

Japan Tax Bulletin

Bad Debt Loss and Bad Debt Allowance

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A corporation is allowed to deduct monetary claims when they become fully unrecoverable. Corporation Tax Law Basic Circular (“CTLBC”) lists cases where a deduction of monetary claims is allowed.

1. Bad debt loss

(1) Bad debts in the case where all or part of a monetary claim has been written down (CTLBC 9-6-1)

Where any of the following events occurs with respect to a monetary claim held by a corporation, the following amounts of the monetary claim shall be included in a deduction as a bad debt loss in the fiscal year which includes the date on which the event occurred.

- A) Where an order of confirmation of a reorganization plan or an order of confirmation of a rehabilitation plan is made, the amount of the write-down as a result of such order.
- B) Where an order of confirmation of an agreement pertaining to special liquidation is made, the amount of the write-down as a result of this order
- C) The amount of the write-down resulting from any of the following decisions reached through consultations among the parties concerned that are not subject to liquidation proceedings pursuant to the provisions of laws and regulations:
 - (a) A consultative decision of a creditor meeting that provides for the liquidation of the debtor's liabilities based on reasonable standards; or
 - (b) A contract concluded through consultation between the parties based on mediation by an administrative organ, a financial institution or any other third party, the content of which is equivalent to (a).
- D) In cases where the debtor's insolvency continues for a considerable period of time and it is recognized that the creditor is unable to receive repayment of its monetary claims, the amount of debt forgiveness that has been clarified in writing to the debtor.

(2) Deduction of unrecoverable monetary claims (CTLBC 9-6-1)

Where it becomes clear that the full amount of a monetary claim held by a corporation cannot be collected with reference to the debtor's assets, solvency, etc., such a claim may be accounted for as a bad debt in the fiscal year in which it becomes clear. In this case, if the monetary claim is secured by collateral, the bad debt may be accounted for as a bad debt only after the disposal of such collateral.

(3) Deduction of monetary claims where there is no repayment after a suspension of transactions for a certain period of time (CTLBC 9-6-3)

Where any of the following events occurs with respect to a debtor, a corporation is allowed to treat the debtor's accounts receivable (meaning accounts receivable, unpaid contracts receivable and other similar claims, but not including loans and other similar claims) minus a memorandum value as a deduction.

- A) Where one year or more has passed since the time when transactions with the debtor were suspended (or if the last due date or the time of the last payment was after the time of such suspension, the latest of these times). This does not include cases where there is collateral against such accounts receivable.
- B) Where the total amount of such accounts receivable held by the corporation from a debtor in the same region is less than the travel expenses and other costs required for collecting the same, and no payment has been made despite demanding payment from the debtor.

(4) Discharging a financially troubled related company from an intercompany debt

In a corporate group, a creditor company sometimes forgives a financially-troubled debtor company's debt to provide financial support. In this case, a bad debt loss for the debt forgiveness is not always tax-deductible but treated as a donation (“kifukin”) for tax purposes, which is subject to restrictions on deduction. A debt forgiveness is not treated as a donation where it is made based on a reasonable restructuring plan that is unavoidable in order to prevent the bankruptcy of a poorly performing subsidiary, etc. (CTLBC 9-4-2).

2. *Bad debt allowance*

A corporation with stated capital amount of JPY100M or less (excluding one wholly-owned by a corporation with stated capital amount of JPY500M or more) is allowed to provide for a bad debt allowance and take a tax deduction. Bad debt allowance is provided for individually-evaluated monetary claims and collectively-evaluated monetary claims respectively.

(1) Bad debt allowance for individually-evaluated monetary claims

The maximum amount of provision for an individually-evaluated monetary claim is the amount that was estimated to be unrecoverable when evaluating the claim.

(2) Bad debt allowance for collectively-evaluated monetary claims

The maximum amount of provision for collectively-evaluated monetary claims is the total book value of collectively-evaluated monetary claims at the end of the fiscal year multiplied by the bad debt ratio. The bad debt ratio is the average loan loss ratio over the past three years. Providing for a bad debt allowance using the statutory provision rate instead of the actual bad debt ratio is also allowed.

The statutory provision rates are 0.1% for wholesalers or retailers, 0.008% for manufacturers, 0.003% for finance or insurance businesses, 0.007% for installment sales retailers etc. and 0.006% for others.