

Limitations on deductible losses for bad debt reserves

1. **Introduction**

The Japanese corporate tax rate has been reduced, pursuant to the 2011 tax reform, as one of the measures taken under the government's new growth strategy. However, in conjunction with the reduced corporate tax rate, the tax reform has also abolished or reduced various tax benefits and deductions in order to enhance the tax base and maintain government revenue sources. This update summarises the limitations on deductible losses for bad debt reserves for corporate taxpayers that were introduced in the 2011 tax reform.

2. **Before the 2011 tax reform**

Before the 2011 tax reform, a corporate taxpayer was allowed to deduct a portion of its bad debt reserves from taxable income for corporate tax purposes in the following ways:

- Bad debt reserve booked upon the occurrence of a credit event – if a bad debt reserve was booked on financial statements for accounting purposes for any monetary claim due to a credit event (eg, court approval of a corporate reorganisation plan) that was likely to render a monetary claim unrecoverable, a corporate taxpayer was allowed to deduct a portion of the applicable bad debt reserve from corporate taxable income (up to the maximum amount provided for the respective credit event under Japanese tax law). A monetary claim subject to this rule is called a 'separately valued monetary claim'.
- Bad debt reserve booked on the past bad debt loss percentage – bad debt reserves for account receivables, loan receivables and other similar monetary claims (ie, 'block valued monetary claims') booked on financial statements could be deducted from a corporation's taxable income for tax purposes up to the amount permissible under the tax law. This was based on the average bad debt loss percentage of such block valued monetary claims for the corporation's past three financial years.
- Tax deduction rule – a corporate taxpayer was required to re-evaluate its bad debt reserves every year for tax purposes. The amount deducted in the preceding financial year for bad debt reserves had to be added to taxable income for the current financial year and the amount that was deductible

with respect to the reserves was re-calculated.

All Japanese corporations were eligible to make a deduction of taxable income for bad debt reserves for separately valued monetary claims and block valued monetary claims.

3. **2011 tax reform**

The 2011 tax reform introduced several limitations on deductions of bad debt reserves.

Eligible entities

The 2011 tax reform limited the types of entity that may deduct the amount of bad debt reserves from their taxable income. An entity must be one of the following in order to do so:

- entities with a stated capital of Y100 million or less (ie, 'small corporations') as of the end of the applicable financial year;
- banks and insurance companies; and
- certain financial corporations (including leasing companies, securities companies and consumer lending providers).

A small corporation may not deduct the amount of bad debt reserves from its taxable income if it is a wholly owned subsidiary of a large entity with a stated capital of Y500 million or more.

Types of monetary claim

An additional restriction applies to financial companies (that are not banks or insurance companies), which limits the types of monetary claim that can be the subject of deductible bad debt reserves to the following:

- leasing receivables of finance lease transactions (owned by a leasing corporation);
- loan receivables in connection with credit transactions (owned by a securities corporation); and
- loan receivables booked on a type of account ledger that must be maintained pursuant to the Money Lending Business Law (owned by a consumer lending services provider).

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4. Effective date

The new rules introduced by the 2011 tax reform are applicable to corporate taxes for fiscal years commencing after April 2012.

5. Transition period

The new rules provide for a three-year transition period. All Japanese companies – including companies that are eligible to deduct the amount of bad debt reserves from their taxable incomes under the 2011 tax reform – are eligible to take deductions under certain grandfathering rules during the transition period.

Grandfathering provisions

During the transition period, all corporate taxpayers may deduct the amount of bad debt reserves subject to the following limitations for each year:

- financial years commencing between April 2012 and March 2013 – three-quarters of the maximum amount of taxable income deduction for which the corporation is eligible in respect of its bad debt reserves for the past financial year subject to the rule before the 2011 tax reform (ie, the ‘maximum pre-reform deductible’);
- financial year commencing between April 2013 and March 2014 – half of the maximum pre-reform deductible; and
- financial year commencing between April 2014 and March 2015 – one-quarter of the maximum pre-reform deductible.

‘Cherry-picking’ allowed for eligible taxpayers

A corporate taxpayer that is eligible to deduct bad debt reserves under the 2011 tax reform may instead opt to apply the grandfathering provisions. This enables entities that fall under the third category of corporate taxpayer listed above – which can deduct the amount of bad debt reserves from their taxable incomes following the 2011 tax reform – to make deductions on bad debt reserves for types of monetary claim that they are not permitted to make under the 2011 tax reform.

Separately valued monetary claims

A corporate taxpayer may elect to apply either the new rules for bad debt reserve deductions under the 2011 Tax Reform or the grandfathering provisions with respect to each separately valued monetary claim. For example, a leasing company can choose to apply the new rules with respect to its leasing receivables from a finance lease transaction (ie, the same deductible loss can be deducted from its taxable income in respect of bad debt reserves for such leasing receivables of a finance lease transaction). On the other hand, it can also choose to apply and enjoy the benefit of the grandfathering provisions in respect of other separately valued monetary claims (ie, bad debt reserves that a leasing

company is not allowed to deduct from its taxable income after the 2011 tax reform).

In respect of separately valued monetary claims, it seems that the rational choice for financial corporations (other than banks or insurance companies) would be to apply the new rule for bad debt reserves for eligible monetary claims and to apply the grandfathering provisions for bad debt reserves for ineligible monetary claims.

Block valued monetary claims

Corporate taxpayers may choose to apply the new rules or grandfathering provisions with respect to block valued monetary claims. However, once a taxpayer opts to apply the new rules or the grandfathering provisions for a financial year, the chosen rules and provisions will apply to all of its block valued monetary claims. In other words, the corporate taxpayer cannot vary its choice to apply the new rules or the grandfathering provisions in respect of the block valued monetary claims within a financial year. It can modify its choice every financial year during the three-year transition period.

For example, a leasing company can choose not to apply the grandfathering provisions for the financial year ending in March 2013. This choice may be reasonable for leasing companies that have no bad debt reserves booked for leasing receivables for finance lease transactions, but do have bad debt reserves for other block valued monetary claims booked for that financial year. If this situation changes, the taxpayer can modify its choice of whether to apply the new rules or the grandfathering provisions for the next financial year (during the three-year transition period).

6. Comment

The new rules regarding deductions of bad debt reserves introduced by the 2011 tax reform may have a significant impact on business activities in Japan, especially for financial corporations (other than banks or insurance companies) that regularly engage in lending activities.

A corporate taxpayer that cannot take deductions under the new rules may consider reducing its stated capital to Y100 million or less, effective as of the last day of its fiscal year. However, a stated capital reduction of a Japanese corporation will require certain procedures under the Companies Act and normally takes one-and-a-half months to become effective.

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