

# Japan Tax Bulletin

## Treatment of estimated expenses under Japan tax law

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### 1. Overview

Deductible expenses under Japan corporation tax law are determined as follows:

- 1) Cost of goods sold (COGS)
- 2) Selling, general and administrative expenses (SGA)
- 3) Losses

The amount of allowable expenses is computed according to generally accepted accounting principles (GAAP) and with some adjustments under Japan tax law.

### 2. Deduction of estimated expenses under Japan corporation tax law

#### 2-1 Cost of goods sold (COGS)

COGS is generally allowed to be deducted in the fiscal year when the corresponding revenue is realized and earned.

If the amount of COGS corresponding to sales revenue is not fixed at the end of a fiscal year in which the revenue was recognized, it should be accrued properly according to the principal of matching cost and revenue under GAAP, and this approach is followed by Japan corporation tax rules.

#### 2-2 Selling, general and administrative expenses (SGA)

SGA should be allocated to the fiscal year according to principle of periodical allocation cost under GAAP and Japanese corporation tax rules adhere fundamentally to it. These expenses include periodic costs that are difficult to match directly to revenue. Only fixed obligations can be deductible expenses for tax purposes. Estimated costs and reserves cannot be deductible unless allowed specifically by tax law for example depreciation and reserves for bad debts.

For a fixed obligation to be deductible it must meet the following 3 criteria:

- 1) An obligation has been established by the end of the fiscal year.
- 2) A fact that causes specific performance based on the obligation has occurred by the end of the fiscal year.
- 3) The amount of expense can be estimated reasonably by the end of the fiscal year.

To satisfy the above requirements, delivery of goods or services rendered should have been completed by the end of the fiscal year and the amount of cost should be estimated based on concrete evidence such as contracts and agreements with billing sources.

#### Examples

Repair costs can be deductible expenses as fixed obligations if the repair has been completed by the end of the fiscal year and the amount of expense can be reasonably calculated by the final agreed estimate etc.

Accrued audit fees cannot be deductible in the fiscal year subject to the audit because the audit service has not been completed by the end of the relevant fiscal year, and so the accrued amount of the audit cannot be regarded as the fixed obligation.

Employee performance bonuses are basically deducted in the fiscal year of payment has made for tax purposes even if the expense meets the requirements above 1) – 3).

#### 3. Prior period adjustment losses

With respect to revenue recorded in the previous fiscal year, losses resulting from situations such as cancellation, withdrawal, discount, return, etc. of the contract in the relevant fiscal year are deducted in the fiscal year in which the situation occurred without retroactive action.

#### 4-1 Treatment of estimated expenses under Japan consumption tax law

If a corporation makes a taxable purchase where the amount of consideration is not fixed by the end of fiscal year, the amount is estimated based on the situation as of that day.

If the actual amount of consideration determined in the following fiscal year is different from the previously estimated amount, the difference is added to or deducted from the amount of taxable purchases in the taxable period during which the amount is determined.

#### 4-2 Difference between corporation tax law and consumption tax law

As mentioned in 2-1, if the amount of COGS is not finalized by the end of a fiscal year, the amount can be estimated based on the situation at the time under corporation tax rule.

On the contrary, under consumption tax rule, only the amount of COGS which has been transferred or service rendered can be estimated even if the corresponding revenue is realized and earned in the fiscal year.

For example, under corporation tax rules, if a corporation sells machinery and equipment including installation work and recognizes the total revenue at the time of the delivery of the machinery and equipment, even if the installation work was not completed at the end of the fiscal year the costs can be appropriately estimated and recorded as cost of sales. However under consumption tax law, since it is only allowable to estimate costs for transactions that have actually been taxed, in the case of the above example the estimated cost of installation work cannot be deductible because the service has not been completed.



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