and forest allowance (for construction of roads and buildings used in timber extraction activities).

Despite the various types of capital allowance, there are assets that are left out of the capital allowance scheme. The main issue within the capital allowance for machinery or plant regime is the meaning of the terms 'machinery' and 'plant'. The law does not define these terms. Generally speaking, defining 'machinery' does not pose major difficulties (Singh, 2013). However, the term 'plant' is ambiguous. To clarify this, many cases have been brought to court to determine whether an asset is 'plant' and therefore eligible for capital allowance. As a result, in tax law the statutory capital allowance rules apply only to a narrow list of assets. The cost of some depreciable assets does not fit into the capital allowance regime and consequently these costs are never recognised for tax purposes. This issue has become a problem not only in Malaysia but in most Commonwealth countries, including the UK and India. Australia has solved the problem through the a reform of the capital allowance regime, where the term 'plant' has been substituted with 'depreciating asset', which expands the type of assets that are eligible to receive the capital allowance (Stewart, 2007).

Some guidance as to what constitutes 'plant' can be gleaned from judicial decisions. The earliest decision can be traced back to 1887 in *Yarmouth v France*, in which Lindley LJ held:

> *"There is no definition of plant in the Act; but in its ordinary sense it includes whatever apparatus is used by a businessman 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 in his business."*

Since then, many cases have been brought to court by taxpayers seeking to claim a capital allowance on assets which they claim are 'plant'. It is therefore up to the judges to decide what constitute 'plant'. These judicial decisions have led to a narrowly-defined term, where many assets have been deemed not to constitute 'plant'. The rules adopted in relation to the definition of 'plant' include (i) an apparatus used for carrying on a business is 'plant'; for example a horse (*Yarmouth v France, 1887*), book (*Munby v Furlong, 1977*), swimming pool of a caravan park (*Cooke v Beach Station Caravans Ltd*, *1974*) and a multi storey car park (*Tropiland Sdn Bhd v KPHDN, 2010)*; (ii) a mere part of the setting used for carrying on the business is not 'plant', e.g. electric lamps and fittings *(J Lyons & Co Ltd v Attorney-General*, *1944)* and a ship used as a floating restaurant (*Benson (Inspector of Taxes) v Yard Arm Club Ltd*, *1979)*; and (iii) a shelter to the business is not 'plant', e.g. a canopy at a petrol station *(Dixon v Fitch's Garage Ltd*, *1975)*.

There is still no single definition of 'plant'. The courts agree that each need to be assessed individually. They need to consider the context of the particular industry concerned, and in the particular circumstances of the individual taxpayer's trade. Each case needs to be carefully considered based on the nature of the particular trade being carried on, and how the expenditure incurred is related to the promotion of the trade (*CIR v Scottish and Newcastle Breweries Ltd*, *1982)*.

While a building is normally not included as plant, there is a separate capital allowance scheme for an 'industrial building'. The term 'industrial building' is defined by the Act, which includes a factory, dock, wharf, jetty (and other similar building), warehouse (for public hire), buildings used in the businesses of water, electricity, telecommunication, farming and mining, private hospitals, maternity and nursing homes, research buildings, hotels, airports and motor racing circuits. However, much confusion still arises as to what can be considered an industrial building. There are buildings that are not eligible as either plant or industrial building, such as office building; hence not eligible for any deduction.

4. Gap in the rate of deduction and useful life

The third gap is on the rate of deduction and the period of measurement to fully allocate the cost of asset. In accounting, depreciation is provided to allocate the money spent on purchase of the asset throughout its useful life. It follows the accounting's matching concept, where expenses must be matched with revenues earned. MFRS 116 (2012) does not specify the useful life for any type of asset. The estimation of an asset's useful life is a matter of judgment based on the company's experience with similar assets. In addition, the useful life should be regularly reviewed. The standard also does not stipulate which depreciation method should be used. Whether it be the straight line method, the diminishing balance method or the units of production method, the correct method shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

In contrast, the tax capital allowance scheme for general plant and machinery and industrial buildings requires the use of the straight line method, with the rate and the period of eligibility of capital allowance for each class of assets has been specified by the tax rule. There are two components of capital allowance – initial allowance and annual allowance. Initial allowance is given only in the first year of claim, on top of the annual allowance that is provided every year, so long as the asset is in use until the cost is fully claimed. The initial allowance results in higher capital allowance being deducted in the first useful life of the asset. This causes income to be deferred to future periods; hence lower taxable income in the year of purchase of asset. The initial allowance is inherited from the British tax system, in which it was introduced to encourage investment in new assets. However, in the 1984 tax reforms, the initial allowance was removed from the capital allowance regime (HM Revenue and Customs). The change made the regime more like accounting depreciation. On the other hand, initial allowance in the Malaysian tax system is not specific to new assets only as it is also granted on purchase of second-hand asset.

For some assets, the period of measurement is substantially out of line with their actual effective life. For example, if an aeroplane is expected to be used in the business operation for 25 years, the depreciable amount of the aeroplane should be allocated over the 25 years. However, under the Malaysian tax rule, an aeroplane is classified as a motor vehicle, which eligible for an initial allowance of 20% and an annual allowance of 20% in the first year of usage, and annual allowances of 20% in each of the three subsequent years. This means the cost of the aeroplane is fully claimed within four years. In addition, there is also accelerated capital allowance given to assets favoured by the government. The accelerated capital allowance scheme allows deduction of the cost of asset in shorter period than its usual life. This results in wider gap between accounting profit and taxable income.

5. Discussion and policy implication

The IRBM and legislature should consider whether the current practice is appropriate in assessing the real taxable income of a business. There is no clear rationale for permitting a capital allowance only for certain assets. In calculating taxable profits, the legislation allows deductibility of expenses incurred wholly and exclusively in the production of gross income. Tax should be imposed on business taxpayers based on profits calculated using this rule. In accounting, profit is derived after deducting all 'matched' expenses, including depreciation. Depreciation is provided on assets used in the business. There is no doubt that it is incurred in production of gross income. The purchase of assets is part of normal course of doing business. Unfortunately, currently Malaysia's income tax system does not share the same view.

The money spent by a business on purchase of asset is converted into services or benefits brought in by the asset. Thus the 'once and for all' payment made reflects the benefits utilised for several years. If payment made for the rental of office building is tax deductible, why then is the depreciation charge on the same asset not tax deductible? Both payments are made to get benefits from assets. It is clear that the office building is used for business purpose. By not allowing depreciation for tax purposes, payments made on assets that do not fall within the category of 'machinery', 'plant' and other capital allowances become losses to the business. Indirectly, the government ‘prefers’ businesses to rent an office instead of purchasing one. This is a strange policy since there is no clear reason for the government to favour rental over purchase of buildings. Office buildings, and all other assets used for business purposes, should be allowed a capital allowance.

This paper would also like to propose for withdrawal of initial allowance from the current capital allowance system. It does not serve the same purpose as Britain’s initial allowance that promotes investment in new assets. Its real purpose is vague. Even if the purpose is the same, under the current situation the government is not promoting that. The government should review the current capital allowance system to reflect its overall objectives.

In countries such as Germany and the US, a capital allowance is allowed on non-current assets other than land, at the rate provided by the tax authorities (CCH Tax Editors, 2009/10). Although the amount allowed may differ from the accounting depreciation each year, at least the outflow of cash is recognised for tax purposes. Since it is a standard practice to have a different set of capital allowance or depreciation rules for tax purposes instead of using accounting depreciation, it is acceptable for Malaysia to follow the same practice. However, it is desirable that Malaysia’s capital allowance regime be revised to include all business assets, so that all such assets are recognised for tax purposes.

6. Conclusion

This paper analyses the gap between accounting depreciation and tax capital allowance in Malaysia. There is a very wide gap since the two systems were developed independent of each other, Furthermore, each system serves different purpose. As a result, accounting profit and taxable income differ, although both accounting and tax are trying to find the income of a business. This paper proposes the government to revise the current capital allowance regime and recognise depreciation of assets as a normal, deductible business expense.

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