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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

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

Meeting to be held on Thursday 08 December 2005

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WORKING DOCUMENT

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I. Background information

1. The purpose of this note is to summarise progress and highlight the main outstanding issues in relation to the discussions held in Rome in the sub-group on reserves, provisions and liabilities (hereafter SG 2).
2. At the last meeting of the CCCTB Working group on 23 September 2005, it was agreed to deepen the discussion on the elements for a tax definition of provisions whatever the tax treatment would be for the CCCTB purpose (general principle of tax deductibility or general principle of non deductibility), to get more technical input on specific provisions (warranties and legally required provisions) and to examine more in detail the treatment of bad debts provisions. Thus, a third meeting of the SG 2 chaired by Italy was held in Rome on 26 October 2005. Experts from twelve MS¹ attended this third meeting of the SG 2 : Belgium, Czech Republic, France, Germany, Hungary, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain and Sweden.
3. The Commission services also attended the meeting and prepared four room documents : CCCTB/SG2/006 on definitions ; CCCTB/SG2/007 on warranties and legally required provisions ; CCCTB/SG2/008 on bad debts and CCCTB/SG2/009 background document aimed at giving an overview of amendments to IAS 37 proposed by the IAS board. The Chair of the SG 2 also provided a room document including a table setting out the tax treatment of various items of provisions to compare the tax treatment in the MS and find common views on several items of deductible provisions.
4. As in the past, the Chair of the SG 2 prepared a report on the results of the third meeting of the SG 2, which gives an overview of the discussion and views expressed by the members of the group. The SG 2 being a technical group, the conclusions contained in the report represent a contribution by the sub-group to be discussed at the main working group and represent a valuable input for the Commission Services when formulating any subsequent formal proposals.

II. Key discussion points to emerge

Definitions and principles

5. The SG 2 had concentrated at its first two meetings on the question over whether a general principle of deductibility or a general principal of non deductibility should prevail in the future common base (negative list versus positive list approach) but this type of discussion turned out to divide the sub group rather than incite experts to find common views on the definition criteria of a provision.

¹ In common with all CCCTB Working Group documents references to 'Member States considered that...' etc refer to the comments by experts from the various Member States administrations and do not represent a formal position of a Member State.

6. In fact, whatever the general tax treatment should be, there is a strong need for a common understanding of what should be a deductible provision. As the Commission Services repeatedly pointed out the group of tax deductible provisions (or accruals) is likely to be very similar regardless which of the two methods is used. Therefore the Commission Services suggested examining the elements and criteria for tax deductible provisions in order to provide them with a technical guidance for potential CCCTB solution.
7. If the positive list approach were to be chosen, these criteria would serve as guidelines in case of a necessity to update and extend the list of the deductible provisions. If the negative list approach (general principle of deductibility) were to be chosen, the criteria would provide guidance to the taxpayer to determine whether or not a deductible provision can be recognised. At this meeting of the SG 2, even experts who expressed a clear preference for a positive list approach accepted the necessity to build a clear definition based on the accounting principles.
8. In this respect, members of the group agreed to use IAS 37 as a starting point for a tax definition and there is a general consensus to make use of the IAS criteria (provisions are liabilities of uncertain timing and amount and liabilities are present obligations of an entity arising from past events).
9. However, when looking more in detail at the criteria mentioned in this IAS definition, views diverge on one of the important items mentioned in IAS 37 definition.

Thus, as regards the constructive obligation², several experts seemed quite reluctant to allow the recognition of a tax deductible provision in relation to liabilities that a company does not have towards a third party. They expressed some concerns that it could lead to some tax planning. The argument that the constructive obligation may be easily turned into a contractual obligation did not convince these experts. They consider that when mentioned in a contract, the nature of the obligation changes ; since an obligation to a third party has been created, this third party has then the possibility to take legal action if the obligation mentioned in the contract is not properly settled.

In contrast, other members of the group currently accept and would support for the common base the recognition of such provisions, because the company has created a legitimate expectation that could be regarded as an obligation to a third party or because the treatment of a provision should be examined in relation to the treatment of the corresponding expense when incurred.

If such obligations were to be excluded from the definition of a provision (assuming that such provisions would be deductible) it might discourage companies from accepting responsibilities particularly in relation to redundancy

² IAS 37 (paragraph 10) : a constructive obligation is an obligation arising from past actions of a an entity which create an expectation among the public that the company would accept certain responsibilities.

measures or environmental costs and it should be stressed that public authorities often encourage companies to accept such responsibilities. It is important to underline that such an obligation would obviously require from the company sufficient documentation and data to establish that according to its past actions, it will accept such responsibilities.

10. If the principle of non deductibility of provisions (positive list approach) were to be chosen, the definition of accruals would be necessary to distinguish between tax deductible accruals and tax non deductible provisions. The discussion at the three meetings of the SG 2 has provided limited input in terms of definition criteria of accruals because members concentrated mainly on general characteristics of tax deductible provisions. The Commission services room documents mentioned the definition of IAS 37 (which refers to the level of certainty) but no MS among those who support the non deductibility principle suggested additional criteria or commented on the IAS 37 definition of accruals. However when discussing the clean up costs provisions example (in reference to long term obligations) and the conditions for their deductibility, it emerged that in one MS where provisions are generally tax non deductible, such items are treated as tax deductible accruals. This highlights the importance of defining accruals when provisions are generally non deductible. MS who favour this approach are invited to comment on the definition criteria of accruals.

Long term liabilities

11. On the issue of long term liabilities, most MS rejected the Commission Services suggestion of placing a time limit on tax deductible provisions. Some MS mentioned measurement difficulties in this type of situation. It was stressed that in any case, a company would have to reassess the measurement of a provision at the end of each tax year which should reduce the risk of over provisioning.
12. One Member of the SG 2 said he would favour that this type of provisions should be treated as a non deductible reserve because when the obligation is so remote, the estimate of the expense cannot be reliable.
13. Considering that this type of provision could be quite large in relation to the tax base of an entity, this question would deserve to be examined by the main group. The Commission Services would like to underline that this idea of imposing a limit for long term obligation could be a way to protect the tax base, considering that the estimate of such a liability should be very difficult to check. On the other hand, most MS appear to consider that even long term liabilities give rise to obligations and should be deductible whatever the period.

Special provisions

Repairs

14. In room document CCCTB/SG2/006 the Commission Services raised the question of whether tax deductions should be allowed for provisions on repairs and maintenance. Members of the SG2 were in general of the view that such items

- should not qualify as a tax deductible provision, but should be classified as reserves. Some members referred to a link between such a reserve and the treatment of assets and saw the possible deduction as an incentive.
15. This question seems to be quite connected to the criteria of the definition which are not met in this case. If a provision is only an obligation to a third party, a provision for repair should not be recognised since the entity has in general no obligation towards third parties. If a provision is a liability and a liability a present obligation of uncertain timing and amount arising from past events but which is connected to a deductible expense that should be incurred in the future, provision for repairs should be recognised. Here again, this issue refers to the question over whether the third party criterion should apply in the CCCTB.
 16. A number of MS acknowledged they would agree for some future maintenance costs to be tax deductible if they relate to ships and aircrafts because it is required by law. However such items would be described as reserves.
 17. One MS stressed that if the component approach is not followed for the CCCTB depreciation rules (actually participants of the SG 1 unanimously rejected the use of the component approach for the CCCTB³), it would be logical to accept the deduction of provisions for repairs of parts of assets which may require more maintenance.

Warranties

18. A number of Members of the SG2 agree that companies should be allowed to create tax deductible provisions for warranties. The main concerns some Members of the SG2 have are linked to the measurement of such provisions in case of a new company or of a new product. This issue seems to be quite sensitive and at each of the SG 2 meetings it was the occasion of a quite long discussion. In reaction to the room document prepared by the Commission Services, MS agreed that statistical data based on the company past experience itself was a good way to calculate a reliable estimate of warranties provisions.
19. In order to avoid any terminology confusion, the term "statistical data" in the Commission services' room document should not be understood as only external data or industry data. It may also be a mathematical treatment of the data that the company has collected from its past experience in order to estimate the potential warranty claims, instead of analysing the risks of warranty claims on an item by item basis.
20. It seems that MS are quite divided on the question over whether external data could be accepted when internal data are not available (e.g. when the entity is new or when the entity is issuing a warranty on a new product). Some MS would be prepared to accept reliable external data when internal statistics are not available.

³ Report prepared by the Chair on the results of the two meetings of the subgroup (SG 1) on "Asset and tax depreciation" and "Intangible assets and tax depreciation" – p. 9

If available external data are not reliable or comparable to examined situation a provision cannot be created. On the other hand, other experts remained quite reluctant to accept any external data and/or admit that the estimate of a warranty provisions could be disassociated from the past experience of the entity itself.

21. The Commission services would like to draw the attention of the main group to this issue. If the CCCTB rules were to refuse the deduction of warranty provisions to new companies or to companies starting new businesses or new products, it could raise concerns in terms of competitiveness of the tax base and in terms of fair competition and in terms of encouragement to innovation. A tax base refusing de facto to any newcomers on a market or to the most innovative companies a deduction which would be accepted for the well established companies already operating on the market would not favour innovation and open markets and could be regarded as a restriction to business competition.

Thus, the Commission services would like to encourage the MS to consider the importance of an equal treatment of companies in relation to warranties provisions (assuming that the tax deduction of such provisions were to be accepted).

Legally required provisions and the mutual recognition principle

22. The mutual recognition principle is a necessity in a common tax base since it aims at removing barriers and obstacles to the single market and promoting competitiveness.
23. The discussion in the SG 2 revealed a certain level of consensus on this issue. Thus, a provision calculated in accordance with the requirements arising from the non tax legislation implemented in one MS should be recognised in the CCCTB as acceptable for the provision deductibility even though it would impact the share of the common base of another MS. However, two members of the sub group did not support this approach.
24. However in response to the concerns expressed in relation to the potential harmful impact of the mutual recognition consequences (some experts had raised fears that the non-tax legislation of one MS could reduce indirectly the share of another MS), the Commission services had suggested imposing some limits (fixing a maximum deductible amount for example).
25. Despite those difficulties, most MS considered as inappropriate to impose such limitations considering that the legal obligation arising from a MS legislation represents real cost and thus the company is legitimate to recognise a provision in relation to this cost provided that this cost would be tax deductible when incurred. At the same time, some MS stressed that the issue was in fact a very sensitive

issue from a political point of view and should inevitably be brought up again when discussing the apportionnement.

26. One expert expressed some concern about the mutual recognition and linked his remark with his opposition to a general deductibility principle. However the Commission Services consider that both in a positive list approach and a negative list approach, the mutual recognition principal and the question over whether some limitations should apply has to be raised. If a clean up cost provision is mentioned on a positive list of the deductible provisions, an entity may recognise a different amount of provision depending on the applicable national legislation and will expect the tax deductibility of this provision. Thus, a negative list approach does not solve by itself the issue of the mutual recognition principle and its possible consequences.

Bad debts provisions

27. Concerning the bad debts, the Commission Services had envisaged to combine a fixed rate approach (fixed rate deduction of mature receivables depending on the time of overdue of the receivables) with a traditional approach for higher amount of provisions (up to 100 % of their receivables whatever the amount is, provided that the company has a detailed justification).
28. The discussion held in the SG 2 on this combination revealed little support and several experts expressed doubts because (i) they had just abolished a fixed rate approach in their legislation, or (ii) because they do not see clearly the differences between the type of justification required in the fixed rate approach and those required in the traditional one or (iii) because they are reluctant to admit the deduction of provisions which would not be supported by some detailed justifications.
29. On the traditional approach itself, the main features described in the Commission Services room document CCCTB/SG2/008 (possible justifications / regular reassessment / statistical treatment for companies handling a large amount of small transactions) did not receive any objections in the subgroup.

SUMMARY AND PRELIMINARY CONCLUSIONS

- A common definition of a provision is a key element whatever the approach regarding the deductibility principle is chosen. However, if the positive list approach (general principle of non deductibility) were to be chosen for the CCCTB, an accurate definition of accruals would be necessary, together with more work on the list itself.
- IAS 37 could be used as a tool to build this definition. However MS are divided on the question over whether the deduction of provisions arising from a constructive obligation should be admitted. Besides it should also be clarified

whether the third party criteria should be kept or taken out (it is a key element as regards provisions for repairs).

- Provisions generally tax deductible (a negative list approach) as an appropriate approach for CCCTB is supported by a majority of Members of SG2 (including some who currently apply the positive list approach) and by the Commission services. However a minority of MS are strongly opposed to this approach and favour a non deductibility principle subject to exceptions (positive list approach).
- On warranties provisions past experience has been identified as the most reliable principle to apply as regards the measurement of such provisions. However the implementation of this principle should not bar in practise new entities or entities issuing new products from recognising such provisions.
- The implementation of the CCCTB may require a mutual recognition of non-tax legislation without any financial limitation. This principle should apply whatever the approach in terms of deductibility principle is chosen.
- In relation to bad debts, the fixed rate approach appeared to receive very little support. Thus, the tax treatment should concentrate on a case by case approach and the deduction of such provisions should be accepted only when backed by proper justification and documentation.
- Members of the group are invited to give their views on how the subgroup should proceed in the immediate future. One option would be for it to suspend its work and reconvene at a later date as necessary.