

# Japan Tax Bulletin

## Bad debt loss and bad debt allowance

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Under the Corporation Tax Acts, where monetary claims such as account receivables, loan receivables etc. become uncollectible, losses on such monetary claims are tax deductible subject to certain conditions. Further, SME<sup>1</sup> and certain other corporate taxpayers are allowed to make a tax-deductible provision for bad debt allowance subject to the deductible limitation.

### 1. Bad debt loss

Bad debt losses are treated as tax-deductible losses where the following conditions are satisfied:

#### 1.1 Legal cancellation of monetary claims

- the amount of monetary claims is cancelled by a decision to approve a corporate rehabilitation plan or decision to approve a civil rehabilitation plan,
- the amount of monetary claims is cancelled by a decision to approve an agreement of a special liquidation under the Company Law,
- the amount of monetary claims is cancelled by an arrangement among relevant parties not based on legal proceedings such as
  - ✓ an arrangement of a reasonable debt consolidation by creditors meetings,
  - ✓ an agreement of relevant parties with mediation by an administrative organization or financial institution.
- The amount of monetary claims forgiven is notified in writing where a debtor has been insolvent and collection cannot be expected.

Where a company has forgiven monetary claims to a related company in financial difficulty and deducted the amount of monetary claim forgiven, the deductibility is sometimes scrutinized and challenged as a non tax-deductible gift to the related company. In order to avoid this, the forgiveness of a related company's debt needs to be based on a reasonable rehabilitation plan to avoid the bankruptcy of the debtor company.

#### 1.2 Debtor's economic conditions

Where it is evident that all of the monetary claims are uncollectible judging from the debtor's assets and solvency, the creditor company is allowed to record a bad debt loss in its accounting ledgers and treat it as deductible loss for tax purposes.

#### 1.3 No collection after termination of transactions with debtors

If the following facts apply to a debtor, a creditor company is allowed to record a bad debt loss for trading account receivables, by deduction of note value in its accounting ledgers and treating it as a deductible loss for tax purposes.

- 1 year or more has passed after termination of transactions with a debtor; and
- Travelling costs to debtors' locations are larger than the total amounts of debtors in the area.

Termination of transactions means termination of continuous transactions due to deterioration of a debtor's financial conditions and solvency.

### 2. Bad debt allowance

The provision of a bad debt allowance is not tax deductible unless a company is an SME, financial institutions, public interests corporation etc.. The corporate taxpayers listed above are allowed to provide for tax-deductible bad debt allowances on the condition that bad debt allowance is recorded in the accounting ledger, subject to the deductible limitation.

#### 2.1 Monetary claims subject to individual evaluation

For the following monetary claims, the amount that is expected to be uncollectible is tax deductible.

- The amount of monetary claims to be repaid after 5 years or later from the end of a business year when postponement of payments or installment payments are decided by approval of corporate rehabilitation plan or for similar reasons;
- The amount of monetary claims expected to be uncollectible for reasons of debtors' insolvency for a reasonably long period and there is no expectation of recovery, significant damage by natural disasters or rapid and significant changes in economic conditions, or similar factors; or
- 50% of monetary claims of the end of a business year when a commencement of proceedings of corporate rehabilitation plan is filed for the debtor or other similar reasons.

<sup>1</sup> An SME is a company whose stated capital is JPY 100M or less. However, where a company is wholly owned by a company whose stated capital is JPY 500 M or more, the company does not qualified as an SME even though its stated capital is JPY 100 M or less.

## 2.2 Monetary claims subject to overall evaluation

For monetary claims excluding those at 2.1 at the end of a business year, the tax deductible limit is calculated as the total amount of monetary claims x bad debt loss ratio.

The bad debt loss ratio is A/B.

A = (bad debt losses + provision of bad debt allowance for individual evaluation – reversal of bad debt allowance for individual evaluation in business years that commenced 3 years prior to the beginning of the business year) x 12/total number of months in the period.

B = (the total amount of monetary claims at the end of business years that commenced 3 years prior to the beginning of a business year)/ the number of business years in the period.

For an SME, the following bad debt loss ratio instead of actual bad debt loss ratio above can be utilized depending on type of industries.

Retail or wholesale	1%
Manufacturing	0.8%
Finance or insurance	0.3%
Installment retail sale etc.	1.3%
Others	0.6%