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## **COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)**

*An overview of the main issues that emerged at the  
first meeting of the subgroup on reserves, provisions  
and liabilities*

**Meeting to be held on Thursday 02 June 2005**

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**WORKING DOCUMENT**

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## **I. Background information**

1. The purpose of this note is to facilitate the discussion and to give a brief overview of the main issues that emerged at the first meeting of the subgroup on reserves, provisions and liabilities (hereafter SG2), and in particular to highlight those on which the SG2 sought more guidance from the plenary.
2. The first meeting of the SG2 was organised on 28 and 29 April 2005 in Rome by Italy. Sixteen Member States (MS<sup>1</sup>) were represented at the meeting: Austria, Belgium, Cyprus, Czech Republic, Finland, France, Germany, Hungary, Italy, Latvia, Luxembourg, Malta, Netherlands, Poland, Slovenia, and Sweden together with the Commission Services. The meeting was chaired by Italy.
3. Two room documents were prepared by the Commission Services for the SG2 meeting and circulated to all CCCTB WG members. Both documents were based on the written comments received from twelve MS<sup>2</sup> (Cyprus, Czech Republic, Finland, Germany, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Spain, and Sweden) following the Working Group meeting in March 2005.
4. The discussions themselves were structured along the lines of the background notes circulated at the meeting by the Chair and the results of the meeting are reported in the Chair's Summary Record.

## **II. Key discussion points to emerge**

### Definitions

5. Although there is general agreement that provisions are linked to liabilities and reserves are part of equity the discussions in the Subgroup revealed that there are differences between MS over some individual 'transactions'. It seems that there are some 'transactions' which would currently be treated as a provision in some MS and a reserve in other MS. This may create problems if, for example, provisions are generally treated as deductible and reserves are generally treated as not deductible. Unless specific 'transactions' are treated in the same way in all MS it will be difficult to determine tax deductibility by reference only to the classification as either a provision or a reserve.
6. Although it was not explicitly discussed at the SG2's meeting members of the Group might have registered that a similar problem as regards the distinction between provisions and reserves may exist in the distinction between provisions and accruals. This could be particularly relevant in jurisdictions where currently both provisions and reserves are generally tax non deductible, but accrued liabilities are deductible. The definition of provisions should therefore be very clear in order to eliminate this potential confusion as well.

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<sup>1</sup> Although the term Member State is sometimes used this, as in all documents relating to the CCCTB WG and Subgroups, should not be understood as a formal commitment or position taking by a Member State.

<sup>2</sup> Additional comments were subsequently received from France and Greece

7. It was suggested that provisions could be defined as *liabilities of uncertain timing and amount* and reserves as *appropriations of retained earnings which form part of equity*. Several members agreed that it could be further developed to include the conditions that have to be met in order to make the provision potentially tax relevant. The link to liabilities and an effective existing economic burden of the taxpayer (perhaps limited to third party liabilities/burdens) were two conditions mentioned in the discussion.

#### Scope of subgroup 2 discussions

8. The question of how to treat 'provisions' related to assets needs to be resolved. The Commission Services have identified two main types: (i) 'provisions' generally related to 'fixed' assets, such as provisions for depreciation and provisions for impairment and (ii) 'provisions' generally related to 'current' assets, such as provisions related to debtors. The subgroup was divided over whether the second type should be discussed together with provisions (within this subgroup) or discussed together with assets in subgroup 1 and specifically referred the question to the main Working Group.
9. The Commission Services agree with the general consensus that depreciation and impairment should continue to be discussed in subgroup 1 as directly related to assets. However, provisions related to debts should be discussed in subgroup 2. This seems preferable for a number of reasons. For example discussions on tax deductibility of provisions traditionally includes bad debt provisions; like other provisions a degree of judgement is involved in quantifying them; and like other provisions they often effectively accelerate tax deductions. Finally, despite extensive discussions on assets in subgroup 1 bad debts have not been mentioned; nor did any MS express surprise that they were included in the original Working Document on Reserves, Provisions and Liabilities.
10. A similar question may arise in relation to reserves. It seems to be generally accepted that it is helpful to work on a definition of reserves in conjunction with work on a definition of provisions. However, whether work on the tax deductibility of reserves should continue in subgroup 2 or should be dealt with when the whole question of incentives is considered is less clear, with some MS considering tax deductible reserves as always incentives, and some less convinced. Whereas no immediate decision seems necessary the Commission Services would welcome comments from members of the Working Group (WG).

#### Tax deductibility

11. As regards reserves there seems to be general agreement that, subject to finalising a satisfactory definition (see paragraph 5 above), the best approach would be that these should in general not be tax deductible. However a method for dealing with exceptions will still need to be found, together with a resolution of the 'incentive' question.

12. As regards provisions two main approaches were identified: (i) in general not deductible with a positive 'list' of deductible examples; and (ii) in general deductible with a negative 'list' of non-deductible examples. Although it is proposed that subgroup 2 will carry out further work on this the Commission Services would welcome further comments, particularly from MS who were not at the subgroup meeting. In principle the Commission Services believe the second approach would be more straightforward to implement in a CCCTB but recognise that this is closely linked to how 'strict' the definition is of a provision. If the second approach is adopted it is the tax deductible / relevant provision that needs to be defined and it may be linked to the set of conditions as mentioned in Para 7.
13. Although it was not discussed in detail at the subgroup meeting the Commission Services would like to remind MS that the greater the flexibility available to companies on loss carry forward and carry back, the less crucial the tax treatment of provisions becomes for companies.

Legally required provisions and reserves

14. There is general agreement amongst MS that the mere fact that a company may be required by national legislation (in some cases legislation related to non-tax policies such as environmental or sector specific policies) to create either a provision or a reserve should not make such provisions or reserves tax deductible. However, when defining general criteria for determining whether or not tax deductibility is appropriate the issue of MS domestic non-tax legislation will have to be taken into account. For example, a criterion based on whether or not a company has a legal or constructive obligation as a result of a past event (as is the case in accounting under IAS 37, paragraph 2(a)) may be 'triggered' simply because of a specific domestic legal requirement for a company to restore a polluted site to its previous condition. Further work is therefore necessary to arrive at a solution which will permit the necessary level of certainty to be achieved in any definitions of deductibility and how these interact with national legislation in individual MS. Some MS seem to be willing to take into account some non tax legislation requirements, not on a general basis, but as exceptions in specific areas such as pensions, health care or labour law requirements. Further comments from MS on this are welcome.

Further discussions

15. The Commission Services would like the subgroup to continue its work, taking into account the outcome of the first meeting and any further comments from the main Working Group. They suggest that in order to progress the work it would be helpful to 'test' draft definitions of provisions and reserves against specific examples such as warranties, repairs, environmental 'clean up' costs or some specific statutory provisions and reserves. This would help to ensure that the necessary common understanding can be achieved.
16. Work on provisions to date has been based on the assumption that only provisions for future tax deductible expenditure could be considered to be tax deductible. As

work progresses on provisions the logical next step would be to extend the work to include the necessary definitions of what types of actual expenditure should be tax deductible. Although the work on provisions is not completed the Commission Services would welcome any preliminary comments on whether the work of the subgroup should eventually be extended to include this more general question.

***The Commission Services look forward to a discussion on progress as reported by the Italian delegation and the issues as outlined above.***