

Reducing balance method to be used for Tax depreciation

The recently gazetted Income Tax Bill (ITB or Bill) introduces a fundamental reform to the capital allowance regime by granting taxpayers an option to calculate tax depreciation using the Reducing Balance Method as an option to the current Straight-Line Method. Currently, assets can only be depreciated using the Straight-Line Method. In this article, words importing the masculine shall be deemed to include the feminine.

The current regime

Under the current law, capital allowances technically replace accounting depreciation, which is not deductible for tax purposes. Taxpayers have been required to spread the cost of qualifying assets evenly over their useful lives. For example, commercial buildings attracted a 2.5% annual allowance on cost, while industrial buildings benefited from a once-off 25% initial allowance in the first year of use, followed by the same 2.5% annual allowances thereafter.

On the other hand, movable assets such as furniture, machinery and vehicles were also subject to prescribed straight-line rates, i.e., 10%, 15% and 25%, respectively, with cost restrictions applying to motor vehicles capped to P175,000. This cap is generally an international best practice where the taxman aims to prevent excessive claims on luxury vehicles. To put it in another way, under the current regime it is apparent that the cost of acquiring furniture, machinery and vehicle must be claimed over 10years, 7.5years and 4years, respectively. It is also unarguable that while this framework is predictable, it, at times, mismatched the pace at which some assets lost value against the time it will be fully claimed for tax purposes.

Enter the new regime

Accordingly, the new Income Tax Bill modernises this approach and provides that taxpayers may calculate depreciation deductions either on an individual asset basis using the straight-line method or, for movable assets such as motor vehicles and computer equipment, on a pooling basis using the reducing balance method.

Once a taxpayer makes an election to use either the SLM or RBM, the election is irrevocable and must be applied consistently across the relevant asset classes. On the other hand, class 4 assets which are buildings, structural improvements and business intangibles remain confined to the straight-line method.

Enter the RBM

The diminishing value method, however, introduces a dynamic mechanism of calculating capital allowances. It follows that assets are grouped into pools, and the deduction is calculated by applying the pool's rate (RBM rate) against the net book value at year-end. The RBM establishes how taxpayers may calculate depreciation on a pooling basis using the rates

specified in the Act for the respective asset classes. The net book value is adjusted upward by 50% of the cost of new assets added in the current and prior year, and downward by the proceeds from disposals. This system accelerates deductions in the early years and reduces as the pool diminishes. If the pool's value falls below P3,000, the remaining balance is fully deductible and the pool resets to zero. If the pool becomes negative, the excess is treated as taxable income. Where all assets in a pool are disposed of, any remaining balance is deductible and the pool is closed.

Additionally, under the new regime motor vehicles remain subject to cost limits, which is now revised upwards to P500,000, with excess treated as private assets. Industrial buildings continue to attract the 25% initial allowance maintaining the same treatment for tax payers in the manufacturing and hospitality industry.

Conclusion

In conclusion, the new Income Tax Bill transforms capital allowances from a rigid, uniform system into a flexible framework.

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