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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Reserves, Provisions and Liabilities

Meeting to be held on Thursday 10 March 2005

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WORKING DOCUMENT

I Introduction: Purpose of the Paper

1. This paper introduces the discussion on Reserves, Provisions and Liabilities. It refers to, and should be read in conjunction with:
 - (i) accounting practice (the main reference text used is IAS 37 'Provisions, contingent liabilities and contingent assets', although the IAS Framework for the Preparation and Presentation of Financial Statements ('IAS Framework') and other IAS are applicable in certain circumstances¹,
 - (ii) tax practices as currently followed in the Member States (MS) and
 - (iii) tax principles as discussed in the Working Paper on General Tax Principles (CCCTB/WP/001Rev1).

It seeks to identify some of the main issues which need to be addressed in designing a Common Consolidated Corporate Tax Base (CCCTB) and draws attention to a number of differences and similarities between current MS practices.

2. Reserves and provisions represent an important part of the tax base in that they accelerate tax relief. The tax treatment of actual expenditure under most of the categories of provisions currently recognised across the EU is tax deductible. The treatment of provisions is therefore a sub-set of the more general issue concerning what types of expenditure should be tax deductible in the CCCTB. This paper is essentially an introduction to the question of how to define the categories of 'expense' that should be recognised before the expenditure is actually incurred and how the amounts should be calculated.
3. Provisions are generally dependant on the definition of a liability, since the provision is required once the liability is recognised. When the liability is recognised in the balance sheet a corresponding entry is made in the profit and loss account. The terms liabilities and provisions are sometimes used in slightly different ways, sometimes as a liability in the balance sheet and a provision in the profit and loss account; sometimes as a provision in both the balance sheet and the profit and loss account. As noted in the IAS Framework the term used in the balance sheet may depend on the degree of estimation used to quantify the amount because some countries distinguish between a liability in the balance sheet (a certain and definite amount) and a provision in the balance sheet (an amount which has been estimated).

¹ for example IAS 11 for construction contracts, IAS 12 for income taxes, IAS 17 for leases and IAS 19 for employee benefits

4. Some provisions which are particularly important for taxation are more linked to an underlying asset than a liability, such as debts or receivables². In these cases the amount of the provision is calculated with reference to the asset when the company assesses the valuation of the debts or receivables. However for tax purposes it is the effect which the provisions have on the profit and loss account, ie the tax base, which is of most interest. In the bad debt example the timing of the tax deduction resulting from non-payment varies across the EU. In some MS the reduction in the tax base can occur before a company takes legal proceedings for non-payment; in other MS the reduction of the value of the debt or receivable is only recognised for tax purposes when the company has actually commenced legal proceedings or indeed obtained a legal judgement.
5. In addition to the question of what type of provisions should be tax deductible at what point in time this paper also introduces the issue of reserves. Whereas provisions are associated with liabilities (and in some cases, such as bad debts, associated with assets), reserves are associated with equity. The IAS Framework categorises the financial statements of a company as (i) assets, (ii) liabilities and (iii) equity. Equity being the residual interest in the assets after deducting the liabilities, with reserves one part of the equity along with share capital and retained earnings etc.
6. Although the paper concentrates on the creation of a provision or reserve it follows that if a provision or reserve is reversed because it is no longer required, or because the liability to which it referred proves to be less than expected, the tax treatment of this reversal should be the mirror image of its creation. For example, when a provision against a doubtful debt is tax deductible, if the company later receives payment, it is assumed that the reversal or release of the provision should be taxable.
7. As there is a well-established tradition within all MS of recognising the creation of certain provisions as tax deductible a lot of the work on this structural element of the tax base is likely to be directed towards identifying the similarities and differences between MS current rules and arriving at a set of common 'rules' which could be applied in the CCCTB. A major part of the work is therefore expected to involve a detailed comparison of the current rules in MS. The examples quoted in this paper rely heavily on publications prepared by the International Bureau of Fiscal Documentation and do not claim to be authoritative statements of MS tax legislation. A Room Document containing a more detailed survey of the tax treatment of reserves and provisions in individual MS will be made available to interested MS.

➤ *Can members of the group agree that reserves, provisions and liabilities should be discussed together, and that the main issues concern:*

² When the terms 'debt', or 'receivable' are used they refer to the asset in a company's balance sheet – the amount of cash which the company expects to receive. The debtor is the person who must pay, or the company may make a provision or start a court action for payment.

- *(i) the amount and timing of the recognition of a liability*
- *(ii) whether or not the creation of a provision or reserve is tax deductible, and that for this subject:*
- *(iii) close reference to existing MS practice will be helpful in defining a common approach.*
- *To what extent do members of the group think general tax principles can be a guide to defining common rules on reserves, provisions and liabilities?*

II Provisions and IAS

8. In accounting terms a provision is essentially a liability that is uncertain in timing or in amount. It should be recognised in the accounts (ie created) only when a company has a present obligation, as a result of a past event, it is probable that there will be an outflow of resources to satisfy the obligation (for example a cash payment), and the amount can be reliably estimated.
9. The IAS Framework states that (paragraph 64):
'Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates....Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.'
10. For discussion purposes it might be helpful to note that a distinction is sometimes made between an 'accrual' and a 'provision'. It is the making of accruals to match revenues and costs which distinguishes accruals accounting from cash accounting. An accrual would generally be more certain than a provision in both timing and amount. It would be, for example, for goods or services that have already been received such as electricity used by a factory which has not yet been invoiced. However, recognising a liability such as for future warranty work on goods sold is subject to a degree of estimation and hence the provision could be considered to be less certain. In accounting a third term is also sometimes referred to: that of contingent liability.
11. A contingent liability is at the other extreme from an accrual – it is less certain than a provision. It is a possible obligation that is not yet confirmed, and the company itself does not control whether and/or when it will be confirmed; or the amount cannot be measured with sufficient reliability. For example, a company may be the subject of a legal claim for damages against it but the possibility of the company losing the case is remote. The potential obligation is so uncertain that it should not be recognised in the accounts by the company, but for accounting certain disclosures may be required in the notes to the accounts. A provision could therefore be described as being somewhere 'between' an accrual and a contingent liability. For tax purposes it is unlikely that tax relief would ever be available for a

contingent liability. However, it is by no means certain that tax relief will always be available for provisions whereas it would normally be available for accruals.

12. As is the case in a number of the IAS, a significant degree of judgement is left to the company itself to determine how the principles as laid down in the accounting standard should be applied. For example as concerns the measurement of the provision 'the estimates of outcome and financial effect are determined by the judgement of the management of the enterprise' (para 38 IAS 37), and where a large number of individual transactions are concerned there is scope for probability theory to be applied in calculating the amount of the provision. Similarly there is scope for the discounting of the amount to take into account the time value of money.

III Provisions - links between tax and accounts

13. Within IAS 37 there is therefore a great deal of useful guidance as to how and when a provision should be created in the accounts. There is a general requirement for financial accounts to be accurate, but provisions and reserves are areas where there is inevitably an element of judgement required (see paragraph 8 *above* 'a provision is essentially a liability that is uncertain in timing or in amount'). In addition, the underlying purposes of the financial accounts are not necessarily the same as those of the 'tax accounts' (the set of rules for calculating the taxable base) which may lead to this judgement being exercised in different ways. There are clearly some commonalities – such as the aim to match income with expenses – but in the financial accounts there is potentially a greater emphasis on ensuring that profits are not overstated, which perhaps contrasts with a tax administration's emphasis on ensuring that profits are not understated.
14. In many Member States (MS) this potential distinction between the different emphases in financial accounts and tax accounts is less of an issue because of the linkages between accounts and tax – the accounting/tax dependency, or reverse dependency depending on whether the tax rules follow the accounting rules or the accounting rules follow the tax rules. In both cases the national accounting rules and the national tax rules are closely aligned and national tax policy as regards provisions can be reflected in the national accounting rules (or vice versa). However, because IAS are international and are essentially 'principles based', companies are required to exercise their judgement and some of the definitions and rules are less detailed than they may be in national accounting legislation or standards.
15. As with many of the structural elements of the tax base it follows therefore that the IAS definitions of provisions may not be sufficiently detailed to serve as a set of tax definitions of provisions for the CCCTB WG. However, clearly they can provide a framework for discussion. For some MS, who currently have close links between accounting and tax, work on the more detailed definitions of provisions may prove problematic as they have to consider the wider implications for their

accounting rules and legislation. Work on reserves and provisions will therefore be influenced by national considerations related to national accounting standards and legislation, but as this is true for many of the structural elements of the tax base it is suggested that the whole issue of tax and accounting dependency be dealt with as a separate issue.

- *Can Members agree that although tax and accounting links will influence work on reserves and provisions this issue should be dealt with separately?*

IV Reserves and IAS

16. IAS has less to say explicitly on the subject of reserves than on provisions. Reserves are defined as a part of equity which is defined as a residual (defined as assets less liabilities). The IAS Framework (paragraph 66) does however note that:
'The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effect of losses. Other reserves may be established if national tax law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made....Transfers to such reserves are appropriations of retained earnings rather than expenses.'
17. Whereas provisions are essentially charges against the operating profits of a company – ie they are included in the profit and loss account as 'expenses' to be recognised which need to be taken into account when calculating the profit for the period – reserves are rather different. Reserves may be created either as a result of a legal requirement or on the basis of professional judgement. Reserves are more generally appropriations of retained earnings rather than expenses, created for example to protect creditors by reducing the amount of profits that may be distributed to shareholders.
18. Despite the fact that their purpose may be to maintain capital rather than to reflect the profitability of a company over a given period they may be tax deductible in certain circumstances in some MS. Indeed when a company is legally required to make a transfer from profits into a reserve there is a strong case that this should be tax deductible because it reduces the amount of profits which a company may distribute. Although the transfer of profits into a tax-free reserve may be considered to be a tax incentive it is suggested that these should be considered initially as part of the work on reserves and provisions, rather than separately when the general issue of 'tax incentives' is discussed. An example of such a tax free reserve would be the 'periodisation reserve' in Sweden where literature suggests that up to 25% of a company's taxable income can be temporarily transferred to a separate reserve thereby avoiding taxation until reversal within a maximum period of six years.

- *Can Members agree that reserves should be considered together with provisions, or do they wish to postpone discussion until later when 'tax incentives' in general are discussed?*

19. IAS are increasingly moving towards 'fair value' accounting which necessarily requires the creation of revaluation reserves. Typically when an asset is re-valued upwards to its market value the increase in value is credited to a revaluation reserve and this reserve is then used to charge any additional depreciation on the re-valued amount. It is also used to reflect any subsequent downward revaluations to the extent that the balance is sufficient. It is suggested that the tax treatment of such re-valuation reserves (transfers to and from as values increase or decrease) should be considered in relation to the underlying asset. The main issue is whether companies should be taxed on unrealised gains and therefore it is more appropriate to discuss this type of reserve when the tax treatment of the asset is dealt with.

- *Can Members agree that the tax treatment of revaluation reserves should be discussed when the treatment of the underlying asset is discussed (capital gains), or do they wish to discuss it together with reserves and provisions?*

V Tax Categories of provisions and reserves

Sector

20. Although the tax treatment of provisions and reserves follows general principles it is generally accepted that certain industry sectors require different detailed rules. This applies mainly to the financial sector, including banking, insurance and credit institutions. Although there is no reason why the CCCTB should not cover these sectors they do represent a 'special case' and it is suggested that any specific provision and reserve policies be considered separately from the more general policies.

- *Do Members agree that first, a general policy for provisions, reserves and liabilities applicable to all companies should be considered and only after work on this has progressed should second, work on possible sector specific policies commence?*

National requirements

21. Some provisions and reserves are created within specific MS as a response to national legislation and practice. The CCCTB will therefore have to reconcile these different practices in order to provide an acceptable common treatment. The treatment of provisions related to employee costs is a good example of this. In addition to the 'basic' provisions related to for example 'holiday' pay (which might be considered more as an accrual than a provision in any case) Member States currently have a range of different rules for provisions which relate to national requirements.

22. For example, in some MS a company has a requirement to make certain payments to an employee should the employee be made redundant. As these payments are a legal requirement, reserves established to satisfy them are generally tax-deductible. Similarly, national rules concerning pension provisions vary according to how pensions are provided within individual Member States. For those MS where the company has a requirement to provide pensions, the company may be permitted to create tax-deductible reserves, whilst retaining the cash. Other MS permit deductions for pension commitments only when the company makes a payment into a separate pension fund. Other MS may have legislation concerning profit sharing by employees and provisions created to satisfy these obligations are tax deductible.
23. It is clearly important to establish the principle relating to particular provisions and reserves, for example where a company is required by national legislation to create a particular type of pension reserve for its employees it will generally be tax deductible. However, many areas of companies' activities are subject to different national rules and there could be a range of different tax effects across the EU. The introduction of a CCCTB does not require a complete harmonisation of such non-fiscal based practices and legal requirements. However, as the aim is to establish a common consolidated tax base MS will need to have a reasonably detailed understanding of any such material national requirements if they are automatically tax deductible since they will reduce the CCCTB.
- *Do Members agree that as a broad principle, legally required provisions and transfers to reserves should be automatically tax deductible?*
 - *If yes, do they agree that each MS will need a reasonably detailed understanding of current national requirements?*
 - *If no, how do Members think this should be approached?*
 - *Are Members aware of any such required provisions or reserves other than those relating to pensions and employees which are material³?*
24. In addition to the category of legally required provisions or reserves there is the broader category of 'discretion' or 'judgement' based provisions or reserves. As outlined above in many cases these derive from the application of national accounting principles and are therefore 'required' in the sense that to produce accurate accounts they are necessary but they may not be so strictly defined as the legally required provisions.
25. In general MS may be already applying relatively similar principles as regards provisions and reserves but the effect of these may be different, due to differences in national traditions or to the existence of additional specific definitions either in tax legislation, tax circulars, statements of practice, or decided court cases etc depending on the respective legal systems of MS. The rules for a CCCTB will need to define not only the principles to be applied for tax-deductible provisions and reserves but also consider how to ensure that these are applied in a common

³ For example compulsory transfers to legal reserves which cannot be distributed to shareholders.

manner by different MS. The existing situation in the different MS reveals the wide range of detailed responses to applying some similar basic principles.

- *Do Members agree that both agreed broad principles for tax deductibility of provisions and reserves and more detailed rules will be required, or do Members believe that agreed broad principles would be sufficient?*

VI Some examples of commonly recognised provision categories that are the subject of different treatments across the EU

Debts/Receivables

26. In most, if not all MS, there are rules to permit a tax deduction for unpaid trade debts. However, beyond this general principle there are many different ways of implementing this policy. For example a provision may only be deducted if legal proceedings against the debtor have been commenced or concluded; or only those debts specifically identified as doubtful may be provided for; or a certain percentage of total debt may be provided; or a calculation may be required based on previous experience, or based on industry average etc. MS will need to either agree on common rules or evaluate the extent to which such variations could continue in a CCCTB.

Repairs and Maintenance

27. The deductibility of provisions for Repairs and Maintenance (R&M) varies widely. The issue of distinguishing between R&M and capital expenditure is being considered as part of the work on Depreciation and Fixed Assets. The question here is when such ‘expenditure’ can be recognised before it is actually incurred. Some MS are ‘stricter’ than others in this area, some have different rules depending on the life of the asset involved. For example regular planned maintenance on large capital long life assets such as ships and aircrafts may be permitted on the basis that if there is a regular formal plan for periodic maintenance every, for example five years, it is prudent to provide for a part of this expense each year.

Product Guarantees and Warranties

28. Although many MS recognise that it is appropriate for companies to allocate the expected costs of future guarantee and warranty expenses to the period when the sale is made there are many different ways of calculating the permissible amounts.

Asset Replacement Reserves

29. Several MS permit the establishment of tax-deductible reserves for the future replacement of fixed assets. However, other MS specifically disallow any such provisions. The specific treatment of such reserves is often linked to the tax treatment of the sale of fixed assets. For example if the profits on a sale of a fixed asset are treated as part of the company’s taxable base then the company may be permitted to create a ‘temporary’ tax-deductible ‘re-investment’ reserve to avoid

being taxed on the sale of the asset as the company is going to re-invest in a replacement asset. However, the same effect may be reached in another MS, who specifically does not permit tax-deductible reserves for replacement of fixed assets, by the quite different method of permitting any 'gain' on the sale to be 'rolled over' into the cost of the new asset (nb this issue is likely to be dealt with in more detail when capital gains are discussed).

VII Conclusions

30. Establishing the broad principles for defining tax-deductible reserves and provisions may be relatively straightforward as MS in general seem to have a reasonably similar approach in their existing tax systems. The IAS definitions are also a useful starting point. However, the application of these general principles currently differs widely across MS and a great deal of work will be needed in order to arrive at a single set of principles which can be applied in a common way, together with rules on how they should be applied in specific circumstances. Agreement will also have to be reached over how detailed the rules should be. In order to progress further the Commission Services suggest that this task should be progressed in a sub-group to enable more detailed work to be carried out by appropriate experts with a view to them reporting back to the Working Group on their progress towards defining a common set of principles and rules for reserves and provisions.

- *Do Members agree that work on this should be carried out in a new sub-group? If so, are any Members able to indicate now whether they would like to participate and/or chair the sub-group?*
- *Do Members wish to comment further on how the sub-group should address the issue?*
- *Do Members wish to add anything to this introductory paper?*