PKF O'CONNOR DAVIES
ACCOUNTANTS AND ADVISORS

Hotel Bad Debts: Are They Always Tax Deductible?

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Many hotel companies have a standard operating procedure for calculating allowance for doubtful accounts. Generally, it is based on a percentage of amounts from the hotel's accounts receivable aging combined with specific identification of potentially uncollectible accounts. Due to the coronavirus pandemic, many hotel companies are experiencing collection issues and, as a result, recorded increases in the allowances for doubtful accounts on their financial statements.

The recognition of an allowance for doubtful accounts for financial statements reporting generally is not deductible for tax purposes.

Financial Statements Reporting

In accordance with generally accepted accounting principles in the United States of America (US GAAP), an allowance for uncollectible accounts is an estimate required to be made by management at each balance sheet date.

For private companies, an allowance for doubtful accounts should be established when it becomes probable that a receivable will be completely (or partially) uncollectible. The allowance is based on historical experience, specific appraisal of individual accounts, or other accepted methods (e.g., percentage amounts from the hotel's accounts receivable aging). Accounts that become uncollectible are charged to the allowance for doubtful accounts account. Recoveries of accounts previously written off are credited to allowance for doubtful accounts account.

The balance of the allowance for doubtful accounts account at the end of any period represents management's best estimate of the portion of accounts and notes receivable which will not be collected.

Tax Reporting

Unfortunately, while bad debt policies for financial statement purposes may lead to significant write-offs for hotels, those write-offs may not translate into equivalent tax deductions. The tax rules do not support the deduction of bad debts based only on the age of accounts receivable, but instead require a debt-by-debt analysis. Thus, for a hotel using the accrual method for tax purposes, which must recognize income when accrued, there's a real risk of being required to recognize income on unpaid accounts receivable without being able to deduct a corresponding bad debt allowance amount.

For tax purposes, bad debt deductions are allowed when a debt incurred in a trade or business is deemed "worthless." A debt is worthless when the facts and circumstances demonstrate that there is no "reasonable expectation" of repayment. This determination must be made on a debt-by-debt basis. Age of accounts receivable, while a factor, is not sufficient alone. The bankruptcy or insolvency of the debtor may be sufficient proof that a debt is worthless; however, general financial struggles may not be enough.

Without clear proof that there's no reason to pursue the receivable, the taxpayer must be able to demonstrate that it made all reasonable efforts to collect on the receivable, but that for some reason those

efforts were futile. Reasonable efforts could include pursuing a legal judgment against the debtor (although that is not necessarily required). A bad debt can be partially worthless, but this requires an actual charge off for financial statement purposes to be tax deductible.

The following illustrates different scenarios when a bad debt may or may not be deductible for tax purposes:

> **Scenario 1** – A hotel provides a block of rooms to a tour group arranged by a travel agency in March 2020. The hotel records the income when it provides the rooms to the tour group. The travel agency did not pay the hotel. In August 2020, the hotel learns that the travel agency has declared bankruptcy. The hotel may deduct the accounts receivable as worthless for both financial reporting and income tax purposes without further pursuit of the debt. (***Note:*** a bad debt deduction may only be taken in the year the debt becomes worthless – thus the travel agency declaring bankruptcy in 2021 would not be sufficient evidence for a deduction in 2020.)
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> **Scenario 2** – A hotel provides conference space to a large marketing firm for a meeting in February 2020. The marketing firm refuses to pay, not because it is insolvent, but because it is concerned about cash flow during the pandemic. In order to deduct all or a part of this amount as a bad debt for income tax purposes, the hotel must prove it has exercised all reasonable efforts to collect the receivable. The hotel should consider negotiating a settlement on the receivable whose collection is uncertain, so that it can take a tax deduction for the portion of any receivable that will go unpaid. If the hotel wants to continue to pursue the payment of the entire receivable, it will be unable to take a bad debt tax deduction in 2020.
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> **Scenario 3** – An airport hotel provides rooms regularly for the crew members of an airline. The airline is significantly late on paying for these rooms. However, the hotel continues to provide additional rooms to the airline. This is evidence that the hotel may not take a bad debt tax deduction for the accounts receivable relating to the airline because continuing to extend credit is an indication that the hotel believes the debt will eventually be paid.

Contact Us

PKF O'Connor Davies offers an array of services and expertise to the hospitality industry. If you have any questions on these or other topics addressed here, relating to the hospitality industry, we invite you to contact our hospitality industry specialists.

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