This is an in-depth study of Article 23 ‘Provisions’ in the tax base of the Proposal for a Council Directive on a Common Corporate Tax Base. It includes an analysis of and a comparison with IFRS and German, Dutch and United Kingdom tax law.

It deals with questions like whether the recognition of provisions is or should be mandatory, the role of obligations in the recognition of provisions (legal obligations, constructive obligations and probable future legal obligations) and measurement.

The systems and their approaches are discussed separately and compared with each other, including the history of each system, the main workings of their respective tax bases, the recognition and measurement of provisions and the practical application of the approaches towards provisions.

Both from a theoretical and a practical viewpoint, several shortcomings of Article 23 CCTB have been found. In this study, proposals for improvements have been made, taking into account the objectives of a modern tax base and the objectives of CCCTB specifically.
The concept of provisions in Article 23 CCTB

A critical analysis and comparison with IFRS, Germany, the Netherlands and the United Kingdom

P.C. de Heer
The concept of provisions in Article 23 CCTB
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A critical analysis and comparison with IFRS, Germany, the Netherlands and the United Kingdom

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List of abbreviations

AO Abgabenordnung
B Beslissingen in Belastingzaken
BEPS Base Erosion and Profit Shifting
BFH Bundesfinanzhof
BilMoG Bilanzrechtsmodernisierungsgesetz
BIM Business Income Manual
BStBl Bundessteuererblatt
CCCTB Common Consolidated Corporate Tax Base
CFC Controlled Foreign Company
CLC Civil Law Code
CTA Corporation Tax Act
EC European Commission
ECJ European Court of Justice
ECLI European Case Law Identifier
ECOFIN Economic and Financial Council
EEC European Economic Community
EU European Union
EStDV Einkommenssteuer-Durchführungsverordnung
EStG Einkommensteuergesetz
EStR Einkommensteuerrichtlinien
FRS Financial Reporting Standards
GAAP Generally Accepted Accounting Principles
HGB Handelsgesetzbuch
IAS International Accounting Standards
IASB International Accounting Standards Board
IASC International Accounting Standards Committee
ICAEW Institute of Chartered Accountants in England and Wales
IFRS International Financial Reporting Standards
ITA Income Tax Act
ITTOIA Income Tax (Trading and Other Income) Act
IWB Internationale Wirtschafts-Briefe
KStG Körperschaftsteuergesetz
NTFR Nederlands Tijdschrift voor Fiscaal Recht
NTFR-B Nederlands Tijdschrift voor Fiscaal Recht - Beschouwingen
OECD Organisation for Economic Co-operation and Development
OJ Official Journal of the European Union
PE Permanent Establishment
SME Small- and Mediumsized Entities
Stb. Staatsblad
TC Tax Court
TEU Treaty on the European Union
TFEU Treaty on the Functioning of the European Union
WFR Weekblad Fiscaal Recht
Preface

This is an in-depth study of Article 23 ‘Provisions’ in the tax base of the Proposal for a Council Directive on a Common Corporate Tax Base, part of CCCTB. It includes an analysis of and a comparison with IFRS and German, Dutch and United Kingdom tax law.

The systems and their approaches are discussed separately and compared with each other, including the history of each system, the main workings of their respective tax bases, the recognition and measurement of provisions and the practical application of the approaches towards provisions.

Both from a theoretical and a practical viewpoint, several shortcomings of Article 23 CCTB have been found. In this study, proposals for improvements have been made, taking into account the objectives of a modern tax base and CCCTB specifically.

Materials have been included up to 1 February 2017.
Acknowledgements

When I started writing about CCCTB virtually no one believed that a CCCTB Directive would stand a chance in the European Union, even leading some to believe that doing research which involves CCCTB is or was a waste of time. While it is still far from certain, the shift in mentality with regards to tax law which took place in the last five years meant that CCCTB is looked upon very differently and future application of CCCTB has even become a realistic possibility. While research is seldom a waste of time, these developments have given me even more sense of satisfaction.

Among the many rewards that writing a thesis brings, gratefulness is the asset that stands out. I owe many thanks to many people.

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Chapter 1 Introduction

1.1 Reason for the research

1.1.1 Provisions and the element of uncertainty in financial reporting

In the financial reporting of enterprises, provisions are often important entries, both in quantity and in quality. A lot of the questions regarding provisions can basically be compared to a weather forecast, which also concerns an uncertain future event, which arises from the present and for which one should be prepared. When the forecast is that there is a 60% chance of rain the following day, one can ask similar questions as when determining whether or not a provision should be recognised. When rain is forecasted, users of that information can determine what to do: stay inside or go outside; when going outside, picking another route, pack a raincoat or just accept that one can get wet.

Is there a 60% chance of rain and a 40% chance of no rain? Meaning it will be either one or the other?

This relates to future events that either occur or do not occur. It is a question of recognition. The striking thing is that when the likelihood of occurrence is 49%, no provision is recognised, but generally one would deem the chances of rain big enough to still pack a raincoat and would still want to know whether a light shower or a big thunderstorm is expected.

Or does it mean that it is expected that it will rain 60% of the time and will be dry the other 40%?

This means that the event, the rain, will occur and thus will have to be recognised. What remains is a question of measurement (a light shower or a big thunderstorm).

When it rains, will it rain with light, average or high intensity? If yes, what are the odds for each possibility?

This too is a matter of measurement.

When the forecast is made, this is basically a statistical expectancy, but when a grey cloud is moving towards you, it is a different type of expectancy

This is a question of when to recognise a provision: the forecast is based on large numbers and statistics (when such and such clouds and such and such wind combine, there is a x % chance of rain in this and that area at a certain moment in time). This means that the estimate can be made quite early on. When one is
already outside and sees a grey cloud moving towards him, this is a relatively late moment of recognition and based on the individual and actual information.

Provisions have an effect on both the balance sheet and the profit and loss account. In the determination of taxable income, provisions have an equally important role.

For example, when an enterprise has delivered a faulty product which created damage for the buyer and the enterprise expects that the damages will need to be paid and be €100,000, a liability of €100,000 is entered on the balance sheet of the year in which the requirements for a provision are met and cost of €100,000 is deducted from the profit. The outflow itself will take place after the end of the reporting period. Whether or not the €100,000 is tax deductible is an equally important question.

For over a century it has been debated in accounting literature what exactly constitutes a provision and when it shall or can be recognised.¹ This debate has not reached a final conclusion or full consensus. Generally speaking, provisions imply that a certain future outflow of resources is expected, the cause of which lies in the past. This means that the past performance of the enterprise is affected, the value of the enterprise is decreased by this event and that the enterprise must take responsibility for the fact that the future outflow is expected to take place and inform its users of this. This leads to the entry on the balance sheet and the cost as mentioned in the example above. The following cases are viewed as examples of situations that can give rise to the recognition of a provision, whether or not rightfully so:²

- Warranties;
- Expected outflow for clean-up of contamination;
- Expected onerous work-in-progress;
- Expected maintenance and repair of assets;
- Expected court-cases (claims);
- Restructurings;
- Expected future pensions.

These examples all have in common that an uncertain future outflow of resources is expected and the cause of this future outflow lies in the past. Therefore the company performance of that particular year in the past is affected

in a negative way and users of the financial information must be informed of this. A second category of cases that are viewed as leading to the recognition of a provision are the so-called deferrals. When an enterprise is confronted with third party actions that lead to higher future costs and the enterprise is reimbursed for these costs beforehand by a lump sum, it can be argued that this reimbursement should not be viewed as revenue when it is received, but should be attributed to the same period as the expenses it aims to cover (otherwise a profit would occur in the year that the reimbursement is received, while the character of a reimbursement for expenses actually prevents it from being a ‘profit’). Though still dependent on uncertain future events, it revolves around the deferral of an inflow and not a future expense.

For example, an enterprise uses the natural flow of a river to generate its electricity. A neighbouring enterprise builds a dam in the river, which means that the enterprise can no longer generate electricity. The enterprise expects that the present value of the increased electricity bill over its lifetime is € 100,000. The neighbouring enterprise pays € 100,000 to the enterprise to cover these costs. The question is whether the expected future outflows should be directly deductible when recognising the inflow as income.

The provisions recognised in the financial reporting of an enterprise provide information to users of the financial report. Differentiation must be made between several categories of users of the financial report. Each category of users will have its own information-needs and –desires. Investors and potential investors have different information-needs than governments in their role as tax collector. The latter will be primarily interested in the amount of taxable income whereas the former will have various other interests. What all these users of the financial reporting will have in common is that they want to be informed about situations that have led to expected future outflows and what the amounts of these future outflows are expected to be.

The concept of income in taxation is not always equal to the concept of income in national or international financial reporting. Various degrees of congruence exist, from two (virtually) standalone concepts to virtually identical concepts.

In the European Union, the recognition of provisions has a notable influence on the tax base as such, both for large companies and the small- and medium sized entities, along with for example depreciation.

1.1.2 Common Consolidated Corporate Tax Base


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consisting of a harmonized stand-alone tax base for the determination of the (consolidated) taxable income of multinational enterprises.\textsuperscript{4} Harmonization of taxes within the European Union has been on the agenda of the European Commission for a long time. Examples of such harmonization include the harmonization of indirect taxes via the Sixth VAT Council Directive.\textsuperscript{5} Harmonization of direct taxes has proven a much more difficult task than the harmonization of indirect taxes, even though the presumed positive effects of such a harmonization have been acknowledged since the early 60’s of the last century.\textsuperscript{6} The European Commission developed several proposals for a directive on the harmonization of direct taxes, in 1975, 1985 and 1988, all of which were either withdrawn or never tabled at all.\textsuperscript{7} The reason for this lack of progress is likely that Member States fear the loss of their tax sovereignty and therefore the loss of control over their tax revenues. Nevertheless, in 1992, the Ruding report, named after the chairman of the committee, was issued.\textsuperscript{8} One of the main conclusions of the Ruding report was the need for harmonization of the corporate tax base. While full harmonization of the tax base remained politically unattainable, several important aspects of direct taxation have been harmonised after the Ruding report, of which the Merger Directive\textsuperscript{9} and the Parent Subsidiary Directive\textsuperscript{10} are the most well-known. Full harmonization of direct taxes remains one of the biggest challenges of company taxation in the European Union. Of these challenges, the 2001 Bolkestein report concluded that a common consolidated tax base would be an answer to the challenges of company taxation in the European Union.\textsuperscript{11} In the following years, the plans for a common tax base were developed further. The European Commission issued a

\begin{itemize}
\item \textsuperscript{4} Commission document 121 of 2011, final version. I will refer to this proposal as either ‘CCCTB’ or ‘CCCTB-Directive’. Over the course of the years several additions and alterations have been made in the form of compromise proposals. I refer to paragraph 2.3 for an overview.
\item \textsuperscript{6} See Rapport du Comité Fiscal et Financier, 1 February 1962, generally known as the ‘Neumark Report’.
\item \textsuperscript{7} For an overview see http://ec.europa.eu/taxation_customs/taxation/company_tax/gen_overview/
\item \textsuperscript{9} Council Directive (EC) 90/434 of the European Commission of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (OJEC 1990, L 225/1).
\item \textsuperscript{10} Council Directive (EC) 90/435 of the European Commission of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJEC 1990, L 225/6).
\end{itemize}
non-paper on a common tax base, which was discussed at the informal ECOFIN-meeting in September 2004. The result of this was the formation of a Working Group on CCCTB by the European Commission, that laid the foundation for the development of a (proposal for a) directive on a CCCTB. In order to tackle the diversity of issues, the Working Group set up several subgroups. The work of the Working Group laid the basis for the proposal for a council directive on CCCTB. The aim of this proposal is primarily to harmonise the corporate tax base and thus solve a number of direct tax related issues. For this study, the most relevant aspect is harmonization of the corporate tax base. The proposal was not met with unanimous enthusiasm. It barely survived the national parliaments warning-mechanism of the European Union. After 38 amendments, the European Parliament adopted a resolution on the proposal that supports the application of CCCTB, even up to the point of mandatory application in the future. Such consultation of the European Parliament was not mandatory, as the proposal is based on Article 115 TFEU. The fact that the European Parliament was consulted nonetheless shows the political sensibility and importance of the issue. For a number of years, there has been a stand-still where the adoption of the directive was concerned. Five years after the initial introduction of the CCCTB-Directive, a re-launch of CCCTB took place. The idea is to implement CCCTB in two steps: first the common tax base and afterwards the consolidation. I will refer to the former as the common corporate tax base of CCCTB. Among various Member States a large amount of hesitation to adopt the proposal was present when the CCCTB-Directive was proposed in 2011. This has not changed with the 2016 re-launch. One of the main concerns was and is the issue of subsidiarity: does it really concern an issue that needs to be solved at the level of the European Union?

12 [http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/]
14 Explanatory Memorandum to Commission document 121 of 2011, final version.
15 Under Article 5, Paragraph 3 and Article 12, Paragraph b TEU, national parliaments monitor compliance with the principle of subsidiarity in accordance with the procedure set out in Protocol No 2. Under this procedure, any national Parliament or any chamber of a national Parliament has eight weeks from the date of forwarding of a draft legislative act to send to the Presidents of the European Parliament, the Council and the Commission a reasoned opinion stating why it considers that the draft in question does not comply with the principle of subsidiarity. If ‘negative’ reasoned opinions represent at least one-third (one vote per chamber for a bicameral Parliamentary system and two votes for a unicameral system) of the votes allocated to the national parliaments, the draft must be reviewed (‘yellow card’). See [http://www.europarl.europa.eu/ftu/pdf/en/FTU_1.2.2.pdf]
18 Commission document 685 of 2016, final version.
20 Commission document 373 of 2012, final version.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

This leads to the question of relevance. Of what use is CCTB or CCCTB when actual application in the near future is still uncertain? To my mind, the relevance of CCCTB as a whole and in its current form stems from the following. First of all, the harmonization of direct taxes has been on the European agenda for over sixty years and this is simply too long to expect that the issue will disappear. The fact that the European Commission re-launched the CCCTB-Directive serves as proof for this continuing relevance. The underlying issues giving rise to CCCTB are still relevant. No good alternatives to CCCTB seem to be under discussion either. This would mean that either the current proposal will be adopted in the future, most likely after a trial-period, or a new tax proposal for a harmonised corporate tax base will be written at one point. It seems unlikely that in the latter case it would be possible to ignore the current proposal, with the amount of work that has been put into it. Also, the fact that the 2016 tax base changed only slightly from the 2011 tax base suggests that there is a strong belief on the side of the European Commission that the tax base is fit for its purpose as a harmonised tax base in the European Union. Because of the fact that the changes in the 2016 proposal were limited, I will primarily refer to the 2016 proposal in this research, but will mention when there are significant differences when compared to the 2011 proposal. Under the influence of the OECD Action Plans against Base Erosion and Profit Shifting (BEPS), CCCTB has gathered a new momentum, as CCCTB is thought to be beneficial and effective in fighting base erosion and profit shifting. The European Commission seems to be set on implementing a mandatory common corporate tax base (CCTB), whereby the aspect of consolidation (the third C in CCCTB) is of secondary concern, as the latter implies the import of losses (consolidation means that both EU-profits and EU-losses are taken into account). This follows from the fact that the CCCTB-Directive is planned to be implemented in two steps, first the tax base and then consolidation. Because consolidation is one of the more politically sensitive issues of CCCTB (it can create situations where foreign losses need to be offset against taxable profits), it has been given lower priority (by implementing it at a later stage), as this makes it less likely that this issue would stand in the way of accepting a harmonized EU-wide common corporate tax base. As full CCCTB is still the objective if the EU, I will refer to the project as a whole as CCCTB and not as CCTB.

Secondly, when no CC(C)TB is adopted in the near future and Member States alter parts of their tax base in the future, there is always the question whether such new components constitute harmful tax competition in any way. The current proposals can serve as a basis for comparison, in which respect the proposed tax base of

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21 This does not mean that alternatives do not exist. The concept of Home State Taxation has been discussed as an alternative to CCCTB, but currently does not seem to be discussed anymore. See http://ec.europa.eu/taxation_customs/taxation/company_tax/home_state_taxation/index_en.htm

22 Commission document 610 of 2015, final version.

CCCTB can be considered a ‘safe haven’ from the viewpoint of combating harmful tax competition on the tax base. A third argument is that when adoption of the actual Directive would fail, an enhanced cooperation agreement between a minimum of eight Member States with regards to CCCTB is still possible and would be likely in case that full adoption of CCCTB fails. In every scenario, the current tax base in the proposal remains relevant. Therefore research and improvement of the tax base remains relevant as well.

1.1.3 Necessity for adequate treatment of provisions in the tax base of CCCTB

When provisions form part of the tax base, they represent an important factor in determining the actual cash outflow.

For example, when the enterprise makes a € 1.000.000 profit at a 25% corporate tax rate, the question whether or not to deduct the recognition of a € 100.000 provision makes a large difference in the cash flow of the enterprise (25% x € 100.000 = € 25.000).

When there is consensus that the recognition of a provision should be tax deductible (which is the case in CCCTB), this raises the question what exactly constitutes a provision.

Although harmonization of CCCTB with the International Financial Reporting Standards (IFRS) or any other set of standards for financial reporting would be beneficial from the perspective of diminishing compliance costs, when the majority of the enterprises also uses that set of standards (the less difference between general financial reporting and the corporate income tax return, the less costly it will be to prepare the corporate income tax return), such harmonisation is not an objective of CCCTB. No formal link between CCCTB and existing accounting standards exists (although IFRS has been used as a starting point) which makes CCCTB formally independent from any national or international generally accepted accounting standards. This in itself already makes CCCTB interesting, because not having a link between taxable income and general purpose financial reporting is rare in existing national systems of taxation. The reason for this is in itself understandable, as a formal connection to, for example, IFRS can lead to unwanted political pressure on a standard-setter, such as the International Accounting Standards Board (IASB), which has no democratic legitimacy itself. It would also mean that this standard-setter will

26 Although there are good arguments against this reasoning, see W. Schön, ‘International Accounting Standards - A "Starting Point" for a Common European Tax Base?’, European Taxation, 2004, vol. 44, p. 426-440. Even though I agree with the formal aspects of Schön’s arguments (such as that democratic legitimacy is guaranteed by how IFRS are adopted in the European Union), I still fear that arguments of taxation will slip into the discussions at the IASB. Also because of the fact that actual carve-outs from
have to take tax consequences into account when designing a new standard or an alteration of a standard, for which it is not equipped. The danger of a standalone approach is that it is not tested in practice and therefore inconsistencies and ambiguities can exist. Another danger is that a tax base that is agreed upon between 28 Member States becomes a political issue of “give and take” making the tax base effectively an average of the national systems, which may lead to imbalances and more inconsistencies. Furthermore, the current proposal for a CCCTB is not accompanied by guidance in the way that, for example, IFRS is\(^27\) and offers no principles of determination of taxable income to fall back on.\(^28\) This means that differences in application of the text of the Directive can exist between Member States.\(^29\) As CCCTB will be a Directive and not a Regulation, Member States will need to draw up their own national laws in which the CCCTB is included. Differences in application form an unwanted effect, as it can distort competition within the European Union. When one Member State is more lenient in the application of the Directive than the other, it would make sense for an enterprise to base its economic decisions on this tax-driven fact instead of other factors, therefore distorting the internal market. Formally, the European Court of Justice will oversee uniform implementation and application of CCCTB, but it can only act when parties go to court and the national court asks for a preliminary ruling.\(^30\) Not all of those cases will be brought before the national courts and it will take decades before a substantial amount of cases will have been brought before the court and the interpretations have been decided upon. The reason for this study to concentrate on provisions is twofold. First of all, provisions play a large role in the determination of the taxable income.\(^31\) Provisions in themselves lead to deferral of tax and thus whether or not being able to recognize a provision can lead to large timing differences. Timing differences in taxation are still highly relevant for both tax payers as well as

\(^{27}\) Such as the Conceptual Framework and the accompanying documents to IFRS, which provide a lot of explanation on how to apply the standards.

\(^{28}\) Article 9 CCCTB of the 2011 proposal (Article 6 CCCTB of the 2016 Proposal) is called General Principles, but they are not designed as principles on which a taxpayer or tax authority can fall back on when the application of one of the rules leads to unreasonable effects. It was also apparent in the later compromise proposals that Article 9, Paragraph 1 CCCTB 2011 will be deleted, although this did not take place in the 2016 proposal.

\(^{29}\) This, to my mind, has been proven by the large amount of case-law that exists on the Sixth VAT Directive. Council Directive (EC) 77/388 of the European Commission of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment \((OJEC 1977, L 145/1)\).

\(^{30}\) In this respect difference must be made between preliminary rulings and infringement cases. Application and interpretation of the CCCTB-directive by the different Member States will generally lead to the obligation for national courts to ask the European Court of Justice for a preliminary ruling. The European Commission may launch an infringement case against a Member State if it has not implemented the CCCTB-Directive correctly.

governments. Since provisions can have a large influence on the amount of taxable income, the timing difference is an important issue in determination of taxable income and therefore on the cash-flow of the enterprise. IAS 37\(^{32}\) is the IFRS-standard on provisions, contingent liabilities and contingent assets and as such is the most widely accepted standard on provisions, not only in the European Union, but also internationally. While clear influences of IAS 37 can be found in Article 23 CCTB 2016,\(^{33}\) large differences do exist between IAS 37 and the common corporate tax base of CCCTB, such as the non-recognition of constructive obligations in Article 23 CCTB 2016 and the differences in the definition of a provision. Not all of the differences are accounted for and motivated in the public documents (such as the so called ‘Working Papers’). Deviation from either IFRS or national generally accepted accounting practices (GAAP) will always increase the administrative burden for a tax payer, simply because it will be more work to do the Corporate Tax Return. Since one of the primary arguments in favour of CCCTB is diminishing the administrative burden, this is an aspect that always needs to be taken into account. Article 23 CCTB 2016 is the part of the tax base of CCCTB that deals with provisions. In particular, this study addresses the question whether Article 23 CCTB 2016 is in line with the objectives of CCCTB and in line with what can or must be expected from a modern tax base. These objectives are set out in Chapter 2. This raises the question whether it is necessary to alter the current proposal for a CCCTB-Directive with regards to provisions or to add supplementary EU-legislation. Apart from the direct financial effect of deducting costs when recognising a provision, there are specific issues in Article 23 CCTB 2016 “Provisions” that are likely to prove unclear in tax practice. The following issues occur and are researched in this study. In Chapter 6 these will be answered.

1. The literal text of Article 23 CCTB 2016 suggests optional recognition (‘shall be deductible’) whereas further analysis leads me to believe that recognition is mandatory.
2. The words ‘probable’ and ‘expected’ are both used in Article 23 CCTB 2016; do they refer to the same amount of probability? Is this comparable to the words ‘more likely than not’ i.e. over 50% as used in IAS 37?
3. The concept that large groups of items can statistically lead to a likely outflow (when they would not on an individual level) is implicitly accepted in IAS 37 as an obligation. Article 23 CCTB 2016 does not make reference to this, whereas it does mention the concept of an obligation. If such groups of items can lead to the presence of an obligation, it also leads to questions how to measure these obligations.
4. What kind of situation does the ‘probable future legal obligation’ aim to solve? How does it compare to IAS 37: as an addition or a clarification? How

\(^{32}\) International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*. I will refer to the 2016 edition in this research.

\(^{33}\) I will refer to Commission document 685 of 2016, final version as ‘CCTB’ as it contains the common corporate tax base but not the consolidation. As stated, I will refer to the project as a whole as CCCTB.
The concept of provisions in Article 23 CCTB
does it relate to court cases, warranties, repairs and maintenance, provisions that build up over the course of the years?
5. Not allowing the recognition of a provision for constructive obligations may lead to less decrease of administrative burden and subjectivity than might be thought. When compared to IFRS, it rules out most restructuring-provisions, which are common and serve a purpose.
6. Article 23 CCTB 2016 does not mention whether the integral cost must be taken into account when a provision is measured.
7. The recognition of provisions for onerous contracts (recognition or not, can they be split in an onerous and a non-onerous part) is not mentioned in Article 23 CCTB 2016.
8. Article 23 CCTB 2016, like IAS 37, approaches measurement of provisions as the settlement value at the end of the year, which is IFRS's liabilities' version of fair value. This value is generally not equal to the actual expected outflow (as settlement value based on full information would take into account chances of win or lose, whereas the actual expected outflow in individual cases that either occur or not will always be 100% of the amount), as settlement at the end of the reporting period is mostly not realistic.
9. Article 23, Paragraph 2 CCTB 2016 specifically gives rules concerning the measurement of the present legal obligation, whereas it does not mention the probable future legal obligation.
10. Article 23, Paragraph 2 under (d) CCTB 2016 states that future benefits directly linked to the event giving rise to the provision shall be taken into account; however, this leads to a tension between Article 23 CCTB 2016 and Articles 6, 15 and 16 CCTB 2016 (in the sense that realization has not yet taken place). Furthermore, it is not clear what is meant by 'shall be taken into account'; do they diminish the provision or are the benefits to be taken into account as such (therefore unrealized)?
11. Article 23, Paragraph 2 CCTB 2016 requires the use of present value in longer term situations. However, settlement value would already take this into account. Paragraph 2 can therefore be understood as clarification or guidance of Paragraph 1 or as a mistake.
12. Article 23, Paragraph 1 CCTB 2016 uses the words 'activities or transactions' (implying active) instead of the slightly more common wording 'facts or circumstances' (implying passive). The question is whether this leads to differences in application.
13. Maintenance and repairs are dealt with as a provision in certain systems (such as the Dutch tax base) and via the component approach in others (such as IFRS). CCTB does not specifically address the issue at all.
14. Article 23, Paragraph 2 under (d) CCTB 2016 might be an exception to Article 16 CCTB 2016, whereas Article 23 CCTB 2016 only defines itself to be an exception to Article 17 CCTB 2016. The same question applies to Article 22 CCTB 2016.
15. Is Article 23 CCTB 2016 to be viewed as an exception to Article 22, Paragraph 3 CCTB 2016? How should Article 23 CCTB 2016 be applied to long-term contracts?
16. A reimbursement for future higher costs would be taken fully as profit under CCTB. Since the reimbursement and the higher costs are not attributed as a combination (although economically they are linked) and the future higher costs are not present obligations, this would lead to taxing the full reimbursement ahead of the deduction of the costs (apart from the 'probable future legal obligation' which I think is unlikely).

17. What is the purpose of Article 23, Paragraph 2 under (a) CCTB 2016 concerning the prevention of excessive provisions? It would already naturally follow from the fact that Article 23, Paragraph 2 first sentence CCTB 2016 requires that the expected expenditure required to settle the present legal obligation at the end of the tax year is to be taken into account.

18. IAS 37 implies that there is a differentiation to be made between the obligation (requirement: a reasonable estimate can be made) and the measurement of the outflow itself. Article 23 CCTB 2016 does not make this distinction.

The proposal itself leaves all these questions unanswered, which makes it unlikely that, with Member States coming from different cultural and legal backgrounds, CCCTB or CCTB would be implemented and applied uniformly by all Member States from the start. With a number of Member States currently not allowing the recognition of provisions for the determination of the tax base, while other Member States do, the risk of differences in implementation and application by the different Member States is likely to be high. Since harmonization and therefore uniformity is one of the most important issues for CCCTB, this is a highly undesirable effect. Differences in application can lead to distortions of the internal market.

Even though the European Court of Justice oversees the uniform implementation and application of the Directive, it will take a lot of time before enough preliminary rulings are at hand to answer all the questions raised above (on the condition that preliminary rulings are asked for in the first place). Interpretation of law is inherent to every legislative process, but the number of inconsistencies and ambiguities in Article 23 CCTB 2016 seems higher than necessary and as such can and needs to be resolved beforehand as much as possible. Whether or not the implementation of CCCTB will lead to infringement cases with respect to such application remains to be seen, but it is not impossible. Therefore, I start this study under the assumption that a clear and comprehensive concept of provisions in CCCTB is necessary within the functioning of the internal market and is currently not provided by Article 23 CCTB 2016. It is not my intention to provide an overall, internationally applicable, comprehensive concept of provisions that can replace all other current forms or existing definitions or approaches. It is my intention to provide targeted improvements of the current wording of the CCTB-Directive, from which future developments of CCCTB or tax bases in the European Union can draw inspiration.

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35 Explanatory Memorandum to Commission document 121 of 2011, final version.
Being primarily aimed at improving the wording of the CCTB-Directive with regards to provisions, this means that mainly multinational enterprises doing business in the European Union will benefit from such improvement. The word ‘multinational’ should not be interpreted as either ‘listed’ or ‘very large’. Research done by the European Commission has shown that small and medium sized enterprises (SME’s) are expected to benefit from CCCTB even more than larger sized enterprises as compliance costs are disproportional, making the matter highly relevant for SME’s as well.36

1.2 Object of research

1.2.1 Definition of a provision

Currently, no universal definition of a ‘provision’ exists. This means that there is no fixed definition or set of requirements that can be implemented in Article 23 CCTB 2016 without further alteration. Provisions, like several entries on the balance sheet, can be approached either in a static37 or dynamic way.38 An example of a widely-used definition of a static provision can be found in IFRS.39 IAS 37 defines provisions as liabilities of uncertain timing or amount.40 Provisions are to be recognised under IFRS when

– an entity has a present obligation, either legal or constructive, as a result of a past event; 
– it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and 
– a reliable estimate can be made of the amount of the obligation.

A dynamic approach to provisions can be found in the definition of provisions in, for example, Dutch personal and corporate income tax law,41 which defines provisions as expected future expenses, that originate from facts or circumstances that occurred in the period prior to the date of the balance sheet, and that can be attributed to that period and of which a reasonable amount of

36 Explanatory Memorandum to Commission document 121 of 2011, final version.
37 A static approach towards the balance sheet indicates that the balance sheets’ primary goal is to show the value of assets and liabilities.
38 A dynamic approach towards the balance sheet indicates that the balance sheets’ primary goal is to determine profit. See E. Schmalenbach, Grundlagen dynamischer Bilanzlehre, Leipzig: G.A. Glöckner, 1925.
39 The definition used in United Kingdom Financial Reporting Standard 102 Section 21 Provisions and Contingencies is similar.
40 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.
41 Determination of taxable profit in the Netherlands is quite unique in that it is both an almost stand-alone tax base as well as based in an open norm (‘sound business practice’) and is largely derived from case law.
certainty exists that they will actually arise in the future. Both definitions have in common the expected future outflow of resources that originates from a past event.

1.2.2 Provisions in Article 23 CCTB 2016

The title of Article 23 CCTB 2016 is ‘Provisions’. It states that where
- at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation;
- arising from activities or transactions carried out in that, or previous tax years;
- any amount arising from that obligation which can be reliably estimated shall be deductible;
- provided that the eventual settlement of the amount is expected to result in a deductible expense.

Provisions for pensions were originally dealt with in Article 26 CCCTB 2011. In Article 24 CCTB 2016 an option has been created that Member States may provide for the deduction of pension provisions. Since provisions for pensions represent a very specific issue, they are not included in the scope of this study, as it would not be possible to deal with them in depth without putting too much focus on them.

1.2.3 Difference between general purpose financial accounting and accounting for tax purposes

The objective of general purpose financial reporting standards, such as IFRS, is to provide standards that lead to financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. IFRS has a tendency towards a static balance sheet. Though not necessary for general purpose financial reporting standards, static elements will generally be present. The objective of accounting for tax purposes is primarily to determine taxable income for direct taxes. This often leads to a more dynamic approach to the balance sheet. In provisions, this difference can show itself quite clearly. In a dynamic approach the main issue will be whether there has been an economic event that triggered an expected future outflow. In a static approach it is much more important whether there is an obligation present at the end of the reporting period. This means that the question that needs to be asked differs.

For example, in year 1 the use of a machine led to wear and tear. The enterprise expects that this wear and tear will cost € 100,000 to repair in year 2. As long as the machine is owned by the enterprise, this will not constitute an obligation.

The concept of provisions in Article 23 CCTB

In a dynamic approach this could well lead to a deduction (the expected future expense has its origin before the end of the reporting period and expected future outflow). In a static approach this will generally not lead to a deduction.

1.2.4 Accounting for tax purposes and tax accounting

There is a difference between determining the amount of taxable income on the basis of tax rules and tax accounting. The former is in itself irrelevant for general purpose financial reports, apart from the fact that it represents the taxes that are to be paid as part of liabilities. The second is a broader category which not only determines taxable income and taxes payable, but also the amount of tax that corresponds with profit in the general purpose financial report. It is therefore mostly part of general purpose financial reporting, although determination of taxable income will still be relevant in this, as this constitutes the actual debt that the entity has towards the tax authorities. Tax accounting deals with the accounting treatment for income taxes in the financial report. An example of this is found in IAS 12 Income Taxes. IAS 12 prescribes how to account for the current and future tax consequences of the future recovery of the carrying amount of assets and liabilities.

For example, when an enterprise makes a profit of € 1.000.000 but because of timing difference between the general purpose financial reporting and the corporate income tax return, the taxable income is € 800.000. If the tax rate is 25%, the actual tax debt will be € 200.000 (25% x € 800.000 taxable income) and the taxes in the general purpose financial reporting will be € 250.000 (25% x € 1.000.000). Accounting for tax purposes is the determination of the € 800.000 taxable income. Tax accounting includes both that and the determination of the taxes in the general purpose profit and loss account.

1.2.5 In a European context

On 16 March 2011 the European Commission’s proposal for a Council Directive for a CCCTB was published. CCCTB aims to solve a number of issues that occur specifically in a European context. These issues must be taken into account when analysing provisions as part of the tax base of CCCTB. Current developments are that in the wake of the OECD BEPS Action Plan, a CCCTB or CCTB would be highly beneficial in combating base erosion and profit shifting.

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44 The carrying amount is the amount at which an asset or liability is recognised in the statement of financial position.
within the European Union. This has provided the CCCTB-project with a new momentum. 47 25 October 2016 this has led to the re-launch of CCCTB 48

1.2.6 In the field of direct taxes

The proper functioning of the European Union Single Market is dependent on both the harmonization of indirect taxes and direct taxes, as these forms of harmonization remove unwanted barriers in the internal market. Since CCCTB only applies to corporate income taxes, 49 its scope is limited to direct taxes. Therefore, indirect taxes fall outside the scope of this study. Harmonization of indirect taxes within the European Union has been achieved to a large degree by the so-called Sixth VAT -Directive. 50 Improvements to the VAT-Directive have been made since and are expected to continue in the future. 51

1.2.7 Timing difference as a general consequence of provisions

For tax purposes, a characteristic of provisions is that provisions are a way of attributing expected deductible future expenses to the reporting year to which they relate. They defer income taxes and do not alter the total profit over the lifetime of the enterprise. They influence the timing of costs or losses. Deferral of taxes leads to a cash flow advantage for an enterprise, as tax paid in the future is less burdensome than tax paid now from a cash flow perspective. The reason to do so is different for tax purposes than for general purpose financial reporting. In general purpose financial reporting the recognition of a provision is a heads-up for (potential) investors and other users. With regards to tax, it puts the enterprise in a position where it can save liquidity for the eventual outflow, instead of providing a deduction afterwards.

For example, an enterprise makes an annual profit of a € 100,000 consistently. All cash needs to be put back into the company. A damage towards a third party has taken place before the end of the reporting period (year 1), which is expected to lead to an outflow of € 100,000 after the end of the reporting period (year 2). When no provision can be recognised, a tax outflow (at a tax percentage of 20%) of € 20,000 will have to take place for the profit in year 1,

49 Explanatory Memorandum to Commission document 121 of 2011, final version.
leaving the enterprise with a cash flow problem when it has to pay the damages. The fact that it can deduct the costs in year 2 will not solve the issue, as the damages will have to be paid much earlier. When the amount can be deducted in year 1, it will prevent the initial outflow of € 20.000, leaving the enterprise in a more less problematic position. The total profit over the lifetime of the enterprise remains unchanged. This issue relates to the ‘ability to pay taxes’.

This means that differences in application of Article 23 CCTB 2016 between competing enterprises in different Member States, such as when one is allowed to recognise a provision, whereas the other is not in an otherwise similar situation, lead to differences in the liquidity of these competing enterprises on a European level, putting one in an advantageous position compared to the other. This means that it makes a difference for a company where it is located from a tax perspective, thus creating an inefficiency (the choice of residency would not be purely driven by natural economic factors, but also influenced by the tax regime). Such inefficiencies can distort the internal market.

1.2.8 Research object: provisions in Article 23 CCTB 2016

The scopes of general purpose financial reporting and accounting for tax purposes are different. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other users in making decisions about providing resources to the entity. The objective of accounting for tax purposes is to determine taxable income in line with principles such as the ‘ability to pay taxes’ and the ‘least pain’. This means that differences between the two will, to some extent, be unavoidable. On the other hand, unnecessary differences between the two lead to an increase in the administrative burden of multinational enterprises using (C)CCTB for the determination of their taxable income. The combination of this is that, while some administrative burden is unavoidable, it must be kept to a minimum. The proper functioning of European internal market benefits from harmonization of direct taxes. The tax base itself (the rules on how to determine profit) is one of the most important aspects of direct taxes. Harmonization of direct taxes is only possible when rules are clear and concise and not subject to varying interpretation in the Member States. The tax base consists of what is considered part of the total profit (the question what income is taxable and which expenses are deductible) and of what is considered part of

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53 Both principles strive to levy tax on a moment when it is either possible (ability to pay taxes) or least uncomfortable (least pain). Therefore they can both relate to timing aspects. For the discussion whether or not the principle of ability to pay taxes can actually apply to entities, see Chapter 2, paragraph 2.4.3, Note 31.
54 For example, it can be relevant information to show unrealised income in general purpose financial reporting, where it will generally be unwanted to tax unrealised income, as there might not be an expected inflow of resources with which the tax can be paid.
the annual profit (given which income and expenses are part of the total profit, in which year they are taxable or deductible).

For example, the question whether the costs for the wife of a CEO accompanying him on a business trip are deductible from the taxable profit is a question that relates to total profit. Whether these costs are deductible when the booking is made or when the trip takes place, is a question of annual profit.

These issues of annual profit range from simpler aspects, such as deduction of costs in the year when the expense becomes due,\(^{55}\) to more complex timing issues.

In general, the attribution of expenses is more complex than the attribution of revenue. The provisions of Article 23 CCTB 2016 are among the more complex timing issues in the common corporate tax base.\(^{56}\) This means that differences in interpretation of Article 23 CCTB 2016 are more likely than in the interpretation of, for example, Article 16 CCTB 2016 on the accrual of revenues. Because of this importance, the issues that arise and the inherent complexity, I chose Article 23 CCTB 2016 as the object of this study.

1.2.9 Statement of the problem

Based on the aforementioned criteria, the topic of my study is defined as follows:

a) to determine how provisions are defined and applied in both CCCTB, IFRS and a selection of Member States;

b) to determine in how far CCCTB deviates from the other systems mentioned under a) and whether these deviations are necessary;

c) to determine which problems and inconsistencies exist with regards to the application of Article 23 CCTB 2016;

d) to formulate specific proposals for improvements or additions to Article 23 CCTB 2016.

The objective of this study is to identify problems and inconsistencies that follow from the application of Article 23 CCTB 2016, taking into account the interests of the Member States themselves and taxpayers in the Member States and to formulate proposals for improvements or additions.

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55 See Article 17 CCTB 2016.

56 In general, provisions are thought of as being among the softer and more subjective entries on the balance sheet, thus leaving room for window-dressing or earnings-management, which is undesirable in both general purpose financial reporting and accounting for tax purposes. See M.N. Hoogendoorn, *Voorzieningen in de jaarrekening*, ’s-Gravenhage: Delwel, 1997.
1.3 Method of research

1.3.1 Sources and methods

This study will include a comparison between the concept of a provision in IFRS, German, Dutch, United Kingdom tax legislation and CCCTB. I have selected IFRS for the reason that IFRS was used as a starting point to create the tax base of CCCTB, which means that it does not only serve as comparison, but is also a necessary step in gaining insight in the background of CCCTB. When compared to CCCTB it has a number of relevant characteristics. First of all, like CCCTB, it is also a supranational system and therefore not related to only one national system. Secondly, contrary to CCCTB, it has already been in widespread use for over ten years. Revisions of and additions to IFRS take place continuously, which means that it has been and will remain to be shaped by practical experience and discussion. IFRS, however, was never designed as a system for the determination of taxable income, which is its primary shortcoming as a tax base. Also, its focus on the balance sheet (most standards deal with balance sheet entries) means that the aspect of performance measurement is less developed. One of the main arguments against the use of IFRS as a tax base is the lack of democratic legitimacy of the party that creates IFRS, the International Accounting Standards Board. With regards to the applicable standards, since the application of IFRS 15 ‘Revenue from Contracts with Customers’ is not mandatory until 1 January 2018, I have not taken this standard, that will replace IAS 11 and IAS 18 into account. Furthermore, I have selected the national systems of three Member States of the European Union. From a research perspective, it would have been ideal to analyse the tax regimes all 28 Member States of the European Union on the topic of provisions. However, from a practical viewpoint, that would lead to either a research that lacks depth or a research that lacks focus. Therefore a selection of Member States was needed in order to create an in-depth and focused research.

The Dutch national tax legislation is selected for the following reasons. First of all, its tax base is characterized by an almost complete absence of codified law as far as the determination of profit is concerned. Therefore it is highly dependent on case law developed by the Dutch Supreme Court. This means that development in practice is an important characteristic of the Dutch system, even though the Dutch Supreme Court rarely gives a full analysis of the system that

58 See W. Schön, ‘International Accounting Standards: A “Starting Point” for a Common European Tax Base?’, European Taxation 2004, vol. 44, p. 426-440 for a critical analysis of this argument. I do feel however that given the fact that the EU endorses virtually all IFRSs and seldom uses carve outs, the use of IFRS as a EU-wide tax base might lead to political pressure on the IASB that in turn leads to standard setting that is of a lesser quality than it would have been without the political pressure.
59 IASB, Effective Date of IFRS 15, September 2015.
determines taxable income in its case law. Secondly, Dutch national tax legislation is also a system of determination of taxable income that is formally unconnected to local GAAP, which is close to the approach followed in CCCTB. It is also the system that I am most familiar with, being primarily schooled and trained in the Netherlands.

The German tax legislation system is selected because it is generally thought to be the opposite of the Dutch system, in the sense that determination of taxable income is formally linked to national GAAP (a concept which known as ‘Maßgeblichkeit’ in Germany, which I will translate as ‘congruence’). It is also a system that is practically applied in a national setting. Germany furthermore represents the largest economy in the European Union. Determination of taxable business income in the United Kingdom tax legislation is based on national GAAP. The viewpoint underlying UK national GAAP and the determination of taxable income is generally very close to IFRS, especially in recent years. In a way, this proves that IFRS can serve as a tax base, which provides an interesting contrast to CCCTB, that has used IFRS as an important starting point, but deviates from IFRS in a lot of subject matters for different reasons, but one of them being that IFRS is deemed to be unfit for use as a tax base. The fact that the United Kingdom has chosen to opt out of the European Union provides an interesting perspective in this: it is the system closest to internationally harmonising GAAP and the determination of taxable income on the one hand and, during this research, it apparently moves out of the European Union on the other hand. All systems have in common that they recognise provisions in the determination of taxable income. Since all these systems come from different backgrounds, I researched their history and background. This also contributes to a better comparison with CCCTB as parallels and differences often follow from the backgrounds of the individual systems. Furthermore, I will test the application of the aforementioned systems in a number of representative practical cases with regards to recognition of provisions, in order to illustrate the specifics and consequences of each system. Both the comparison between CCCTB, IFRS and German, Dutch and United Kingdom legislation and GAAP and the application of the rules to representative practical cases lead to findings about Article 23 CCTB 2016. These findings are then grouped together and form the backbone for my proposals for improvement of Article 23 CCTB 2016.

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62 Profits computed in accordance with generally accepted accounting practice form the starting point for the computation of taxable profits. Adjustments to those profits may, however, need to be made to conform to tax law. See Business Income Manual 31010.

63 Financial Reporting Standard 102 applicable in the United Kingdom and Republic of Ireland.

64 More specifically, FRS 102 is based on IFRS for SMEs.
1.3.2 Contents of the research

Normative framework
In the end, every tax system is based on politically driven decisions, which means that a degree of opportunism will always be present in the design of a tax base. When researching or analysing tax law, the objects of that particular tax base need to be clear. This leads to the conclusion that a normative framework is essential in order to assess the quality of such a tax base. This framework can partially be derived from CCCTB itself and its background, as the objective of CCCTB is to solve a number of issues that exist within the European Union. Since the objectives of CCCTB are quite specific and generally do not strictly relate to the tax base as such, the question what should be expected from a modern tax base also needs to be answered. Chapter 2 addresses this normative framework.

Description of IFRS and German, Dutch and United Kingdom legislation, generally accepted accounting practice (GAAP) and CCCTB
In Chapter 3 I will describe the general characteristics of IFRS, German, Dutch and United Kingdom legislation and generally accepted accounting practice (GAAP) and CCCTB in order to provide a background against which their approach towards provisions can be understood. A comparison between the characteristics and conclusions regarding the added value of these characteristics for CCCTB are included.

Analysis of provisions and similar entries
Chapter 4 will consist of an analysis per system of what provisions are, how they are measured and what their role in their own system is. This also provides for a comparison between provisions in the five systems and conclusions derived from this comparison. Since there is no common international definition of provisions and the dividing line between provisions and similar entries can be thin and overlaps can even occur, a study and analysis of these similar entries is also part of Chapter 4.

Practical application
In Chapter 5 I will examine the practical application of provisions under CCCTB, IFRS and German, Dutch and United Kingdom legislation and generally accepted accounting practice (GAAP). The starting point of the practical application is a selection of five types of provisions that are commonly found in general purpose financial reporting and determination of taxable income, which are quite common and relate to specific issues in recognition and measurement of provisions:
- Warranties;
- Onerous contracts;
- Maintenance and repairs;
- Restructuring;
- Clean up;
– Landfill of a quarry.

*Analysis of the issues found*  
The issues with regards to Article 23 CCTB 2016 that are found in the preceding chapters are gathered and grouped in Chapter 6. I will analyse them per theme and compare them to the normative criteria as set out in Chapter 2.

*Proposals*  
Insofar the analysis of Chapter 6 leads to justified criticism of Article 23 CCTB 2016, proposals for improvements and amendments of Article 23 CCTB 2016 are made in Chapter 6.

The work on this dissertation was closed as of 1 February 2017.
Chapter 2. Normative framework on Provisions and CCCTB

2.1 Introduction

The 2011 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base introduced a possible solution to a number of issues that arise from the lack of harmonisation of corporate income tax in the European Union. The 2016 re-launch addressed a number of additional issues, but it mainly proved that harmonisation of corporate income tax in the European Union is still on the agenda. When researching Article 23 CCTB 2016 or proposing improvements to any part of CCCTB, its history, background and objectives must be taken into account. In this chapter I will describe the history of harmonisation of direct taxes in the European Union of which the CCCTB is an important part. After that, I will delve into the history and objectives of CCCTB itself. What is researched in this study is however a specific part of CCCTB: the tax base. I will not delve into issues such as the technical elements of consolidation or entering or leaving the group. The objectives of CCCTB only relate to the tax base to a limited extent, leaving a somewhat incomplete normative framework. Since CCCTB contains, in fact, a modern tax base, it is highly relevant what the current idea is of what can be expected of a modern tax base. This is therefore the second part of this chapter. This provides a normative framework that I will use to analyse the issues that arise from the research of Article 23 CCTB 2016 and to develop proposals for improvement of Article 23 CCTB 2016.

2.2 History of harmonisation of direct taxes in the European Union leading up to CCCTB

The Treaty of Rome,\textsuperscript{65} which entered into force 1 January 1958, led to the founding of the European Economic Community, which resulted in the creation of a common market in which free movement of goods, workers, services and capital is facilitated. The operational and allocational efficiency of the common market benefits from harmonisation of taxes, including direct taxes. The need for harmonisation of corporate income tax can be derived from Article 100 of the Treaty of Rome, as harmonisation of corporate tax is necessary for the future of the common market.\textsuperscript{66} As the treaty did not provide explicit guidance in this area, further research has been done since the early 60’s of the last century. These researches directly and indirectly contributed to the development of CCCTB.

In the process, the words corporate income tax, corporation tax and company taxation have been used as synonyms. Since CCCTB uses the words corporate tax, these are the words I will use throughout this study.

\textsuperscript{65} Treaty establishing the European Economic Community, Rome, 25 March 1957.
\textsuperscript{66} Article 99 of the Treaty of Rome was more explicit with regards to the harmonization of indirect taxes.
2.2.1 1960-1980: From the Neumark Report to Commission document 139 of 1980

On 1 February 1963 the Neumark Report was released by the Fiscal and Financial Committee, which was appointed by the European Commission and chaired by Fritz Neumark. This report dealt with general principles to govern tax harmonisation and included a number of recommendations. Although the report is of a general nature, does not intend to provide an ideal taxation system and is not limited to direct taxes, it concluded that harmonisation of corporate tax is beneficial to the functioning of the internal market and proposes a harmonised corporate tax accompanied by a multilateral convention for the avoidance of double taxation. The 1969 Van den Tempel Report was an independent study requested by the European Commission. The objective of the report was tax harmonisation, from the perspective of the structure of how distribution of profits should be taxed. Its main recommendation on the harmonisation of corporate tax was that the classical approach should be used as the basis as opposed to the imputation systems used in several Member States. Following the Neumark Report and the Van den Tempel Report (but not strictly adhering to their conclusions) the European Commission developed a proposal for a directive on the harmonisation of corporate tax in 1975. The proposal consisted of a common partial imputation system (contrary to the recommendation of the Van den Tempel Report). It also included a range for corporate tax rates, varying between 45% and 55%. The proposal was rejected by the European Parliament and eventually led to the European Commission concluding that, while the adaptation of the 1975 proposal would be beneficial for the internal market, the time was not ripe for setting a schedule for the measurements to be taken, because of lack of strong political resolve to make substantial headway.

2.2.2 1980-1990: Directives that led to partial harmonisation

As the attempt at full harmonisation of direct taxes came to a virtual standstill in 1980’s, the European Commission decided to concentrate on limited measures in the field of direct taxes that would be beneficial to the internal market. The European Commission directly asked the European Council to adopt without delay three proposals for a directive. These were the Merger Directive, The Council Directive (EC) 90/434 of the European Commission of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (OJEC 1990, L...
2.2.3 1990-2001: From the Ruding report to the Bolkestein report

In 1990 a special committee on European company taxation was formed by the Commission. The objective of the committee, chaired by Onno Ruding, was to consider three general questions.

- Do differences in taxation among Member States cause major distortions in the internal market, particularly with respect to investment decisions and competition? Special attention is focused on those distortions considered to be discriminatory;
- Insofar as such distortions arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between Member States, or is action at the Community level required?
- What specific measures are required at the Community level to remove or mitigate these distortions?

The committee concluded that some remaining differences in tax regimes distort the functioning of the internal market. It is unlikely that they will be reduced significantly through independent action by Member States. More specifically, the committee set a number of priorities: the removal of discriminatory features, the setting of a minimum level for corporation tax rates and transparency of tax incentives. It also concluded that a programme of total harmonisation was not justified at that stage, but that a common system of corporate tax was a desirable objective. The latter put harmonisation of the corporate tax base back on the European agenda, even though the direct effects of the Ruding report, in the short run, were limited. The 2001 Bolkestein report on the one hand

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76 Commission of the European Communities, Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for
acknowledged that the Ruding report had limited effects, but recognised that in order to meet the European Union’s strategic goal "... to become the most competitive and dynamic knowledge-based economy in the world..." harmonisation of corporate taxes would be necessary. The harmonisation of company taxation was thought to be beneficial to reaching this objective, as it would remove tax obstacles from the internal market.

The Bolkestein report stated that, from an economic point of view, company taxation in the Internal Market must:
- Contribute to the international competitiveness of EU businesses in line with the strategic goal established by the Lisbon European Council;
- Ensure that tax considerations distort as little as possible economic decisions by operators;
- Avoid unnecessary or unduly high compliance costs and tax obstacles to cross-border economic activity;
- Not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition.

The tax obstacles were further specified as:
1) high compliance costs of transfer pricing;
2) double taxation following from cross-border flows of income;
3) double taxation following from lack of cross-border loss relief;
4) double taxation following from cross-border restructurings;
5) bias towards domestic investment following from certain tax systems;
6) compliance costs following from different sets of tax rules.

A number of these tax obstacles could be (and have been) solved by targeted measures, such as amendments to the Merger Directive and the Parent Companies and Subsidiary Directive. However, the need for a comprehensive
solution under which companies can operate on the basis of one consolidated corporate tax base for their EU wide activities was also acknowledged, as it would contribute to greater efficiency, effectiveness, simplicity and transparency. The Bolkestein report also stated that the International Accounting Standards (IAS) could serve as a starting point for developing a common tax base, as from the year 2005 listed EU companies would have to prepare their consolidated accounts in accordance with IAS.\footnote{81}

2.3 Introduction to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base

The Bolkestein Report was essentially the starting point for the work that led to the 2011 Commission proposal for a Council Directive on a Common Consolidated Corporate Tax Base (and there the later compromise proposals and the re-launch of 2016). In July 2004 the European Commission presented a non-paper on a common consolidated EU corporate tax base.\footnote{82}

The main reason for a non-paper on this subject was that the European Union was still lagging behind the Lisbon-goals and in particular its objective of becoming, by the year 2020, the most competitive economic zone in the world. It was deemed essential that the European Union would adopt as quickly as possible a common consolidated definition of taxation on company profits covering all EU company activities. Without this, rival companies from the USA and Japan would retain a distinct competitive advantage.

This illustrates that the expected effects of a common consolidated corporate tax base on the functioning of the internal market and the competitiveness of the European Union as a whole were still high, despite the fact that since the 1960’s progress in the field of harmonisation of direct taxes has been limited.

A Working Group was set up by the European Commission, which was split up in several subgroups. The subgroups discussed separate issues, the results of which were written down in the Working Papers.\footnote{83} The work of the Working Group eventually led to the presentation of a technical outline for a common consolidated corporate tax base.\footnote{84} The technical outline was used as the basis for the eventual proposal for a directive, which was released 16 March 2011.\footnote{85}

Under different presidencies the proposal was discussed. Under the Irish

\footnote{81}{The International Accounting Standards were, and to a lesser extent are, the basis for IFRS.}
\footnote{82}{http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/cctbwpnon_paper.pdf}
\footnote{83}{http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm}
\footnote{84}{Working document of the Common Consolidated Corporate Tax Base Working Group nr. 57 of the year 2007.}
\footnote{85}{Commission document 121 of 2011, final version. For an extended overview of the history of CCCTB see M. Lang e.a., Common Consolidated Corporate Tax Base, Vienna: Linde Verlag, 2008.}
The concept of provisions in Article 23 CCTB

Presidency the CCCTB Roadmap was created and this split the discussion of the proposal into six blocks.\textsuperscript{86}

In the Roadmap, these blocks were divided over two steps:

1. general issues, basic elements of the common tax base, anti–avoidance issues, international issues and operational issues
2. consolidation and apportionment

The first step concerns primarily technical issues, whereas the second step is much more politically driven: consolidation includes the discussion of import of losses and apportionment concerns the issue of which Member State receives the tax revenue.

CCCTB versions

At the time of writing this thesis no CCCTB-Directive is yet definite. After the introduction of the original draft in 2011, the proposal was discussed and altered several times in the form of compromise proposals. The original proposal of 2011 and the different compromise proposals are often referred to with regards to the presidency at that time. A timeline and overview of the proposals is as follows:

\begin{itemize}
\item 16 March 2011 Hungarian presidency\textsuperscript{87}
\item 16 April 2012 Danish presidency\textsuperscript{88}
\item 2 May 2013 Irish presidency\textsuperscript{89}
\item 14 October 2013 Lithuanian presidency\textsuperscript{90}
\item 26 May 2014 Hellenic presidency\textsuperscript{91}
\item 19 November 2014 Italian presidency\textsuperscript{92}
\item 2 December 2015 Luxembourg presidency\textsuperscript{93}
\end{itemize}

In October 2016 a re-launch of CCCTB took place in two parts. The first proposal was the tax base itself (the common corporate tax base)\textsuperscript{94} and the second the proposal concerning consolidation.\textsuperscript{95}

\textsuperscript{87} Commission document 121 of 2011, final version.
\textsuperscript{88} Council of the European Union document 8790 FISC 52 of 2012.
\textsuperscript{89} Council of the European Union document 9180 FISC 80 of 2013.
\textsuperscript{90} Council of the European Union document 14768 FISC 181 of 2013.
\textsuperscript{91} Council of the European Union document 10177 FISC 84 of 2014.
\textsuperscript{92} Council of the European Union document 15756 FISC 197 of 2014.
\textsuperscript{93} Council of the European Union document 14544 FISC 171 of 2015.
\textsuperscript{94} Commission document 685 of 2016, final version.
\textsuperscript{95} Commission document 683 of 2016, final version.
2.4 Normative criteria

2.4.1 Introduction

This study focuses on Article 23 CCTB 2016 and is expected to result in a number of issues that indicate that parts of Article 23 CCTB 2016 are either unclear, impractical, incomplete or otherwise in need of improvement. However, whether the proposals for improvement are valid or not, they will always be largely dependent on the normative criteria that apply. The applicable normative criteria are dependent on the background of the research object. In the case of Article 23 CCTB 2016 there are three relevant aspects to consider when determining the normative criteria. First of all, Article 23 CCTB 2016 is part of CCCTB and therefore subject to the objectives of CCCTB. Since these objectives are primarily aimed at improving the functioning of the internal market, they do not always relate directly to parts of the tax base and therefore might not provide enough input for a normative framework aimed at improving the tax base or parts thereof. Also, the argument of improving the functioning of the internal market is relevant, but it is also unfocused. The relevant tax principles underlying the tax base have been discussed in the Working Papers produced by the CCCTB Working Group. The opinions put forward in these Working Papers provide additional information with regards to the normative framework. Since the Working Papers do not analyse the issue of a normative framework with regards to the tax base thoroughly, additional guidance is needed of what can or must be expected of a modern approach of a tax base. The CCCTB-project has been limited in answering this question and a normative framework based on the objectives of CCCTB and its Working Papers is likely to be incomplete for a full analysis of Article 23 CCTB 2016. Therefore, additional external research has to be taken into account in order to assess, along general lines, what are relevant criteria when researching a modern tax base. There have been several attempts at determining these factors. The most striking or relevant for this research are the 1998 Ottawa Taxation Framework, for this is likely the most authoritative framework in this respect, and the 1999 UK ‘Ten tenets for a better tax system’ which has led to a thorough revision of the British tax system. Though aimed at the British tax system, the ten tenets are by nature largely applicable to every modern western tax system, of which CCCTB is an example. It also relates to one of the systems that are researched in this study. I will complete the normative framework for analysing

96 Explanatory Memorandum to Commission document 121 of 2011, final version.
Article 23 CCTB 2016 by adding to it the relevant issues from the Ottawa Taxation Framework and the tenets from the aforementioned UK paper.

2.4.2 Objectives of CCCTB

General objectives
Since the proposal for a council directive on a CCCTB is a follow-up to the 2001 Bolkestein report\(^{100}\), the basic objectives of a CCCTB, following from the Bolkestein report can be summarised as providing a solution for:

1) high compliance costs of transfer pricing
2) double taxation following from cross-border flows of income
3) double taxation following from lack of cross-border loss relief
4) double taxation following from cross-border restructurings
5) bias towards domestic investment following from certain tax systems
6) compliance costs following from different sets of tax rules

In the Explanatory Memorandum to CCCTB\(^{101}\) reference is made to the priorities set in Europe 2020.\(^{102}\) In the Explanatory Memorandum these objectives are restated as:

1) prevention of overtaxation and double taxation (objectives 2–4 Bolkestein report)
2) diminishing the heavy administrative burdens (objective 6 Bolkestein report)
3) diminishing high tax compliance costs (objective 1 Bolkestein report)
4) increase of growth–friendliness

Later on, under the influence of the OECD BEPS Actions, a slight shift towards the Anti-BEPS objectives can be seen:\(^{103}\)

1) reduce administrative burdens
2) simplify the Single Market
3) reduce complexities
4) reduce compliance costs
5) tackle profit shifting

What is striking is that the objectives do not fully overlap, which indicates that they develop over time and that political priorities shift. Tackling profit shifting


\(^{101}\) Explanatory Memorandum to Commission document 121 of 2011, final version.


\(^{103}\) Commission document 302 of 2015, final version.
is, for example, an objective that was not explicit from the start. The 2011 Impact Assessment\textsuperscript{104} differentiates between general objectives and specific objectives.

The general objectives are:

\begin{itemize}
  \item simplicity and efficiency of the corporate income tax for reduced tax distortions to investment decisions and increased opportunities for cross-border investments
  \item competitiveness and performance of enterprises
  \item improvement of the overall macroeconomic performance
\end{itemize}

The specific objectives are:

\begin{itemize}
  \item reduction of additional corporate tax related compliance costs for companies
  \item elimination of double taxation for companies operating in the EU Internal Market
  \item elimination of overtaxation on cross-border economic activity, mainly stemming from the absence or limited availability of cross-border loss relief
\end{itemize}

Elimination or reduction of these obstacles will help minimise the tax-induced distortions and inefficiencies in the Internal Market. For the analysis of Article 23 CCTB 2016 the direct influence of these objectives will be limited and their guidance in determining the tax base is insufficient. The tax base itself is instrumental in reducing tax compliance costs and the administrative burden, but it is unlikely that provisions in the tax base are the key driver of these issues, even though administrative issues will occur when the approach deviates strongly from existing national systems. These objectives are therefore a part of the normative framework, but additional normative criteria are needed. The context of the 2016 CCCTB relaunch mentions the fact that business models and corporate models have become more complex, making it easier to shift profits. Whereas the initial focus, based on the Bolkestein Report was mostly on prevention of double taxation, allowing the recognition of cross-border losses and diminishing the administrative burden and therefore was mostly aimed at decreasing the issues that multinational enterprises had, it has become clear the multinational enterprises do not only encounter problems from international taxation, but they often find ways to benefit from it as well, in ways that are mostly unintended. Therefore, an additional argument has come forward: preventing profit shifting and erosion of the tax base. In that way, CCCTB also provides an anti-tax avoidance function as it encompasses a uniform tax base and provides rules for allocation of profit.\textsuperscript{105}

\textsuperscript{104} Commission Staff working Document Impact Assessment – Accompanying document to Commission document 121 of 2011, final version.

\textsuperscript{105} Commission document 683 of 2016, final version.
2.4.3 Principles of the tax base
As far as the principles of the tax base go, a differentiation needs to be made between the general tax principles as well as accounting principles. General tax principles determine what requirements a tax base should meet. An example of this is the principle of the ability to pay taxes: taxes should be levied in accordance with each taxpayer’s individual ability to pay them.\(^{106}\)

Accounting principles, especially in taxation, mainly determine when profit should be taken into account. Additional criteria will apply, such as that the information presented must be reliable and timely. When they are part of the tax base, accounting principles should generally reflect the underlying tax principles.

**General tax principles**

In Working Paper 001Rev1 the general principles for the design and assessment of tax systems are discussed.\(^ {107}\) The Working Paper mentions eight general principles:

1. vertical equity\(^ {108}\)
2. horizontal equity\(^ {109}\)
3. efficiency and neutrality\(^ {110}\)
4. effectiveness\(^ {111}\)
5. simplicity, transparency and certainty
6. consistency and coherence\(^ {112}\)
7. flexibility\(^ {113}\)
8. enforceability\(^ {114}\)

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\(^ {106}\) The principle of ability to pay, stemming from A. Smiths’ *An Inquiry into the Nature and Causes of the Wealth of Nations*, is sometimes thought of as irrelevant for corporate tax and only relevant for individuals. For the purpose of this research I will treat the principle of ability to pay taxes as a given, since for an entity as well as an individual it makes no sense to demand taxes when it cannot reasonably be expected that they can be paid by the taxpayer. Smiths’ book is considered a classic and the version I used for the purpose of this research was A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, New York: Random House, 1994.


\(^ {108}\) The burden of taxation should be shared in accordance with taxpayers’ respective ability to pay, sometimes referred to as the ‘ability to pay’ principle.

\(^ {109}\) Taxpayers in the same economic circumstances should receive equivalent treatment.

\(^ {110}\) Generally taxes should be neutral to ensure that investment decisions take into account the ‘best’ location from an economic perspective.

\(^ {111}\) Effectiveness is essentially the capacity of the tax base to achieve its basic objectives.

\(^ {112}\) When two transactions have the same commercial result they should have the same tax result. This overlaps with the principle of substance over form.

\(^ {113}\) Markets and business practices change over time. The tax base should be responsive and be capable of change as well.

\(^ {114}\) The rules of a tax base must be easy to enforce as an unenforceable system is unlikely to be either equitable or neutral.
The Working Group states that some of these principles are undoubtedly of relevance for the design and assessment of tax systems (such as simplicity, flexibility and enforceability), while efficiency and equity are of less relevance. Apart from the fact that equity always plays or should always play a role in a tax base, the downside of the approach chosen by the Working Group is that on the one hand the Working Group acknowledges the existence and possible relevance of such principles or requirements, but it does not analyse the consequences of that acknowledgement. The other Working Papers do not refer to the principles on a systematic basis, which implies that they were not instrumental in the design of the proposal for a CCCTB Directive. This can be understood in the light of a large number of Member States coming to an understanding and not wanting to postpone the project by discussing over principles. However, it can be questioned whether a consistent and coherent tax base can be created without having such a basis or that the proposal becomes a general average obtained by political consensus over individual elements. Working Paper 020 makes a reference to general tax principles by stating that the rules for the new tax base must be acceptable and understandable to all, though it is debatable what understandable is and who ‘all’ are. In my opinion these remarks must be taken as a confirmation of equity (in general acceptability will largely be determined by equity) and simplicity (understandable) and not as additional criteria. The criteria mentioned are all relevant when analysing Article 23 CCTB 2016. Some might prove more relevant than others in the end, but they are all part of a normative framework.

**Accounting principles**

Working Paper 001Rev1 also mentions accounting principles. It mentions as underlying assumptions the accrual basis and the matching concept, as qualitative characteristics understandability, relevance, reliability, faithful representation and neutrality and furthermore materiality, substance over form and prudence.

The other working papers do not systematically refer to these concepts. Working Paper 020 even mentions that a full set of principles was found neither necessary nor desirable, as a high amount of consensus between the Member States as to what constitutes taxable income was thought to exist. The latter is contrary to the outline of Working Paper 001Rev1 where it was stated that it is difficult to see how Member States with currently different tax bases could agree on a

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115 Although the working document of the Common Consolidated Corporate Tax Base Working Group nr. 20 of 2005 makes a clear reference to the ability to pay taxes principles by stating that not allowing the recognition of a provision would leave a taxpayer with no profit to pay for the clean-up.


118 These concepts are defined in the Conceptual Framework to IFRS.

119 Working document of the Common Consolidated Corporate Tax Base Working Group nr. 20 of the year 2005. What exactly constitutes a high amount of consensus is unclear.
common tax base without the broad agreement on some underlying tax principles. It seems that the conclusion in Working Paper 020 evades the discussion about underlying principles and justification of (corporate) income tax, in order to reach political consensus. With underlying principles and rules being open to multiple interpretation, it will be easier for all parties involved to recognise their own suggestions or opinions instead of having clear principles and clear rules which require a larger and more specific amount of consensus. However, especially in a harmonised tax base in the European Union it is highly relevant that Member States agree on underlying principles, as uniform interpretation is a determining factor in whether a harmonised tax base is not only formally harmonised (i.e. the rules are the same in all the Member States) but also materially harmonised (i.e. the rules are interpreted the same in all the Member States).

Apart from the Working Papers, Article 6 CCTB 2016 (General principles) mentions four principles:

1. In computing the tax base, profits and losses shall be recognised only when realised.\(^{120}\)
2. Transactions and taxable events shall be measured individually.
3. The calculation of the tax base shall be carried out in a consistent manner unless exceptional circumstances justify a change.
4. The tax base shall be determined for each tax year unless otherwise provided. A tax year shall be any twelve–month period, unless otherwise provided.

Although these are called principles by Article 6 CCTB 2016, they are effectively rules. The realisation principle of Article 6, Paragraph 1 CCTB 2016 could have been a principle, but in Chapter III the moment of realisation is defined and thus it effectively is a rule.

**Accounting principles and general principles: relevance**

The accounting principles that are mentioned in the Working Papers are high-level principles. An accrual basis still needs further details in order to be useful to act as a tax base: it is one thing to state that cash flows are attributed but another thing to actually determine how they are attributed. For example, accrual can be applied prudentially or not, both of which have a large influence on the tax base.

*For example, if a cash flow of -/- € 100,000 is expected in year 2, attributing the amount to the year in which it occurs would mean attribution to year 2,*

\(^{120}\) In the compromise text under Danish presidency, it was suggested that part of 2011 Article 9, Paragraph 1 CCCTB was likely to be deleted. See Council of the European Union document 9180 of 2013. The later compromise texts followed this approach. It is therefore quite striking that Article 9 CCCTB 2011 remained unchanged and became Article 6 CCTB 2016.
attributing the amount to the year in which it is caused might mean attribution to year 1 (for longer periods use of the present value would be reasonable).

The qualitative characteristics refer to the information presented in the financial reporting and are therefore of limited value when designing a tax base. For example, requiring that the information is provided timely makes sense when approached from the viewpoint of the user of the general purpose financial information. Timeliness of providing information by the taxpayer is inherent to taxation and not specifically part of the tax base. Accounting principles will therefore not be part of the normative framework, but as part of the general tax principles. I will not add them as a separate set of criteria to the normative framework. The principles of Article 6 CCTB 2016 do not provide relevant normative criteria and will therefore not be added to the normative framework. In Chapter XVI of CCCTB 2011 the apportionment of the consolidated tax base is dealt with. CCTB 2016 contains a similar apportionment. Without going into detail, the apportionment of the consolidated tax base for the group members largely depends on three factors: sales, labour and assets. What is striking, especially from the viewpoint of this research, is that none of these three factors directly relates to provisions. This implies that the effect of provisions on the tax base is apportioned on the basis of these factors. Provisions therefore do not determine or influence the apportionment in a specific way. Although this concept can be challenged, for the purpose of this research it means that apportionment is not a relevant argument in how provisions should be dealt with in Article 23 CCTB 2016.

2.4.4 Normative criteria for a modern tax base

2.4.4.1 Introduction

The former indicates that the normative framework of CCCTB is incomplete and has not been applied thoroughly in the Working Papers. Therefore, the question remains how to complete the normative framework that will be used for the analysis of Article 23 CCTB 2016 in this research. This is effectively the question of what can be expected from a modern tax base, apart from the objectives that are already mentioned. In a way, it is tempting to refer to the principles of taxation that were introduced in Adam Smith’s famous An Inquiry into the Nature and Causes of the Wealth of Nations, and that were instrumental in shaping income taxes in general, such as the equality principle, the principle of legal certainty and the principle of the least pain and ability to pay taxes. Although these principles still hold, the world has moved on since 1776, when the book was first published (with industrialisation, internationalisation, digitalisation and the focus towards preventing base erosion and profit shifting having followed the publication of the book), also because the

actual development of income taxes took place in the centuries after the book was published. This means that a large amount of reflection on income taxes has taken place after 1776. While it is not within the scope of this research to provide a full overview of research on this issue, the current state of thinking needs to be taken into account.

2.4.4.2 Ottawa Taxation Framework

In 1998 the OECD Member governments agreed on a set of taxation framework principles as a response to the increase of e-commerce. It basically led to the conclusion that e-commerce should be taxed in a similar way as other commercial activities, but the main advantage was that it led to a rethinking or evaluation of how taxation should take place, which essentially meant an update of existing tax principles. For the purpose of this research it is relevant that this led to a set of broad tax principles that governments apply to taxation of conventional commerce and which should also apply to e-commerce.

**Neutrality**: taxation should seek to be neutral and equitable between forms of e-commerce and between conventional commerce and e-commerce, so avoiding double taxation or unintentional non-taxation

**Efficiency**: compliance costs to business and administration costs for governments should be minimised as far as possible

**Certainty and simplicity**: tax rules should be clear and simple to understand, so that taxpayers know where they stand

**Effectiveness and fairness**: taxation should produce the right amount of tax at the right time and the potential for evasion and avoidance should be minimised

**Flexibility**: taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments

Apart from the specific principle of neutrality, which in the Ottawa Taxation Framework has a specific target in relation to e-commerce and conventional commerce, these objectives are in line with the UK’s Ten tenets for a better tax system, which are dealt with below, meaning that they play a role in the practical evaluation of a tax system.

2.4.4.3 The United Kingdom: Ten tenets for a better tax system

In a way the United Kingdom provides an interesting case as it has traditionally been known to have a large and complex body of tax law, which means that

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ideas for improvement make sense there. The Tax Faculty of the Institute of Chartered Accountants in England & Wales released a discussion paper in 1999 that dealt with the perceived problems of the tax system in Great Britain. It identified a number of issues that are relevant for every modern tax system, such as complexity, unjustifiable anomalies and difficulties with regards to democratic control following from lack of adequate consultation. From this, it developed ten tenets for a better tax system. This paper has proven to be effective and influential.

According to the paper the tax system should be:

Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system, by targeting it to close specific loopholes.

Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant then it should be repealed.

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124 The ICAEW has systematically used the ten tenets to evaluate tax policy and tax policy changes.
Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

When applying these criteria to any part of CCCTB, application needs to be in a European context instead of a British context. The first five criteria can be applied to an analysis of Article 23 CCTB 2016. The other five are of less relevance. A tax base should be constant, subject to proper consultation, regularly reviewed, fair and reasonable, but these criteria cannot be applied to Article 23 CCTB 2016 directly. Competitiveness of tax rates is also relevant for a national tax system, but the European Commission does not aim to harmonise tax rates with CCCTB.125

2.4.4.4 OECD: Action Plans against Base Erosion and Profit Shifting

What must not be forgotten is the role that income taxes play in society’s view of fairness, justice and equality. Whereas the reason for the original introduction of income taxes merely was a way to finance wars (which was the case in the 19th century) and which failed in the long run, introducing income taxes as a way of distributing the burden over society and thus calm social unrest, especially in the wake of industrialisation was far more successful. Even when the total collected VAT is often higher than income tax, there is an inherent sense of justice and equality that surrounds income taxes. It is therefore interesting that in the current age multinationals general attitude towards taxation, to view taxes mainly as cost (and thus using oftentimes aggressive tax planning to lower these costs) and not as society’s rightful share in the profit of a company, has led to a shifting view on multinationals and their role in society, as parts of society no longer seem to accept this attitude. In response to this global concern, and at the request of the G20, the OECD published an Action Plan on Base Erosion and Profit Shifting.126 In 2015 the final report was issued, consisting of 15 Actions.127 These actions can be split into three categories (without going into the details of all 15 Actions):

a. guidance based on convergence of national best practices
   – mandatory disclosure by taxpayers of aggressive tax planning arrangements

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– building blocks of Controlled Foreign Company rules

b. a common approach to structures
– limit base erosion through interest expenses
– neutralise hybrid mismatches

c. minimum standards
– counter Harmful Tax Practices
– prevent treaty abuse
– country–by–country reporting
– make dispute resolution mechanisms more effective
– prevent artificial avoidance of PE Status
– transfer pricing outcomes in line with value creation

A harmonised tax base in the European Union will undoubtedly reduce a number of problems that underlie the BEPS Actions. For example: within a harmonised tax base hybrid mismatches would not be possible (although the group can interact with non-group members outside the European Union, this would still limit hybrid mismatches within the European Union). Excessive interest deduction, treaty abuse and artificial avoidance of the permanent establishment status would also be limited, as would the need for transfer pricing in general, under a harmonised tax base. However, the fact that the concept of a harmonised tax base is in line with the BEPS Action Plans, does not mean that the BEPS Actions provide additional normative criteria that can be used for the development of a harmonised tax base. The 2015 proposed changes to the CCCTB-Directive to bring CCCTB more in line with the BEPS Action Plans do not add relevant issues to the normative framework for this research.\(^{128}\) This means that, although the world has changed since the Ottawa Taxation Framework was developed and there is a noticeable shift in how part of society views taxation and the role of multinationals in this, I do not think the concept of how a tax base should be constructed has shifted largely, especially since a lot of the BEPS Actions stem from lack of harmonisation of national tax bases rather than problems in the national tax bases themselves. The message that follows from BEPS is (to a large extent) that multinational enterprises should not be able to use differences between national tax systems to their advantage. The discussion about differences as such (in the sense that dividends should be both taxed and deducted as dividends and interest should be both taxed and deducted as interest) does not go so far that it states whether a certain flow is either interest or dividend. CCCTB solves a large number of the BEPS Actions simply because it is a common consolidated corporate tax base and that a lot of hybrid mismatches are simply not possible anymore within the European Union when multinational enterprises apply CCCTB. The main BEPS-issues that remain, BEPS-wise, stem from the fact that CCCTB is solely an EU-initiative and there

are no walls around the European Union. A CCCTB-tax base therefore will often have interaction with non-EU tax bases, which means that for example hybrid mismatches and transfer pricing can still occur. This is however not an issue that can be solved exclusively within the tax base of CCCTB. Once CCCTB is implemented widely (in the sense of by all enterprises in the European Union, which is not a likely scenario for the short term) in the European Union, the BEPS Actions will apply mainly to the interaction between CCCTB and non-EU Member States. The interaction between CCCTB and the BEPS-Action plan can be seen clearly in later additions to the CCCTB-proposal.\footnote{See for example Commission document 121 of 2011, final version.} A number of issues actually link up:

\begin{itemize}
  \item[a)] definition of permanent establishment (PE)
  \item[b)] controlled foreign company (CFC)
  \item[c)] switch-over clause
  \item[d)] general anti-abuse rule
  \item[e)] exit taxation rules
  \item[f)] interest limitation rules
  \item[g)] hybrid mismatches
\end{itemize}

Proposals have been made on how to deal with those in the CCCTB-Directive in a more specific manner.\footnote{Council of the European Union document 14544 of 2015.}

### 2.5 Normative framework

Paragraphs 2.4.2 to 2.4.4 lead to the following normative framework for the analysis of Article 23 CCTB 2016.

- prevention of overtaxation and double taxation
- diminishing the heavy administrative burdens and high tax compliance costs for enterprises
- increase growth-friendliness
- vertical and horizontal equity
- efficiency, effectiveness and neutrality
- simplicity, transparency and certainty
- consistency and coherence
- flexibility
- enforceability
- competitiveness

### 2.6 Conclusion

This chapter has been set out to determine the normative framework to use for the analysis of Article 23 CCTB 2016 in this study. The normative criteria are derived from three main sources. First of all, the objectives as set out in the
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Explanatory Memorandum of CCCTB. Second of all, the general tax principles mentioned in WP 001Rev1. Third of all, the Ottawa Taxation Framework and the Ten Tenets for a Better Tax System developed by the Tax Faculty of the Institute of Chartered Accountants in England and Wales. Although CCCTB has a positive influence on what the OECD strives to achieve with their Action Plans against Base Erosion and Profit Shifting, it does not add criteria to the normative framework. This provides the basis for a thorough examination of Article 23 CCTB 2016 in Chapter 6.

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131 Explanatory Memorandum to Commission document 121 of 2011, final version.
Chapter 3. Description of IFRS, German, Dutch and United Kingdom legislation and generally accepted accounting practice (GAAP) and CCCTB

3.1 Introduction

The tax base of CCCTB does not make reference to an existing system of standards for financial reporting, nor is it formally connected to a set of standards for financial reporting. For a tax base this is a unique situation, as most tax bases are either formally or informally linked to standards for general purpose financial reporting.\(^1\) For the design of the tax base in the draft for a CCCTB directive, IFRS has been used as a starting point, as opposed to writing an isolated tax base from scratch.\(^2\) This raises the question how Article 23 CCTB 2016 compares to similar legislation in both IFRS and other tax systems. This also refers to the issue of the administrative burden. Most national general purpose financial reporting standards are moving towards IFRS (full application of IFRS is still rare amongst non-listed entities, but there is a large influence of the international accounting standards and international financial reporting standards visible in national financial reporting standards of Western and non-Western countries). For this study I will limit the comparison to IFRS, German law, Dutch law and United Kingdom law. With regards to the national systems (German, Dutch and United Kingdom) I will focus on tax law, although, with the tax base being primarily based on civil law in Germany and the United Kingdom, a study of national civil law is necessary as well. For a good comparison, insight into the backgrounds of these systems is necessary. In order to achieve such insight, this chapter will provide a description of relevant elements of these systems in general and how their commercial and tax accounts relate to each other. The chapter starts with an outline of the relevant issues that will be dealt with. After that, these issues will be delved into per system.

3.2 Relevant issues

3.2.1 Short history of the system and its objectives

A short introduction of the history of each system and its objectives is provided in this chapter. This provides an understanding of the past and the backgrounds and makes it possible to contextualise the accounting rules in relation to the


\(^3\) I will refer to these tax bases and standards for financial reporting as ‘systems’. The words ‘tax base’ would rule out IFRS, as this is not a tax base and the word ‘accounting rules’ pulls the focus of the fact that most are in fact tax bases.
research concerning the feasibility of Article 23 CCTB 2016.\footnote{C.J. Napier, ‘Research Directions in Accounting History’, \textit{British Accounting Review}, p. 237.} Every type of financial reporting translates facts into monetary terms.\footnote{W. Schön, \textit{Steuerliche Maßgeblichkeit in Deutschland und Europa}, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 59.} In this regard it is important to note that standards for general purpose financial reporting depend on the usefulness of information for users of that information.\footnote{See for example Chapter 1, OB2 of the Conceptual Framework to IFRS, 2016 Edition.} The array of users of general purpose financial reporting can be rather wide as is the array of decisions that can be made with this information. For a tax base there is only one user, the tax authorities that use the information to determine the taxes due. Over the past couple of years, the amount of taxes paid by especially bigger multinational enterprises has become something of increased interest to the general public. That in itself does not make the general public a user of the information provided by the enterprise to the tax authorities, but there is a noticeable shift towards the taxes paid by an enterprise being relevant information for the general public.

### 3.2.2 Congruence

Congruence\footnote{In German law this is commonly known as ‘Maßgeblichkeit’. For the purposes of this research I will translate ‘Maßgeblichkeit’ as congruence. See A. Haller, ‘The Relationship of Financial and Tax Accounting in Germany: A Major Reason for Accounting Disharmony in Europe’, \textit{International Journal of Accounting}, 1992, p. 310. For a standardwork on Maßgeblichkeit in German law see W. Freericks, \textit{Bilanzierungsfähigkeit und Bilanzierungspflicht in Handels- und Steuerbilanz}, Cologne: Carl Heymanns Verlag, 1976 or W. Schön, \textit{Steuerliche Maßgeblichkeit in Deutschland und Europa}, Cologne: Verlag Dr. Otto Schmidt, 2005.} refers to when the determination of taxable profit is derived directly from the general purpose financial reporting. In a system of full congruence both the applicable rules and their application are the same for the commercial accounts and determination of taxable profit.

For example, when the rules allow fixed assets to be measured at either historical cost or fair value and the enterprise opts for the application of historical cost in their general purpose financial reporting, full congruence would mean that the same systems (either historical cost or fair value) and the same choice (in this case historical cost) must be applied in the tax accounts as well.

The main reasons for a high level of congruence are both of practical and theoretical nature. In a practical sense, it removes the necessity of an additional set of accounts and thus leads to legal uniformity and less administrative burden for both taxpayer and tax authorities. From a theoretical point of view, there are generally opposed tendencies between general purpose financial accounting and tax accounting and they are thought to even each other out.
For example, in general purpose financial accounting it is often beneficial to the enterprise to show a relatively high profit, as users will view this as a positive aspect. With regards to taxable income, it is generally beneficial to show a relatively low profit, as this leads to lower taxes. This means that the tendencies with regards to both sets of accounts are opposite.

Another theoretical point of view is the concept that the State is just a different stakeholder in a company, much in the same way that a shareholder is and should therefore be treated as such, with the same applicable set of accounts. Legal certainty is also increased by using one set of accounts for both purposes.\textsuperscript{142}

A lower level of congruence is generally motivated by the fact that, since the tendencies towards commercial accounting and the determination of taxable income will often be opposite, a high level of congruence will diminish the quality of both forms of reporting (financial reporting and the determination of taxable income), as the addition of extra types of stakeholders leads to compromises.\textsuperscript{143}

Also, it would mean that the tax courts can decide directly on issues with regards to financial reporting and such influence is often undesirable. With both approaches (full congruence and no congruence) having their merits and their downsides, a general move towards a middle ground is likely. There is some evidence that this move is taking place in Europe.\textsuperscript{144} Comparing the five systems as mentioned above (IFRS, the German, United Kingdom and Dutch national systems and CCCTB), raises the question what the relation is between the general purpose financial reporting and the determination of taxable income, both in applicable rules and their application. The more the determination of taxable income follows the general purpose financial reporting, the less the administrative burden and compliance costs for the business community will be.

Reverse congruence\textsuperscript{145} can also occur, in the sense that the general purpose financial reporting follows the tax accounts. Reverse congruence can occur either because civil law or the standards for general purpose financial reporting refer to tax rules or standards for reporting.\textsuperscript{146} I will refer to this as formal reverse congruence. There is also a possible reverse congruence when tax considerations influence the choices that are made for the general purpose financial reporting, that would not have been made in the same way when tax considerations would not have been present. I will refer to this as material reverse congruence. The downside of congruence is that general purpose financial reporting does not necessarily take into account tax principles such as

\textsuperscript{142} See for example W. Schön, \textit{Steuerliche Maßgeblichkeit in Deutschland und Europa}, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 51.

\textsuperscript{143} In a perfect capital market this would be a different issue. See W. Schön, \textit{Steuerliche Maßgeblichkeit in Deutschland und Europa}, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 52.


\textsuperscript{145} In German law this is commonly known as ‘umgekehrte Maßgeblichkeit’.

\textsuperscript{146} An example of this is found in Article 2:396, Paragraph 6 Dutch Civil Code.
the ability to pay taxes. The determination of taxable profit will automatically lead to an outflow of resources, in the form of taxes payable, whereas this is not the case for profit in the general purpose financial reporting. This difference in profit determination can create situations where high quality general purpose financial reporting leads to a taxable income that is not in line with the ability to pay taxes. This might lead to the situation where the enterprise chooses to apply the rules in such a way that less taxes have to be paid, while financial reporting is of a lesser quality than it could have been. From the viewpoint of a legislator or standard-setter, congruence also creates a situation where the rules concerning the general purpose financial reporting (often referred to as the ‘standards’) directly influence determination of taxable income and thus the public finances. This can lead to the situation that a civil law legislator or standard-setter takes tax consequences into account when creating laws or rules. Doing so does not necessarily improve the quality of either. It also can lead to pressure groups targeting the civil law legislator or standard-setter with tax arguments, which are not necessarily the civil law legislators’ or standard-setters’ field of expertise. There are systems in existence where congruence is mostly absent and systems where congruence is fully present. Essers differentiates between five categories of congruence.

1) **Formal congruence**: the standards for the commercial accounts determine the taxable profit and choices for the commercial accounts determine the taxable profit;

2) **Almost formal congruence**: the standards for the commercial accounts determine the taxable profit and choices made in the commercial accounts determine the taxable profit, but special tax rules can lead to differences;

3) **Material congruence**: the standards for the commercial accounts determine the taxable profit, but the choices for the determination of taxable profit can differ from the commercial accounts;

4) **Material incongruence**: the commercial accounts are the starting point for the determination of taxable income, but in practice so much differences exist that de facto separate commercial and tax accounts exist;

5) **Formal incongruence**: there is no formal or material connection between the commercial accounts and the determination of taxable profit.

The underlying relevant facts will remain the same whatever the financial reporting standards are. Often, the accounting rules will contain options (which

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147 See Paragraph 2.4.3.
148 The use of the word ‘standard-setter’ is on purpose. For example, the International Accounting Standards Board creates the International Financial Reporting Standards. It is however a private party and not a legislator. It refers to itself as a standard-setter.
implies that choices can be made), which means that there is a difference between using the accounting rules for tax purposes (which does not necessarily lead to financial reporting and a tax return that are the same, which is reflected in the situation under 3) or requiring that the financial reporting and thus the choices with regards to the options are used in the tax return, which is the situation under 1) and 2).\(^{151}\)

Because the German and the United Kingdom tax law do not have a standalone tax base, but rely on generally accepted national accounting practice this will mean that the description and analysis of their systems takes place by using the generally accepted national accounting practice as the basis and adding the alterations made by tax law.

3.2.3 To whom does the system apply?

The answer to the question to whom rules or standards in accounting apply (such as investors, creditors or tax authorities) makes a comparison more sound, as differences in that respect may lead to valid differences in the rules or standards themselves. Possible differences are applicability to natural persons or entities, large enterprises or SME’s, multinational enterprises or national enterprises and groups of entities or single entities, the use of fair value or historical cost.

3.2.4 Role of the balance sheet

The balance sheet in financial reporting can play different roles. It can be either for internal or external users, its aim can be to show the capital that must be maintained in order to protect creditors or its aim can be to provide information to investors (or both). This also means that it can be aimed at showing expected future cash in- and outflows (which is a form of fair value) or past cash flows, such as showing the historical cost of assets and liabilities. None of these aims are inherently good or bad, their justification depends on what the objectives of the financial reporting are. A balance sheet can be either primarily aimed at giving a fair representation of assets and liabilities\(^{152}\) or be primarily aimed at supporting the determination of profit.\(^{153}\)


\(^{152}\) This is generally known as the static approach to the balance sheet.

\(^{153}\) This is generally known as the dynamic approach to the balance sheet. See E. Schmalenbach, *Grundlagen dynamischer Bilanzlehre*, Leipzig: G.A. Gloeckner, 1925. See also W. Schön, *Steuerliche Maßgeblichkeit in Deutschland und Europa*, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 303, about the concepts of the balance sheet as a ‘Vermögensbilanz’ and ‘Überschussrechnung’.
Financial accounting is based on double entry bookkeeping. Double entry bookkeeping leads to both a profit and loss account and a balance sheet.

For example the journal entry of a sale

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>€ 100.000</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>€ 100.000</td>
</tr>
<tr>
<td>Costs of goods sold</td>
<td>€ 50.000</td>
</tr>
<tr>
<td>Inventory</td>
<td>€ 50.000</td>
</tr>
</tbody>
</table>

The accounts receivable debits the balance sheet, whereas the inventory credits the balance sheet. The sales revenue credits the profit and loss account, whereas the costs of goods sold debits the profit and loss account. In determination of taxable profit in its most basic form, a balance sheet is not necessary as profit can be determined by the profit and loss account alone. It can however be useful for purposes of control and auditability (which is actually the benefit of double entry bookkeeping in the first place: it provides a system of checks and balances) to have a balance sheet (and thus be a dynamic balance sheet). Therefore a balance sheet can be useful as a tool for supporting the determination of profit and providing control and auditability. Since CCCTB does not require an enterprise to make up a balance sheet, research of the role of the balance sheet in the other accounting systems will provide relevant information.

3.2.5 Principles based or rules based

In recent years questions have risen about the effectiveness and efficiency of laws and rules on accounting issues. From well-known cases like Enron, it has become clear that where strict and detailed laws or rules are given, a literal interpretation of these laws or rules can be expected and what is not explicitly forbidden is therefore allowed. Empirical evidence shows that profit management by structuring or otherwise manipulation of profit is more likely in the case of strict and formal rules that leave no room for interpretation than

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154 Double entry bookkeeping has been around much longer than income taxes are. See L. Pacioli, *Summa de Arithmica, Geometria, Proportioni et Proportionalita*, Venice, 1494, which is generally accepted as the first published account of double entry bookkeeping, which has in practice existed even longer. J. Gleeson-White, *Double entry: how the merchants of Venice created modern finance*, New York: W.W. Norton, 2012, p. 49-114.

155 CCCTB approaches the determination of profit as a profit and loss account and does not require to recognise entries on a balance sheet.

156 A highly rules based approach is often thought to be typically American, in the sense that personal freedom leads to ‘anything goes’ unless explicitly forbidden and the complexity of the American society calls for a large amount of rules. Whether this is completely true or not would provide for a highly interesting research. However, this debate falls outside the scope of this study. The concept does illustrate a point that is relevant for this study: in how far is the system dependent on principles and in how far are highly detailed rules present and needed.
when rules are of a more general nature.\textsuperscript{157} The search for loopholes in strict and formal rules will eventually lead to more detailed rules, as they need to cover every thinkable situation.\textsuperscript{158} Rules or standards that are highly detailed will generally aim to cover every possible situation. The problem is that this objective of completeness can never be fully reached, but it will lead to increased compliance costs.\textsuperscript{159} Therefore it has been suggested to take a more ‘principles-based’ approach in matters of financial reporting.\textsuperscript{160} This does not only apply to accounting rules but to tax rules as well, as the amount of rules is ever-increasing and in its wake, the costs of compliance for the business community are too as do the costs of auditing and enforcement by governments. One of the primary objectives of CCCTB is to decrease costs of compliance and the administrative burden for the business community.\textsuperscript{161} Principles can be defined as fundamental tenets or primary assumptions forming the basis of a chain of reasoning.\textsuperscript{162} The objective of an approach based on principles is therefore to provide one or more fundamental tenets or primary assumptions on which the enterprise can base its conclusions when the rules do not provide a solution. The intended effect is that when the amount of written rules can be limited, the compliance costs can be kept relatively low and the effectiveness of the rules will increase. There are some inherent problems with the principle based approach to financial reporting.\textsuperscript{163} It can lead to legal uncertainty, since principles will not always provide clear answers, but only general guidance or intention instead. Accounting principles can also be contradictory, in which case one of the principles must prevail over the other. It will not always be clear which principle is leading in every case. In the field of taxation, where the purpose is essentially to determine how much tax a taxpayer is due, the inherent legal uncertainty of a more principles based approach may be considered undesirable. In general purpose financial reporting this can be different, as it basically must be approached from the idea which form of presentation of the facts benefits the user most. It must always be clear that one rule takes priority over the other, while principles can have different weights in different situations.


\textsuperscript{158} Securities and Exchange Commission, \textit{Study Pursuant to Section 108(d) of the Sarbanes Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System}.


\textsuperscript{161} Explanatory Memorandum to Commission document 121 of 2011, final version.


Principles can conflict, whereas rules should not. Another problem is that once a rule is called a principle, taxpayers can feel inclined to discuss what the principle means (and thus create their own uncertainty) whereas when it is called a rule, this inclination might be less. When a principles based approach is followed, this does not mean that no rules can exist. There is no strict mutual exclusiveness between principles and rules. Rules can be given, along with principles to fill in the blanks, should they arise. The effect of such a system is that there is no or at least less of a perpetual increase of detailed rules that try to fill in the blanks, but there is always a basis on which all conclusions can be drawn when no rule exists for a particular situation. The principles are the foundation on which the rules are based, which also means that the rules must be interpreted in accordance with the principles. The decrease in legal certainty that a principles based approach causes is offset against the perceived decrease in administrative burden.

3.2.6 Determination of annual profit

When provisions and similar entries are recognised, this invariably has an effect on the amount of income that can be taxed in a particular year. The role in the determination of profit on provisions is therefore dependent on the determination of the annual profit itself. Within any type of financial reporting or determination of taxable income, the question arises what income is and how it is determined. This question has been present as long as financial reporting and income taxes exist. Special attention is given to the principles that govern the determination of profit and specific categories relevant for provisions. In the determination of profit the concept of ‘prudence’ is often relevant, but does not always refer to the same concept. In continental accounting, such as the Dutch or German system, prudence refers to protection of creditors or capital and generally consists of recognising profit as profit only when it is realised and recognising losses as losses as soon as they become apparent or likely. Prudence in Anglo-American accounting tends to not explicitly acknowledge a similar approach (although there is a large amount of ‘continental prudence’ present in for example IFRS, which otherwise has a lot of characteristics of Anglo-Saxon accounting) but refers to prudence as ascertaining that enough care is taken in estimation of uncertain positions. This difference can sometimes lead to confusion as to what the principle of prudence is.

This study deals with recognition and measurement of provisions. Provisions are a way of attributing expenses to a certain period in time, as cost. Attributing expenses is generally more complex than attributing income. There are three categories of attribution of expenses.

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165 See for example W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 249 for this issue.
166 It must be noted that this is a relatively simplified way of how the expenses take place. In practice the cash flows will be more complex as the actual expense may not take place but
Below is an overview of how and when expenses can be attributed to the past, present or future, including illustrative examples. This model comes back for all the researched systems.

In this overview, ‘expense’ means the actual outflow of money and ‘cost’ means the attribution of that expense to a certain period. ‘Cost’ refers to the year in which the profit is decreased by that amount.

For example, an expense is expected to take place in year 3, but is attributed to year 1. In year 1, the future expense leads to cost.

A. The expense is attributed as cost to the future

This means that the expense takes place before it is recognised as cost in the determination of income.\footnote{In reality this can be made more complex when the assets bought are not yet paid, so that a debt occurs and the expense takes place in the future. Although this often happens, I will take the occurrence of a debt as a species of the genus ‘expense’ and will not deal with it separately.}

For example, an enterprise pays € 100,000 in year 1. This expense is attributed as cost to years 2 and 3, € 50,000 each. This means that in years 2 and 3 a € 50,000 deduction takes place.

In general, there are three possible causes for expenses to be attributed as cost to the future

A.a The expense can be attributed to a future realisation moment

This occurs for example when inventories are bought in one year and sold in the next. The expense (buying the inventories) is attributed to the period in which the inventories are sold. This will generally follow from the principle of realisation and the principle of matching.

For example € 100,000 worth of inventories is bought in year 1. In year 2 these are sold for € 125,000. The € 100,000 expense is attributed as cost to year 2. Therefore the profit of year 2 is € 125,000 -/- € 100,000 = € 25,000.

A.b The expense is attributed to the period in which it no longer has any use

This occurs when an asset is bought at one point and becomes wholly or partially useless in a future year in the sense that it loses its value for the enterprise. This occurs for example when an asset is destroyed or goes bad (for example in the case of perishable goods) or is taken out of use.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

This is considered a loss which is caused in that period. This will therefore follow from the principle of causation or the principle of prudence.

*A machine is bought in year 1 for € 50.000. No write-off takes place in year 1. A year later it becomes damaged beyond repair. The € 50.000 expense is therefore attributed to year 2.*

A.c  *The expense is attributed to the period in which it has expected use, other than because of expected realisation*

This occurs for example when certain expenses relate to a certain future period. For example when rent is paid upfront before the period to which it relates, the expense will be attributed to the future. The principle of causation (the expense is caused, for example, by the fact that the rented asset is used in a certain period) is mostly dominant in this regard. An accrual will be recognised for this.

*At the end of year 1 the € 50.000 rent for year 2 is paid. The expense is attributed to year 2 as cost.*

B.  *The expense is attributed to the same period in which it is attributed as cost*

B.a  *The expense is attributed to realisation in the same year*

This is basically the same situation as under A.a, but as the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

*For example € 100.000 worth of inventories is bought and sold in year 1 for € 125.000. The € 100.000 expense is attributed as cost to year 1. Therefore the profit of year 1 is € 125.000 -/- € 100.000 = € 25.000.*

B.b  *The expense is attributed to the period in which it no longer has any use*

This is basically the same situation as under A.b, but as the asset becomes useless in the same year in which the expense takes place, attribution takes place in the same year.

*For example, a machine is bought in year 1 for € 50.000. It becomes damaged beyond repair in year 1 as well. The € 50.000 expense is therefore attributed to year 1 as cost.*

B.c  *The expense is attributed to the period in which it has expected use, other than because of expected realisation*

This is basically the same situation as under A.c, but as the expense takes place in the year to which the expense relates, attribution takes place in the same year. In practice, this situation will occur more often than the situation as under A.c.
For example, real estate is bought for € 500,000, in which the business of the enterprise is carried out. There is no direct relation between the amount of sales and the use of the real estate. The expected residual value after 20 years is € 100,000 in which year the real estate is sold. The expense is attributed as cost by annual depreciation of € 20,000 and € 100,000 cost of sale in year 20.

C. The cost is attributed in the period before the expense occurs

C.a The expense is attributed to the period in which it is caused as a loss
This is the situation when a loss becomes apparent, but the expense is expected to take place in the future. This generally follows from the principle of causation or the principle of prudence. Provisions are an example of this.

For example, an employee accidentally causes damage to the property of a third party in year 1. The expected outflow is € 100,000 in year 2. This is attributed as cost to year 1. In year 2 the actual outflow is € 110,000. Of this amount € 100,000 has already been taken into account and € 10,000 is attributed to year 2.

C.b The expense is attributed to the period in which it has expected use, other than because of it representing a loss
This is basically the same situation as under A.c and B.c, but the expense takes place in the period after the period to which it relates. This means that an accrual will be recognised for this situation. This can occur for example when an asset is bought and sold before it is actually paid for.

For example, € 100,000 worth of inventory is sold at the end of year 1, but the agreement with the supplier leads to payment in the beginning of year 2. The € 100,000 is attributed to year 1 as cost and the expense takes place in year 2.

The conclusion that can be derived from this is that provisions, the main topic of this research, take place in category C.a.

3.3 IFRS

3.3.1 Short history of the system and its objectives

IFRS, as a set of accounting standards, has been the most successful project in harmonisation of international accounting standards thus far, with currently more than 140 countries requiring or permitting reporting in accordance with IFRS.\textsuperscript{168} When IFRS was first adopted by several countries in 2005, it was not a

\textsuperscript{168} \url{http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx}.
The concept of provisions in Article 23 CCTB

fresh start from scratch, but rather a culmination of about a hundred years of work.
The ICA-meeting in St. Louis in 1904 is thought to be the starting point of international harmonisation of accounting standards.\textsuperscript{169} Research of harmonisation of international accounting standards took off under the leadership of Sir Henry Benson in the late 1960’s, which ultimately led to the founding of the International Accounting Standards Committee (IASC) by 16 national CPA-organisations. The primary goal of the IASC was the development of internationally accepted accounting standards (IAS).\textsuperscript{170} Though the IASC has been largely successful in both the creation of such standards and gaining worldwide acceptance,\textsuperscript{171} the growth and influence of the organisation called for a more democratic way of decision-making in order to gain more worldwide acceptance for the standards. This led to the foundation of the International Accounting Standards Board (IASB) in 2001, which included enhanced procedures for decision-making in a more democratic way. Although the IASB considers itself to be more democratic than the IASC, it is still a non-public, private organisation and not a formal legislator.\textsuperscript{172}

Since 2001, the IASB has worked on the development of the International Financial Reporting Standards (IFRS). Currently, the IAS still make up a large part of IFRS, though every year several IAS standards are replaced by new IFRS standards. For the consolidated accounts of companies listed on a stock exchange in the European Union, the application of EU-endorsed IFRS standards is obligatory.\textsuperscript{173} For small and medium-sized entities the IASB has developed IFRS for SMEs, which standards do not match the success of ‘full’ IFRS, especially from a European perspective. The practical application of IFRS for SMEs is quite limited in the European Union.\textsuperscript{174} The objective of the IASB is to provide standards for general purpose financial reporting. The IASB

\begin{itemize}
  \item \textsuperscript{171} By 2000, over 150 national CPA-organisations had become member of the IASC.
  \item \textsuperscript{172} The IASB considers itself to be independent. See http://www.ifrs.org/About-us/IASB/Pages/Home.aspx.
  \item \textsuperscript{173} Regulation (EC) nr. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (\textit{OJEC}. L 243/1). IFRS standards need to be endorsed in order to be recognised within the European Union. Although most IFRS-standards are endorsed in the European Union, differences do occur when an IFRS standards is not endorsed.
  \item \textsuperscript{174} Since IFRS for SMEs was found to be incompatible with the Directive (EC) 78/660 of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (\textit{OJEC} L 222/11) and the Directive (EC) 83/349 of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (\textit{OJEC} L 193/1), IFRS for SMEs was not endorsed in the European Union. See European Commission, \textit{Summary report of the responses received to the commission’s consultation on the International Financial Reporting Standards for Small and Medium-Sized Entities}, Brussels: May 2010.
\end{itemize}
considers financial statements to be a way of providing information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management’s stewardship of the resources entrusted to it. The latter implies that the financial statements function as a measure of accountability over a past period. The definitions of both assets and liabilities indicate that the expected future inflows and expected future outflows are the main determinants of both recognition and measurement. This means that IFRS recognises both past-oriented aspects and future-oriented aspects.

3.3.2 Congruence

IFRS is designed as a set of standards for general purpose financial reporting. It was not designed as a basis for the determination of taxable profit. The main objective of IFRS/IAS is therefore to provide information for a general public in which the general public’s needs are thought to be in line with the needs of investors. Therefore, there is no issue of congruence within IFRS itself, nor does the IASB concern itself with the implications of IFRS as a possible tax base for levying corporate income tax. In my opinion this is a benefit, as this makes the objectives clearer than when the IASB would also have to take arguments with regards to taxation into account. Despite the IASB’s own objectives, it has been the object of several researches to determine whether IAS/IFRS could be used as a tax base.

3.3.3 To whom does the system apply?

IFRS consists of a conceptual framework, reporting standards, interpretations and guidance and a basis for conclusions. The Conceptual Framework is not a standard and thus does not have similar status as a standard does. The Conceptual Framework provides some insight in the reasoning of the IASB and the how and why of IFRS, as it assists the IASB when developing and revising

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175 International Accounting Standard 1.9.
176 Conceptual Framework, 4.8.
177 Conceptual Framework, 4.15.
178 Conceptual Framework, OB2.
IFRS. In practice, the IASB seldom refers to the Conceptual Framework in Standards, Exposure Drafts and other publications. This means that whereas the Conceptual Framework could have been the backbone of IAS/IFRS, in practice it is not. It is likely that this too comes from difficulties with regards to political consensus. When there is an individual standard to be discussed, several parties can provide their input and some form of consensus can be reached. On a higher level, therefore as to what the exact ideas behind the set of standards are, this is much more difficult, because once this is set in stone, most of the room for negotiation will be gone, which is generally undesirable from a political perspective, as it gives away an amount of sovereignty. A similar situation can be found in CCCTB: it is easy to see the benefits of full international consensus with regards to the determination of profit in general, up until where states have to agree on the main principles and rules and derive the rules from that. It seems to be much more attractive for states to agree on issues on a case-by-case approach. The problem with this is that it is unlikely that a compact and coherent system will result from this. The standards do not clearly indicate to whom IFRS applies. The objectives of the IASB indicate that IFRS provides standards for financial reporting to help investors, other participants in the various capital markets of the world and other users of financial information in making economic decisions. The standards are therefore written from the perspective that the users of the financial information based on the standards are primarily investors. This indicates that the primary targeted audience of users of IFRS are listed entities, rather than SMEs, as investors and other participants in the various capital markets will generally invest in listed entities. The existence of a separate set of standards for SMEs confirms this. It does mean that the use of IFRS is inherently limited to listed and/or multinational enterprises.

### 3.3.4 Role of the balance sheet

IFRS, like its ‘predecessor’ IAS, is often thought to strive for a primarily static approach, whereby the role of the balance sheet is more important than the role of the profit and loss account. The primary users of IFRS reports are existing and potential investors, lenders and other creditors, who are often interested in the value of the entity’s assets and liabilities. Most IAS/IFRS standards refer to the entries on the balance sheet which indicates that the determination of profit is subsidiary to the role of the balance sheet. The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements. It identifies principles for the IASB to use when it

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181 IFRS for SMEs.


184 The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements. It identifies principles for the IASB to use when it
mentions little about the determination of profit, performance measurement or accrual of income either. The official opinion of the IASB, however, is that the balance sheet does not prevail over the profit and loss account. According to the IASB, no primary statement has primacy over the other primary statements and both statements should always be looked at together.\textsuperscript{185} With regards to the balance sheet the question can be raised whether the balance sheet primarily aims to provide information about current assets and liabilities or that the information is more focused on what the future expectations concerning the performance of the company are.\textsuperscript{186} As stated in Paragraph 3.3.1, the acknowledgement of the concept of stewardship implies that the financial statements provide a measure of accountability over the past whereas the definitions of assets and liabilities imply that expected future cash in- and outflows are the main determinants of both recognition and measurement. This means that aspects of both approaches can be recognised in IFRS.

3.3.5 Principles based or rules based

The Conceptual Framework to IFRS states that financial information must provide a faithful representation of the entity’s financial position, in the sense that it is complete, neutral and free from error, to the extent possible.\textsuperscript{187} Along the same lines, IAS 1 determines that financial statements shall present fairly the financial position, financial performance and cash flows of an entity.\textsuperscript{188} In itself this can be considered a principle, in the sense that a principle can overrule the rules when the outcome of the application of a rule is unreasonable or misleading. However, according to IAS 1, in virtually all circumstances an entity can only achieve a fair presentation by full compliance with the applicable IFRS.\textsuperscript{189} It is only in extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS standard would be so misleading, that it would conflict with the objective of financial statements set out in the Conceptual Framework, that the entity shall depart from that requirement.\textsuperscript{190} The amount of standards, basis for conclusions, details and examples give rise to the idea that preparing financial statements under IFRS essentially comes down to mandatory following the rules and guidance. This leads to the conclusion that IFRS is predominantly rules based.

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\textsuperscript{188} International Accounting Standard 1.15.
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\textsuperscript{189} International Accounting Standard 1, \textit{Presentation of Financial Statements} 1.17.
\end{flushright}

\begin{flushright}
\textsuperscript{190} International Accounting Standard 1, \textit{Presentation of Financial Statements} 1.19.
\end{flushright}
3.3.6 **Determination of annual profit**

3.3.6.1 **Income and expenses**

IFRS defines income as ‘increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants’.\(^{191}\) This includes both revenue and gains.\(^{192}\) Although unrealised gains are conceptually part of the income, it does not mean that IFRS follows an approach where realisation is not relevant for the recognition of income. Contrary to popular belief, IFRS does not revolve primarily around unrealised income and showing the fair value of assets and liabilities.\(^{193}\) Expenses are defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.\(^{194}\) IFRS therefore approaches the concept of income primarily from the balance-sheet, because it refers to increases or decreases of assets and liabilities as its basis. The attribution of inflows and outflows of resources to specific years in the form of costs and revenue is not explicitly mentioned in IFRS. The relationship between total profit and annual profit is not delved into in IFRS.

3.3.6.2 **Principles**

Despite the fact that IFRS is not primarily principles based, a number of generally accepted accounting principles can be recognised in the system underlying IFRS.

Principle of realism

IFRS recognises the concept of fair presentation of the financial position, financial performance and cash flows of an entity, despite that in virtually all circumstances, an entity (only) achieves a fair presentation by compliance with applicable IFRS.\(^{195}\) This also follows from IAS 8, where it is stated that information must be reliable and reported in accordance with economic substance rather than strictly on the basis of the legal form. Therefore, the principle of realism is present in IFRS, but only in exceptional circumstances it will lead to deviation from the standards.

\(^{191}\) International Accounting Standards, *Conceptual Framework* 4.25 (a).

\(^{192}\) International Accounting Standards, *Conceptual Framework* 4.29. Revenue arises in the course of the ordinary activities of an entity whereas gains are income that arises other than in the course of the ordinary activities of an entity.


\(^{194}\) International Accounting Standards, *Conceptual Framework* 4.25 (b).

\(^{195}\) International Accounting Standard 1, *Presentation of Financial Statements* 1.15.
Accrual
IFRS mentions that accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity’s economic resources and claims in which year those effects occur, even if the resulting cash receipts and payments occur in a different period. IFRS does not elaborate on the principles that govern the accrual of income and expenses in the Conceptual Framework and neither does IFRS elaborate on what triggers the accrual of income and expenses and therefore how attribution must take place.

Causation, prudence and neutrality
When the accrual basis underlies a set of accounting rules, the question is how to determine to which period income and expenses must be attributed. Principles such as the principles of causation, prudence and neutrality are relevant in this respect as they give direction on how to attribute the income and expenses. IFRS does not mention the principle of causation. With regards to prudence and neutrality, up until 2010, the Conceptual Framework to IFRS stated that neutrality (information being free of bias) is a part of reliability and means a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty. The exercise of prudence does not allow the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income or the deliberate overstatement of liabilities or expenses, as this would not be neutral and thus lead to information that is not reliable. From the year 2010 onwards the word prudence is no longer mentioned in the Conceptual Framework as the IASB fears that any reference to prudence could lead to issues with regards to reliability. Despite this obvious restraint with regards to the use of the word prudence (which is characteristic to the Anglo-American approach), the approach to the recognition of revenue is in general prudential, as most profits and revenue need to be realised in order to be recognised. The role of fair value in IFRS must therefore not be overstated.

For example, when the value of an asset increases from € 100.000 to € 120.000, this would only lead to revenue or profit under application of historical costs as a basis, when the asset is sold. Under application of fair value, such an increase in value would lead to revenue when it occurs. Application of historical cost is therefore more prudential than fair value in this respect.

The difficulty with fair value when using it in a tax base lies in the ‘ability to pay taxes’ and the deemed liquidity of an entity. When an asset increases in

196 International Accounting Standard 1, Presentation of Financial Statements 1.27.
198 See for example International Accounting Standard 18, Revenue.
value, this does not mean that the liquidity of the entity will increase in the short run which means that there are no additional means to pay the taxes with. When the asset is sold (and thus the profit realised), there will generally be an increase in liquidity. In a perfect capital-market, the concept of fair value would be in accordance with the ‘ability to pay taxes’, meaning that any increase in value can be financed by an external party. In a perfect capital-market it can even be stated that not using fair value is against the principle of ability to pay taxes, as the existence of silent reserves hides the actual ability to pay taxes.\(^{200}\) The problem is that the European economy does not resemble a perfect capital-market and increases in asset-value can often not lead to financing of tax debts, as external parties will simply not always lend money for this.\(^{201}\) The above implies that the IASB acts in a restrained manner with regards to the use of the word prudence, even though the principle of prudence still underlies IFRS to a large extent. The fear of prudence leading to hidden reserves and excessive provisions that can be used for window-dressing and earnings-management overlaps with the traditional view in the United Kingdom (see Paragraph 3.6).

Realisation
As stated above, IFRS is often thought not to adhere to the principle of realisation, because of its use of fair value.\(^{202}\) The Conceptual Framework does not mention the principle of realisation,\(^{203}\) although it does differentiate between realised and unrealised income.\(^{204}\) IAS 18 Revenue determines that one of the main criteria for the recognition of revenue is when it is probable that economic benefits associated with the transaction will flow to the entity.\(^{205}\) This refers to the moment when realisation has taken place. Therefore, despite the fact that IFRS is often referred to as based on fair value, it adheres to the concept of realisation for normal revenue.

Matching
IFRS does not refer to the principle of matching as such. The concept of attributing expenses as costs to moments of realisation can be derived from, for example, IAS 2.34, which states that when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. This is a clear reference to matching expenses with income on the moment of realisation.


\(^{205}\) International Accounting Standard 18, *Revenue* 18.14, 18.15, 18.20.
For example, when inventories are bought for €100,000 in year 1 and sold in year 2 for €120,000, this means that both the income and expense are attributed to year 2, leading to a €20,000 profit.

For matching period bound expenses with the periods to which they relate, no general rules exist. Furthermore, when the definition of an asset is not met, recognition of an asset on the balance sheet is not allowed, which rules out part of the principle of matching.

For example, an enterprise spends €100,000 on advertising in year 1. This relates to a product that will be introduced on the market in year 2. The sales in year 2 are €200,000. The €100,000 advertising costs do not constitute an asset. They will therefore be attributed to year 1, whereas the €200,000 sales are attributed to year 2.

This means that matching underlies IFRS, even though no explicit reference is made to it in the standards themselves or the Conceptual Framework. The fact that the expenses must constitute an asset to be attributed to a future period limits the applicability of the principle of matching.

Principle of simplicity and materiality
IFRS does not recognise the principle of simplicity, but it does recognise the concept of materiality.\textsuperscript{206} Under IFRS, information is material if omitting or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.\textsuperscript{207}

3.3.6.3 Consequences for attribution of expenses

In this paragraph the model of Paragraph 3.2.6 is applied to IFRS.

A. The expense is attributed as cost to the future

A.a \textit{The expense can be attributed to future realisation}

IFRS recognises situations where the expense can be attributed to a future realisation moment. IAS 2.34, first sentence, states that when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. This means that the expense is attributed to the future realisation-moment.

IAS 16.67 determines that the carrying amount of an item of property, plant and equipment shall be derecognised on disposal, which means that the remainder of the book-value is attributed to the moment of realisation (disposal).\textsuperscript{208} Expenses can only be attributed to the future

\textsuperscript{207} International Accounting Standard 8, Accounting Policies, Changes in Accounting Estimates and Errors BC20.
\textsuperscript{208} International Accounting Standard 16, Property, Plant and Equipment 16.67 (a).
when they constitute an asset. When it constitutes for example inventories or property, plant and equipment the expense can be attributed to the future. When this is not the case, attribution of an expense to the future is not possible.

A.b The expense is attributed to the period in which the assets lose their recoverable amount

IFRS 2.34, second sentence, states that the amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs (which is an expression of the principles of causation and prudence and not of matching, as the costs are attributed to the period in which they occur and not to the period in which the connected revenue is realised). Therefore, when this occurs in a year after the asset is bought, the expense is attributed as cost to that later year. Impairment of assets is dealt with in the separate standard IAS 36 Impairment of Assets, but this refers to the same concept. IFRS also determines that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. This separate depreciation of each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is known as the ‘component-approach’. While IAS 16 makes clear that such assets shall be depreciated, it does not answer why items are depreciated. It is not clear whether they are depreciated because they represent a loss or because their costs shall be attributed to the periods in which they are in use.

Since IFRS adheres to a rather stringent definition of assets in the Conceptual Framework, it can be expected that the reason for depreciation is a decrease in expected future inflow connected with the assets. However, in its basis for conclusions for IAS 16, the IASB does not refer to the definition of assets. Instead, it mentions that the concept of depreciation is ‘a’ cost allocation technique. This means that it is very likely, but not certain, that depreciation falls under category A.b under IFRS. It could also be stated that depreciation falls under category A.c (the expense is attributed to the period in which it has expected use, other than because of expected realisation), as the use and benefit of the asset takes place in the period after the expense has taken place, but no

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210 Impairment testing refers to the practice of comparing the book value with fair value of an asset, in order to assess whether the book value is not out of line (especially not higher than) with the fair value of the asset. If the book value is higher than fair value, an additional write-off can be necessary.
211 International Accounting Standard 16, Property, Plant and Equipment 16.43.
212 International Accounting Standard 16, Property, Plant and Equipment 16.43.
213 International Accounting Standard 16, Property, Plant and Equipment 16.43.
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reference is made to the future use. The former also follows from the definition of an asset: when there is no realisation-moment to which expenses can be attributed, or the realisation-moment itself is uncertain, the definition of an asset, which relates to expected future inflows will not, or not fully, be met, when there are no or less expected future inflows connected with the expense.\(^{215}\) The expense can therefore no longer be recognised as an asset and is immediately recognised as cost, when and as far as the expected future inflows decrease.

A.c. \textit{The expense is attributed to the period in which it has expected use, other than because of expected realisation}

This occurs for example when certain expenses relate to a certain future period. Examples of this are rent, wages and interest when paid upfront and most likely, also depreciation of a fixed asset. Since IAS/IFRS generally do not refer to the Conceptual Framework, it is often difficult to answer the question why such expenses are attributed to the period to which they relate. The principle of causation applies in this respect (the expense is caused, for example, by the fact that the rented asset is used in a certain period). With regards to period bound expenses (such as wages, interest and rent), IFRS does not recognise a general rule that they shall be attributed to the period to which they relate in the same way that Dutch sound business practice recognises this as a rule. This is understandable since under IFRS the basic question that must be answered in matters of attribution is whether an asset or liability is present or not. Rent will generally fall under the scope of IAS 17, as an operating lease.\(^ {216}\) The lessee shall recognise the lease payments under an operating lease as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit.\(^ {217}\) This implies that it is not treated as a loss (otherwise it would be treated as an onerous contract), but rather as a depreciable asset.

Interest is dealt with in IAS 23 Borrowing costs. Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.\(^ {218}\) Under IAS 23, interest can be either directly attributable to the acquisition, construction or production of a qualifying asset and thus form part of the cost of that asset or be recognised as costs or otherwise be a cost in the period to which the interest relates.\(^ {219}\) When interest is treated as part of the costs of an asset, it follows the rules for depreciation of that particular asset, which will generally mean that


\(^{216}\) Operating lease is defined as a lease other than a finance lease and a finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset, whereby the title may or may not eventually be transferred. See International Accounting Standards 17.4 and 17.8.

\(^{217}\) International Accounting Standard 17, \textit{Leases} 17.33. IAS 17 will be replaced by IFRS 16, \textit{Leases}.

\(^{218}\) International Accounting Standard 23, \textit{Borrowing Costs} 23.5.

\(^{219}\) International Accounting Standard 23, \textit{Borrowing Costs} 23.1 and 23.9.
the expense takes place before the attribution as cost. IAS 23 does not answer why interest that is recognised as cost at that moment (and thus not as part of an asset) is attributed to a particular period. Recognising the costs in the period to which the interest relates suggests that it is attributed to the period in which the service has been received, which is the use of the loan. Therefore, when interest does not form part of an asset, it is only attributed as cost to the future when it is paid up front. Wages and salaries are dealt with in IAS 19 Employee benefits and are to be recognised when an employee has rendered service in exchange for those benefits. This also implies that these expenses are not treated as a loss, but attributed to the period in which the service is received. Attribution to the period after the period when the expense takes place, will therefore be a rare occurrence with regards to wages.

B. The expense is attributed to the same period in which it is attributed as cost

B.a The expense is attributed to realisation in the same year
This is basically the same situation as under A.a, but when the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

B.b The expense is attributed to the period in which it no longer has any use
This is basically the same situation as under A.b, but when the asset becomes useless in the same year in which the expense takes place, attribution takes place in the same year.

B.c The expense is attributed to the period in which it has expected use, other than because of expected realisation
This is basically the same situation as under A.c, but when the expense takes place in the year to which the expense relates, attribution takes place in the same year.

C. The cost is attributed to the period before the expense occurs

C.a The expense is attributed to the period in which it is caused as a loss
This is the situation when a loss becomes apparent, but the expense is expected to take place in the future. This occurs for example when a provision is recognised. IAS 37 states that a provision is a liability of uncertain timing or amount and that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Repairs and maintenance are not recognised as provisions in IFRS, as they do not meet the criteria for the recognition of a provision;

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220 International Accounting Standard 19, Employee Benefits, 19.5 (a) and 19.9.
221 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.
they do not constitute an obligation, despite the fact that there is a distinct cause-and-effect with regards to the expense.\textsuperscript{222} This is another example of the fact that IFRS requires that only items that meet the definition of an asset or a liability are recognised on the balance-sheet. Provisions will be dealt with in detail in Chapter 4.

C.b \textit{The expense is attributed to the period in which it has expected use, other than because of it representing a loss}

This is another example of the fact that IFRS requires that only items that meet the definition of an asset or a liability are recognised on the balance-sheet. Provisions will be dealt with in detail in Chapter 4.

3.4 German law

3.4.1 Short history of the German accounting and tax systems and their objectives

Commercial law
Contrary to the Dutch system, where the standards for general purpose financial reporting and the determination of taxable profit are formally unconnected, the German approach has traditionally been renowned for a large amount of congruence between commercial law and taxable profit. I will deal with this issue further in Paragraph 3.4.2. The first law on commercial accounts in the German territory\textsuperscript{223} was the ‘Allgemeine Landrecht für die Preussischen Staaten’ of 1794.\textsuperscript{224} In the century after its introduction, economic activity in the German territory increased as did the interconnection between the states that would later form the current German Republic. Under the influence of the 1807 French Code de Commerce (also referred to as the Code Napoléon), a new law was introduced in the nineteenth century. In 1861 the general German commercial code (‘das allgemeine deutsche Handelsgesetzbuch’) entered into force in what was then known as the German Confederation. Like the Code Napoléon, protection of creditors (‘Gläubigerschutz’) and capital maintenance (‘Kapitalerhaltung’) were and are two main themes in the accounting rules.\textsuperscript{225} In


\textsuperscript{223} Germany as we currently know it only exists since 1990, but the development of the current Germany has a complex history. I will however refer to the predecessors of Germany and being German, as long as they were on the current territory.


1900 the new commercial code (‘Handelsgesetzbuch’) entered into force. Several modernisations have taken place in the course of more than a century. In the year 2004 the German commercial code was reformed to allow and, in specific cases, require the use of IFRS, by means of the ‘Bilanzrechtsreformgesetz’.\(^{226}\) The most recent reform was the ‘Bilanzmodernisierungsgesetz’ or ‘BilMoG’ in 2009. The latter modernised multiple parts of the code and incorporated changes brought forward by several EU-Directives.\(^{227}\) This means that German accounting has moved somewhat towards an orientation on capital markets. Like the Netherlands and the United Kingdom, Germany has a national accounting standards board (‘Deutsches Rechnungslegungs Standards Committee’), which is a non-public organisation, with its legal basis in Article 342 Handelsgesetzbuch.\(^{228}\) It provides recommendations for the application of the law, which recommendations are laid down in the German Accounting Standards (‘Deutsche Rechnungslegungsstandards’).

Income and corporate tax
Income tax was first introduced in the German territories in 1811 in East-Prussia as a temporary measure to finance the war against Napoleon. It was however abandoned two years later, as the population did not fully accept the tax and the administrative infrastructure was too weak to allow proper enforcement.\(^{229}\) After several attempts it was reintroduced successfully in 1851, after the idea took hold that the richer part of society should pay a higher amount of taxes (which was a social issue that grew over the course of the nineteenth century, eventually culminating in the twentieth century), as well as to support the states’ finances.\(^{230}\) A number of the other German states introduced income taxes in the following years. The first real German income tax (as far as being an income tax that was applicable in all the German states) was the ‘Reichseinkommenssteuer’ of the Weimarer Republik that entered into force on 29 March 1920 and which

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\(^{227}\) See Article 315a HGB.


underwent large reforms in 1925 and 1934. It aimed to tax the income of individuals. One of the categories of taxable income was profit (‘Einkünfte aus Gewerbebetrieb’). 231

For the determination of taxable profit, the profit that was determined under the requirements of the ‘Handelsgesetzbuch’ was the basis. Entrepreneurs that did not fall under the scope of the ‘Handelsgesetzbuch’ were obliged to determine their profit on the basis of Article 12 EStG 1925, which came down to cash-based accounting. With the tax-reform of 1920 corporate income tax was introduced in Germany (‘Körperschaftsteuer’). From 1953 and onwards, distributed profits were taxed lower than non-distributed profits. The reason for this was the fact that the distributed profits were also taxed with income tax at the level of the individual. This difference in treatment was eliminated in 1973 as it became possible to offset corporate tax with income tax. The most recent major reform of the German tax codes took place in the year 2001, which mainly lowered tax rates considerably. Over the years, German income tax has become more complex and more detailed, which made it more susceptible to tax planning and which has led to higher costs of compliance. 232

3.4.2 Congruence

Traditionally, determination of taxable profit in Germany has been renowned for requiring a high amount of congruence (‘Maßgeblichkeit’). The concept of congruence has a long history in Germany, stemming originally from 1861, and is filled with debate. 233 German tax law used to determine that the principles (‘Grundsätze’) for orderly accounting of the commercial law (‘Handelsgesetzbuch’) are also applicable to the tax balance sheet (‘Steuerbilanz’). 234 This meant that both the principles and the choices made with regards to those principles applied to the determination of taxable profit. To a large extent this meant that commercial profit and taxable profit were virtually identical. The initial justification of this high amount of congruence was practicality and simplicity: it would require almost no extra work to determine the taxable profit once the commercial profit was determined. Traditionally in Germany, the government was seen as a ‘silent shareholder’ in the enterprises, which meant that the government would be entitled to a share of the commercial profit, just like regular shareholders would. This meant that there was no room

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233 For this history see W. Schön, *Steuerliche Maßgeblichkeit in Deutschland und Europa*, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 150.

234 See Article 5 EStG up until 2008.
for determination of taxable profit that differed from commercial profit. One of the interesting effects that the high level of congruence has had is the fact that the German Federal Fiscal Court (which rules over the determination of taxable income) has ruled a relatively high amount of cases on accounting rules, meaning that the Federal Fiscal Court has helped shape the application of accounting rules. This follows from the fact that taxpayer and tax authorities tend to take stronger oppositions than a reporting entity and the users of the financial information of that entity do. On 25 May 2009 Article 5 EStG was changed, as part of the modernisation of accounting rules (‘Bilanzmodernisierungsgesetz’). As a result of this change, German tax law no longer requires full congruence. The accounting principles are still the basis for the determination of taxable profit, but when tax law offers a choice, that choice can lead to a deviation from the commercial accounts. This means that congruence between the commercial accounts and taxable profit in German tax law is less than before, but still high. Apart from the accounting principles, there are and have always been exceptions that applied only to taxable profit. Specific tax rules can overrule accounting principles. Essers still deems the approach in German tax law to be of the second category: almost formal congruence. In practice, the commercial accounts will, on a general basis, determine the amount of taxable profit, despite not being fully formally congruent. Article 5, Paragraph 1 first sentence EStG currently determines that the tax accounts are made using the ‘handelsrechtlichen Grundsätzen ordnungsmäßiger Buchführung’, which translates roughly as the generally accepted accounting principles. Article 5, Paragraph 1 first sentence EStG and thus the amount of congruence also applies to entities on the basis of Article 8, Paragraph 1 KStG. The question is whether the ‘Handelsgesetzbuch’ fully reflects German generally accepted accounting principles. If so, the question remains why reference was not made to the ‘Handelsgesetzbuch’ directly and if not, where the differences are. The consensus in Germany tends to be that the background of a high amount of ‘Maßgeblichkeit’ (congruence) is to reduce differences between commercial accounts and taxable income, for reasons of simplicity. This does not speak in favour of differences between the concept of German GAAP and the ‘Handelsgesetzbuch’. Congruence is not achieved by using a set of accounting

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236 W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 56.
237 BStB. I 2010, 239.
238 For example Article 6a, Paragraph 1 EStG. For more details on the subject, see W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005.
principles for the determination of taxable income that differ from the ones used for the general purpose financial reporting. This implies that the ‘Handelsgesetzbuch’ determines generally accepted accounting principles and that the latter are not a separate set next to the ‘Handelsgesetzbuch’. Therefore, where tax law does not offer specific rules, the commercial accounts need to be followed and where tax law offers specific rules, these specific rules must be followed. The difficulty arises where the ‘Handelsgesetzbuch’ offers options. This means that all options will be in accordance with German GAAP and thus the question becomes relevant whether German GAAP must be followed or strictly the commercial accounts. The German Federal Fiscal Court has decided that congruence is not adhered to in that situation.\textsuperscript{241} The standards for commercial accounts are the German GAAP of the ‘Handelsgesetzbuch’.\textsuperscript{242} Article 315a HGB determines that entities that are required to prepare their consolidated accounts on the basis of IFRS, following Regulation 1606 of 2002,\textsuperscript{243} are exempt from parts of the German GAAP. Non-listed entities are allowed to use IFRS for the preparation of their accounts. This means that the general basis for the determination of taxable profit is commercial law, in the sense of German GAAP. Specific tax rules can however overrule this. When IFRS is used for the preparation of the commercial accounts, whether because it is obligatory or by choice, IFRS determines the commercial accounts which are the basis for the tax accounts. In that case, IFRS provides for the relevant standards for the determination of taxable income.\textsuperscript{244} The main objectives of the German accounting system are therefore to provide information to users of the financial information, the protection of creditors and limitation of the distributable profit and the determination of taxable income.

3.4.3 To whom does the system apply?

Article 238 HGB states that every businessman (‘Kaufmann’) is obliged to keep the books of his business and give insight into his capital in line with the accounting principles. This means that both individuals and entities, listed and non-listed, should adhere to the rules of the ‘Handelsgesetzbuch’.\textsuperscript{245} Only to very small individual business an exemption applies.\textsuperscript{246} The basic accounting rules are laid down in Article 238-263 HGB to which all businesses are expected to adhere. For certain types of businesses, such as entities with a share-based capital, specific rules are given.\textsuperscript{247} The ‘Handelsgesetzbuch’ is the primary basis

\textsuperscript{241} German Federal Fiscal Court 3 February1969, GrS 2/68, BStBl. II 1969, 291.
\textsuperscript{242} H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart, Schäffer-Poeschel, 2013, p. 67.
\textsuperscript{244} A. Hintz, Das Problem der Maßgeblichkeit der Handels- für die Steuerbilanz im Lichte der wachsenden Bedeutung für IFRS, Munich: Grin Verlag, 2007, p. 10.
\textsuperscript{245} H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart, Schäffer-Poeschel, 2013, p. 2.
\textsuperscript{246} Article 241a HGB.
\textsuperscript{247} Articles 264-335b HGB.
for the determination of (taxable) profit, for both individuals and entities.\textsuperscript{248} Article 140 and 141 AO determine that everyone that is required to keep accounts for other purposes than for tax is also required to do so for tax purposes. German law used to allow certain forms of reverse congruence (‘umgekehrte Maßgeblichkeit’), such as accelerated depreciation for tax purposes, that was to be entered into the commercial accounts as well.\textsuperscript{249} With the modernisation of the commercial law in 2009 (‘Bilanzmodernisierungsgesetz’) this reverse congruence was ended.

### 3.4.4 Role of the balance sheet

According to Article 238 Paragraph 1 and 247 HGB one of the objectives of keeping the books is to provide an overview of assets and liabilities. Therefore the balance sheet is a separate objective and its primary objective is the particular oversight of assets and liabilities. Under German corporate law it is obligatory to draw up both a balance sheet and a profit and loss account. The concept of a dynamic balance sheet (a balance sheet which primary objective is supporting the determination of profit) was originally put forward by Schmalenbach who wrote about the dynamic balance sheet in his standard volume ‘Grundlagen dynamischer Bilanzlehre’.\textsuperscript{250} Traditionally, the approach in Germany has been characterised by protection of creditors, which translates in to a prudential approach towards determination of profit, as it is careful not to recognise distributable profit too early. This also leads to imparity: profits are recognised not before they are realised and losses as soon as they are likely.\textsuperscript{251} Under current German corporate law the balance sheet contains both static elements and dynamic elements,\textsuperscript{252} which means that it serves both to determine taxable income as well as to inform users of the balance sheet about certain positions at a given time. Since taxable profit under German tax law is determined on the basis of the ‘Handelsgesetzbuch’, a tax balance sheet is required. The tax balance sheet itself is effectively a dynamic balance sheet, as it only serves to determine taxable profit. However, in the past, the German Federal Fiscal Court ruled that under German tax law there is no such thing as a dynamic balance sheet.\textsuperscript{253} This indicates that the general purpose financial reporting does not revolve around the dynamic balance sheet and the taxable profit is simply derived from the general purpose financial reporting. From a tax perspective a balance sheet primarily serves to determine taxable profit. Furthermore, from Article 5, Paragraph 1 first sentence EStG it follows that profit is to be determined on the basis of a balance sheet comparison, which

\textsuperscript{248} Article 1, Paragraph 1 first sentence EstG and Article 8, Paragraph 1 KStG.
\textsuperscript{249} Article 5, Paragraph 1 second sentence EStG up until 2009. Article 254 HGB, Article 7g EStG.
\textsuperscript{250} E. Schmalenbach, Grundlagen dynamischer Bilanzlehre, Leipzig: G.A. Glöckner, 1925.
\textsuperscript{251} W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 4.
\textsuperscript{252} Articles 242, 250 and 253, Paragraphs 2 and 3 HGB.
\textsuperscript{253} German Federal Fiscal Court 23 November 1983, BStBl II, 1984, 278.
underwrites this conclusion. Still, for tax purposes, both a balance sheet and a profit and loss account are required.

### 3.4.5 Principles based or rules based

The German law governing the commercial accounts contains written as well as non-written parts, both of which are binding. A great deal of principles (‘Grundsätze’) can be recognised in these rules. Traditionally, they are divided into framework principles (‘Rahmengrundsätze’), principles for the accrual to the correct year (‘Abgrenzungsgrundsätze’) and additional principles (‘Ergänzungsgrundsätze’). Theoretically, when specific circumstances would lead to the financial statements not showing a true and fair view, additional disclosures are required, but this is deemed extremely rare in practice. This means that an unreasonable outcome would not lead to alteration of the application of the rules, but to additional disclosures. The balance sheet and the profit and loss account as such would not be different. When the legal requirements lacks detailed descriptions for specific accounting issues (such as accounting for leases), the principles, along with case law, support in filling in the gaps. As far as the level of detail goes, German commercial law (the ‘Handelsgesetzbuch’) is of a somewhat detailed level, but not comparable to the high amount of rules and guidance found in United States GAAP or IFRS. Because of Article 5, Paragraph 1 second sentence EStG the determination of taxable profit is largely dependent on the commercial accounts and always needs to be based on the rules of the ‘Handelsgesetzbuch’, unless tax law provides a different specific rule. Article 5, Paragraph 1 second sentence EStG contains no additional rules that allow deviation from the rules of the ‘Handelsgesetzbuch’ when the outcome would be unreasonable or unforeseen. This means that both the rules for the commercial accounts and the determination of taxable profit are fully rules based or principles based, but show signs of both approaches.

### 3.4.6 Determination of annual profit

#### 3.4.6.1 Income and expenses

The relationship between the concepts of total profit (‘Totalgewinn’) and profit over a given amount of time (‘Periodengewinn’), where the sum of the annual

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254 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 41.
255 Article 60, Paragraph 1, second sentence EStDV.
256 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 144.
258 Article 264, Paragraph 2, second sentence HGB.
profits is equal to the total profit over the lifetime of the enterprise, has been introduced in Germany by Schmalenbach.\textsuperscript{260} The concept that the sum of the annual profits is equal to the total profit and the attribution of income and expenses is not specifically mentioned in the ‘Handelsgesetzbuch’, but is inherent to Article 275 HGB, which deals with the profit and loss account.\textsuperscript{261}

3.4.6.2 Principles

As stated in Paragraph 3.4.5 German commercial law refers to a number of principles.

Principle of realism
Neither the German ‘Handelsgesetzbuch’ nor the ‘Einkommenssteuergesetz’ make an explicit reference to the principle of realism, although a number of other principles are mentioned that overlap with realism. The accounts must be true (‘Bilanzwahrheit’), which means that they must be correct with regards to the facts and be free of arbitrariness.\textsuperscript{262} Article 243 HGB mentions the principle of clarity, which states that the annual accounts are to be made in an orderly and clear fashion. They also must be complete, in the sense that they shall not be lacking any relevant information.\textsuperscript{263} Article 246 contains an economic substance over form principle.\textsuperscript{264} Article 39, Paragraph 2 AO also contains an economic substance over form principle, as economic ownership of fixed assets prevails over legal ownership when certain criteria are met.\textsuperscript{265}

Accrual
In German accounting the concept of accrual (‘periodengerechten Zurechnung’) is recognised, even when it is not mentioned literally in the ‘Handelsgesetzbuch’. It follows from both the principle of realisation and the principle of imparity, both of which are recognised in German accounting law (see the following paragraphs) and therefore from Article 252, Paragraph 1 Nr. 5 HGB.\textsuperscript{266} These principles cannot exist without underlying recognition of the concept of accrual. For the determination of taxable income the principle of accrual follows from Article 11 EStG. Only for very simple and small enterprises the possibility of cash based accounting exists.

Prudence, causation and imparity
In Germany, the principle of causation (‘Verursachungsprinzip’) is also thought to

\textsuperscript{260} E. Schmalenbach, Grundlagen dynamischer Bilanzlehre, Leipzig: G.A. Glöckner, 1925.
\textsuperscript{262} Article 239 HGB. H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 145.
\textsuperscript{263} Article 246, Paragraph1 first sentence HGB.
\textsuperscript{264} Article 246, Paragraph 1 second sentence HGB.
\textsuperscript{265} See German Federal Fiscal Court 9 July 1985, BStBl II, 1985, 722.
\textsuperscript{266} H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 46.
follow from Article 252, Paragraph 1 Nr. 5 HGB. This means that the method used for accrual is causation. Therefore revenues and costs are recognised in the year in which they have been caused from an economic perspective. This economic perspective is also influenced by the principle of prudence and the principle of imparity. The principle of prudence (‘Vorsichtsprinzip’) is mentioned explicitly in Article 252, Paragraph 1 Nr. 4 HGB. It states that all foreseeable risks and losses which are caused before the date of the balance sheet need to be taken into account. In Germany the principle of prudence is also thought to lead to the principle of imparity (‘Imparitätsprinzip’). Profits are to be taken into account only when they are realised on the date of the balance-sheet and losses are to be taken into account when they are foreseeable on the date of the balance-sheet.

In that sense it is similar to the principle of prudence as it is known in Dutch sound business practice (see Paragraph 3.5.6.2). From the viewpoint of the commercial accounts, the application of the principles of prudence and imparity lead to capital maintenance and protection of creditors. This is caused by the fact that only realised profit can be distributed to the shareholders and losses should be taken into account as soon as they become likely, which means that they diminish the distributable profit as soon as they become likely. From the viewpoint of income tax, the application of these principles leads to taxation on a moment when a taxpayer can reasonably be expected to possess the means to pay the tax (‘ability to pay’).

Realisation
The principle of realisation (‘Realisationsprinzip’) is recognised in the ‘Handelsgesetzbuch’ and thus in the determination of taxable profit. The principle of realisation states that profits are only to be recognised when they are realised at the date of the balance sheet. Because the word ‘Gewinn’ (profit) is used and this is generally understood as the difference between revenue and costs, this leads to the conclusion that relevant revenue as well as costs need to be attributed to the moment of realisation. The moment of realisation is generally understood as the moment when the right to receive the consideration has arisen, which also suggests that the significant risks and rewards of ownership have been transferred.

267 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 45 and 149.
268 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 149.
269 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 150.
270 Article 252, Paragraph 1 nr. 4 HGB. H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 149.
The Concept of Provisions in Article 23 CCTB

Matching
Since the principles of causation, prudence, imparity and realisation are generally understood as attributing income and expenses to a certain period, there is no separate general concept of a matching principle in Germany.  

Simplicity and materiality
German commercial law or tax law do not explicitly recognise a principle of simplicity. The concept of materiality is not mentioned in the ‘Handelsgesetzbuch’ either. In German economic literature and especially auditing theory, the ‘Grundsatz der Wesentlichkeit’ is mentioned, which is similar to the concept of materiality, but does not seem to have gathered as much attention as it has done in IFRS. Within the context of taxation, it is not an issue that is discussed separately.

3.4.6.3 Consequences for attribution of expenses

Here, the model of Paragraph 3.2.6 is applied to the German rules. In the same way as is described in Paragraph 3.2.6, expenses can be attributed as costs to either the future, the current year or costs can be attributed to a current year before the expense has taken place.

A. The expense is attributed as cost to the future

A.a The expense can be attributed to future realisation
From the ‘Realisationsprinzip’ of Article 252, Paragraph 1 Nr. 4 HGB it can be derived that expenses, when they are part of the profit, are to be attributed to the realisation-moment. This also follows explicitly from Article 4, Paragraph 3 fourth sentence EStG, which states that the expenses for the acquisition of non-depreciable fixed assets or current assets are to be attributed to the moment on which they are sold or otherwise disposed of.

A.b The expense is attributed to the period in which the assets lose their recoverable amount
From the principle of causation (‘Verursachungsprinzip’) of Article 252, Paragraph 1 Nr. 5 HGB and the principle of prudence (‘Vorsichtsprinzip’) of Article 252, Paragraph 1 fourth sentence HGB it follows that when an asset loses its value, it needs to be impaired. This means that the expense has taken place in the past and is attributed to the period in which the loss becomes apparent.

272 Article 252, Paragraph 4 HGB.
273 Institut der Wirtschaftsprüfer, Prüfungsstandard 250 Wesentlichkeit im Rahmen der Abschlussprüfungen.
274 H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band 1, Stuttgart: Schäffer-Poeschel, 2013, p. 149.
For example, when a machine with a book value of € 100,000 becomes useless in the business of a company and can only be sold in the market for an amount of € 50,000 and the enterprise does not sell it, it still needs to impair the machine to € 50,000.

At this point a difference between the commercial accounts and the determination of taxable income becomes apparent. For the commercial accounts any impairment for unforeseen depreciation is to be taken into account.\(^{275}\) This applies to both fixed and current assets. For the determination of taxable income, such depreciation is not obligatory but optional.\(^{276}\) In German accounting, the reason for the depreciation of assets is the attribution of the cost of an asset over the periods in which it is used.\(^{277}\) No connection with income is required. This implies that it does not necessarily express decrease in value because of wear and tear, but it is not a matter of matching costs with revenue either. In German income tax depreciation is thought to express wear and tear resulting from use of the asset or the decrease in value from the passing of time (‘Absetzung für Abnutzung’).\(^{278}\)

A.c The expense is attributed to the period in which it has expected use, other than because of expected realisation

German corporate law (‘Handelsgesetzbuch’) does not elaborate on the attribution of period bound costs. Article 11, Paragraph 2 EStG determines that recurring expenses are attributed to the year to which they belong economically, even when they are paid shortly before or after that particular year. Rent falls under this category, as do wages, salaries and interest. The German Income Tax Act does not elaborate on what is the economic trigger that makes the expenses belong to a particular year. Expenses in general can be attributed as costs when they occur, before they occur or after they occur. Period bound costs are attributed, in general to the period to which they belong economically, which means that salaries, interest and rent will be attributed to the period when the service is received. In the case of interest, the expense can also be attributed to a fixed asset that is produced by the entity and thus attributed to the period in which the fixed asset is depreciated.\(^{279}\) Therefore, when these expenses are made before the period to which they relate, they fall under this category. Apart from the situation when they become part of the book-value of another asset (as can be the case with interest and

\(^{275}\) Article 253, Paragraph 3 HGB.

\(^{276}\) Article 6, Paragraph 1 nr. 1 second sentence EStG.

\(^{277}\) Article 253, Paragraph 1 first sentence and Paragraph 3 HGB. See H. Hörschitz e.a., Bilanzsteuerrecht und Buchführung, Finanz und Steuern, Band I, Stuttgart: Schäffer-Poeschel, 2013, p. 339.

\(^{278}\) Article 6, Paragraph 1 first sentence EStG.

\(^{279}\) Article 255, Paragraph 3 second sentence HGB.
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wages), an accrual (‘Rechnungsabgrenzungspost’) will be recognised for having made these expenses which are attributed to a future year.\(^{280}\)

Unlike the Anglo-American approach, which tends to adhere to the definition of an asset quite strongly, German accounting rules have traditionally preferred matching of costs over the strict adherence to the definition of an asset.\(^{281}\) This makes sense in a system that adheres to protection of creditors and capital maintenance and which is therefore more preoccupied with the determination of distributable profit than the balance sheet as a standalone source of information. However with Germany’s move towards a more Anglo-American balance sheet driven approach, it can be expected that in the coming years the traditional approach will fade into the background.

B. The expense is attributed to the same period in which it is attributed as cost

B.a The expense is attributed to realisation in the same year
This is basically the same situation as under A.a, but when the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

B.b The expense is attributed to the period in which it no longer has any use
This is basically the same situation as under A.b, but when the asset becomes useless in the same year in which the expense takes place, attribution takes place in the same year.

B.c The expense is attributed to the period in which it has expected use, other than because of expected realisation
This is basically the same situation as under A.c, but when the expense takes place in the same year to which the expense relates, attribution takes place in the same year.

C. The cost is attributed in the period before the expense occurs

C.a The expense is attributed to the period in which it is caused as a loss
This is the situation when a loss becomes apparent, but the expense is expected to take place in the future and thus the principle of prudence and the principle of causation oblige to recognise the loss in the accounts.\(^{282}\)

This loss must be attributed to the period in which it becomes apparent.\(^{283}\)

A loss can consist of only costs or of costs and revenue, in which case the

\(^{280}\) Article 250, Paragraph 1 HGB.


\(^{283}\) Article 252, Paragraph 4 HGB.
costs are expected to exceed the revenue. Under German law, this leads to the recognition of a provision (‘Rückstellung’) on the basis of Article 249, Paragraph 1 HGB. Provisions are also recognised when determining taxable income and deducted from taxable profit, but there are differences between the general purpose financial reporting of the ‘Handelsgesetzbuch’ and taxable accounts in this respect. Attributing the expenses as a loss to the period in which they are caused, thus as a provision for an onerous contract (‘Drohverlustrückstellung für Dauerschuldverhältnis’) is required for the commercial accounts when the requirements are met.\textsuperscript{284} It is likely that this is the case for employment contracts (salaries), rental contracts and leases (rent) and loans (interest). However, a provision for onerous contracts is not allowed for tax purposes.\textsuperscript{285} See Chapter 4 for an in depth analysis of these provisions.

C.b The expense is attributed to the period in which it has expected use, other than because of it representing a loss
This is basically the same situation as under A.c and B.c, but the expense takes place in the period after the period to which it relates. This generally means that a liability will be recognised for the outflow that will take place in the year after the period to which the expense is attributed as cost. This occurs for example when certain expenses relate to a certain future period. Examples of this are up-front payments of rent, wages and interest.

3.5 Dutch law

3.5.1 Short history of the system and its objectives

Before the introduction of income tax in the Netherlands, the main tax on enterprises was the patent-tax.\textsuperscript{286} This tax was inspired by the French tax system and was based on the guild-structures that have existed in the Netherlands for a long time. It consisted of a payment that had to be made for the exercise of certain trades. Many complaints were brought forward against this tax. There were too many unreasonable exemptions, large enterprises paid low taxes compared to their income, the system was very rigid, taxes were levied even when losses were apparent, entrepreneurs with several activities paid high taxes compared to their income and the poor paid high taxes when compared to the rich.\textsuperscript{287} Another tax that was levied before the introduction of the income tax was the personal tax, which taxed appearances of prosperity such as the amount of

\textsuperscript{284} German Federal Fiscal Court 19 July 1983, BStBl II 1984, 56.
\textsuperscript{285} Article 5, Paragraph 4 a first sentence EStG. See German Federal Fiscal Court 19 July 1983, BStBl II 1984, 56.
\textsuperscript{286} K.M.G. de Meyïer, De geschiedenis van het Nederlandse patentrecht, Arnhem: Nijhoff, 1870, p. 63.
hearth and windows of a house. The combination of the fact that these taxes were perceived as unreasonable and the social uprisings and unrest in the middle of the nineteenth century led to a revision of the Dutch tax system. In line with other western countries, an income tax was introduced in the Netherlands in the late nineteenth century, which solved a number of the aforementioned issues or at least provided a less unreasonable alternative. Corporate tax, on the other hand, initially started out as a tax on the distribution of profit and only later developed into a tax on corporate income. The time from the late eighteenth century up until the Second World War in the Netherlands can be characterised as an experimental phase in which the laws on income taxation were developed. It was also the time when the concept of ‘sound business practice’ was introduced with regards to the determination of annual profit, even though the exact origins of sound business practice are unclear. During the German occupation of the Netherlands in the Second World War both personal income tax laws and corporate income tax laws were introduced. The corporate income tax code of 1940, although introduced during German occupation and the first Dutch tax code to tax the income of entities on the level of the entities themselves, was essentially designed before the war started, by the Bodenhausen Committee in 1938 and, contrary to popular belief, thus cannot be classified as German heritage, even though the German occupier increased the tax rate on 11 December 1940. The corporate income tax code of 1942 increased the tax rates again and added foundations and foreign entities as taxpayers, but did not alter the concept and character of the Dutch corporate income tax. It did formally introduce the concept of sound business practice to entities. With regards to the income tax, the determination of annual profit underwent a number of changes under the German influence. The new law was decidedly more strict with respect to rules for recognition of provisions and tax-deductible reserves. What is clear, however, is that determining taxable income according to sound business practice is not a German influence. In the decade

289 Dutch Income Tax Resolution 1940.
290 Dutch Income Tax Act 1893 mentions ‘the practice of the honest, precise merchant’ in Paragraph 26 of its guidance. The Dutch Income Tax Act 1914 first mentioned ‘sound business practice’ but not in relation to annual profit but only in relation to depreciation. The Dutch Supreme Court started using the concept of sound business practice during this time for the determination of annual profit, which was later codified. See Dutch Supreme Court 5 March 1919, B 2168 and Dutch Supreme Court 27 June 1922, B 2983. See Vereniging voor Belastingwetenschap, Goed koopmansgebruik Quo Vadis? – De mogelijke invloed van IFRS en CCCTB op GKG, vol. 254.
after the Second World War no extensive experimentation with income taxes could take place as the tax revenue was needed to rebuild the country. After the immediate post-war period, the whole concept of income tax has never been thoroughly called into question again by the Dutch legislator or the Dutch public. In the decades after the Second World War the Dutch legislator added more elements of instrumentalism and incentives in the income tax, such as for instance the deduction of interest on home loans and the tax treatment of personal computers, bicycles and cars. These elements have no direct relation with the principle of ‘ability to pay taxes’ and have been added for reasons of an instrumental nature. As to what constitutes annual taxable business income, the legislator has never given clear guidance or strict rules for the determination of taxable business profit. This has mainly been done to provide an enterprise with an amount of freedom how to determine taxable income by its own principles (instead of according to strict and detailed legislation). This follows from the open norm of the present Article 3.25 Dutch Income Tax Act 2001 and its predecessors, of which the contents are largely provided by the case law of the Dutch Supreme court (the concept of Article 3.25 Dutch Income Tax Act 2001 being an open norm will be dealt with further in Paragraph 3.5.5). These contents still leave an amount of bandwidth, during which profit or loss is to be taken into account and which are not strict rules per se. In recent years the Dutch legislator has added a number of elements in the tax code to diminish this freedom of determination of taxable profit. In the year 2007 several strict and restrictive tax depreciation-rules have been added. The reason for this was not to introduce stricter rules per se, but it served to finance a lower general corporate tax rate. With Article 3.25 Dutch Income Tax Act 2001 still being an open norm, the issue of legal certainty has been raised on several occasions in Dutch tax literature, despite the fact that the Dutch legislator never saw any reason to alter the way taxable profit is determined in the Netherlands. The conclusion is that the Dutch legislator seems quite pragmatic in its approach towards income tax, rather than being very strict about underlying thoughts and principles.

3.5.2 Congruence

Article 3.25 Dutch Income Tax Act 2001 does not refer to the annual accounts. The determination of taxable income is formally unconnected to the annual accounts. Article 3.25 Dutch Income Tax Act 2001 determines that the annual

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297 Meaning the moment when income is taxed and not what constitutes income (which is a matter of total profit).


profit for tax purposes has to be determined on the basis of sound business practice. Article 3.25 Dutch Income Tax Act 2001 provides no guidance on how to determine taxable income, in accordance with 'sound business practice'. The articles that follow Article 3.25 Dutch Income Tax Act 2001 do provide a number of strict rules, but very much on a case-by-case basis. In practice, the commercial accounts are often used as the starting point for the determination of taxable income. This practice is accepted by the Dutch Supreme Court, as long as there is no conflict with tax law, specific tax rules, tax principles or the general design of the tax law.\footnote{Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274 which mentions that every system that is acceptable within business economics is in principle acceptable under sound business practice, as long as there is no conflict with tax law, tax principles or the general design of the tax law. What the exact boundaries of business economics are is still unclear (but it is broader than just national GAAP). See A.O. Lubbers, ‘De bedrijfseconomische benadering in de fiscaliteit’, \textit{NTFR} 2011, vol.1, p.1 and W. Bruins Slot, ‘De bedrijfseconomische benadering in de fiscaliteit (2)’, \textit{NTFR} 2011, vol. 4, p. 161. In any case, contrary to what the words ‘sound business practice’ imply, a system does not need to be common practice in order to be in line with sound business practice. See Dutch Supreme Court, 16 February 1972, ECLI:NL:HR:1972:AY4458 and Dutch Supreme Court, 18 December 1991, ECLI:NL:HR:1991:BH8011.} This leads Essers to the conclusion that, while there is no formal congruence on the annual accounts, in practice there is also no full incongruence, so the Dutch system is of the fourth category, material incongruence. \footnote{P.H.J. Essers, ‘De winstbepaling in de Conceptrichtlijn CCCTB’, \textit{WFR} 2011, vol. 6927, p. 1395-1404.} Since both Dutch GAAP and IFRS fall under the scope of Dutch Supreme Court 8 May 1957,\footnote{Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274.} it is possible to determine taxable income on the basis of IFRS, provided that no conflicts with tax law, tax principles and the general design of the tax law occur. The Dutch Supreme Court effectively determines what is in line with sound business practice and what is not. The absence of democratic legitimacy is therefore an issue, although in some cases the Dutch legislator has interfered with this case law, by overruling it via new law. While there are no indications that in practice this development of rules via case law currently creates an unacceptable amount of problems for taxpayers or the tax authorities in the Netherlands, it is an approach that is unlikely to provide a balanced situation when it would be applied in the European Union, as the legal uncertainty that has preceded the case law in the Netherlands is unacceptable when a harmonised tax base is the objective. The risk of arbitrariness and thus inefficiencies in the internal market of the European Union would become too large.

3.5.3 \textit{To whom does the system apply?}

The determination of annual profit is determined by Article 3.25 Dutch Income Tax Act 2001. The annual profit is part of the taxable profit mentioned in Articles 3.2 and 3.3 Dutch Income Tax Act 2001. Three categories of persons fall under the scope of Articles. 3.2. and 3.3 Dutch Income Tax Act 2001:
The way profit is determined by Article 3.25 Dutch Income Tax Act 2001 is also relevant for the exploitation of assets other than as an entrepreneur. The common factor in this is that these categories all concern individuals that derive income from an enterprise in one way or another. Article 3.25 Dutch Income Tax Act 2001 is also relevant for the determination of corporate income tax of the entities. The Dutch corporate income tax code allows for certain types of groups to be taxed on a group level, thus allowing a consolidated approach. This leads to the conclusion that Article 3.25 Dutch Income Tax Act 2001, which is the legal basis for determination of annual profit by means of sound business practice, is applicable to individuals and entities, the latter both in a separate and consolidated manner. This also means that neither the size of the enterprise, nor whether it is listed on a stock exchange, nor whether it is a strictly national or multinational enterprise, is a relevant factor for the applicability of Article 3.25 Dutch Income Tax Act 2001, although the size of the enterprise is taken into account by the Dutch Supreme Court when determining what can be required from an enterprise from an administrative perspective.

3.5.4 Role of the balance sheet

Before 1950 the Dutch income tax code did not provide guidance whether to determine profit by comparison of the balance sheet at the end of the year with the balance sheet at the beginning of the year (the method of equity reconciliation) or by deducting costs from revenue. Since the revision of the income tax code in 1950 equity reconciliation is obligatory. In 1964 a law was introduced which did not oblige equity reconciliation anymore, which implies that both methods are acceptable. Since the purpose of Article 3.25 Dutch Income Tax Act 2001 is the determination of taxable income and no formal connection to the commercial accounts exists, the balance sheet is dynamic, because its primary purpose is the determination of profit. The Dutch income

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308 Article 8, Paragraph 1 Dutch Corporate Tax Act 1969.
309 Article 15 Dutch Corporate Tax Act 1969.
311 Dutch Tax Revision Act 1950.
tax code does make references to the balance sheet, which means that determination of profit without a balance sheet is not possible.\textsuperscript{314} Taxable income is determined over a fixed period in the past. The reporting under Article 3.25 Dutch Income Tax Act 2001 is used to determine how much income is generated and how much tax is due. It is therefore primarily an indication of past performance. It is not primarily an indicator of the enterprises expectations of the future, in the sense that the assets represent expected future inflows and the liabilities represent future outflows. For some entries, such as provisions, expectations of the future are necessary.\textsuperscript{315}

**3.5.5 Principles based or rules based**

Annual profit is determined on the basis of the aforementioned Article 3.25 Dutch Income Tax Act 2001. This article states that annual profit is determined in accordance with sound business practice, in a consistent manner, independent from the expected outcome. The consistent manner can only be adjusted when it is justified by sound business practice. This is to be interpreted as that a taxpayer has, in itself, the freedom to choose the system by which he determines his taxable profit, as long as it is in line with sound business practice. The Dutch Supreme Court has ruled that every system that is in line with business economics\textsuperscript{316} is acceptable under sound business practice, as long as it is not contrary to tax law, tax principles or the general outline of tax law.\textsuperscript{317} In itself, this offers the taxpayer a considerable amount of freedom, as even less common ways of determining income, such as the ‘Festwert-system’ for the valuation of inventories are allowed.\textsuperscript{318} In addition to Article 3.25 Dutch Income Tax Act 2001, the Dutch legislator added an amount of detailed tax rules concerning specific topics in the personal income tax law with regards to the determination of profit.\textsuperscript{319} This means that the amount of legislation governing the tax base is limited, as is the amount of general detail, but there is a large amount of case law. The Dutch system is not rules based in the sense that a legislator provided explicit rules, as the core of the determination of profit is not codified in law, but based on case law by the tax courts. This raises the question whether it can be administratiekostenreserve-arrest’, *NTFR-B*, 2012, vol. 3, p. 10. Static elements are rare, but do occur, see Dutch Supreme Court 19 April 1970, ECLI:NL:HR:AX5190.

\textsuperscript{314} See for example articles 3.29, 3.29a, 3.29b, 3.29c, 3.30, 3.30a, 3.31 Dutch Income Tax Act 2001.


\textsuperscript{316} It can be stated, that if the Dutch Supreme Court would have ruled this case in 2015 instead of in 1957, it would probably have used the words ‘externe verslaggeving’ (financial accounting) instead of ‘bedrijfseconomie’ (business economics). See Vereniging voor Belastingwetenschap, *Goed koopmansgebruik Quo Vadis? – De mogelijke invloed van IFRS en CCCTB op GKG*, vol. 254.

\textsuperscript{317} Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274.

\textsuperscript{318} The Festwertsystem is a system of valuation of inventories developed in order to account in situations of hyperinflation. It is therefore considered extremely prudent.

considered principles based. This depends on what the meaning of the words ‘sound business practice’ is. Despite the fact that several authors have gone to great lengths to find the origin of sound business practice, the consensus is that the origin of the words remains shady and no origin has been conclusively proven. Apart from the origins being unknown, the Dutch tax courts have never, in over a hundred years of case law on the subject, made any reference to a set of rules or principles governing sound business practice, that existed outside and before the Dutch income tax code. This makes a search for the origins of sound business practice unnecessary and without purpose, as there currently does not seem to be a concept of ‘sound business practice’ existing outside Dutch tax law which holds any relevance in Dutch tax law. The consequence of this is that Article 3.25 Dutch Income Tax Act 2001 is not principles based, but merely an open norm, as the criterion ‘sound business practice’ provides no guidance in itself. In case law, the courts have created a set of principles that govern the determination of taxable income. This means that it is not so much Article 3.25 Dutch Income Tax Act 2001 that is principles based, but the case law on sound business practice that is principles based. Sound business practice cannot overrule specific legal tax rules. An example of this is Article 3.26 Dutch Income Tax Act 2001, which forbids taking future inflation and future increases in wages into account when determining the taxable profit. On the basis of sound business practice itself, it would be allowed to take these into account. This means that unreasonable outcomes following from the application of the specific provisions in Articles 3.26-73 Dutch Income Tax Act 2001 fall outside the scope of sound business practice. In other situations unreasonable or unrealistic outcomes can be mended by the Dutch Supreme Court via sound business practice. An example of this is the case of hedge-accounting, which was, for a large part, mended in sound business practice by the Dutch Supreme Court. A taxpayer is offered an amount of freedom to determine how to solve an unreasonable outcome, as long as it the solution compliant with sound business practice.

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3.5.6 Determination of annual profit

3.5.6.1 Income and expenses

In Dutch tax law the relation between total profit and annual profit resembles the system devised by Schmalenbach in the early 20th century. Total profit represents the profit that the enterprise makes over the course of its lifetime and the annual profit is the part of the total profit that is attributed to a certain year. Determination of the annual profit (the attribution of income and expenses to a certain year) is governed by Article 3.25 Dutch Income Tax Act 2001, which states that annual profit is to be determined on the basis of sound business practice. However, the term ‘sound business practice’ does not offer any guidance on how the attribution of income and expenses must take place. The norm has been left open by the legislator and its contents have been developed by the Dutch tax courts in their case-law.

3.5.6.2 Principles

From case-law several principles of determination of annual profit can be derived. The objective of these principles is to determine to which year income and expenses shall be attributed. This means that these principles are the basis for the determination of annual profit and loss.

Principle of realism

The overarching principle in sound business practice is the principle of realism (‘realiteitsbeginsel’). The principle of realism states that the annual profit must be determined in such a way that it gives a realistic impression of the taxable income of the enterprise. In general, the principles of prudence, matching and realisation will lead to a determination of profit that is within the boundaries of the principle of realism. It is therefore only in very specific cases that the principle of realism overrules prudence, matching and realisation. The principle

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of realism states that no arbitrary shifts in profit must take place\textsuperscript{331} and that the annual profit must only be determined by events that are attributable to that year, \textsuperscript{332} while certainties must not be doubted and losses that have not been incurred cannot be realised.\textsuperscript{333}

**Accrual**

The principle of realism does not, by itself, give much guidance on how to practically determine annual profit for tax purposes. In order to provide a realistic impression of the annual profit of the entity, income and expenses must be attributed to the book-year by means of accrual. Financial accounting is a translation of transactions and positions into monetary amounts. However, solely recording the monetary amounts (known as ‘cash-based-accounting’) is generally thought of as an incorrect method of determining profit. The cash-flow and cash-position of an enterprise can easily be manipulated and the presence or absence of cash does not give an impression of economic performance. Cash-based accounting is not allowed under Article 3.25 Dutch Income Tax Act 2001, except for rare circumstances.\textsuperscript{334} Attributing income and expenses as revenue and costs to the periods to which they relate is therefore necessary. The determination of the period to which it relates is dependent on the accrual system, of which multiple types exist. Under sound business practice the accrual system is primarily based on the principles of causation, prudence, realisation and matching.

**Prudence and causation**

In order to practically apply the accrual principle, it must be clear when an economic link with a year exists. Under sound business practice, this is determined in a prudent manner, which means that profits are recognised when they are realised and losses when they are probable.\textsuperscript{335} In commercial accounting, protection of creditors has long been a primary issue as is maintenance of capital. This led to a restraint in recognition of (distributable) profits, as distribution of uncertain or unrealised profits can damage both the interests of creditors as well as the continuity of the enterprise. Up until 1940 there was no separate development of determination of taxable profit and profit for commercial purposes. This means that in the early stages of development, the conceptual differences between commercial and taxable profit were more limited than they currently are. The realisation that commercial accounts and taxable profit can lead to differences with regards to how profit is determined (and that there is no universal concept of profit) developed over time as well.


\textsuperscript{335} J. Doornebal, ‘Invulling van goed koopmansgebruik’, *NTFR* 2003, vol. 11, p. 469.
The principle of prudence is one of the key factors of keeping determination of profit in line with the ability to pay taxes. When profit is only recognised when realised (and thus the inflows are almost certain) and losses are recognised when probable, the enterprise will generally be able to pay taxes when profit is recognised. It is somewhat coincidental that determination of profit in a prudential manner serves both the interests of creditors and the ability to pay taxes. Especially when attributing an expense (the outflow of money or other resources) the main determinant of attribution is the aspect what caused the outflow.\textsuperscript{336} An example of this is when part of the inventory is broken. The cause of the loss is the breakage, so this is when the original expense is attributed as cost (whereas otherwise it would have been attributed to the moment when it was sold, which is the reason why it was bought to begin with: to sell it on).

Realisation
From the principle of prudence it follows that when realisation leads to a profit, both income and expenses are attributed to the year in which realisation takes place as revenue and cost respectively. This is known as the principle of realisation.\textsuperscript{337} An example of this is the situation when goods are bought and sold. Both the expense for the acquisition of the goods and the income following the sale are attributed to the period in which the goods are sold with a positive margin (and thus profit is realised). Realisation of income generally takes place when the enterprise has completed its performance.\textsuperscript{338} This will also be the moment when the significant risks and rewards of ownership have been transferred.\textsuperscript{339} Two categories of exceptions to the principle of realisation exist. The first category consists of legal exceptions such as the introduction of the percentage of completion method for work-in-progress in the year 2007, which leads to the recognition of profit before realisation.\textsuperscript{340}

\textit{For example, when a long-term project is expected to last four years before its complete realisation, at a €4,000,000 revenue and €2,000,000 expenses and the progress is completely linear, on the basis of the realisation principle, both the revenue and the expenses would be attributed to year 4, leading to a €2,000,000 profit in year 4. On the basis of percentage of completion, a

\textsuperscript{336} Dutch Supreme Court 8 April 1953, ECLI:NL:HR:1953:AY3230. P.H.J. Essers in: Cursus Belastingrecht IB.3.2.16.B.b2.II.


€ 1,000,000 revenue and € 500,000 expense is attributed to every year, leading to a € 500,000 profit in years 1 through 4.

The second category consists of exceptions developed in case-law. Examples of this are the cases on hedge-accounting (in which the principle of reality prevailed).\textsuperscript{341} Other exceptions occur when there is a large probability that the ownership of the sold enterprise will return to the seller.\textsuperscript{342} Although the general consensus is that taxing unrealised profits is undesirable because of the conflict with the ability to pay taxes, there have been discussions in Dutch tax literature whether realisation is the moment when profit must be recognised or whether earlier recognition is allowed. The latter would lead to the possibility of recognising unrealised profit on a voluntary basis by the taxpayer. This can be desirable for a taxpayer when certain losses would otherwise evaporate.\textsuperscript{343} The current view of the Dutch Secretary of State is that recognition of profits before realisation is not generally possible.\textsuperscript{344} From case-law it can be derived that, for liquid assets, taking the unrealised profit into account is allowed.\textsuperscript{345} Recently, the Dutch Supreme Court ruled a case, from which it can be derived that the Dutch Supreme Court is of the opinion that the revaluation of immovable property is possible. Future case-law will tell us whether this is a general opinion or not.\textsuperscript{346}

The most pressing issue for the Dutch Secretary of State and the taxpayers is the possibility to offset losses, which is limited in time in the Netherlands. This means that after a certain amount of time, losses can evaporate. Although this was introduced mainly as a budgetary issue, the fact that there is a limit to the offsetting of losses in time is not unreasonable: over time the character of an enterprise will change and not being able to offset losses of, for example, fifty years old is understandable from a practical and administrative point of view as well. However, when an enterprise has unrealised profits and losses that are ageing and therefore evaporating, being able to offset these is, in my opinion, not unreasonable, when the enterprise revaluates assets on a systematic basis.

Matching

The principle of matching states that expenses need to be attributed to the year


\textsuperscript{343} Article 20, Paragraph 2 Dutch Corporate Tax Act 1969 leads to the evaporation of unused losses after nine years.


\textsuperscript{345} Dutch Supreme Court 18 November 1931, B 5082.

\textsuperscript{346} Dutch Supreme Court 30 September 2016, ECLI:NL:HR:2016:2199.
to which the connected revenue is attributed, unless there is insufficient connection between revenue and expense.\textsuperscript{347} This part of the principle of matching is effectively a part of the principle of realisation, which attributes profits (revenue minus costs) to the period in which realisation has taken place.\textsuperscript{348} When expenses cannot be matched with (future) revenue, attribution needs to take place on the basis of the character and cause of the expenses, such as the period to which they relate. This second part will often be more complex than the first part, as it deals with the situation when expenses cannot be matched with revenue (therefore it always deals with losses of some kind). Provisions will generally be part of this category. The loss is not attributed to a period in which realisation takes place, but to the period in which the loss as such becomes probable and is caused before the end of the period. This is the part of the principle of prudence that deals with losses.

Interestingly, in the example given in Paragraph 3.3.6.2, where an enterprise spends € 100.000 on advertising costs in year 1, for a product that will be introduced on the market in year 2, current sound business practice would require the cost to be attributed to the future, despite the fact that it does not constitute an asset.\textsuperscript{349} Since the case concerned is relatively old and the idea that an entry on the balance sheet should meet a definition of asset or liability has developed since then, the question is whether this still holds. I am of the opinion that, since the developments in IFRS and Dutch generally accepted accounting practice have moved towards not recognising an entry for such expenses, sound business practice should not allow such recognition anymore either.

Principle of simplicity and materiality
Determination of profit under sound business practice must not only be realistic. Unreasonable demands from an administrative point of view shall not be made either.\textsuperscript{350} This is known as the principle of simplicity. This means, for example, that for very simple enterprises, very simple administrative procedures and accounting rules are acceptable.\textsuperscript{351} In a more recent case, the principle of simplicity was held against the taxpayer. A taxpayer was not allowed to use a certain system of determination of profit because it went against the principle of simplicity.\textsuperscript{352} Materiality is not recognised explicitly, but overlap with the principle of simplicity exists.

\textsuperscript{352} Italian Court of Cassation 27 February 1999, ECLI:IT:CS:1999:1470.
3.5.6.3 Consequences for attribution of expenses

In this paragraph the model of Paragraph 3.2.6 is applied to the Dutch rules. In the same way as is described in Paragraph 3.2.6, expenses can be attributed as costs to either the future, the current year or costs can be attributed to a current year before the expense has taken place. It needs to be taken into account however that, more than the other systems, sound business practice generally offers a certain bandwidth and freedom within which the taxpayer can determine taxable income, contrary to the other researched systems, in which the taxpayer is often expected to basically follow the rules.

A. The expense is attributed as cost to the future

A.a The expense can be attributed to future realisation
The principle of matching under sound business practice consists of two parts. The first part attributes expenses that are connected to a certain realisation-moment. The second part attributes other expenses (see below). The first part of the principle of matching therefore attributes expenses that are in effect caused by the realisation-moment to that particular realisation moment. This occurs for example with cost of goods sold. 353

A.b The expense is attributed to the period in which the assets lose their use
Cash-based accounting usually does not show the actual performance of an enterprise. This is why the principle of matching matches expenses with either income or a specific period. The Dutch Supreme Court decided that depreciation expresses wear and tear caused by the use of the asset and made no reference to realisation. This indicates that the Supreme Court views depreciation as the expression of a loss. 354 This also leads to the conclusion that when no wear and tear is caused by the use of the asset, depreciation is not possible. 355

With regards to depreciation under sound business practice, it must also be taken into account that in principle an asset is not viewed as several separable and depreciable parts, but as a whole. 356 This means that the asset is depreciated as a whole. However, the Dutch Supreme Court decided that parts of the asset that are both independent enough and have an expected lifespan that differs from the asset as a whole can be

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356 Dutch Supreme Court 7 November 1962, ECLI:NL:HR:AX7891.
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depreciated separately.\footnote{Dutch Supreme Court 7 November 1962, ECLI:NL:HR:AX7891. Dutch Supreme Court 19 March 1997, ECLI:NL:HR:1997:B15847. This is largely similar to what IFRS calls the component-approach.} The principle of prudence requires losses to be taken into account as soon as they become apparent. Losses can be divided into two categories:

1) A future realisation moment with which the expenses are connected is expected, but the expenses are likely to exceed the connected income (the loss consists of costs and revenue)

   For example, a contract is entered into. At one point it becomes clear that the costs of meeting the contract are € 100.000 and the value of the asset to which the enterprise is entitled is € 90.000, which means that a € 10.000 loss is expected. This decreases profit by € 10.000 at that moment.

2) The expenses are not connected to a realisation-moment and are therefore not connected to revenue (the loss consists solely of costs and no revenue)

   For example, a machine becomes obsolete and cannot be sold. The remaining book value is € 60.000. This means that no revenue is connected to the contract anymore the € 60.000 book value needs to be written-off in the year in which the obsoleteness becomes clear.

before it became apparent that a loss would occur, it falls under category A.b.
When the expense has not yet taken place when it became apparent that a loss would occur, it will fall under the subsequent category C.a. In the case of useless expenses, there is no realisation-moment to which the expenses can be attributed as costs (or the future realisation-moment is so uncertain that it cannot realistically be taken into account). Since there is no ‘use’ to be expected from the expense the expense cannot lead to the recognition of an asset. 361 The useless expense must therefore be recognised as a cost immediately. When the expense has taken place before it became clear that no realisation moment will take place in the future, it falls under category A.b. When it is immediately clear that no future realisation moment will be connected to the expense, it will fall under category B.b. When it is probable that the expense will take place in the future and no future realisation moment will be connected to the future expense and the expense is caused in the past, the expense will fall under category C.a.

A.c The expense is attributed to the period in which it has expected use, other than because of expected realisation
As stated, the principle of matching under sound business practice consists of two parts. The first part attributes expenses that are connected to a certain realisation-moment. The second part attributes other expenses. One of the categories of expenses that are not directly connected to a certain realisation-moment is the category period bound costs, such as interest, rent and wages. These are generally attributed to the period to which they relate. 362 The question is why this is the case: are they thought to be losses, are they thought to connect to realisation-moments in the period to which they relate or do they form a separate category? The first category (losses) are unlikely, because the Dutch Supreme Court concluded that attributing period bound costs as a loss (in the form of a provision) is only allowed when expected expenses exceed the expected revenues. 363 Obviously, this is also the case when there are no connected revenues. This means that when these criteria are not met (which will often be the case) period bound costs are not viewed as losses. 364 Under certain conditions, period bound costs can be attributed to specific realisation-moments (and are thus part of category A.a). 365 However, in general, the Dutch Supreme Court does not require the

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occurrence of realisation-moments when attribution period bound costs to the period to which they relate. This suggests that period bound expenses are not attributed on the basis of being part of either profit or loss, but regardless of being part of either profit or loss. What is interesting is that this means that they are not attributed by the principle of prudence (as they are not attributed as being either part of profit or loss), but by the principle of causation. Therefore, when these expenses are made before the period to which they relate, they fall under category A.c. Apart from the situation when they become part of the book-value of another asset (as can be the case with interest and wages), an accrual will be recognised for these expenses which are attributed to a future year.  

B. The expense is attributed to the same period in which it is attributed as cost

B.a The expense is attributed to realisation in the same year
This is basically the same situation as under A.a, but when the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

B.b The expense is attributed to the period in which it no longer has any use
This is basically the same situation as under A.b, but when the asset becomes useless in the same year in which the expense takes place, attribution takes place in the same year.

B.c The expense is attributed to the period in which it has expected use, other than because of expected realisation
This is basically the same situation as under A.c, but when the expense takes place in the same year to which the expense relates, attribution takes place in the same year.

C. The cost is attributed in the period before the expense occurs

C.a The expense is attributed to the period in which it is caused as a loss
When a loss is caused before the expense takes place, it is attributed to the year in which it is caused. This can occur when there are solely expenses with no connected revenue (therefore a useless expense is expected) or when the expected loss consists of both expected expenses and connected revenue (therefore a less useful expense is expected). It can sometimes be difficult to differentiate between useless and less useful expenses on the one hand (which must be recognised) and future losses (which may not be recognised) on the other. The difference between the two lies in the fact that useless and less useful expenses have arisen before the end of the reporting period, while future losses have not.

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366 Article 250, Paragraph 1 HGB.
C.b  *The expense is attributed to the period in which it has expected use, other than because of it representing a loss*

This is basically the same situation as under A.c and B.c, but the expense takes place in the period after the period to which it relates. This generally means that an accrual will be recognised for the outflow that will take place in the year after the period to which the expense is attributed as cost.

### 3.6 United Kingdom law

#### 3.6.1 Short history of the system and its objectives

**Commercial law**

The starting point of accounting legislation in the United Kingdom was the Joint Stock Companies Act of 1844, which allowed the incorporation of joint-stock companies, which was formerly only possible when granted by royal charter or private act. The possibility of establishing a Limited Liability Company was added in 1856. The Joint Stock Companies Act of 1844 required companies to prepare a ‘full and fair’ balance sheet. There were no requirements with regards to the form or presentation of the balance-sheet. A profit and loss account was not required either. The Joint Stock Companies Act of 1956 introduced optional accounting rules that were far more detailed and advanced than the previous rules. The accounting rules were primarily aimed at protecting the interests of both shareholders and creditors. The Companies Act of 1900 introduced the requirement that the balance sheet shall exhibit a true and correct view of the state of the company’s affairs, as shown by the books of the company. From 1929 onwards, the Companies Act required annual publication of the balance sheet.

The accounting rules of the United Kingdom have been influenced to a large extent by several landmark court-cases on income smoothing by means of using hidden reserves. In the beginning of the 20th century it was more or less common practice that when a company made profit, this profit was fully distributed to the shareholders. This led directors to show restraint in recognising profits, which led to the creation of hidden reserves. In itself this was a healthy practice, which improved the continuity of the enterprise, as the outflows (in the form of

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367 Joint Stock Companies Act 1844 (7 & 8 Vict. c.110).
368 See the Bubble Act 1720 (6 Geo I, c 18).
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dividends) were diminished. However, when the actual performance of the enterprise declined, the hidden reserves would be used to improve profit. This concealed the fact that the actual performance was declining. The fraud of Kylsant and Morland of the 1920’s, whereby the hidden reserves had been used to show profits, while the results were actually in decline, led to heavy discussions because this was obviously an unwanted effect, especially since Kylsant and Morland were acquitted of the charges, as what they did was deemed standard practice.  

This practice was heavily discussed in the 1930’s, but was not dealt with in law until 1948. It was found that more honesty was needed in the accounts and to the consensus that prudence, insofar as it led to the creation of hidden or secret reserves, could be as damaging as the recognition of unrealised profits. This idea has thoroughly influenced accounting in the United Kingdom up until today and its influence can even be seen in the restraint that IFRS shows in accepting the concept of prudence. This approach (‘neither too high nor too low’) is somewhat contrary to the classic continental approach (such as in France, Germany and The Netherlands) which encouraged prudence (‘undervaluation is good’) as that was thought to serve the interests of the creditors better. Therefore both the Anglo-Saxon approach and the classic continental approach aim to protect the interests of users of the financial information, whereby the Anglo-Saxon approach primarily protects the shareholders and investors and the classic continental approach primarily protects the interests of creditors. The bottom-line of the 1948 Companies Act was therefore to provide rules for more honesty in financial accounts. As this did not prevent further scandals from happening, the Accounting Standards Steering Committee (ASSC) was created, which sought to harmonise accounting practice and to improve disclosures. The ASSC had no legal or disciplinary authority. The ASSC eventually was replaced by the Accounting Standards Boards (ASB), in order to create a standard-setter that was more independent and task-oriented.  

Since the creation of the Financial Reporting Review Panel in 1990 the accounting standards of the ASB can be legally enforced. Like the Dutch and German accounting system, the European influence on the accounting rules in the United Kingdom follows from both the Fourth and Seventh Accounting Directive and IFRS. In 2012 and 2013 the Financial


378 Directive (EC) 78/660 of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (*OJEC L 222/11*) and the Directive (EC) 83/349 of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (*OJEC L 193/1*). Directive (EU) 2013/34 of the European Parliament and of the
Reporting Council made an interesting move by thoroughly revising the financial reporting standards in the United Kingdom, just before the 2013 EU-revision of the Fourth and Seventh Directive. These revisions were primarily based on IFRS for SME, despite IFRS for SME not being formally accepted in the European Union. As stated before, the other way round is also true, as Anglo-Saxon accounting has had a strong influence on the approach towards the balance sheet in IFRS as well as the concept of the ‘true and fair view’ in IFRS. The Financial Reporting Council revised the financial reporting standards with effect from 1 January 2015.

Income and corporate tax
In 1799 William Pitt the Younger introduced the first income tax in England, mainly in order to finance the Napoleonic Wars. It was repealed later because of fierce opposition, but reintroduced by Henry Addington and repealed again some time later. Since the re-introduction in 1842 by Robert Peel, the United Kingdom has had an income tax without interruption. A separate corporation tax was not introduced in the United Kingdom until 1965. The corporation tax of 1965 sought to tax the profits of corporate entities exclusively, whereas up until 1965 entities and persons were both taxed similarly with income tax. Like in the Netherlands, the determination of taxable income under corporation tax was and is very similar to the determination of taxable income under income tax. Initially, the corporation tax was a classical system, i.e. the entity was taxed with corporation tax and the individual receiving distribution of profit was taxed on the distributed profits, without the corporate tax being credited. In 1973 the system changed to an imputation system, whereby the individual receiving distribution of profit received a credit for the corporation tax paid by the entity. In the year 1999 the classical system was reinstalled.

3.6.2 Congruence

Traditionally, the relationship between taxable profit and the financial accounts in the United Kingdom has been perceived as having only a small amount of congruence, up to the point of being almost the opposite of the German
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system.\textsuperscript{383} However, as early as 1892 it was stated by the United Kingdom court that taxable profit must be determined on ordinary principles of commercial trading.\textsuperscript{384} Since 6 April 1999, the generally accepted accounting practice has to be considered when determining taxable profit.\textsuperscript{385} Section 42 of the Finance Act 1998 stated that

‘the profits of a trade, profession or vocation must be computed in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in computing profits for those purposes’

The current section 25 ITTOIA and section 46 CTA 2009 replaced section 42 of the Finance Act 1998 and stated that

‘the profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits’

This means that the use of GAAP itself is limited by the law, which states that the application of generally accepted accounting practice is subject to any adjustment required or authorised by law. On the subject of congruence three important cases have been decided in the last thirty years.\textsuperscript{386} In Symons v Lord Llewellyn Davies’ Personal Representative and Others an enterprise applied the percentage-of-completion method for the recognition of income on their long-term projects, instead of recognising revenue upon its receipt for the determination of its taxable income, which was relatively early in the specific case, as all their long-term projects were frontloaded.\textsuperscript{387} This was in accordance with the then-current accounting practice. The court found that the determination of taxable profit had been correct, as there was no rule of law that stated that the accounts were to be drawn up on an earnings-basis and that neither profits nor losses should be anticipated. In Threlfall v Jones and Gallagher v Jones it was decided that taxable profits should not be computed on a basis divorced from the principles of commercial accountancy.\textsuperscript{388} This means that the courts should always first look to see what


\textsuperscript{386} See Business Income Manual 31095 – Tax and accountancy: timing of receipts and expenditure: accountancy practice and case law developments.

accountancy prescribes and then see whether there is any rule of law that contradicts it, instead of considering both commercial accounting and other rules of law and then decide which one should prevail.\textsuperscript{389} This implies a large amount of congruence. In Johnston v Britannia Airways Ltd the company was required to overhaul the engines of their fleet of aircraft every 17,000 hours of operation.\textsuperscript{390} The company accrued the estimated costs of repairs over the 17,000 flying hours. Under generally accepted accounting practice this would not be possible, as the requirements for the recognition of a provision were not met, because there was no ‘present obligation’. The Supreme Court decided that the method was acceptable for tax nonetheless. This meant that a departure from GAAP was accepted. In Chapter 5 specific reference will be made to this case.

Essers considers the system in the United Kingdom to be of the third category: material congruence.\textsuperscript{391} This means that United Kingdom GAAP are the basis for the determination of taxable profit, but deviations are possible and choices made in general purpose financial reporting do not necessarily determine taxable income. Although I largely agree with Essers, it needs to be stressed that, although deviations are possible, the amount of them will often be limited and there is much less difference between general purpose financial reporting and determination of taxable income than is often thought.

3.6.3 To whom does the system apply?

Commercial law
The commercial law in the United Kingdom differentiates between enterprises run as self-employment or partnerships and enterprises run as companies (entities). The Companies Act 2006 applies to every company and states that every company must keep adequate accounting records.\textsuperscript{392} In principle, the self-employed as well as partnerships are not required to keep records and accounts on the basis of the Companies Act 2006. The new Financial Reporting Standards FRS 102 (see Paragraph 3.6.1) do not mention directly to whom they apply. It is stated that the Financial Reporting Standards apply to financial statements that are intended to give a true and fair view of the assets, liabilities, financial position and profit and loss for a period.\textsuperscript{393}

Income and corporate tax
Sole proprietorships and partnerships fall under the scope of the United Kingdom income tax,\textsuperscript{394} whereas corporate entities fall under the scope of the

\textsuperscript{390} Johnston v Britannia Airways Ltd, 1994, \textit{67 TC 99}.
\textsuperscript{392} Article 386 Companies Act 2006.
\textsuperscript{393} Financial Reporting Council, FRS 100, \textit{Application of Financial Reporting Requirements}, November 2012, Paragraph 1 \textit{Objective} and Paragraph 2 \textit{Scope}.
United Kingdom corporation tax. 395

3.6.4 Role of the balance sheet

Commercial law
Much like IFRS, the definitions of assets and liabilities in United Kingdom Financial Reporting Standards are primarily concerned with expected future inflows and outflows. 396 This implies that a balance sheet is mostly an overview of expected future inflows and outflows and not an overview of expenses and inflows that have taken place in the past. Like IFRS, The United Kingdom Financial Reporting Standards are more concerned with the positions on the balance sheet than with performance measurement. Most of the standards deal with entries on the balance sheet, whereas little attention is paid to performance.

Income tax and corporate tax
With the determination of taxable profit being heavily dependent on corporate law and generally accepted accounting practice, this means that in the tax law of the United Kingdom no separate approach is taken towards the balance sheet and the profit and loss account. With corporate law and generally accepted accounting practice in the United Kingdom being largely oriented towards the balance sheet and static and determination of taxable profit being inherently more dynamic and based on the determination of profit, this can be expected to lead to an amount of tension, for example with regards to the ability to pay taxes. However, there is no proof that the use of corporate law and generally accepted accounting practice for the determination of taxable income leads to structural problems in the United Kingdom. Since the United Kingdom’s generally accepted accounting practice, especially FRS 102, is rather close to IFRS for SMEs, this also makes a case for the use of IFRS or IFRS for SMEs as a tax base.

3.6.5 Principles based or rules based

Neither income tax nor corporation tax in the United Kingdom has a stand-alone tax base, see Paragraph 3.6.2. This means that the rules or principles underlying the determination of taxable income are mostly found in company law and generally accepted accounting practice, which serve as the primary base for the tax base in the United Kingdom. 397 Generally accepted accounting practice in the United Kingdom has its legal basis in section 495 of the Companies Act 2006, the latter of which states that the financial accounts should present a true and fair view. 398 Like under IFRS, a true and fair view override, where the rules

can be put aside in order to provide a better ‘true and fair view’, is considered to be extremely rare.\textsuperscript{399} Even though the Financial Reporting Standard states that financial reporting is not a matter of simply following the rules, it will often essentially come down to that. This means that the conclusion on United Kingdom GAAP is the same as the conclusion reached on IFRS; it is not fully rules based, as there is a theoretical possibility of a true and fair view override, but it does not follow a principles based approach.

3.6.6 Determination of annual profit

3.6.6.1 Income and expenses

Since the current section 25 ITTOIA and section 46 CTA 2009 refer to generally accepted accounting practice, determination of annual profit takes place primarily on the basis of FRS 102. The definition of income under FRS 102 is equal to the definition under IFRS:

\textit{“Income is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors.”}\textsuperscript{400}

The definition of income encompasses both revenue and gains.\textsuperscript{401} Gains include unrealised income as income.

The definition of expenses in FRS 102 is equal to IFRS as well:

\textit{“Expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.”}\textsuperscript{402}

The attribution of inflows and outflows of resources to specific years in the form of revenue and costs respectively is not explicitly mentioned in FRS 102. The relationship between total profit and annual profit is not dealt with as such.

3.6.6.2 Principles

Principle of realism
FRS 102 does not explicitly recognise a principle of realism the way sound business practice does. However, FRS 102 does recognise the concept of a fair

\textsuperscript{399} This is not literally mentioned in FRS 102, but it follows from Section 393 Companies Act 2006.
\textsuperscript{400} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.23 (a).
\textsuperscript{401} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.25.
\textsuperscript{402} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.23 (b).
presentation of the financial position, financial performance and cash flows of an entity.\textsuperscript{403} This implies that there are similarities with the principle of realism, which also requires a presentation that reflects economic reality. However, FRS 102 states that in virtually all circumstances, an entity achieves a fair presentation by compliance with the applicable financial reporting standards. This means that it is more of an underlying principle than a standard to invoke.\textsuperscript{404} FRS 102 also recognises the concept of the economic substance prevailing over the legal form as a qualitative characteristic.

Accrual
FRS 102 does recognise the concept of accrual accounting whereby the annual profit must only be affected by events that are attributable to that year.\textsuperscript{405}

Causation, prudence and neutrality
The principle of prudence is mentioned in FRS 102, but in a way comparable to the Conceptual Framework to IFRS up until 2010.\textsuperscript{406} It states:

\textit{“Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias.”}

Given the history of accounting in the United Kingdom and the fear of hidden reserves, which could lead to income-smoothing (see Paragraph 3.6.1) this is an understandable approach,\textsuperscript{407} but it fails to recognise that prudential attribution is what effectively takes place under United Kingdom GAAP, e.g. by not recognising profit before it is realised (even though the definition of income leaves room for this, but like IFRS, this is not consistently followed through in the standards) in recognising revenue\textsuperscript{408} and recognising losses when they are probable, such as in the case of provisions.\textsuperscript{409} As stated, the fear of the principle of prudence in accounting in the United Kingdom (or better said: the fear of the abuse of hidden reserves) comes from the same source as why in the Continental approach the prudence principle was applied in the first place (i.e. protection of external parties). This means that the Anglo-Saxon approach does not so much oppose prudential accounting, but the abuse of prudential accounting, much in the same way that the Continental approach traditionally tried to prevent the

\textsuperscript{403} Financial Reporting Standard 102, Section 3 \textit{Financial Statement Presentation} 3.2.
\textsuperscript{404} Financial Reporting Standard 102, Section 3 \textit{Financial Statement Presentation} 3.4.
\textsuperscript{405} Financial Reporting Standard 102, Section 2 \textit{Concepts and Pervasive Principles} 2.36.
\textsuperscript{406} Financial Reporting Standard 102, Section 2 \textit{Concepts and Pervasive Principles} 2.9.
\textsuperscript{407} See http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx
\textsuperscript{408} Financial Reporting Standard 102, Section 23 \textit{Inventories}.
\textsuperscript{409} Financial Reporting Standard 102, Section 21 \textit{Provisions and Contingencies}. 
abuse of fair value accounting.

Realisation

FRS 102 Section 23 attributes revenue in a similar fashion as IAS 18 does. In general, the definition of income in FRS 2.25 leaves room for the application of fair value and thus unrealised profits, but, like in IFRS, it is used sparingly. The principle of realisation is not mentioned literally in FRS 102, but it does underlie Section 23. The realisation principle was explicitly recognised in the case of JP Hall & Co Ltd v IRC.410

Matching

The principle of matching is not explicitly part of FRS 102. The focus on the balance sheet over the determination of profit (and thus the principle of matching) is confirmed in FRS 102.2.45, which states that the recognition of items in the statement of the financial position of the enterprise that do not meet the definition of assets or liabilities is not allowed, regardless of whether they result from applying the notion commonly referred to as the ‘matching concept’ for measuring profit or loss. There are writers that feel that this strict adherence to the definitions of assets and liabilities and thus the balance sheet is contrary to the accrual method that FRS 102 mentions in FRS 102.2.36.411 In IRC v Gardner, Mountain & D’Ambrumenil Ltd the definition of the matching principle was given, that deviates somewhat from the matching principle as it is generally understood in Dutch and German law. The matching principle matches receipts with the moment the services are rendered or the goods supplied, not with the moment a legally enforceable right to the payment arises.412 This comes down to the principle of accrual and the principle of realisation.

Principle of simplicity and materiality

Whereas FRS 102 does not recognise the principle of simplicity, simplification of tax law has been on the agenda since the 1999 ICAEW report.413 FRS 102 does recognise the concept of materiality, as FRS 102.3.16A states that an entity need not provide a specific disclosure if the information is not material.

3.6.6.3 Consequences for attribution of expenses

In this paragraph the model of Paragraph 3.2.6 is applied to the rules in the United Kingdom. In the same way as is described in Paragraph 3.2.6, expenses can be attributed as costs to either the future, the current year or costs can be attributed to a current year before the expense has taken place.

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411 Charity Finance Group: FREDs 46, 47 & 48, The future of financial reporting in the UK and Republic of Ireland.
A. The expense is attributed as cost to the future

A.a The expense can be attributed to future realisation
Like IFRS, FRS 102 recognises situations where the expense can be attributed to a future realisation moment. FRS 102 Section 13.20 states that when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. This means that the expense is attributed to the future realisation-moment. Furthermore, FRS 102 Section 17.28 determines that an entity shall recognise the gain or loss on the derecognition\textsuperscript{414} of an item of property, plant and equipment in profit or loss when the item is derecognised.

A.b The expense is attributed to the period in which the assets lose their use
FRS 102 Section 13.19 deals with the impairment of inventories. When inventories are impaired, the entity shall recognise an impairment loss in the period in which the loss occurs. Therefore, when this occurs in a year after the asset is bought, the expense is attributed as cost in a later year. The same effect occurs with for example property, plant and equipment.\textsuperscript{415} Impairment of assets is dealt with in the separate Section 27.
FRS 102 determines that depreciation falls under the expenses that arise in the course of the ordinary activities of the entity.\textsuperscript{416} Section 17.18 states that an entity shall allocate the depreciable amount of an asset on a systematic basis over its useful life. It is implied by Section 17.21 that usage, physical wear and tear and technical or commercial obsolescence are relevant factors in determining the useful life of an asset (which also means that neither one necessarily has the upper hand). Section 17.22 states that the depreciation method should reflect the consumption of the assets’ future economic benefits. The latter implies that, although the physical wear and tear is a factor in determining the useful life of an asset, what depreciation effectively tries to express is the consumption of the assets’ economic benefits. The connection with the economic benefits means that there can be some relation between the realisation (which is reflected by the economic benefit) and the expense. This means that depreciation can be an expression of the principle of matching and not of a useless expense or loss. The component-approach is obligatory under FRS 102 when the major components of an item of property, plant and equipment have significantly different patterns of consumption of economic benefits. Such components shall be depreciated

\textsuperscript{414} Derecognition is the removal of an asset or liability from the balance sheet and therefore the reverse of recognition.

\textsuperscript{415} Financial Reporting Standard 102, Section 17 Property, Plant and Equipment 17.15

separately over their useful lives.  

Like under IFRS, when there is no future realisation-moment to which expenses can be attributed (and thus no future inflows are expected), or the realisation-moment itself is uncertain, the definition of an asset will not be met, since there are no expected future inflows connected with the expense.  

This means the expense cannot be recognised as an asset and will need to be recognised as a cost.

A.c  

The expense is attributed to the period in which it has expected use, other than because of expected realisation

With regards to period bound expenses (such as wages, interest and rent), like IFRS, FRS 102 does not recognise a general rule that they shall be attributed to the period to which they relate in the same way that Dutch sound business practice recognises this as a rule. Period bound expenses can generally be attributed in the following ways. First of all they can be attributed to the period to which the service applies. This means that when they are paid up-front, they would lead to the recognition of an asset, provided that they meet the definition of an asset. When they are paid after the applicable period, they would constitute a liability. The second possibility is that they are part of a foreseeable loss or do not meet the definition of an asset and are taken as a cost immediately. In that situation a provision will need to be recognised, such as in the case of an onerous contract.

The third method is that they are recognised as an asset or as a part of a larger asset, such as development costs. This means that with regards to attribution of expenses, they follow the depreciation of the bigger asset.  

Rent will generally fall under the scope of FRS 102 Section 20.4, as an operating lease.  

The lessee shall recognise the lease payments under an operating lease as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit or the payments to the lessor are structured to increase in line with the expected general inflation to compensate for the lessor’s expected inflationary cost increases.  

This implies that it is not treated as a loss (otherwise it would be treated as an onerous contract), but rather like a depreciable asset (situation 3). In that sense the attribution is mainly period-bound: the expense is attributed as cost to the period in which the user receives the connected benefit. In my opinion the connected benefit should be interpreted as the use of the particular asset and not the realisation-moments that might benefit from the leased asset.  

Employee benefits are split into four categories by Section 28:

- Short term employee benefits

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417 Financial Reporting Standard 102, Section 17 Property, Plant and Equipment 17.16.
418 Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.15.
419 Operating lease is defined as a lease whereby all the risks and rewards incidental to ownership are not transferred substantially. See Financial Reporting Standard 102 Section 20 Leases 20.4.
420 Financial Reporting Standard 102, Section 20 Leases 20.15.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

- Post-employment benefits
- Other long term benefits
- Termination benefits

For employee benefits, a general recognition principle is given in FRS 102 Section 28.3: “an entity shall recognise the cost of all employee benefits to which its employees have become entitled as a result of service rendered to the entity during the reporting period, either as a liability or as an expense”.

This means that attribution of such costs is primarily period-bound as it connects with the service rendered by the employee. It does not make specific reference to realisation-moments (and thus matching) or to the expense being related to a loss. With a definition as given above, a provision for an onerous contract is virtually impossible, unless Section 21 is seen as an exception to FRS 102 Section 28. The wording of FRS 102 Section 28.3 is not clear on whether such an exception is possible. Interest is dealt with in FRS 102 Section 25 ‘Borrowing costs’.

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that particular asset. Where an entity does not adopt a policy of capitalising borrowing costs, all borrowing costs shall be recognised as an expense in profit or loss in the period in which they are incurred. This means that when capitalised as the costs of an asset, the attribution of costs follows the system of depreciation of the asset. However, when the costs are not capitalised, FRS 102 does not elaborate on why attribution takes place to the period in which they are incurred. This suggests that they are not attributed to the period to which they relate, but to the period in which they are incurred (although FRS 102 does not define the verb ‘to incur’).

When such expenses are paid in the year before the year to which they are attributed (which is more likely for rent than for wages and interest), the expense precedes the cost.

B. The expense is attributed to the same period in which it is attributed as cost

B.a The expense is attributed to realisation in the same year
This is basically the same situation as under A.a, but when the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

B.b The expense is attributed to the period in which it no longer has any use

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This is basically the same situation as under A.b, but when the asset becomes useless in the same year in which the expense takes place, attribution takes place to the same year.

B.c  The expense is attributed to the period in which it has expected use, other than because of expected realisation
This is basically the same situation as under A.c, but when the expense takes place in the same year to which the expense relates attribution takes place in the same year.

C. The cost is attributed in the period before the expense occurs

C.a  The expense is attributed to the period in which it is caused as a loss
FRS 102 Section 21 states that an entity shall recognise a provision only when the entity has an obligation at the reporting date as a result of a past event, it is probable (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement and the amount of the obligation can be estimated reliably.424 This also means that the expense is taken into account as cost before the actual expense takes place.

C.b  The expense is attributed to the period in which it has expected use, other than because of it representing a loss
This is basically the same situation as under A.c and B.c, but the expense takes place in the period after the period to which it relates. This generally means that an accrual will be recognised for the outflow that will take place in the year after the period to which the expense is attributed as cost.

3.7  CCCTB

3.7.1 Short history of the system and its objectives

For the history of CCCTB and its objectives I refer to Paragraphs 2.3 and 2.4 of this study.

3.7.2 Congruence

The common corporate tax base of CCCTB 2016 makes no reference to an existing set of standards for financial reporting, such as IFRS. According to the Working Papers that preceded the proposal for a Directive, IFRS has been used as a starting point for the design of the common corporate tax base of CCCTB,425 although no formal link exists.426

The main reason for using IFRS as a starting point, as opposed to writing an isolated tax base from scratch is that the latter was expected not to be practicable and workable. As late as even WP/057, the idea still held that unless uniform treatment is explicitly provided for in the CCCTB-legislation, the tax base would be computed by reference to national GAAP, whereby the entity would make a ‘bridge’ between the commercial accounts and the taxable income under CCCTB.

This would have been an entirely different approach than the approach that is eventually followed. In the original idea a certain amount of congruence would have been present. However, this idea has been let go in the eventual 2011 proposal which makes no reference to any external accounts, either general purpose or tax. None of the compromise proposals offered changes in this respect and neither did the 2016 proposal. This also means that no formal congruence exists in the current proposal. In Essers’ analysis, this means that the common corporate tax base of CCCTB belongs to the fifth category, formal incongruence. This makes the approach that is followed quite rare, since in national determination of taxable income both stronger and weaker links with accounting rules exist, but full incongruence rarely occurs in the European Union.

One of the questions is why IFRS has been used as a starting point for the common corporate tax base of CCCTB and not the more common Fourth and the Seventh European Accounting Directives or their recent update. IFRS is obligatory for the consolidated accounts of companies listed on a European Stock exchange and allowed to be applied for most other companies (although not all). This means that while IFRS is obligatory for some enterprises and voluntarily applied by others, most non-listed multinational enterprises in Europe do not apply IFRS but national GAAP. For these enterprises reference to IFRS delivers no decrease of the administrative burden.
However, the national GAAP of every Member State must be in accordance with the aforementioned European Accounting Directives and thus it would have made sense to use the European Accounting Directives as a starting point. In Working Paper WP/016 this question is raised.\textsuperscript{433} The arguments mentioned in WP/016 against the use of the European Accounting Directives, especially the Fourth Accounting Directive, are not convincing. It is mentioned that the recognition of unrealised profits is undesirable for tax purposes, but this aspect was never at the core of the Fourth Accounting Directive and is even less prominent in the Fourth Accounting Directive than in IFRS. Furthermore, the argument that IFRS is more detailed than the Fourth Accounting Directive is not very convincing when taken into account that the common corporate tax base of CCCTB was to be kept simple and none of the guidance in IFRS is used in CCCTB.

The argument that for tax purposes the financial information should be about historical performance rather than about future expectations is also more in favour of the Fourth Accounting Directive rather than IFRS. WP/016 also mentions the use of the definitions in IFRS as an advantage, which is striking since the definitions of IFRS are generally not used or referenced in CCCTB. With regards to congruence a lot of discussion about a formal link between CCCTB and IFRS has been focused on the democratic legitimacy of the IASB.\textsuperscript{434} Giving the IASB, being a non-public organisation, power over the tax base of the Member States of the European Union is often viewed as a problem. Schön has shown that this is theoretically a non-founded argument as IFRS used in Europe have to be formally endorsed by the European Commission\textsuperscript{435} in order to have force of law.\textsuperscript{436} This gives all EU-endorsed IFRS-standards democratic legitimacy.\textsuperscript{437} The fact that carve-outs of IFRS\textsuperscript{438} are relatively rare in the European Union might still mean that tax arguments may unintentionally enter IFRS, although similar effects may occur in any type of legislation. Independent of whether IFRS or another system provided the starting point for CCCTB, the fact remains that, since no formal connection exists, interpretation of the terms in CCCTB can be difficult because no terms of reference exists. In such a situation, referring to IFRS’s definitions is formally incorrect, although it does give an indication of how a certain word is interpreted in general.

\textsuperscript{433} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 16 of the year 2005.
\textsuperscript{434} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 1 of the year 2004, revised version.
\textsuperscript{435} http://ec.europa.eu/internal_market/accounting/docs/ias/endorsement_process.pdf
\textsuperscript{437} Because of the endorsement the European Court of Justice is therefore competent via Article 267 TFEU. See W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 110.
\textsuperscript{438} A carve-out refers to the situation where the EU has not adopted a certain IFRS Standard completely. The most famous example of this is the temporary carve-out of part of International Accounting Standard 39 on the recognition and measurement of financial instruments.
3.7.3 To whom does the system apply?

The words ‘common consolidated corporate tax base’ suggests CCCTB is only applicable to groups of entities (hence the word ‘consolidated’) and not to either individuals or separate entities. The Explanatory Memorandum of the 2011 proposal mentions that CCCTB will be available for all sizes of companies, but is expected to be particularly relevant for small and medium sized enterprises, as the administrative burden of corporate tax weighs heavy on them.\textsuperscript{439} Article 2 CCTB 2016 determines which companies are eligible for application of the common corporate tax base. These are the companies mentioned in Annexes I and II. Companies that are similar to the companies mentioned in Annexes I and II are eligible for application of the common corporate tax base too.\textsuperscript{440} Therefore, contrary to what the name implies, application of the common corporate tax base is not limited to consolidated accounts or groups of companies, but can be applied to the individual accounts of individual companies as well. Application to groups and their consolidated accounts is allowed, however. The criteria mentioned in Article 2 CCTB do not exclude companies that are not involved in any type of cross-border transactions.

3.7.4 Role of the balance sheet

Article 7 CCTB 2016 defines the tax base as revenues less exempt revenues, deductible expenses and other deductible items. Since no reference is made to a balance sheet in Article 7 CCTB 2016, this implies that the existence of a balance sheet is not necessary. This point becomes even more clear when it is taken into account that CCCTB is not linked to existing standards for financial reporting, which would require a balance sheet to begin with. The question is whether it is necessary for a tax base to require a balance sheet, next to a profit and loss account. According to Working Paper 012 some Member States adhere to the concept of a tax balance sheet, whereas others do not.\textsuperscript{441} The relevance of the question also concerns what documents are required for a company’s tax return and how these should be defined.\textsuperscript{442} In Working Paper 016 it is stated that in Germany the balance sheet is important for the determination of taxable income because profit is determined by comparing the positions on the balance sheet at the end of the year with the positions at the beginning of the year. The balance sheet is also relevant for trade tax and inheritance tax in Germany. It is also mentioned that Germany has a long held tradition of congruence

\textsuperscript{439} Explanatory Memorandum to Commission document 121 of 2011, final version.
\textsuperscript{440} Annex 1 consists of companies that are founded under the national law of the Member States or under European law (such as the Societas Europea). Annex 2 consists of the companies that are taxable under corporate taxes in Europe.
\textsuperscript{441} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 12 of the year 2005.
\textsuperscript{442} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 12 of the year 2005.
None of these issues (comparison of the balance sheet, trade tax, inheritance tax or congruence) are directly relevant for CCCTB and therefore do not prove the necessity of a balance sheet. Working Paper 016 does not draw a conclusion with regards to the relevance or necessity of the balance sheet for a tax base. Working Paper 043 recognises that profit can be determined either by comparing balance sheets or revenues minus expenses, but prefers the latter. This is also the method of Article 7 CCTB 2016. Therefore, at no point a balance sheet is required for determining taxable profit. The Directive does however mention several positions that are or should be recognised on the balance sheet, such as Article 21 CCTB 2016 (financial assets and liabilities held for trading), Article 23 CCTB 2016 (provisions) and Article 43 CCTB 2016 (recognition and valuation of assets and liabilities). Another argument in favour of a balance sheet for tax purposes is auditability. Especially over long periods of time, the concept of continuity of the balance sheet provides for a control mechanism. When no balance sheet is drawn up, other statements would need to be made up in order to know how much depreciation is used or still left, how much provision is already recognised and other matters which can be derived from assets and liabilities. The initial idea that was presented in WP/057, that unless uniform treatment is explicitly provided for in the legislation, the tax base would be computed by reference to national GAAP. However, a certain ‘bridge’ would need to be made by the entity itself, which would lead to the situation where a commercial balance sheet and profit and loss account would exist and via certain additions or alterations the taxable income would be determined. While no separate tax balance sheet would be drawn up, this would lead to a certain base on which tax authorities would be able to fall back on when auditing the taxable income. Since the eventual proposal of 2011 left the whole idea put forward in WP/057 behind, the concept of a balance sheet was, in my opinion, left out in a rather unstructured way. Given the thoroughly different approach in certain areas, of which no structured comparison or translation to IFRS exists, creating such a bridge under the current circumstances will often be very complex and time-consuming, which will often lead to a conflict with one of the primary aims of the CCCTB-project as a whole: diminishing the administrative burden. The same applies to the alternative: creating a separate set of accounts (from scratch) specifically for determination of income. Under certain conditions, not requiring a separate tax balance sheet would be valid. When there are only slight differences between the general purpose financial reporting and the tax accounts and the underlying system is basically similar, the

bridge between the commercial accounts and the tax accounts will be rather straight-forward and thus a separate tax balance sheet would not have any additional benefits. The more structural differences between the two exist, and in the case of CCCTB there is basically no structural overlap or link between the commercial accounts and the tax base, the more relevant a separate tax balance sheet becomes. Provided that CCCTB deviates from general purpose financial reporting in the more complex issues (for example: Article 23 CCTB 2016 differs in quite a lot of places from IAS 37 on provisions), the bridge would be far more complex and a separate balance sheet would make more sense.

3.7.5 Principles based or rules based

The CCCTB-project is a proposal for an EU-directive and not a regulation. When the directive becomes definitive, Member States will have to implement it in order to achieve a certain result. This implementation is rarely a mere copy and paste of given text or rules. Member States will therefore have an amount of freedom in the implementation of a directive. Inherently, this means that a rules based character is always somewhat diminished by the legal form of a directive. The level of detail is generally lower in a directive, as is the exactness and uniformity. I will not go into the question whether for CCCTB the form of a regulation would be preferable to the form of a directive, as I do not see any political possibility for a CCCTB-regulation in the current climate. The inherent danger that lies in this is also that uniform application among the different Member States of the European Union will be lower, as Member States will often implement the directive in the light of their national tax system. Working Paper 004 mentions the discussion of principles based versus rules based systems.\(^\text{447}\) It states that a rules based approach lends itself better for the determination of taxable income than a principles based approach. By comparison, IFRS is mentioned as being principles based. This statement is repeated in Working Paper 010.\(^\text{448}\) Working Paper 6 mentions that because of the fact that IFRS is international and principles based, entities are expected to make judgements and certain definitions and rules are less detailed than national rules.\(^\text{449}\) The conclusion drawn from this is that IFRS’s rules and definitions are not detailed enough to be used for the determination of taxable income. As I have stated in Paragraph 3.3.5 on IFRS, IFRS is not principles based, but primarily rules based, as the possibility of deviation from the standards is in fact merely a theoretical one. It is also striking that IFRS is deemed not detailed enough in comparison to national law in Working Paper 16,\(^\text{450}\) while IFRS was


preferred over the Fourth and Seventh Accounting Directive as a starting point for CCCTB because of its higher amount of detail.\footnote{Working document of the Common Consolidated Corporate Tax Base Working Group nr. 6 of the year 2005.} With the 2016 edition of IFRS containing almost 5,000 pages, the level of detail cannot be deemed less than most national rules either. Working Paper 006 makes a difference between a principles based approach and a rules based approach on the basis of the amount of freedom an enterprise has in determining its annual profit. The amount of freedom that a taxpayer has to determine profit, to my mind, does not determine whether an approach is principles based or rules based. A rules based approach can give a taxpayer a lot of freedom in determining his taxable income, without ever becoming principles based, by offering several options. In Paragraph 3.2.5 I described that a principles based approach provides a set of fundamental tenets or primary assumptions forming the basis of a chain of reasoning, which means that in situations where no rules apply or where the rules lead to a highly unreasonable outcome, these fundamental tenets can provide guidance for a solution. This also means that the amount of rules can be kept relatively low, as there is no need to provide strict rules for every possible situation. CCCTB provides no explicit possibility for such a solution. A taxpayer must follow the rules and although the amount of rules is limited, they are still rules and not principles. Working Paper 022 stresses the importance of uniformity and harmonisation across the European Union and states that this is very hard to achieve with a principles based approach. This makes the the common corporate tax base of CCCTB primarily rules based. The wording of Article 6 CCTB 2016 suggests that certain principles apply, which in turn implies that it is possible to deviate from the explicit rules, if this serves the principles better, but nowhere in the Directive is this possibility formalised. In a way it is even unjustified to call these principles, as they serve no function as such. If anything, they are merely rules. Revision of Article 6 CCTB 2016 therefore seems in place.

3.7.6 Determination of annual profit

3.7.6.1 Income and expenses

The common corporate tax base of CCCTB does not make a clear distinction between the determination of total income (the question as to what income is taxable and what expenses are deductible) and the determination of annual income (the question as to when (in which period) income is taxable and when expenses are deductible). Instead it defines the general tax base as revenues less exempt revenues, deductible expenses and other deductible items,\footnote{Article 7 CCTB 2016.} which, in combination with Article 4, Paragraph 8 CCTB 2016 does imply a concept of total profit.\footnote{P.H.J. Essers, ‘De winstbepaling in de Conceptrichtlijn CCCTB’, \textit{WFR} 2011, vol. 6927, p. 1395-1404.} The issue of profit has been dealt with in several Working
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Working Paper 34 took IAS 18 ‘Revenue’ as a starting point for the attribution of income. The Working Paper defines taxable income as the gross inflow of economic benefits of an entity when those inflows result in the increase of equity, other than increases relating to contributions from equity participants. Along the same lines, Working Paper 34 provides a definition of expenses as being decreases in economic benefits in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases of equity, other than those relating to distributions of profits to shareholders which are made for business and are incurred during the taxable period. Combined, the wordings of the definitions of income and expenses imply a concept of total profit: what inflows and outflows are taxable or deductible, whereby attribution to a certain year (timing of annual profit) is an entirely different question. The main rule on the determination of total profit under the common corporate tax base of CCCTB (when is profit taxable) is found in Article 7 CCTB 2016: the tax base shall be calculated as revenues less exempt revenues, deductible expenses and other deductible items.

3.7.6.2 Principles

With regards to the determination of profit, Article 6 CCTB 2016 states that:
1) In computing the tax base, profits and losses shall be recognised only when realised;
2) Transactions and taxable events shall be measured individually;
3) The calculation of the tax base shall be carried out in a consistent manner unless exceptional circumstances justify a change;
4) The tax base shall be determined for each tax year unless otherwise provided. A tax year shall be any twelve-month period, unless otherwise provided.

The title of Article 6 CCTB 2016 is ‘General principles’, but Article 6 CCTB 2016 consists primarily of rules. For example: there is no fundamental guidance or tenet to be found in a statement like Paragraph 4 that the tax base shall be

456 International Accounting Standard 18 Revenue is the IFRS standard on recognition of revenue arising from the sale of goods, the rendering of services and the use by others of entity assets yielding interest, royalties and dividends. See International Accounting Standard 18.1.
determined for each tax year; this is a rule and not a principle. The first Paragraph of Article 6 CCTB 2016 is a basic timing issue on realisation and therefore creates a basis for the determination of annual profit. Attribution of income and expenses (and thus the determination of annual income) is dealt with in more detail in Article 15 CCTB 2016. Article 15 CCTB 2016 determines that revenues, expenses and all other deductible items shall be recognised in the tax year in which they accrue or are incurred, unless otherwise provided for in this Directive. The main rules on timing of revenue (accrual) and expenses (incurrence) are contained in Chapter V CCTB 2016. The later compromise versions actually imply that the current Paragraph 1 is likely to be deleted. As stated in Paragraph 3.7.5, the common corporate tax base of CCCTB is principally rules based. However, for an analysis of the tax base itself and comparison with the other systems, I will analyse in how far the principles mentioned in Paragraph 3.2.5 underlie the common corporate tax base of CCCTB.

Principle of realism
Aspects of the principle of realism are found in the common corporate tax base of CCCTB, even though it does not mention it explicitly. The common corporate tax base of CCCTB contains its own mechanisms of attribution of inflows and outflows to the tax years, which is a measure of realism in itself (as opposed to a cash-based approach). What is not possible in the common corporate tax base of CCCTB is that when a particular outcome is unreasonable, the principle of realism can overrule the other parts of the common corporate tax base of CCCTB. What needs to be mentioned in this regard is that at one point the idea was put forward that the Commission should initiate a new CCCTB forum, similar to the Joint Transfer Pricing Forum, to which companies and Member States can address issues and disputes relating to the explanation of CCCTB. That forum should be able to give guidance to companies and Member States. Given the fact that there is very little guidance on CCCTB in general, there is added value in this, even though it is hard to imagine what the CCCTB forum would base its opinions on, given this general lack of guidance. It seems unrealistic to introduce a CCCTB forum that is neither legislator nor court (arbitrage is not among the roles given to the forum). This means that this is a proposal that is likely to not solve any issues, simply because the CCCTB Forum would have too little material to go on and has no power to solve an issue.

Accrual
From the first Working Paper it was clear that the common corporate tax base of

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CCCTB would become accrual-based and not cash-based.\textsuperscript{460} In Working Paper 022 it is stated that the principle of accrual is accepted in most Member States.\textsuperscript{461} The approach towards taxable income in the common corporate tax base of CCCTB is accrual-based as well, given Article 15 CCTB 2016: ‘Revenues, expenses and all other deductible items shall be recognised in the tax year in which they accrue or are incurred, unless otherwise provided for in this Directive’. Accrual of revenue and incurrence of costs are defined in Article 16 and 17 CCTB 2016, respectively. The Working Papers do not elaborate on the relation between accrual and the ability to pay taxes. While Working Paper 001Rev1\textsuperscript{462} mentions the ability to pay taxes, the other Working Papers do not refer back to this, with the exception of Working Paper 028.\textsuperscript{463} In general, the main rules of accrual in the common corporate tax base of CCCTB still remain close to the moment when the actual payment takes place. Revenues are generally accrued to the moment when the right to receive them arises.\textsuperscript{464} Expenses are generally incurred when, amongst other criteria, the obligation to make the payment has arisen. A large amount of time can pass between the right to receive revenue and the obligation to make a payment, but in many cases there will be little time between the right or obligation and the actual cash-flow.

Causation, prudence and neutrality

Causation
The Working Papers do not refer to a concept or principle of causation. The Working Papers seem to accept the concept of accrual without any reference to the economic thought behind it or the relation with the ability to pay taxes. Accrual as such is an empty concept (even a cash-based system can be referred to as a form of attribution). What is more relevant is on which basis a cash-flow or expected cash-flow (either inflows or outflows) is attributed. The common corporate tax base of CCCTB itself does provide rules to determine to which period cash-flows must be attributed.

Article 16 CCTB 2016 states that revenues are accrued to the moment when the right to receive the revenue arises.\textsuperscript{465} Economically, it can be maintained that

\textsuperscript{460} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 1 of the year 2004, revised version.
\textsuperscript{461} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 22 of the year 2005. From the research done by Endres et al. it can be derived that the principle of accrual is at the basis of determination of taxable profit in all Member States. D. Endres e.a., \textit{The Determination of Corporate Taxable Income in the EU Member States}, Alphen aan den Rijn: Kluwer Law International, 2007. p. 107.
\textsuperscript{462} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 1 of the year 2004, revised version.
\textsuperscript{463} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 28 of the year 2006.
\textsuperscript{464} Article 16 CCTB 2016.
\textsuperscript{465} The later compromise proposals are more elaborate on when revenues are considered to be accrued and are in general closer to IAS 18. See Council of the European Union, \textit{Proposal for a Council Directive on a Common Consolidated Corporate Tax Base}
this is the actual moment when the revenue is caused or created, which makes this a reasonable form of attribution, although the right to receive the revenue does not increase the direct ability to pay taxes in a less than perfect capital market. In most cases this will not directly present an issue as it is not generally the case that there is a large gap between the right to receive the payment and the actual payment. The later compromise versions give more details as to when the revenue from the trade in goods and the supply of services is accrued. With regards to deductible expenses: they are attributed by Article 17 CCTB 2016 to the moment when they are incurred, which is generally the moment when the obligation to make the payment has arisen (making it almost a mirror-image of Article 16 CCTB 2016). However, the moment when the obligation to make the payment has arisen does not need to be the moment when the expense is caused. There are a number of exceptions to the main rule of Article 17 CCTB 2016. Expenses related to non-depreciable fixed assets are attributed to the year in which the fixed assets are disposed of (see Article 18 CCTB 2016). This too is generally not the moment at which the expense was caused, as the particular type of asset is not bought in order to be sold, but to be used.466

With regards to stocks and work-in-progress, Article 19 CCTB 2016 leads to the effect that costs of goods sold are attributed to the period in which the goods are sold. When the value of the stocks or work-in-progress drops for reasons other than sale, this decrease in value is attributed to the period in which it occurs as well. This means that in Article 19 CCTB 2016 the principle of causation can be recognised. The later compromise versions add more detailed guidance on how to apply this. In Article 23 CCTB 2016 ‘Provisions’ the principle of causation can also be recognised. Where at the end of a tax year it is established that the taxpayer has a legal obligation or a probable future legal obligation, arising from activities or transactions in that or previous years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense. This means that although the common corporate tax base of CCCTB does not strictly follow the principle of causation when attributing expenses, for a large part expenses are attributed on a basis that is in line with the principle of causation.

Prudence

The common corporate tax base of CCCTB makes no reference to the principle of prudence.467 In the Working Papers the principle of prudence is understood as a requirement of caution when judgement is exercised to ensure that assets or income are not overstated or liabilities or expenses not understated.468 This is

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466 (CCCTB) – Explanatory notes, 2011/0058 (CNS), Brussels 2 December 2015.

467 When depreciation of assets should reflect wear and tear, land will generally not be depreciated. However, it can be stated that depreciation should reflect the attribution of an expense. Since land will generally be bought to be used over an amount of time, there is some logic in depreciating it. Otherwise the expense will be attributed to the period in which the land is sold, while land the land is bought to be used and not to be sold.


likely a reference to the pre-2010 Conceptual Framework of IFRS. This approach towards prudence stems from a reluctance of the IASB towards recognition of prudence as over-prudence could lead to the creation of hidden reserves that can be used on a later moment for window-dressing or earnings-management (see Paragraph 3.6.1). This approach towards prudence does not take into account the continental approach towards prudence, which is still prevalent in, for example, legislation of the Netherlands and Germany. In the continental approach prudence is primarily an approach towards attributing inflows and outflows, in the sense that profits are attributed to the period in which they are realised and losses to the period in which they become probable or likely to happen. Article 6, Paragraph 1 CCTB 2016 states that profits and losses shall be recognised only when realised. With regards to profits, taking these into account when realised is prudential, as it generally leads to taking profits into account when the cash-flow can be expected in a short term. With regards to losses, ‘realised’ must be understood as ‘incurred’ in the common corporate tax base of CCCTB, according to Article 15 CCTB 2016 which primarily means that the obligation to pay must have arisen. This implies that the continental approach towards prudence (profits are recognised when they are realised and losses are recognised when they become likely, which is also known as the principle of imparity, as it deals with profits in a different way than it does with losses) is not followed to the full extent. Article 23 CCTB 2016, as an exception to the main rule of Article 17 CCTB 2016, does imply an amount of prudence, as it leads to the recognition of costs when an outflow of resources in the future becomes likely. Articles 20, 25 and 39 CCTB 2016 also attribute losses in a manner that is in line with the principle of prudence. What is striking is that Article 6, Paragraph 1 CCTB 2016 refers to ‘profits and losses’, i.e. the combination of revenue and costs, whereas the general approach in the rest of the tax base is to attribute income/revenue and outflows/costs separately. This issue was likely to be solved, as the compromise proposals suggested that the first Paragraph of Article 9 CCCTB 2011 would be deleted. In the common corporate tax base of 2016 CCCTB-proposals the equivalent Article 6 CCTB 2016 has not been removed though. The former means that the principle of prudence is followed only to a limited extent in the common corporate tax base of CCCTB and not explicitly.

Realisation

Working Paper 001Rev1 mentions that the ability to pay could be relevant when considering whether or not unrealised profits should be taxable. This is discussed further in Working Paper 28 with regards to the principle of

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469 Paragraph 37 pre-2010 Conceptual Framework IFRS.
470 See Paragraph 2.3.
realisation. It is stated that taxing unrealised profits would be contrary to the ‘tax capacity’.

The principle of realisation follows from Article 6, Paragraph 1 CCTB 2016, Article 15 CCTB 2016 and Article 16 CCTB 2016. Article 6, Paragraph 1 CCTB 2016 states that profits and losses shall be recognised only when they are realised. Article 15 CCTB 2016 states that revenues shall be recognised in the tax year in which they accrue and Article 16 CCTB 2016 states that revenues accrue when the right to receive them arises and they can be quantified with reasonable accuracy, regardless of whether payment is deferred or not. In the case of long-term contracts the percentage-of-completion method applies instead of the regular system of Articles 6, 15 and 16 CCTB 2016. Since there is a slight tension between Article 6 on the one hand and Articles 15 and 16 CCTB 2016 on the other hand (with Articles 15 and 16 CCTB 2016 attributing revenue and not profits or losses, whereas Article 6 CCTB 2016 mentions profits and losses), the fact that Article 9, Paragraph 1 CCCTB 2011 was likely to be removed, given the compromise proposals, would have led to a slight improvement of the directive.

Matching

Working Paper 16 mentions that the aim to match income with expenses is a commonality, both for regular accounting purposes as well as for the determination of taxable profit. Although I am of the opinion that expenses are generally matched with income and not the other way around, Working Paper 16 expresses the concept of matching. The common corporate tax base of CCCTB itself does not mention a clear concept of matching. According to Article 6, Paragraph 1 CCTB 2016, profits and losses shall be recognised only when realised. Both profits and losses consist of revenue minus costs. This pairing of revenue and costs implies an amount of matching. Therefore it is striking that Articles 15 CCTB 2016 and further do not attribute profits and losses as such but attribute revenues and costs separately. Article 15 CCTB 2016 states that revenues, expenses and all other deductible items shall be recognised in the tax year in which they accrue or are incurred, unless otherwise provided for in the Directive. Article 17 CCTB 2016, being the general rule for attribution

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473 This is probably meant as a synonym for the ability to pay taxes.
475 In later compromise proposals (see Paragraph 2.3) it is actually suggested that Article 9, Paragraph 1 CCCTB 2011 might be removed, which, in my opinion, would be structurally sound, as the reference to profits and losses is not consistent. However, it has not been removed in Article 6, Paragraph 1 CCTB 2016.
476 Article 22 CCTB 2016.
477 See Paragraph 2.3.
479 Although a loss can exist without revenue and a profit can exist without cost.
of costs to a certain year, states that a deductible expense is incurred at the moment when the following conditions are met (2016 alterations compared to the 2011-version in italics):

(a) The obligation to make the payment has arisen; where an expense consists of payments by the taxpayer at several stages, the obligation to make a payment shall arise when each of the individual instalments becomes due;

(b) The amount of the obligation can be quantified with reasonable accuracy;

(c) In the case of trade in goods, the significant risks and rewards of ownership over the goods have been transferred to the taxpayer and, in the case of supplies of services, the latter have been received by the taxpayer.

This means that costs are attributed as such and not in relation to the attribution of revenue. This implies that there is no differentiation between matching certain expenses with revenue and expenses that have no direct relation with revenue to the period in which they are caused. There are, however, a number of exceptions to Article 17 CCTB 2016 that do imply such an effect. Article 18 CCTB 2016 attributes the costs in relation to non-depreciable assets to the tax year in which the assets are disposed of, provided that the disposal proceeds are included in the tax base. This does imply matching expenses with revenue. Article 19 CCTB 2016 attributes the costs of stocks and work-in-progress to the year in which they affect the valuation of the assets. This means that expenses for goods sold are attributed to the period in which the goods are sold and when the stocks devaluate they are attributed to the year in which they affect the valuation of the assets. Article 23 CCTB 2016 attributes certain expenses to the year in which they are caused and a legal obligation or probable future legal obligation is present. This implies a separation between matching certain expenses with revenue and expenses that have no direct relation with revenue to the period in which they are caused, much in the same sense as what happens in the German and Dutch tax bases.

Principle of simplicity and materiality
The common corporate tax base of CCCTB recognises no principle of simplicity as such or a principle of materiality. It has been the aim of the CCCTB-project to keep the harmonised tax base simple, but where CCCTB would become complex, there is no mechanism for a taxpayer to evade the complexity other than abandoning CCCTB altogether. Materiality is, as always, a difficult concept to apply to taxation. Tax rules generally give no leeway to not strictly apply the rules, with the possible exception of Dutch sound business practice. A concept of materiality is therefore mostly not in line with taxation. When a certain tax return is not done perfectly, there is always a chance that in the case of an audit a correction will take place.

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3.7.6.3 Consequences for attribution of expenses

In this paragraph the model of Paragraph 3.2.6 is applied to the rules of the common corporate tax base of CCCTB. In the same way as is described in Paragraph 3.2.6, expenses can be attributed as costs to either the future, the current year or costs can be attributed to a current year before the expense has taken place. It needs to be taken into account however that, contrary to the other systems, sound business practice generally offers a certain bandwidth within which the taxpayer can determine taxable income, whereas in the other researched systems, the taxpayer is simply expected to follow the rules.

A. The expense is attributed as cost to the future

A.a The expense can be attributed to future realisation

Article 6, Paragraph 1 CCTB 2016 states that in computing the tax base, profits and losses shall be recognised only when realised. This suggests that, as a general rule, all income and expenses are attributed to the connected realisation-moment. As expenses generally take place before the realisation-moment, this means that in general these expenses are attributed to future realisation. Article 7 CCTB 2016 differentiates between revenues, exempt revenues, deductible expenses and other deductible items. Article 15 CCTB 2016 determines the timing of revenues, expenses and all other deductible items. It states that expenses are recognised in the tax year in which they are incurred. Article 17 CCTB 2016 determines that (2016 additions in italics):

A deductible expense is incurred at the moment that the following conditions are met:

(a) the obligation to make the payment has arisen; where an expense consists of payments by the taxpayer at several stages, the obligation to make a payment shall arise when each of the individual instalments becomes due
(b) the amount of the obligation can be quantified with reasonable accuracy;
(c) in the case of trade in goods, the significant risks and rewards of ownership over the goods have been transferred to the taxpayer and, in the case of supplies of services, the latter have been received by the taxpayer.

Contrary to Article 6, Paragraph 1 CCTB 2016, this general rule does not refer to a realisation-moment whatsoever. However, several exceptions to this main rule exist. Attribution of expenses concerning stocks and inventories is dealt with in Articles 19 and 27 CCTB 2016, which are both part of Chapter V Timing and Quantification. In effect, they lead to the attribution of expenses of stock to the year in which realisation (sale
of the stock) or devaluation takes place.\textsuperscript{481} With regards to the disposal of fixed assets, Article 34, Paragraph 2 CCTB 2016 states that where an asset is disposed of during a year, its value for tax purposes and the value for tax purposes of any improvement costs incurred in relation to the asset shall be deducted from the tax base in that year (the texts of the 2011 and 2016 version differ slightly). The latter suggests attributing any amount of the expense that has not yet been taken into account as cost to the year in which it is sold, thus making an exception to Article 17 CCTB 2016 on the incurrence of expenses. This means that attributing expenses for the acquisition or production of an asset as cost to the period in which the asset is sold, is obligatory under certain circumstances. This will generally mean that the actual expense precedes the attribution and thus the deduction of the expense as cost.

A.b The expense is attributed to the period in which the assets lose their value

The common corporate tax base of CCCTB does not explicitly recognise a principle of prudence in its attribution of expenses. In general, both losses and profits are taken into account when realised.\textsuperscript{482} Article 17 CCTB 2016, as a general rule, states that expenses are incurred when the obligation to make the payment has arisen and the amount of the obligation can be quantified with reasonable accuracy. Therefore, it does not follow from the regular system that expenses are taken into account when the assets lose their value. That happens only in the explicit exceptions.

Article 19 CCTB 2016 suggests that when stocks or works-in-progress lose their value, this is attributed to that particular year and the decrease in value is to be deducted in the year in which the stocks and works-in-progress lose their value.\textsuperscript{483}

With regards to fixed assets, a differentiation has to be made between depreciable assets and non-depreciable assets. Several of the Working Papers deal with the concept of depreciation.\textsuperscript{484} Working Paper 004 states that the recognition of the acquisition costs of an asset for tax purposes should primarily relate to the actual useful life of the asset. It does not make clear whether this is because of the wear and tear that an asset suffers or because of attribution of the expenses to the connected revenue.

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\textsuperscript{481} The relation between Article 19 CCTB 2016 and Article 27 CCTB 2016 is not particularly clear and raises a number of questions. However, since this study focuses on Article 23 CCCTB, I will not delve into this issue further.

\textsuperscript{482} Article 6, Paragraph 1 CCTB 2016.

\textsuperscript{483} Later versions of the compromise proposals clarify how stocks and work-in-progress are to be valued. See Paragraph 2.3.

(or any other reason). Since the common corporate tax base of CCCTB prescribes fixed periods of depreciation in Article 33 CCTB 2016, this is a highly theoretical question. However, when fixed assets are not subject to wear and tear (land, fine art, antiques or jewellery) they shall not be subject to depreciation.\(^ {485}\) This implies that the reason to depreciate is wear and tear, which generally does not stem from matching expenses with revenue, but from the recognition of a loss. Contrary to IFRS, the common corporate tax base of CCCTB does not allow depreciation on the basis of the component-approach. Improvement costs shall be depreciated in accordance with the rules applicable to the fixed asset which has been improved as if they relate to a newly acquired fixed asset. In the current proposed common corporate tax base of CCCTB depreciable assets are depreciated on a straight-line basis over fixed time, according to Article 33 CCTB 2016, and this leaves no room for depreciation over an actual useful life. For fixed assets not subject to depreciation that have permanently dropped in value, an amount equal to the decrease in value may be deducted.\(^ {486}\) The 2016 version of the common corporate tax base of CCCTB introduced the requirement that this decrease in value has to be due to force majeure or criminal activities by third parties. This means that, when compared to the other systems, the common corporate tax base of CCCTB leaves much less room for deducting the expense for the acquisition or production of an asset in the period in which it loses its value. Only under specific circumstances and for specific types of assets this is possible.

A.c The expense is attributed to the period in which it has expected use, other than because of expected realisation

Contrary to the Dutch sound business approach, the common corporate tax base of CCCTB does not attribute period bound costs as a separate category. This means that these fall under the main rules of attribution of Articles 15 and 17 CCTB 2016. The obligation to pay rent will generally be present at the start of the period to which it relates, either monthly, quarterly or annually. Since the obligation to make the payment has arisen and the amount can be quantified with reasonable accuracy, the amount shall be deducted in that particular period. When rent becomes useless (i.e. no revenues are connected with it, thus creating a foreseeable loss) this method of attribution will not change. Article 23 CCTB 2016 cannot be applied as the obligation will likely not arise from previous years, unless there is a distinct issue that makes it virtually impossible to rent out the building or start using it again. The rent becomes due with the passing of time. This would be different when the contract itself is seen as the cause of the legal obligation or the future legal obligation. This would require a rather wide interpretation of the ‘arising in’-criterion. This issue

\(^ {485}\) Article 38 CCTB 2016.
\(^ {486}\) Article 39, Paragraph 1 CCTB 2016.
is discussed further in Chapter 4. The same applies to other categories of period bound costs, such as wages and interest.

**B. The expense is attributed to the same period in which it is attributed as cost**

The combination of Articles 15 and 17 CCTB 2016, which creates a general rule that expenses are attributed to the period in which the obligation to make the payment has arisen and the amount of the obligation can be quantified with reasonable accuracy, will often lead to attribution of an expense as cost in the same year as the expense takes place. This does not follow from attribution on the basis of use, remaining usefulness, realisation or because the expenses are period bound. It is a criterion that is solely based on the question whether an obligation to make a payment has arisen, that can be quantified with reasonable accuracy. Several exceptions exist in the articles following Article 17 CCTB 2016.

**B.a The expense is attributed to realisation in the same year**

This is basically the same situation as under A.a, but when the realisation-moment takes place in the same year as the expense, attribution takes place in the same year.

**B.b The expense is attributed to the period in which it no longer has any use**

This is basically the same situation as under A.b, but when the asset becomes useless in the same year in which the expense takes place, attribution takes place in the same year. As stated in A.b the scope of such impairment is limited in the common corporate tax base of CCCTB, as it only applies to non-depreciable fixed assets and only applies in exceptional circumstances. 

**B.c The expense is attributed to the period in which it has expected use, other than because of expected realisation**

This is basically the same situation as under A.c, but when the expense takes place in the same year to which the expense relates attribution takes place in the same year.

**C. The cost is attributed in the period before the expense occurs**

**C.a The expense is attributed to the period in which it is caused**

As stated, Articles 15 and 17 CCTB 2016 determine that expenses are deductible when the obligation to make the payment has arisen and the amount of the obligation can be quantified with reasonable accuracy. Neither the common corporate tax base of CCCTB nor the CCCTB Working Papers define when an obligation to make the payment has

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487 Article 39, Paragraph 1 CCTB 2016.
arisen. It is likely that it is meant that the amount must actually be due, in the sense that payment is presently legally enforceable, since otherwise an overlap would exist with Article 23 CCTB 2016. This means that the expense and the period in which it is caused will often be the same, as generally the moment between payment becoming due and the actual payment will not be too far apart. It is not explicitly required by either Article 17 CCTB 2016 or Article 23 CCTB 2016 that the expense is part of a loss in the sense that connected revenue needs to be present. Although Article 6, Paragraph 1 CCTB 2016 suggests that attribution takes place on the basis of profits and losses (thus as a combination of income and expenses), expenses and revenues in the common corporate tax base of CCCTB are generally attributed separately instead of combined. 

Article 23 CCTB 2016 is an exception to Article 17 CCTB 2016. Where at the end of a tax year it is established that a taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense. This means that a deductible cost is taken into account before the actual expense takes place. This can occur in a situation where no income or other benefits exist or are expected in connection with the expenses or in a situation where future benefits are linked to the event giving rise to the provision. In the latter case these future benefits shall be taken into account by setting them off against the connected expense. 

I will delve into Article 23 CCTB 2016 further in Chapter 4.

C.b The expense is attributed to the period in which it has expected use, other than because of it representing a loss

This is basically the same situation as under A.c and B.c, but the expense takes place in the period after the period to which it relates. This generally means that an accrual will be recognised for the outflow that will take place in the year after the period to which the expense is attributed as cost. Given the wording of Article 17 CCTB 2016 this is an unlikely situation, unless the enterprise is behind with its payments, in the sense that the amount is due in a certain year and meets the criteria of Article 17 CCTB 2016 and is actually paid in the following year.

3.7.7 Compensation of losses under CCCTB

488 Article 27 CCTB 2016 is a notable exception to this rule. The wording suggests that the expenses for stocks are to be attributed to the period in which they are sold and thus realisation has taken place.

489 Article 23, Paragraph 2 under (d) CCTB 2016.
In general, the recognition of a provision is an issue that relates primarily to timing. In that respect, both the time value of money and the liquidity of the company are relevant. The longer the entity can keep liquidity to itself, the more money it can make on that money (making it valuable when taxes can be deferred). For a profitable enterprise, the recognition of a provision will defer taxes, thus keeping the enterprise more liquid. An additional dimension can occur when losses cannot be carried forward or only to a limited amount. When a provision would lead to a loss and the loss compensation is compromised, this leads to a less than optimal tax position for the enterprise. It also makes the question whether the recognition of a provision is mandatory or optional relevant. Therefore, insight into the workings of loss compensation in the common corporate tax base of CCCTB is relevant in a study of provisions in CCCTB. I will not go into the treatment of losses in entering or leaving CCCTB. Article 43 of the original 2011 proposal merely states that a loss incurred by a taxpayer or a permanent establishment of a non-resident taxpayer in a fiscal year may be deducted in subsequent tax years, unless otherwise provided by the directive. It also states that a reduction of the tax base on account of losses from previous tax years shall not result in a negative amount and that the oldest losses shall be used first. This is a standard unlimited loss carry forward. This does not lead to any specific issues with regards to the recognition of provisions. The 2012 Danish compromise proposal \(^{490}\) that proposed alterations of Article 43 CCCTB.

2. \(\text{In a tax year, losses carried forward may be deducted up to a maximum of [EUR X million] for a single tax payer and any losses exceeding this amount shall only be deducted in an amount equal to [X\%] of the remaining tax base.}\)

The fact that it proposes that only a maximum amount of losses carried forward can be deducted, it follows that the loss carry forward is still unlimited, but the timing is altered (the losses are carried forward even more). Losses can theoretically not evaporate under the common corporate tax base of CCCTB by simply exceeding a certain amount. It looks sensible at first: losses can only be deducted up to a certain amount, leaving a taxable amount even when loss carry forward occurs. However, the more time passes, the less relation between the loss carried forward and the annual profit it is deducted from.

The 2013 Irish compromise proposal \(^{491}\) again altered Article 43.

2. \(\text{In a tax year, losses carried forward may only be deducted up to } x \% \text{ of the tax base.}\)

3. \(\text{Carry-forward shall be terminated if the taxpayer or a permanent}\)

\(\text{Council of the European Union document 8790 FISC 52 of 2012.}\)

\(\text{Council of the European Union document 9180 FISC 80 of 2013.}\)
establishment of a non-resident taxpayer ceases the activities due to which the 
losses were incurred, except for the cases where the taxpayer or a permanent 
establishment of a non-resident taxpayer ceases the activities for reasons 
beyond its control.

The activities-test is introduced in Article 43 and when this is not met, again, 
losses will evaporate. This means that provisions can, to an extent, lead to 
situations where the expense can take place in the future, while the deduction 
will not lead to a decrease in taxes due.

The 2014 Hellenic compromise proposal again led to changes in the carry 
forward of losses. 492

2. In a tax year, losses brought forward may be deducted up to a maximum of 
EUR 500 thousand for a single taxpayer and any losses exceeding this amount 
shall only be deducted yearly up to an amount equal to 60% of the remaining 
tax base. A reduction of the tax base on account of losses from previous tax years shall 
not result in a negative amount.

3. Losses incurred by a taxpayer or permanent establishment of a non-resident 
taxpayer in previous years shall not be deducted where:
(i) another company acquires a participation in the taxpayer or in the company 
of the permanent establishment as a result of which the acquired taxpayer 
becomes a qualified subsidiary of the acquirer according to Articles 54 and 55; and
(ii) there is a major change of activity of the acquired taxpayer. Major change 
ofactivity means that the taxpayer discontinues a certain activity which 
accounted for more than [60%] of its turnover in the previous tax year or 
embarks on new activities which amount to more than [60%] of its turnover in 
the tax year of their introduction or the following tax year.

The Hellenic proposal is more detailed than the Irish version, but the idea 
remains the same, meaning that losses can evaporate and thus expenses can 
occur that, by character, would be tax-deductible, but in effect will not decrease 
the tax base. The fact that both control and the activities must change in order 
for the losses to evaporate seems to be mainly an anti-abuse measure against the 
trade in losses, which is by all means reasonable and not uncommon in the tax 
bases of the Member States of the European Union. In the final version, carry 
forward of losses is in itself likely to remain unlimited while actual reduction of 
the tax base is limited over time and when the activities and control change the 
losses will evaporate.

The concept of provisions in Article 23 CCTB

Article 41 Losses

1. Losses incurred in a tax year by a resident taxpayer or a permanent establishment of a non-resident taxpayer may be carried forward and deducted in subsequent tax years, unless otherwise provided by this Directive.
2. A reduction of the tax base as a result of considering losses from previous tax years shall not result in a negative amount.
3. Losses incurred by a resident taxpayer or by a permanent establishment of a non-resident taxpayer in previous years shall not be deducted where all of the following conditions are met:
   (a) another company acquires a participation in the taxpayer as a result of which the acquired taxpayer becomes a qualifying subsidiary of the acquirer as referred to in Article 3;
   (b) there is a major change of activity of the acquired taxpayer, which means that the acquired taxpayer discontinues a certain activity which accounted for more than [60 %] of its turnover in the previous tax year or embarks on new activities which amount to more than [60 %] of its turnover in the tax year of their introduction or the following tax year.
4. The oldest losses shall be deducted first.

3.7.8 Specific additions in the 2016 proposal

The 2016 proposal introduced several specific aspects that can be relevant for the analysis of provisions in the common corporate tax base of CCCTB. Especially Article 11 CCTB 2016 ‘Allowance for growth and investment’ and Article 13 CCTB 2016 ‘Interest limitation rule’ can have an influence on the role that provisions have or need to have in the common corporate tax base of CCCTB.

3.7.8.1 Article 11 CCTB 2016 ‘Allowance for growth and investment’

When a company is financed with debt, the interest on the debt is deductible from taxable income. When a company is financed with equity, this is not the case: dividends are not deductible from the taxable income. In order to address this debt-bias, the European Commission introduced the allowance for growth and investment in Article 11 of the 2016 CCTB-proposal. It provides a deduction of a deemed yield on equity. The defined yield is equal to the yield of the euro area 10-year government benchmark bond in December of the year which precedes the relevant tax year, as published by the European Central Bank, increased by a risk premium of two percentage points. A floor of two per cent shall apply where the curve of the annual yield is negative. Whether this will be enough for enterprises to increase equity and decrease liabilities is still a relevant question, but the fact that the European Commission introduces a mechanism like this in the common corporate tax base of CCCTB is a healthy development.
CHAPTER 3. IFRS, GERMAN, DUTCH AND UNITED KINGDOM LEGISLATION

For the purposes of Article 11, Paragraph 2 CCTB 2016, ‘equity’ is defined as either

- ‘capital and reserves’, as described in letter L. in Annex IV to Directive 2013/34/EU;

This is where the lack of a balance sheet starts showing itself (see Paragraph 3.7.4). For the determination of equity, reference is made to either the accounts drawn up under IFRS or the accounts drawn up under Directive 2013/34/EU (which, in the European Union is reference to European GAAP). The strange thing is that an enterprise can calculate its taxes based upon the common corporate tax base of the CCCTB, with equity determined under IFRS, while it draws up its accounts in accordance with national GAAP. This requires the tax authorities to be able to audit both, which requires a lot of specialized knowledge of a non-tax field, which makes things more complicated than necessary. It takes away some of the intended simplicity. It would have been much easier if a tax balance sheet was mandatory and definitions of liabilities, provisions and equity would have been given.

3.7.8.2 Article 13 CCTB 2016 ‘Interest limitation rule’

Next to an allowance for growth and investment, which creates a deduction for a deemed yield on equity, an interest limitation rule is introduced in Article 13 of the 2016 CCTB-proposal. It means that borrowing costs shall be deductible up to the amount of the interest or other taxable revenues from financial assets received by the taxpayer. Exceeding borrowing costs are only deductible in the tax year in which they are incurred for a maximum of 30% of the taxpayer’s earnings before interest, tax, depreciation and amortisation or for a maximum amount of € 3.000.000, whichever is higher.

Contrary to Article 11 CCTB 2016, where reference is made to the general purpose financial reporting, Article 13, Paragraph 3 CCTB 2016 states that the EBITDA shall be calculated by adding back the tax-adjusted amounts for exceeding borrowing costs, as well as the tax-adjusted amounts for depreciation and amortization. Tax-exempt revenues shall be excluded from the EBITDA of a taxpayer. This means a two-way approach is chosen towards decreasing the differences in tax treatment between equity and liabilities: the deduction of interest on liabilities is decreased whereas the deduction of yield on equity is increased.

3.8 Comparison and conclusions
3.8.1 General outline

In this chapter research has been done into the backgrounds of CCCTB and the systems it is compared with in this study. Relevant elements of these systems have been described as well as how their commercial and tax accounts relate to each other.

3.8.2 A short introduction of the history of each system and its objectives

A short introduction of the history of the several systems and their objectives is given. All of the systems have a lengthy history. The income tax systems (Germany, United Kingdom and the Netherlands) generally have a long history, stemming from the 19th century. International harmonisation of accounting rules, of which IFRS is the product, stems from the early 20th century. European harmonisation of direct taxes, of which CCCTB is the current outcome, is the most recent, having its roots around the 1960’s. The income tax systems primarily aim to provide rules to determine taxable income in a way that is acceptable from a social and economic point of view, although instrumentalism (attaining specific goals other than revenue by taxation) also occurs regularly. The social aspects of an income tax, in a slightly different form, are still relevant today. This differs greatly from IFRS, which aims to provide standards for general purpose financial reporting and thus to provide valuable information to users of that information. CCCTB is more specific in its objectives than the other systems, as it is conceptually an income tax base, but it is designed to solve a number of tax-issues that arise in the European Union as a whole.

3.8.3 Congruence

The former also has effects on the level of congruence, the amount to which the commercial accounts determine taxable income. IFRS is not meant as a tax base and therefore there are no issues in IFRS with regards to congruence. Both the German approach and the approach in the United Kingdom have a large amount of congruence: determination of taxable income is largely dependent on the commercial accounts, although some options and specific tax rules do occur. The Dutch approach differs quite a bit from this as it offers both the possibility of deviating from the commercial accounts as well as a general amount of freedom in determining taxable income. CCCTB is different when compared to these systems. It is formally and materially unconnected to the commercial accounts or a set of standards for determination of income, even though IFRS was used as a starting point. Contrary to the Dutch approach, CCCTB offers virtually no freedom to a taxpayer with respect to the determination of taxable income.

493 Which is the classic 19th century approach to income taxes.
The latter is understandable from the viewpoint of European harmonisation. True harmonisation will generally only take place when taxpayers and tax offices are not offered large amounts of freedom in determining taxable income, because this will create arbitrariness and a false sense of harmonisation. However, the lack of connection to an existing system, such as IFRS, also has a large downside. It means that the ECJ and national courts cannot fall back on existing definitions or rules other than what is written in CCCTB itself (and which is far from complete). This stresses the importance of rules that leave as little room for interpretation as possible.

3.8.4 To whom does the system apply?

IFRS is not developed by a national, European or otherwise international legislator but by a private party standard-setter, the IASB. IFRS has no specific targeted audience (as it aims to provide standards for general purposes financial reporting), but tends to take investors as a starting point for users’ requirements. Within the European Union, the use of IFRS is mandatory for the consolidated accounts of listed companies and optional for most other enterprises. Generally, the use of IFRS is limited to entities (although it is in principle possible to draw up accounts for a sole proprietorship in accordance with IFRS). The systems in the United Kingdom, Germany and The Netherlands define the taxpayers, but none are limited to multinational or listed companies or their consolidated accounts. Both sole proprietorships (and associations of persons that do not constitute an entity) and entities are expected to determine their taxable profit from entrepreneurial activities. The application of CCCTB, contrary to what might be expected, is not limited to the consolidated accounts or to multinational or listed enterprises. Enterprises that do not operate in a multinational environment or which are stand-alone entities (thus do not form a group that can draw up consolidated accounts) and are not listed on a stock-exchange, are free to apply CCCTB in the current proposal. The primary limitation is that only entities (and thus not persons or partnerships) are eligible to use CCCTB when the directive will enter into force.

3.8.5 Role of the balance sheet

When determining the role of the balance sheet, it is mainly striking that CCCTB does not require a balance sheet to be drawn up. Under IFRS, drawing up a balance sheet is mandatory. Since the German and United Kingdom approach are high in congruence, a balance sheet is mandatory as well. The Dutch approach, being low in congruence, would, in principle, be possible without a balance sheet. In theory, it would be possible to determine taxable income in accordance with sound business practice without drawing up a balance sheet. Since some of the predecessors of Article 3.25 of the Dutch Income Tax Code 2001 approached determination of taxable profit by balance sheet comparison and, more practical, all tax return software is based on both revenue minus cost and comparison of the balance sheets over time, it is
unlikely that taxable profit in the Netherlands is determined without drawing up a balance sheet. The added benefit of a balance sheet stems from the concept of double entry bookkeeping: it provides both a control mechanism and more oversight over the years when compared to using only a method of determination of taxable profit as revenue minus costs. It therefore adds to both the quality and the auditability of the determination of taxable profit. This means that it is striking that the common corporate tax base of CCCTB does not require balance sheets to be drawn up at the beginning and end of every reporting year. Inconsistently, the common corporate tax base of CCCTB approaches several separate entries from the viewpoint of the balance sheet (certain types of assets and provisions) and Article 11 of the 2016 CCCTB-proposal even refers to IFRS and EU-GAAP for the definition of equity. What is mainly the issue in this is that when taxable income is determined by starting with the financial reporting and then applying specific tax rules to it, both a balance sheet and a profit and loss account exist. The difference between the financial reporting and the taxable income follows from a certain ‘bridge’ between the financial reporting and the taxable income. In that sense an additional tax balance sheet would not be necessary as the balance sheet from the financial reporting fulfils this role. Auditability is not a problem in this respect, unless the bridge would be unreasonably complex. This was the original idea of the CCCTB-directive that was still put forth as late as Working Paper 57 ‘Possible outlines of a technical outline’. The eventual proposal is much more of a standalone base than the original idea of Working Paper 57. Therefore, the idea that a balance sheet is not necessary for reasons of decreasing the administrative burden is unlikely to hold true, as this will increase other administrative burdens or decrease auditability. In anyway, when using double entry bookkeeping, which is to be expected, the additional burden that follows from drawing up a balance sheet is very limited, while the drawbacks are likely to be bigger. Whether it is actually reasonably possible to draw up a bridge between for example IFRS-accounts and taxable income based on CCCTB has not been tested, to my knowledge. In any case, it seems that leaving out a balance sheet in the common corporate tax base of CCCTB does not result in real benefits, but does seem to have serious drawbacks.

3.8.6 Principles based or rules based

Of the researched systems, only the Dutch sound business practice qualifies as primarily principles based. This means that the amount of codified law is relatively low and when an inconsistent or unreasonable outcome occurs, the taxpayer and the tax office can opt for a different solution, of which the tax courts decide whether it fits in with the existing principles that have been developed over the years. None of the other systems offer such an outcome. IFRS and United Kingdom suffer from a large amount of codified law (or standards, in the case of IFRS). IFRS and the United Kingdom FRS 102 offer the possibility of deviation from the standards, but only in extremely rare circumstances. The common corporate tax base of CCCTB is highly rules based:
it offers strict rules, from which no deviation is possible, even when the outcome is apparently unreasonable. From the viewpoint of a European harmonisation, there is a large amount of logic in this, as a principles based approach is likely to lead to large differences in application among the several Member States of the European Union, which all have their own cultures and legal systems. Unification and harmonisation \(^{494}\) based on case law by the European Court of Justice would likely take long to develop to an acceptable level. However, in the current proposal for the common corporate tax base of CCCTB-Directive, it is not possible to correct an apparently unreasonable outcome that was not foreseen when developing the Directive. This means that once such outcomes occur, the Directive must be altered by the European Commission and adopted by the Member States, which is likely to take even longer than case-law to develop (even though the time it takes to receive a ruling by the European Court of Justice is long as well). An escape-clause for apparently unreasonable outcomes would have provided an opening for this and the application would be overseen by the European Court of Justice. Otherwise uniform application in general will, in part, be dependent on case-law of the European Court of Justice, whose responsibility it is to guard the uniform application of the common corporate tax base of CCCTB-Directive, with the other variable being a CCCTB-Directive that currently does not (or should not) leave room for various interpretations and has not been tested in practice yet. The downsides of having to depend on case-law of the European Court of Justice are that:

- It will take a lot of time for enough case law to develop
- The development of case law is funded by the taxpayer which imposes an excessive financial burden on the taxpayer
- Having to fall back on a large amount of case law is not an ideal situation as it does not always provide the clarity that is wished for, as the Court rules in an individual case and not necessarily to develop a uniform application

This means that it is far from optimal to cut corners in the development of the Directive thinking that the European Court of Justice will solve issues that occur. Wherever possible, potential problems need to be resolved.

3.8.7 Determination of income

With regards to determination of income, the German and Dutch approach generally follow the same approach, with the principle of prudence being the primary guideline. Traditionally, this has meant that the determination of distributable income has led to imparity, whereby profits are recognised once realised and losses when they are likely. IFRS and the United Kingdom approach are much alike as well, whereby it is striking that the focus lies on the balance sheet and not on the determination of the performance of the enterprise. The common corporate tax base of CCCTB does not rely on a specific system or approach. Some overlaps with both the German/Dutch approach and the

\(^{494}\) Which is highly desirable in the context of CCCTB, see Working document of the Common Consolidated Corporate Tax Base Working Group nr. 10 of the year 2005.
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IFRS/United Kingdom approach occur. In itself, it makes sense that, with the common corporate tax base of CCCTB being a stand-alone basis and most likely being somewhat of a compromise, influences from different systems are visible. Furthermore, the common corporate tax base of CCCTB clearly consists of fewer rules than the German law, United Kingdom law and IFRS (and, when taken into account that the Dutch approach consists of a large amount of case law, it is decidedly simpler than the Dutch approach as well). Whether this simplicity is actually of lasting value is the question, as simple rules without many nuances can lead to unreasonable outcomes in some cases, leading to complexities at later date. What is most important for this study is that in all the researched systems it is accepted that an expense that is expected to occur in the future can lead to the attribution of costs in an earlier reporting period. This is the category to which provisions, the primary research object of this study, belong.

3.9 General conclusion to the chapter

What has become clear in this chapter is that in the common corporate tax base of CCCTB is generally the odd one out when compared to the other researched systems. It has the shortest development time, it is a stand-alone tax base, it is highly rules based and it is, upon first reading, decidedly shorter and simpler than the other systems. Whether these are all advantages is debatable. Simplicity is in itself an advantage, but may also lead to ‘crudeness’, i.e. lacking necessary nuances. The same goes for the common corporate tax base of CCCTB being highly rules based: this is probably the best workable approach in a situation where harmonisation of application is wished for between States that have different (legal) cultures. The main problem here is that no escape is provided for in the sense of an ‘unreasonability’ clause. This will also mean that when enterprises find a loophole to create low tax or deferral of taxability, no solution to this exists, other than changing the Directive. The lack of a connected set of standards, such as IFRS, or a set of principles, such as the approach of sound business practice, is also likely to provide difficulties for the courts, as the directive itself provides only limited guidance and the Working Papers only provide limited insight. It is actually quite difficult to find out the meaning or objective of certain areas of the Directive, when they are not clearly defined in the Directive itself. Outcomes might therefore not be as consistent between Member States as is necessary. None of these issues are clearly addressed in the Working Papers or the documents accompanying the proposal for a Directive on CCTB. For the rest of this study, this means that the text of CCCTB must be taken literally and at face value. Whenever unreasonable outcomes or inconsistencies occur, solutions to these must be approached from the normative framework provided for in Chapter 2.

3.10 Schematic overview of the main characteristics
<table>
<thead>
<tr>
<th></th>
<th>IFRS</th>
<th>German tax law</th>
<th>Dutch tax law</th>
<th>UK tax law</th>
<th>CCCTB</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Congruence</strong></td>
<td>N.A.</td>
<td>almost formal</td>
<td>material incongruence</td>
<td>material congruence</td>
<td>formal incongruence</td>
</tr>
<tr>
<td><strong>To whom</strong></td>
<td>primarily entities</td>
<td>individuals and entities</td>
<td>individuals and entities</td>
<td>individuals and entities</td>
<td>entities</td>
</tr>
<tr>
<td><strong>Role of the balance sheet</strong></td>
<td>mainly static</td>
<td>static and dynamic</td>
<td>dynamic</td>
<td>static</td>
<td>N.A.</td>
</tr>
<tr>
<td><strong>Principles or rules based</strong></td>
<td>rules based</td>
<td>signs of both main principles based</td>
<td>rules based</td>
<td>rules based</td>
<td></td>
</tr>
<tr>
<td><strong>Determination annual profit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Realism override</strong></td>
<td>extremely rare</td>
<td>extremely rare</td>
<td>possible</td>
<td>extremely rare</td>
<td>not possible</td>
</tr>
<tr>
<td><strong>Accrual based</strong></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Prudence, causation, imparity</strong></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes, but attributes in- and outflows separately</td>
</tr>
<tr>
<td><strong>Realisation</strong></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Matching</strong></td>
<td>yes, but only within definitions assets / liabilities</td>
<td>yes, but only within definitions assets / liabilities</td>
<td>yes, but only within definitions assets / liabilities</td>
<td>only limited</td>
<td></td>
</tr>
<tr>
<td><strong>Simplicity</strong></td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td><strong>Materiality</strong></td>
<td>yes</td>
<td>limited extent</td>
<td>not explicit</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>
Chapter 4. Provisions and similar entries

4.1 Introduction to the chapter

As stated in Chapter 1, this study deals with the assessment of Article 23 CCTB 2016 ‘Provisions’, which includes a comparison with the treatment of provisions in three existing systems of determination of taxable income (Germany, the Netherlands and the United Kingdom) and one international set of standards for the preparation of general purpose financial reporting (IFRS). This chapter will consist of an analysis per system of what provisions are, how they are measured and what their role in their own system is. This provides the necessary input for a comparison between provisions in the 5 systems, which in turn will lead to conclusions. There is no full international consensus on what exactly constitutes a provision or its boundaries and it is not likely that there will be such a consensus in the foreseeable future. Also, the borders between provisions and other related entries can be rather thin. What would constitute a provision in one system can constitute another type of entry (such as a reserve or an accrual) or no entry at all in another accounting or tax system. A thorough comparison can only take place when entries leading to a similar effect are taken into account as well. The basic outline is that in general purpose financial reporting the recognition of a provision provides information to the users of this reporting about expected future outflows that are caused in one way or another before the end of the reporting period (often it will be required that this expected future outflow is based on a present obligation). In the determination of taxable income a provision largely plays the role of a deferral of taxes because a certain future expense is caused before the end of the reporting period.

For example, when the taxable annual profit before the deduction for provisions is € 100,000 and the tax rate is 25%, the enterprise would pay € 25,000 annually. If it becomes clear in year 1 that a € 100,000 expense is expected to be paid in year 3, this would defer the € 25,000 tax for year 1, as the taxable income in year 1 would be € 0.

This deferral of taxes provides the entity with some of the necessary resources to pay the future expense and thus acts as a way of self-financing.495 There are several approaches and issues that can be dealt with differently when designing requirements for a provision, but it will always come down to the recognition of a cost or obligation for a future expense or otherwise outflow of resources. Therefore, amongst other issues, there always needs to be a view on why provisions are recognised in the first place (such as measuring performance on the basis of the principle of causation or because it represents an obligation), what makes a future expense probable enough to be recognised (any probability or ‘more likely than not’), whether or not an obligation towards a third party

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must be present and how the amount for which the provision is recognised must be determined (i.e. on what basis must it be measured). The common corporate tax base of CCCTB is not aimed at giving insight in the balance sheet or otherwise in the financial position of the enterprise. It does not even recognise the balance sheet as part of the tax base. The other researched systems are either aimed at general purpose financial reporting (IFRS), thoroughly based on national GAAP (German and the United Kingdom law) or derived from business economics (Dutch sound business practice) and do require a balance sheet. In the development of the common corporate tax base of CCCTB, IFRS has been used as a starting point and the common corporate tax base of CCCTB is thus not completely free from influences of a balance-sheet oriented approach. This means that the concept of a balance sheet is present in all these systems. Therefore a provision will generally be thought of as an entry on the balance sheet, mostly as a liability, with an effect on the performance or profit and loss on the entity, representing that an outflow or resources will take place after the end of the reporting period. This means that an in-depth research and comparison of provisions is not possible without taking both the entry on the balance sheet and the effect on performance or profit and loss into account (or, where applicable, vice versa). This chapter is therefore the main theoretical part in this study on provisions and entries that share the main characteristics of provisions. Together with Chapter 5, it provides a bridge between the description of the general characteristics of determination of profit in the five systems described in Chapter 3 and the analysis, conclusions and suggestions for improvements of Article 23 CCTB 2016 that will be dealt with in the following chapters. This leads to an amount of output that can be assessed by the criteria set out in the normative framework of Chapter 2. The problems found and the practical application of the rules governing provisions, when placed against the normative criteria, provide the basis for suggestions for improvements in the following chapters.

The outline of this Chapter is as follows. What needs to be taken into account is that, since the common corporate tax base of CCCTB does not concern itself with entries on the balance sheet, whereas this is largely the case for liabilities in all the other systems, a form of ‘translation’ needs to take place in order to be able to compare CCCTB with the other systems. Therefore the approach of the research will take the relevant entries on the balance sheet as a starting point, whereby reference is made to the effect on the determination of profit. Provisions represent a tax deductible cost in a certain year, (and thus a deferral of profit and corporate income tax) while the connected expense is expected to take place in the future. An effect of this is that this creates an entry on the

498 This follows for example from Article 23 CCTB 2016, which is called ‘Provisions’ and Article 21 CCTB 2016 which deals with classification of financial assets and liabilities.
credit-side of the balance sheet, either as a liability, a provision (when provisions are not viewed as a liability, which is the case in some systems that recognise provisions as a separate category) or a reserve as part of equity, (although the creation of a reserve is generally not viewed as tax-deductible, unless a specific rule applies). For all the researched systems an overview will be given of the entries that are recognised in a similar way. This provides an overview of the place of provisions in the particular jurisdiction. It also leads to the following: since the definitions of provisions in the researched systems do not fully overlap, it might lead to the conclusion that a specific system does not provide for a solution to a certain situation whereas the other system does. It can however occur that the former system simply does not call its solution a ‘provision’, but labels it as another type of entry, such as a tax-deductible reserve or an accrual or deals with the underlying problem in a different way, such as using the component approach instead of a provision for maintenance and repairs. This would mean that a comparison of the systems would not be on a level-playing field if these were not taken into account as well. Analysing the other entries on the credit-side of the balance sheet diminishes this particular risk.

For every system, the following approach will be followed. It starts off with a short analysis of the entries on the credit-side of the balance sheet that represent a future outflow of resources. This will generally consist of two categories that are relevant for this study: liabilities and tax-deductible reserves. Liabilities will generally consist of debts, provisions and accruals (the latter insofar they lead to a deferral of profit, therefore either as a deferral of revenue or an anticipation of future expenses). Provisions will be dealt with further in a separate paragraph, as they are the main category researched in this study. Generally, the compensation paid on equity is not deductible (which therefore also has the consequence of not lowering taxable income) while compensation paid on liabilities is deductible (which therefore has the consequence of lowering taxable income). Differences between equity and liabilities lead to difficulties both in general purpose financial reporting and the determination of taxable income which makes the question of where the line between the two is (and whether there should even be a line between the two) highly relevant. While this question has some relevance for provisions, there is generally no compensation paid on a provision (although the time value of money is to be taken into account under certain circumstances in measuring a provision, giving an effect in some ways similar to interest). This means that this issue falls outside the scope of this research. It is also the reason why I feel that a capital allowance (allowing a certain deduction for the presence of equity in order to even out the difference between equity and liabilities), which can solve at least some of the existing issues from a tax point of view, is not relevant when analysing provisions. The compensation paid on equity (dividends) is not deductible and the compensation paid on a loan (interest) is deductible. The main deduction with provisions lies in the recognition of the entry and not in the compensation. When there is no apparent compensation, deduction is not an issue.
Of provisions, the following will be researched in the aforementioned jurisdictions and IFRS:

1. The definition of a provision;
2. The requirements for the recognition of a provision;
3. Provisions that accrue over the course of years;
4. Measurement of provisions;
5. Large populations of homogenous items;\footnote{\text{499}}
6. Catching up in later years;
7. Compensation and other connected income;
8. Mandatory or optional recognition;
9. Place in the system.

This is followed by an analysis and comparison, whereby CCCTB will be at the forefront. Conclusions will be drawn and collected, in order to provide input for the following chapters.

**4.2 IFRS**

**4.2.1 Liabilities and deductible reserves**

**4.2.1.1 Liabilities**

IFRS defines a liability as a present obligation of the entity, arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.\footnote{\text{500}} While IFRS does not differentiate explicitly between liabilities and debts (it does not even define the word ‘debt’), from the definition it becomes clear that ‘liability’ is the overarching term, which includes debts, provisions and accruals. There is no separate standard that deals with liabilities, although IFRS-standard IAS 37 ‘Provisions, contingent liabilities and contingent assets’ gives some additional insight in the characteristics of liabilities, such as contingent liabilities.\footnote{\text{501}} There is a current academic discussion about the definition of liabilities. It is sometimes thought that, based on this definition, a liability is the same as the ultimate outflow, instead of the underlying obligation that needs to be measured.\footnote{\text{502}} The IASB considers revising the definition of liabilities in order to mend this misunderstanding. The current proposal is that a liability should be defined as a present obligation of the entity to transfer an economic resource as a

\footnote{\text{499}} Items that, individually, would not meet the criteria for the recognition of a provision, especially the criterion of probability, but, when taken as a group of homogenous items, would meet the criteria.

\footnote{\text{500}} International Financial Reporting Standards, Conceptual Framework 4.4(b) and International Accounting Standard 37.10.

\footnote{\text{501}} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.

result of past events.\textsuperscript{503} An obligation is defined as a duty or responsibility to act or perform in a certain way. In itself this does not mean that at the end of the reporting period the obligation is immediately\textsuperscript{504} enforceable by a third party or otherwise due. The performance can be enforceable in the future, as long as the obligation is present at the end of the reporting period in the sense that it must already exist.\textsuperscript{504} It is of course difficult to assess when an enterprise has a duty or responsibility to act in a certain way, especially when no clear legal obligation is present. Therefore additional guidance on obligations will always be necessary, in order to exclude subjectivity in the determination of a duty or responsibility. Sometimes the existence of an obligation is not a 100\% certain.\textsuperscript{505}

Uncertainty with regards to the existence of an actual obligation will occur mostly in the case of provisions, since they are by definition more uncertain than other liabilities, such as loans. An example of this is a legal claim. It will then largely depend on estimates of legal experts whether it can be deduced that an obligation is present. This is likely the reason why uncertainty with regards to the existence of an obligation is dealt with in IAS 37,\textsuperscript{506} that states that the probability of the existence of an obligation must be more likely than not.\textsuperscript{507} When the threshold is not met, this will lead to the disclosure of a contingent liability.\textsuperscript{508} This issue will be dealt with in detail in the following paragraph on provisions. The obligation can be either legal or constructive, as long as the entity has no realistic alternative to settling that obligation.\textsuperscript{509} In the case of a legal claim and a civil court case it is mostly an illusion to think that it is possible to calculate the chances of a win or a loss in the course of the proceedings. Correct undisputed assessment of a 49\%, 50\% or 51\% chance will


\textsuperscript{506}International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.15.

\textsuperscript{507}This suggests that there is a mathematical approach to determining the existence of a liability.

\textsuperscript{508}International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.16. A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

\textsuperscript{509}International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.10.
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generally be impossible. This means that the line between a contingent liability and an actual liability can be very thin when dealing with legal claims and court cases. An enterprise therefore has room for manoeuvring, either to steer profit, to provide a certain position on the balance sheet or because it simply does not want to acknowledge that it thinks it is on the verge of losing a court case. The later will always be very sensitive information, for which IFRS provides no proper solution: there is sometimes tension between providing useful information and the interests of the entity itself. The fact that a liability constitutes a present obligation implies that the entity has no control over the future outflow: it will take place, whether or not the entity wants it to. Differentiation can be made between several types of liabilities: debts, provisions, accruals and contingent liabilities.

Preceding the 2013 paper by McGregor, the IASB identified a number of issues with IAS 37 in its 2010 Exposure Draft. The main issues are identified as:

- The IAS 37 criteria for recognition of a liability are not in line with other IFRS–standards;
- Certain differences between IAS 37 and US GAAP exist;
- Measurement criteria in IAS 37 are vague (‘best estimate’ and what costs to include).

Therefore, the wording below should be read in this light, as there is additional work to be done. Unfortunately, the project to review IAS 37 is on-hold for the time being.

4.2.1.1.1 Debts

IFRS does not provide a definition of the word ‘debt’ in the way that for example Dutch sound business practice does. It does provide a definition of the word ‘liability’ (a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits), of which debts are part. Under IFRS, debts are part of the category financial instruments. A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. IAS 32.11 defines a financial liability as any liability that is a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or a contract that will or may be settled in the entity’s own equity instruments and under which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments and is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments or a derivative that will or may be settled other than by the exchange of a fixed amount of cash or


511 International Accounting Standard 32, Financial Instruments: Presentation 32.11.
another financial asset for a fixed number of the entity’s own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments of the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity’s own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments.

Debts, as a species of the genus liability, give rise to a financial liability of the entity (as an obligation to pay) and a financial asset of another entity and are therefore financial instruments.

An important difference between such financial instruments as debts and provisions, is the fact that financial instruments will be more certain in timing and/or amount than provisions.\textsuperscript{512} Furthermore, the recognition of a provision will generally lead to deductible costs, whereas the recognition of debt does not necessarily do the same.\textsuperscript{513} When a loan is taken, debt is recognised, but not costs for the nominal amount (the interest will lead to the recognition of costs). The same goes for the eventual outflow in the shape of repayment of the debt. In this particular situation the debt as such does not have the character of either revenue or costs and thus does not influence profit directly.\textsuperscript{514}

\textit{For example, a € 100.000 loan is taken, for which a 4\% annual interest rate is agreed upon. The € 4.000 annual interest is deductible from profit as cost. When the € 100.000 loan is repaid, this does not lead to a deduction from profit.}

Provided that differences in certainty with regards to timing and/or amount are relevant information for some users of the financial reporting, it is striking that IFRS does not provide stricter dividing lines between debts, provisions and accruals or more guidance than it does. This may create a tendency that an enterprise presents a liability as being more uncertain than it actually is.

\textit{4.2.1.1.2 Provisions}

Provisions are dealt with in detail in Paragraph 4.2.2.

\textsuperscript{512} International Accounting Standard 37,\textit{ Provisions, Contingent Liabilities and Contingent Assets} 37.11 does not mention debts per se but it is clear that the uncertainty in timing or amount is what sets provisions apart from debts.

\textsuperscript{513} The interest that is paid on the debt is deductible but the amount of the debt does not need to be.

\textsuperscript{514} Issues connected to the loan can however have the character of either revenue or cost.
4.2.1.1.3 Accruals

Accruals are entries that bridge the gap between the measurement of performance and entries on the balance sheet. Costs that apply to a certain year and will be paid to a later year can lead to an accrual.

For example, an enterprise pays € 10,000 interest on a yearly basis. Its book year is equal to the calendar year, but the interest is paid postnumerando on the 1st of July. € 5,000 of this interest is accrued on the 31st of December and forms an accrual at that point and thus an entry on the balance sheet.

These can therefore have either the character of a liability, but also of an asset (if the situation is reversed). IAS 37.11 defines accruals as liabilities to pay for goods or services that have been received or supplied, but not yet paid for or invoiced. The uncertainty of timing and amount is generally much less for an accrual than for a provision. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately. This means that there is a limited distinction between accruals and debt, but a larger distinction between accruals and provisions, which is not dealt with in further detail in IFRS. The definition given in IAS 37.11 does not include accruals as assets and the Glossary of IFRS does not define accruals at all. It would therefore depend on whether the accrual could meet the definition of an asset to determine whether it must be recognised. Advance payments to a third party, for example, will generally meet the definition of an asset as they represent an expected inflow (the enterprise has a ‘right’ to receive goods or services from the third party). It is almost as if the IASB thinks of accruals as a type of entry that both the user and the enterprise are already familiar with and that does not need a more detailed definition or more guidance. When three types of accruals that are close to provisions are analysed in IFRS, the following applies.

Received payments for revenue that is accrued to the future (advance payment)

In this situation the taxpayer has received payments for goods or services that have to be delivered after the end of the reporting period. This occurs for example when the enterprise sells goods on the basis of a prepayment and delivers the goods after the end of the reporting period, while the advance payment was received before the end of the reporting period. Therefore the criteria of revenue-recognition according to IAS 18 are not met and therefore the revenue is not yet realised. This situation does not fall under the definition of an accrual as given in IAS 37.11 (liabilities to pay for goods or services that have been received or supplied but not yet paid for or invoiced), unless the received payment is viewed as goods that have been received and the service or goods to be delivered by the entity is viewed as the payment. Therefore accruals do not fit comfortably under the current definition in IAS 37.11. The liability consists of a performance that has to be delivered by the enterprise in the future. It does however meet the definition of a liability (a present obligation of the entity,
arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits). \(^{515}\) It does not fall under the exception for executory contracts \(^{516}\) (in which case the liability is often not recognised separately), as one of the parties has already performed (i.e. the payment by the other party). It could also be stated that, when the enterprise is unsure when it will deliver the goods, the entry would meet the definition of a provision given in IAS 37.10, as the uncertainty in deliverance makes the timing uncertain, thus meeting the definition of a provision. The situation as such (goods deliverable after the end of the reporting period for which a prepayment is received) will normally be easy to recognise. The fact that a relatively simple situation leads to several questions is, to my mind, undesirable. This could be solved by providing more guidance as to what an accrual is. IFRS seems to take as a stance that as long as it is clear whether something is a liability or not, it delivers little or no additional useful information whether the obligation is uncertain in existence, timing, amount or otherwise. It is hard to imagine that uncertainty with regards to timing or amount is information in which a user of general purpose financial reporting is not interested.

**Reimbursement for higher future expenses, deferral of profit**

In this case an enterprise has received a payment as a reimbursement for expected future costs or increases thereof. No obligation towards the third party that has made the payment remains. \(^{517}\) Since no obligation towards a third party exists (to perform either a service, deliver a good or perform a payment), the definition of a liability is not met. This means that no provision, accrued or other liability can be recognised and the received payment is considered a gain. IAS 1.34 (b) states that an entity may net \(^{518}\) the expenditure related to a provision that is recognised in accordance with IAS 37 and which is reimbursed under a contractual arrangement with a third party against the related reimbursement. However, in the case as described, the future expenses would not lead to the recognition of a provision, as there is no present obligation. There is an obvious relation with the future as future expenses are connected to the received inflow. However, neither the anticipation of expenses, nor the deferral of income are possible for the above, unless an obligation exists towards a third party (which

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516 When an enterprise enters into a contract, this will generally lead both to a right (an asset) and an obligation (a liability). When neither party has performed any of its obligations or both parties partially performed their obligations to an equal extent, these are often not recognised on the balance sheet. See International Accounting Standard 37.3. See www.ifrs.org/Meetings/MeetingDocs/ASAF/2014/May/08B%20Conceptual%20Framework.pdf for the discussion on this subject.

517 In practice multiple types of these situations occur, from having a clear and strict purpose for the received money to it being more or less a compensation for unspecified damages.

518 IFRS applies the word ‘netting’ to situations where assets and liabilities may or must be offset against each other or situations where revenue and cost may or must be offset against each other.
will not always be the case). Recognising this as revenue or profit is somewhat unsatisfactory, as it follows from a foreseeable future loss or expense. IFRS developed its own version of imparity by not adhering to the continental version of imparity. The problem here follows from the strict adherence to the concept of a liability as an obligation.

Reasonable chance of reverse transferral
In the situation where a sale is made, a payment has been received in respect of this sale and a reasonable chance exists that the object of sale will be transferred back in the future, this is dealt with under IFRS in the following way. IAS 18 deals with the issue of recognition of revenue. As far as the sale of goods goes, the following criteria have to be met in order to recognise revenue.

- The entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity; and;
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

When there is a reasonable chance that the object of the sale will be transferred back to the enterprise in the future, the main question will be whether the significant risks and rewards of ownership of the goods have been transferred. When this is not the case, the revenue cannot yet be considered ‘realised’. This creates a situation comparable to the situation with advance payments for revenue that is accrued to the future, although the revenue is not actively accrued to the future but it is uncertain and might not even accrue to the future at all. Therefore a liability, most likely in the form of an accrual, will have to be recognised against the received payment. No guidance is provided for by IFRS for this type of situation. However, these situations occur and recognising profit on them would seem unreasonable and unjust. Leaving this up to the way the enterprise (or its auditor) interprets the question whether the significant risks and rewards of ownership of the goods have been transferred, creates the risk that different outcomes occur for situations that are basically equal. It would be relatively easy to provide guidance in the form of an example in IAS 18.

Anticipation of expenses
IFRS recognises accruals for the anticipation of expenses in IAS 37.11 under (b). When the criteria of a liability are met, it will be mandatory to recognise a liability. This will be the case when for example an insurance-contract exists, whereby the expense takes place annually and not up-front but afterwards and this does not strictly follow the book-year. This means that the service has
already been received, but the payment still has to take place. This will often be very close to a debt.

**Contingent liabilities**
IAS 37.10 recognises two types of contingent liabilities. First of all, a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity and second of all a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

This means that contingent liabilities do not meet one or more of the requirements of recognising a liability: either there is no present obligation, the outflow is not probable or the outflow cannot be measured reliably. Although the name may suggest otherwise, a contingent liability is not (or not yet) a liability, which in a way is confusing, as another name could have been used in order to stress the fact that no liability exists yet. IAS 37.12 stresses the term ‘contingent liability’ is used for liabilities that do not meet the criteria for recognition. Contingent liabilities are not recognised as liabilities either because they are possible obligations or present obligations that do not meet the recognition criteria.519

It will sometimes be difficult to differentiate whether a liability or a contingent liability exists in the case of a possible obligation. When the existence of the liability is thought to be more likely than not it will be present whereas anything less will lead to a (non-recognised) contingent liability. This refers to for example court cases, in which it will not always be known beforehand whether an obligation exists.520 It will be next to impossible to determine exact percentages of likelihood whether an obligation is present or not. This means that the assessment of a 49% percentage of occurrence (leading to a contingent liability) or a 51% percentage of occurrence (leading to a liability) will as a matter of fact always remain arbitrary. The use of any percentage is in itself always arbitrary, but the point here is that a deemed percentage of occurrence of 51% and a deemed percentage of occurrence of 49% are impossible to assess properly in individual cases. When large numbers apply (homogeneous products with a history) at least a proper calculation is possible, even though this estimate will also never be ‘absolute’: it will always be an assessment of an expectancy of the future. In individual cases the ‘more likely than not’-approach is problematic at best, as it provides the enterprise with a rather subjective measure of what it will show on the balance sheet or not. Evidence will generally be


520 It has to be determined whether an obligation is present, whether this obligation is likely to lead to an outflow of resources and what the settlement or transfer value of this obligation is.
asked by the auditors, but it will always be highly difficult to get useful legal
evidence before the court decides, unless the issue is so clear that parties are
mainly stalling for reasons other than the actual court case. This is in itself
similar to the work of any valuator. However, in the case of liabilities, the
probabilities of existence and outflow can be included in measurement itself,
especially considering IAS 37.36 refers to transfer and settlement value for the
basis of measurement.

4.2.1.2 Deductible reserves

IFRS does not give guidance on how equity shall be presented. Contrary to for
example Dutch GAAP,\textsuperscript{521} there is no IFRS standard that deals with equity.
Although equity is defined in the Conceptual Framework as the residual
interests in the assets of the entity after deducting all its liabilities,\textsuperscript{522} this does
not in itself lead to a specific characterisation of reserves or function of
equity.\textsuperscript{523} The reason for this absence of specific criteria is most likely the fact
that IFRS does not establish requirements for capital maintenance or restrictions
on profit distribution (both of which are more characteristic of the traditional
continental approach than the traditional Anglo-American approach) and the fact
that IFRS has a more static approach to the balance sheet. Recognition and
measurement of assets and liabilities is emphasised more than the determination
of annual profit or other forms of performance.\textsuperscript{524} However, if national law
restricts the distribution of profit in any way, this should be disclosed in the
financial statements.\textsuperscript{525}

This implies that the IASB has chosen consensus over clarity in this regard.
Even though equity is defined as a residual (i.e. the difference between assets
and liabilities), there will always be a need for insight into for example what can
be done with the equity: can it be distributed freely or is it bound to the
enterprise in some way? Most national law provisions will provide this, but
since IFRS, in general, does not adhere to national law nor leaves much room
for the application of national law, it is striking that IFRS does not define its
own characteristics of a balance sheet entry as important as equity. As stated,
this is most likely the effect of the IASB not (yet) having made the necessary
choices with regards to what its opinions on capital maintenance and profit
distribution are. In IFRS the recognition of reserves is not deductible from profit
or loss in any way. This means that reserves for equalisation of costs, reserves
for reinvestment or reserves for old-age (which are deductible reserves under

\textsuperscript{521} See Dutch Richtlijnen voor de Jaarverslaggeving, Standard 240.
\textsuperscript{522} International Financial Reporting Standards, Conceptual Framework 4.4 and 4.25.
\textsuperscript{523} It may be noted that there is a great difference between what IFRS calls reserves and the
fiscal reserves under Dutch tax law, the latter of which are deductible from profit and
some of which share a lot of characteristics with provisions.
\textsuperscript{524} Although this cannot be interpreted in the sense that the purpose of IFRS is to reflect the
aggregate financial value of an entity. See P. Danjou, ‘Answering ten great
misconceptions about IFRS’, p. 11. http://www.ifrs.org/Features/Pages/An-Update-on-
IFRSs-by-Philippe-Danjou.aspx.
\textsuperscript{525} International Accounting Standard 1, Presentation of Financial Statements 1.79.
Dutch tax law) cannot be recognised, at least not in combination with a deduction from profits in IFRS. Since the Festwert-system for measurement of inventories is not allowed, a so called ‘manco-reserve’ cannot be recognised either.\footnote{A manco-reserve is a reserve which can occur under the so-called ‘Festwert-system’ which is a way of measuring the value of stocks and inventories and which is especially appropriate in situations of hyperinflations (it was developed in Germany between the two World Wars). For the purpose of this research it is unnecessary to delve deeper into this particular subject, but since it leads to a specific type of ‘reserve’ a short mention is appropriate here.}

4.2.2 Provisions

4.2.2.1 Definition of a provision

IAS 37.10 defines provisions as liabilities of uncertain timing or amount. A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. The Conceptual Framework also mentions that an element of a recognised liability is that it can be measured with reliability.\footnote{International Financial Reporting Standards, \textit{Conceptual Framework} 4.38.}

In defining provisions, the IASB has seen a necessity to differentiate between provisions and other liabilities. The differentiating criterion is the uncertainty of timing or amount. IFRS does not provide any guidance as to how the word ‘uncertain’ has to be understood: does a bandwidth of 10% in either timing or amount constitute uncertainty? That is to say when the actual amount can be anywhere between 95 and 105 does this constitute uncertainty? Or when the amount can be anywhere between 50 and 150? Full uncertainty with regards to the amount means that measurement cannot take place with reliability, thus leading to non-recognition as the requirements of a liability are not met. This means that below the bottom of uncertainty, it is a ‘regular’ liability and not a provision and above the cap of uncertainty, it is not a provision as it is not considered a liability. This means that, although the definition seems quite obvious (‘a liability of uncertain timing or amount’), indicating where the uncertainty with regards to the amount is either too much or too little, although highly relevant, is not defined further and more guidance would be beneficial.

With regards to uncertainty in timing the same principle applies: when is the timing uncertain enough to meet the minimum requirements of a provision and when is the timing so uncertain that it cannot be considered not a liability? The timing can be so uncertain that the probability of an outflow of resources comes into question. Therefore a certain bandwidth exists between which a provision can occur. The former means that the defining criterion of a provision, uncertainty with regards to timing or amount, is actually largely left open, both as to what the minimum requirement is as well as when the defining criterion of...
a provision actually creates a situation where it does not sit well with the requirements of a liability anymore.

4.2.2.2 Requirements for the recognition of a provision

From the definition of a provision and therefore of a liability, several requirements for the recognition of a provision can be derived. The defining criterion of a provision when compared to other liabilities, uncertainty with regards to timing or amount, is dealt with in the preceding paragraph.

4.2.2.2.1 Arising from past events

From the fact that a provision is a liability, it follows that the obligation must arise from past events. IAS 37 mentions this as the ‘obligating event’. An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. This implies that the obligation must exist, independently of the entity’s future actions. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted by the entity before the end of the reporting period. This can also be translated as that the enterprise has no option but to pay, even when the activities are stopped.

This means that what is to be determined is whether the ‘point of no return’ has been reached yet. The conclusion of a contract in itself creates an obligation for the enterprise and therefore is, to some extent, an obligating event. The conclusion of the contract is however not necessarily the obligating event when a restructuring takes place and a claim for damages is to be paid for ending the contract unjustly. In that case the decision to restructure will be the obligating event and not the conclusion of the contract in the past, even when both are necessary steps leading up to the obligation. It is the latter of the two that makes the outflow of resources unavoidable.

529 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.18. The interesting thing, when taking IAS 37.10 into account is that when the obligation exists independent of the entity’s actions, an obligation exists and when the obligation is dependent on a future event not wholly under the control of the enterprise itself, a contingent liability exists. When the obligation is dependent on a future event that is not fully under the control of the enterprise itself, whether or not it is likely that the enterprise will fulfil the condition, no obligation exists. The difficulty will lie mainly in the question whether this leads to the recognition of a contingent liability, as IAS 37.10 under 1. stresses that a future event must be necessary that is not fully under the control of the enterprise itself. I do feel that even when the future event is under control of the enterprise it still constitutes relevant information. To my mind, IAS 37.10 under 1. is too narrow in scope in this regard.
4.2.2.2.2 Attributable to the year

Unlike Dutch sound business practice, IFRS does not separately require that the future expense is otherwise (apart from the other criteria) attributable to the period before the end of the reporting year. When an obligation is present at the date of the balance sheet, it must be recognised on the balance sheet and an effect on the profit and loss will automatically follow (provided that the expense is deductible in the first place). In order to recognise a provision, IFRS does require that the particular expense cannot be avoided by future actions of the entity.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.14.} Also, future operating losses cannot lead to the recognition of a provision.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.63.} This is where the lack of principles or rules for attribution makes itself felt. Attribution follows when and only when an obligation is present and not earlier or later, in the sense that an entry on the balance sheet is made and that effect is mentioned on the profit and loss account. This differs from an approach where attribution determines when an entry is to be made on the balance sheet (as is the case in for example Dutch sound business practice), in the sense that for example expenses are attributed as costs to a certain period and mention of that is made on the balance sheet. In itself this is in line with IFRS’s static approach to the balance sheet. Therefore, there is no place for a criterion of attribution in the requirements for a provision or any other liability in IFRS.

4.2.2.2.3 Probable outflow of resources

In order to recognise a provision, IAS 37 requires that the outflow of resources is probable. An outflow is regarded as probable if it is more likely than not that it will occur.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.23.} When the probability is less than that, the obligation is regarded as contingent and therefore cannot be recognised.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.31.} It can be argued that this means that the probability of the outflow needs to be more than 50%, which implies a mathematical approach. It is argued by McGregor that the IASB never intended to require an entity to recognise an item as a liability unless there was a reasonable likelihood of resources being transferred from the entity to another party.\footnote{W.J. McGregor, Liabilities – the neglected element: a conceptual analysis of the financial reporting of liabilities, AASB Occasional Paper nr. 1, October 2013, p. 35.} This suggests that the actual probability threshold was initially meant to be lower than 50%. There is an amount of unreasonability recognising a liability that has a probability of occurring of 50% or more and not recognising a liability that has a probability of occurring of 49%, especially since both contain about the same information value for a user. This would be the case with any
percentage though and these percentages are themselves often subjective to begin with. McGregor suggests solving the issue in measurement, in a way that captures the uncertainty, which means that the lower the chance of occurring, the lower the measurement, as this prohibits the loss of otherwise valuable information. What McGregor says is that in the case of a € 100,000 expected future expense that meets the criteria for the recognition of a provision, apart from the fact that its expected occurrence is not more likely than not, but, say, 20%, it is better to recognise it on the balance sheet at, for example, expected value (€ 100,000 x 20% = € 20,000), as this takes into account the lower probability of occurring, than to not recognise it on the balance sheet. The upside of this is that the arbitrary threshold of ‘more likely than not’ is removed. Future expenses that have a lower chance of occurring still provide useful information about the enterprise. However, from a more practical point of view, the problem is that there are an unmeasurable number of possible expenses that can occur, so taking into account expenses that have, for example, a 0.0001% chance of occurring, is highly unpractical, if at all possible. Which means that the 50% border will inevitably have to be replaced by another (albeit lower) one, which again will create arbitrariness. The most sensible threshold in this regard is the threshold of materiality, which is in place anyway. This means that if, when leaving the information out, the user’s financial decisions will not be influenced by this lack of information, it is acceptable to leave it out. IFRS does not explicitly mention that in the case of large numbers of homogenous items, this probability is to be determined on the level of the combination and not on the level of the individual items. This situation occurs for example when an enterprise produces and sells identical shoes for multiple years. Of the individual shoes, it cannot be said that they would more likely than not lead to a warranty-claim, up until the point where the customer has actually bought and returned them. When viewed as a whole, it will be possible to approach the amount of goods that will be returned on a statistical basis, based on historical evidence. In individual cases, finding objective criteria for probability will generally be much harder, if at all possible, than in the case of large groups of items. However, recognising a provision on a balance sheet has a large information value, more than when the information is disclosed in the notes, which is the current situation for when the criteria for recognition are not met. This implies that the threshold for recognition of a provision on the balance sheet should be low. The enterprise will likely tend towards not recognising a provision as this improves both profit and equity and will therefore not contain more information than is necessary.

*For example, if a court case is pending against the enterprise, users of the financial information will want to know the probable future financial effect of this. This means that a good estimate leading to the recognition of a provision is generally much better than a highly critical approach leading to the non-recognition of a provision.*
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4.2.2.2.4 Outflow

From IAS 37.14 under (b) it follows that the recognition of provisions is only possible for a future expected outflow. This means that provisions revolve around anticipation of expenses and not around deferral of revenue (for deferral of revenue, see also Paragraph 4.2.1.1.3). Furthermore, the current definition of liabilities states that the outflow must be expected. There is some discussion whether or not to change the requirement of an expectation of an outflow into that of a liability that must be capable of resulting in a transfer of economic resources, which creates a clearer distinction between the obligation and the outflow. It can be argued that it is better to recognise an obligation measured at settlement or transfer value or to just measure the probable outflow as such, since there can be a difference between the settlement value and the probable outflow. I do not agree fully with current IASB views, which insist on the distinction between obligation and outflow. To my mind, an obligation must exist in order to recognise a provision. Therefore, when a provision is recognised, users of the financial information know that an obligation is present. The obligation as such on the financial balance sheet serves no real purpose and adds nothing to what is already known about the enterprise, whereas the actual expected future outflow is the relevant aspect of the obligation. Furthermore, I am generally opposed to measuring a provision at settlement or transfer value, unless the enterprise is actually planning to settle the obligation at the end of the reporting period or to transfer the liability shortly after the end of the reporting period. The probable reason that the IASB has for its current views, that settlement or transfer value reflect a ‘market value’ on the balance sheet, does not convince me, as it is rare that market parties buy and sell all types of liabilities and thus it cannot serve as a measure of including more objectivity. It may happen that liabilities are settled or transferred on short notice. There will, in rare cases, even be parties willing to trade in such liabilities. But since this is not common practice, it is not logical to measure at settlement or transfer value, unless actual settlement or transfer is planned. Also, the concept of showing market value does not apply to assets in most cases either, which means that the use of settlement or transfer value does not lead to an increased consistency either.

4.2.2.2.5 Obligations

IAS 37 is strict in its approach that only present legal or constructive obligations can lead to the recognition of a provision. This means that there is no room

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536 Liabilities such as pensions are transferred on a regular basis. However, most of the types of liabilities on the balance sheet of the average enterprise are not regularly traded.
for provisions for equalisation of costs, such as for repairs and maintenance, since this would not represent a present obligation (either legal or constructive) as a result of past events. A legal obligation is an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law. What this implies is that a legal obligation is an obligation that can be legally enforced. Especially the aspect ‘other operation of law’ makes differentiation between legal obligations and constructive obligations difficult, as certain practices may or may not lead to enforceability through the courts, which means that no strict dividing line exists between the two types of obligations. Since both legal and constructive obligations lead to the recognition of a provision under IFRS, this is not a problem. A constructive obligation is an obligation that derives from an entity’s actions, where by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated that it will accept certain responsibilities; and as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.538 The latter means that in order to recognise a constructive obligation, certain outward criteria must be met. It is not a solely subjective criterion. It can however be difficult to determine whether and to what extent an entity’s past practices, policies or statements are sufficient, in the absence of legal enforceability, to have a valid expectation among other parties that the entity will accept specific responsibilities.539 Also, the interpretation of the definition of a constructive obligation can be difficult. The IASB currently takes the view that in order for a constructive obligation to be present, an entity must have a duty or responsibility towards another party (or parties). To be merely economically compelled to act in a certain way is not enough. The other party must be the party that benefits from the entity fulfilling its duty or responsibility or suffer loss or harm when the entity does not do so. As a result of the entity’s past actions, the other party can reasonably rely on the entity to discharge its duty or responsibility. The identity of the other party does not need to be known.540 The latter makes it even harder to determine whether a valid expectation has been created on the part of third parties. The differentiation between legal and constructive obligations might be hard to make, as under some jurisdictions,541 reasonable expectations can lead to legal obligations and thus a grey area exists between legal and constructive obligations. There will be situations where it is unclear whether a constructive or a legal obligation is present. The current view of the IASB is that both legal and constructive obligations must be retained as obligations and that more guidance

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538 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets37.10.
541 For example in Dutch tax law.
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should be added.\textsuperscript{542} Given the former, I fully agree with the IASB’s conclusion and more guidance should indeed be added. From the definition of a liability it follows that the obligation must be present, in the sense that it exists at the end of the reporting period. IAS 37.15 states that only in rare cases it is not clear whether there is a present obligation. In a case where it is not clear, all available evidence must be taken into account. The determining criterion is whether it is more likely than not that a present obligation exists at the end of the reporting period. This creates a similar criterion as in the probability of an outflow of resources. Recently, the IASB has proposed that the Conceptual Framework should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. It is proposed in a recent IASB Discussion Paper that this issue is dealt with in the individual standards.\textsuperscript{543} To my mind, the IASB underestimates the amount of cases in which it is unclear whether there is a present obligation. When a claim is made against the enterprise and a court case is pending it will often not be clear whether there is a present obligation, let alone that the enterprise will often not be willing to recognise that there actually is a present obligation. This means that in such situations an amount of estimation and subjectivity is called for.

Probable future obligations

According to the IASB Discussion Paper on the Conceptual Framework, it is still unclear whether an entity can have a present obligation while any requirement to transfer an economic resource remains conditional on the entity’s future actions.\textsuperscript{544} Therefore, when existence of the obligation is within the control of the entity’s future actions, it is not clear whether this constitutes a present obligation. IAS 37.19 states that only obligations that exist independently of an entity’s future actions can lead to the recognition of a provision, which implies that the IASB does not interpret the current IAS 37 literally. With regards to contingencies and future obligations the following applies. Where the existence of a possible obligation will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity, a contingent liability exists\textsuperscript{545} that cannot be recognised as a liability.\textsuperscript{546} Therefore, it seems plausible that when the existence of an obligation is dependent on one or more future events, either within control of the entity or not within control of the entity, no obligation and thus no liability exists.

\textsuperscript{545} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.10.
\textsuperscript{546} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.12.
For example, when an enterprise’s activities cause damage to the environment and there is a law that prohibits this, there is an unconditional obligation to clean-up the damage or pay a fine. No condition exists and the enterprise has no control over whether or not the outflow will take place. Insofar the enterprise can still reverse these damages by altering its business, no obligation exists. This is a condition over which the enterprise has control. When the damages are done and the enterprise has no legal obligation or intention to clean up the damages, no obligation exists up until the point where a law is passed that obliges the enterprise to clean up or pay a fine. This is a condition over which the enterprise has no control. This means that as soon as it is virtually certain that such a law will pass, there is a present obligation. 547

Requirements to transfer an economic resource that are conditional on the entity’s future actions, pose an interesting problem. In itself I feel that when there is a reasonable chance that the entity will fulfil the condition, this represents relevant information for a user. The conditionality is however still a ‘future action’ that keeps it from being a direct influence on the current profit and loss and balance sheet and therefore should and cannot be recognised as a provision or otherwise as a liability (it is not a present obligation). It is true that neither situation leads to a present obligation. However, when the existence of a possible obligation will be confirmed by the occurrence of an uncertain event, and the occurrence of this uncertain event is probable, then there is a probable obligation and generally a probable outflow of resources. It is not a present obligation and it can be stated that the fulfilment of the uncertain future event is the obligating event and thus it cannot be arising before the end of the reporting period. This is a different situation than the situation where an obligation is present at the end of the reporting period, but its existence is not known until after the reporting period. For example, when a pair of shoes is sold before the end of the reporting period and is returned after the reporting period because it was a faulty product at the end of the reporting period, this means that there was a present obligation at the end of the reporting period, but it just had not shown itself at that point. That is different from a condition that has to be fulfilled in order for the obligation to go from conditional to present.

The reverse situation can also occur: an obligation is present at the end of the reporting period, but it can be reversed by a future event, either within or not within control of the entity. In itself the obligation is present at the end of the reporting period and thus the criteria of a liability might be met. However, when reversal of the obligation by a future event is likely enough, i.e. what is obliged is not obliged anymore by an event other than performing the agreed upon performance, it can be argued that an outflow of resources is not likely enough

547 A different question is whether the authorities will be able to enforce this law. This, however, is not a question of whether the obligation exists but whether there is a probable outflow of resources.
to recognise a liability.\textsuperscript{548} IAS 37 does not provide explicit guidance for this situation.

Another important issue is that two categories of present obligations can occur. The first is the single obligation that is either present or not (its existence is either more likely than not or it is not). The second are the large populations of items that, when approached as several individual items, do not meet the criteria for recognition, as individually they do not meet the criteria for recognition. When taken as a whole, a future outflow of resources is however likely. IAS 37 does not explicitly recognise the latter category, but the example in IAS 37.39 on measurement of the obligation following from the sale of goods under warranty implies that a group-approach is accepted and most likely required in such cases. This also solves the issue mentioned in the example about shoes that contain faults. When such a fault is present, a present obligation exists, but it is not known until after the end of the reporting period, meaning that no obligation can be recognised because of the lack of information. From a reporting perspective it would be better to approach this as a group of items (whenever possible) and thus determine the average percentage of returns and measure the value of that instead of not recognising the liability.

\textbf{4.2.2.2.6 Reliable estimate}

IAS 37.14 under c. states that in order to recognise a provision, it is required that a reliable estimate can be made of the amount of the obligation. Only in extremely rare circumstances it will not be possible to make an estimate of an obligation that is sufficiently reliable to use in recognising a provision.\textsuperscript{549} This makes sense as any realistic estimate provides more useful information than no recognition at all and while the requirement of a reliable estimate makes sense, it should not be used as an excuse by enterprises to simply refuse the presentation of information. In the extremely rare case where it is not possible to make a reliable estimate, no liability is recognised on the balance sheet.\textsuperscript{550}

\textbf{4.2.2.2.7 Provisions that accrue over the course of the years}

IFRS approaches provisions on the basis that an obligation is either present at the end of the reporting period or it is not. When the obligation is present, measurement of the full obligation takes place (see Paragraph 4.2.2.3). The provision must be recognised and measured for what it is at the end of the reporting period. A provision cannot be recognised before an obligation is present and once it is measured, it has to be measured at its full current value.

\textsuperscript{548} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.10.

\textsuperscript{549} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.25.

(either nominal or present value). When a certain outflow is expected in x years at a y amount, an annual cost of y/x is only possible if an obligation is present from the start and this reflects the actual increase in the obligation, which will often not be the case.

4.2.2.3 Measurement of provisions

IFRS states that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.\textsuperscript{551} The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.\textsuperscript{552}

The latter implies that it is not the actual (expected or most likely) outflow that is measured, but rather the transfer value or settlement value of the liability. IFRS does acknowledge that it will often be impossible or prohibitively expensive to either settle or transfer, but that the estimate of the amount that the entity would rationally pay to settle or transfer the obligation provides the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.\textsuperscript{553} This is therefore a mostly theoretical approach. The likely reason for this is that settlement or transfer value would represent something approaching market value or fair value and thus be thought to be more objective than an estimate of the expected outflow. From the 2010 Exposure Draft, it follows that, although several respondents to earlier papers have expressed their issues with this approach, the IASB will continue taking the amount that an entity would rationally pay to be relieved of the amount as the basis for measurement.\textsuperscript{554} IFRS does not specify how to determine settlement value or transfer value, nor does it provide guidance in this regard. Rationally, determination of settlement value consists of several elements that parties that are willing to enter into settlement would take into consideration. These criteria are relevant for both individual obligations and large populations of items. The probability of the existence of the obligation itself will play a role. If the probability is less than a 100%, this will naturally decrease the amount at which parties would be willing to settle.

\textsuperscript{551} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.36.

\textsuperscript{552} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.37. The 2010 Exposure Draft mentioned that the amount that an entity would rationally pay would be the lowest of the present value of the resources required to fulfil the obligation, the amount that the entity would have to pay to cancel the obligation and the amount that the entity would have to pay to transfer the obligation to a third party. IASB, Measurement of Liabilities in IAS 37. Proposed Amendments to IAS 37, (Exposure Draft ED/2010/1) 2010.

\textsuperscript{553} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.37.

For example, if two parties argue over an immediate payment of € 100.000 and the probability of court requiring the payment of one to the other is 90%, rational parties would be willing to settle at € 90.000. Of the probability of this outflow occurring is 40%, parties would rationally settle at € 40.000. Furthermore, the expected outflow as such will play a role, meaning that the higher or lower the expected outflow is, the higher or lower the settlement value will be.

If the two parties above would argue over a payment of € 200.000 instead of € 100.000, the settlement values would be € 180.000 and € 80.000 respectively.

The time value of money will also play a role. The longer the expected term of the liability, the lower the settlement value will be.

At an interest rate of 5%, the value of € 100.00 in ten years is € 61.391 and in twenty years it is € 37.689.

A main problem in using settlement value is that, when actually approached on a full-information basis, it will accurately reflect the enterprises’ estimates of its chances of paying the actual amount and the amount that it expects to pay. In the case of for example litigation, this will quickly become a self-fulfilling prophecy (when the information is disclosed, the other party will have full information regarding at what amount the enterprise is willing to settle). Enterprises will often not be willing to disclose such information to the full extent. Furthermore, when the enterprise has no intention of settling the amount in the short term or transferring it, referring to a settlement value or transfer value would provide information that is less relevant than simply an estimate of the actual expected future outflow.

For example, when there is a 90% probability of the enterprise being required to pay € 100.000, rationally parties would settle at € 90.000. If the enterprise is not willing to settle, the most likely outcome would be an outflow € 100.000 (since there is a 90% probability that the enterprise will be required to pay € 100.000). Using settlement value in such a case would lead to measurement that is too low from a realistic perspective.

With markets for most types of liabilities being rare, the use of settlement value or transfer value does not provide a more objective estimate of the outflow, unless such a market actually exists (which it does, for example, in the case of provisions). The rule of using settlement or transfer value in a situation where settlement or transfer is not the intention of the enterprise is therefore, to my mind, wrong. In the past, the IASB has acknowledged that the requirements for measurement of IAS 37 are vague, as it is not clear what the term ‘best estimate’ means and in practice the most likely outcome, the weighted average of all possible outcomes or even the minimum or maximum amount in the range of
possible outcomes are all used as ‘best estimate’.\textsuperscript{555} In the same paper, the IASB has proposed that the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time would be an amount that reflects the probability-weighted average of all possible outcomes (‘expected value’) rather than the most likely outcome. As stated above, I do not agree with this view. Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.\textsuperscript{556} The discount-rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The risks specific to the liability shall be either reflected in the discount rate or in the estimation of the amounts required to settle the obligation, but not both.\textsuperscript{557} It must be noted, however, that when including risks specific to the liability, a higher risk will mean a higher discount rate and thus a lower measurement of the liability. While this is mathematically correct, it is problematic in the presentation of a liability on the balance sheet. A lower liability is in itself a good sign and will generally be interpreted as such. However, the former leads to the conclusion that a high risk liability will be measured at a lower amount than a low risk liability when all the other variables are equal. It likely provides a more comprehensible view when only the time value of money would be used. It is rather striking that IAS 37.36 requires measurement at settlement or transfer value at the date of the balance sheet, in which the time value of money will be recognised inherently. This can be illustrated as follows. When the settlement value at the end of the reporting period is to be determined, this value \textit{will} be affected by the term of the liability (i.e. the expected date on which the outflow will take place). The longer the term, the lower the value and vice versa. This means that present value only applies to the actual expected outflow of resources required to settle the obligation and not to the settlement or transfer value at the date of the balance sheet. Requiring the use of present value when settlement or transfer value at the end of the reporting period is already required, means that IAS 37 follows a two-sided approach, on the one hand prescribing the use of transfer or settlement value at the date of the balance sheet and on the other hand using the actual expected outflow. Determining the present value of what is already a present value would be incorrect. The IASB explains its issue as that normally settlement value would take into account:

- The expected outflows of resources;
- The time value of money;

\textsuperscript{555} IASB, Exposure Draft ED/2010/1, Measurement of Liabilities in IAS 37, Proposed amendments to IAS 37.

\textsuperscript{556} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.45.

\textsuperscript{557} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.47.
The risk that the actual outflows might ultimately differ from those expected.  

With regards to the recognition and measurement of provisions, differentiation must be made between several categories. First of all the issue of single, individual outcomes that either occur or do not occur must be mentioned. According to IAS 37, in such cases the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity shall consider other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or a lower amount.

For example when there is a 60% chance that an expense to the amount of a 100 will occur and a 40% that it will not occur, in the view of the IASB it may be measured at 100% of the expected outflow and thus at 100.

IAS 37 does not provide any guidance on how to consider other possible outcomes. The other possible outcome in such a case is 0 (which is below the best estimate) and it is not clear how to take this into consideration. Determining the expected value (which would be 60% x 100 and 40% x 0 = 60) is not mentioned or prescribed, even though this would be a sensible outcome when settlement value or transfer value are the basis for measurement. There is an inconsistency in this, as IAS 37.37 requires measurement at settlement value. Settlement value for an obligation that is not 100% probable will not be 100%, as both parties would be willing to settle at less than 100%. In the former example, if both parties would have full information, they would rationally be willing to settle at 60. This would be the ‘market value’. However, in practice, parties will not have the same information. The party recognising the liability will not always want to disclose that it thinks that it has a 60% chance of being obligated to pay the amount. This is especially relevant in the case of claims and pending court cases. Individual items with multiple possible outcomes are treated in the same way as individual items that either occur or do not occur. This means that where a single obligation is measured, the individual most likely outcome may be the best estimate of the liability. Even in such a case, the entity shall consider other possible outcomes. Where other possible outcomes are mostly higher or lower, this implies a higher or a lower measurement.

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International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.40. Although the IASB acknowledges that this is a particularly vague statement, as it implies that any most likely outcome can be used. See IASB, Measurement of Liabilities in IAS 37. Proposed Amendments to IAS 37, (Exposure Draft ED/2010/1) 2010, p. 19.

Consider the following:

10% outcome 0
10% outcome 15
10% outcome 50
35% outcome 60
30% outcome 95
5% outcome 100

The single most likely outcome is 60, as there is a 35% probability that the outcome will be 60 and the probabilities linked to the other amounts are less.

The expected value is 61, \((10\% \times 0) + (10\% \times 15) + (10\% \times 50) + (35\% \times 60) + (30\% \times 95) + (5\% \times 100)\). When approached from the number of outcomes, most outcomes are below 60 (3 below versus 2 above), indicating that measurement must be less than 60. In percentages, most outcomes are above 60 (35% above versus 30% below), indicating that measurement must be more than 60.

On the basis of the literal text of IAS 37.37, 60 would be the default outcome, but since the other outcomes are not divided evenly around 60, the outcome can be either lower than 60 (in the number of outcomes) or higher than 60 (as, percentagewise, the outcomes are mostly above 60). Expected value is not mentioned as a possible outcome. There is little consistency in this. The literal text of IAS 37.40 implies that there is an amount of freedom in the way to measure. However, when a provision is shown on the balance sheet, it is difficult for a user to comprehend what he or she is exactly looking at: is it the single most likely outcome, the expected value or something else entirely? In itself a point can be made that measurement of liabilities should not be strictly mathematical, as this might imply a certainty or accuracy that is not always actually present. However, the above illustrates that at least three outcomes are possible on the basis of the text. Since IAS 37.37 states that the settlement value is the basis, all three outcomes are inconsistent with IAS 37.37, as settlement value for the obligation would rationally be 61 (being the expected value). In my opinion this creates a situation where a more specific approach is called for. Either settlement value is to be determined (being the expected value of 61), the most likely outcome (being 60) or another approach, but not the sort of inconsistent pick-and-choose method that IAS 37 currently allows. To a certain extent, the IASB acknowledges these issues.\(^{562}\) However, the IASB has seen no possibility to solve the issues. The IASB’s argument that the solution is already clear, but overlooked, is not convincing, given the current text of IAS 37.\(^{563}\) The proposal in the exposure draft states that the amount that the entity would rationally pay at the end of the reporting period to be relieved of the present obligation is the lowest of:

1. The present value of the resources required to fulfil the obligation;


CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

- The amount that the entity would have to pay to cancel the obligation;
- The amount that the entity would have to pay to transfer the obligation to a third party.

Although I do not feel that this ‘lowest of three’ is the best approach, it would still mean a huge improvement over the current text as it is at least clearer. A better approach would be an approach where the intention of the enterprise is reflected in measurement. That is, when the enterprise is planning to transfer the liability, a transfer value is used for measurement, when the enterprise is planning to settle the amount, settlement value is used and so on.

Large populations of items

Large populations of homogenous items can exist, that, individually, would not meet the recognition-criteria (as their individual probability of leading to an outflow of resources would be lower than 50%). As a group, however, (in the case of for example warranties), it can be a given fact that a certain percentage of the items is expected to lead to an outflow, although which individual ones will lead to an outflow of resources is unknown. For example, a shoe manufacturer will have access to percentages of shoes are expected to be returned so it can determine the measurement of this percentage and recognise a provision for it. The fact that the exact shoes that will be returned cannot be pinpointed yet is not a problem. See IAS 37.20, it is not necessary to know the identity of the party to whom the obligation is owed. As stated, this situation can lead to the mandatory recognition of a provision. In such a situation it is much more difficult to differentiate between the existence of the obligation and determination of the expected value, as these are more intertwined than is the case in individual items. IAS 37.39 determines that where the provision that is being measured involves a large population of items, the obligation is estimated by weighing all possible outcomes by their associated probabilities (expected value). Where there is a continuous range of possible outcomes and each point in that range is as likely as any other, the mid-point of the range is used. The latter would already follow from use of the expected value.

*If the same numbers apply again the situation is as follows:*

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>0</td>
</tr>
<tr>
<td>10%</td>
<td>15</td>
</tr>
<tr>
<td>10%</td>
<td>50</td>
</tr>
<tr>
<td>35%</td>
<td>60</td>
</tr>
<tr>
<td>30%</td>
<td>95</td>
</tr>
<tr>
<td>5%</td>
<td>100</td>
</tr>
</tbody>
</table>

The expected value is $61, (10\% \times 0) + (10\% \times 15) + (10\% \times 50) + (35\% \times 60) + (30\% \times 95) + (5\% \times 100)$.

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564 Which will generally be based on historical empirical evidence.

565 As is implicitly acknowledged by the example in International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* 37.39.
The outcome in this case would be 61, as this is the expected value. In itself the expected value is a valid approach of settlement value (provided that both parties have identical information which will not always be the case in practice). Several issues arise though. IAS 37.39, which determines that expected value is to be used, does not refer back to IAS 37.37 or the settlement or transfer value mentioned therein, thus not expressing that expected value is actually an expression of settlement or transfer value. Also, the question is why in individual cases the best estimate should not take settlement value as its basis, especially since IAS 37.37 determines as much, whereas in the case of large populations of items it would. If the difference between individual cases and large populations of items would lie in the fact that it would be harder to estimate the probability of the outcomes or that they are thought to be surrounded by more uncertainty, then this should be mentioned, instead of creating a main rule in IAS 37.36 and IAS 37.37 and then specifying the main rule in IAS 37.40 by methods that do not do justice to the main rule.

What is also striking about the concept of settlement value in IAS 37.37 is that it implies that obligations or outflows that are not more likely than not, will not need to be recognised at economic settlement or transfer value on the balance sheet. When an enterprise is confronted with a 49% chance of an outflow occurring, it will generally be just as tempted to settle the amount as when the chance is 51%, provided that such a detailed differentiation in percentages would actually be possible. However, an obligation that is present and which has a 49% chance of leading to an outflow, actually has a settlement or transfer value. A third party would accept the liability for a zero value. Therefore, when settlement or transfer value is used as a basis (which is the case in IAS 37.37) and the obligation is actually present (although a similar ‘more likely than not-approach’ currently applies to this), the probability of the outflow should only be an issue of measurement and not necessarily an issue of recognition. However way it is turned, this represents useful information for the users of the balance sheet. In such a case an estimated settlement value is of much more use than not recognising it at all. The question is whether occurrences between the end of the reporting period and the moment at which the annual accounts are drawn up need to be taken into account when measuring a provision. IFRS calls these ‘events after the reporting period’. IAS 10 defines adjusting events as events that provide evidence of conditions that existed at the end of the reporting period. Events after the reporting period include all events up to the date when the financial statements are authorised for issue. These adjusting events shall be recognised in the financial statements. Events after the reporting period are to be taken into account when they provide additional evidence, which is relevant for the measurement of the provision. The numerical examples all take as a starting point that it is actually possible to determine possible or probable outcomes. From the perspective of a user, it will generally be better to receive a

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566 International Accounting Standard 10, Events after the Reporting Period 10.3.
567 International Accounting Standard 10, Events after the Reporting Period 10.7.
568 International Accounting Standard 10, Events after the Reporting Period 10.8.
rough estimate of a probable outflow of resources than no estimate at all with the remark that the amount cannot be estimated with enough reliability. Therefore, the requirement of IAS 37.14 (c) (a reliable estimate can be made of the amount of the obligation) should not be interpreted as an easy excuse not to recognise a provision.

Contrary to determination of taxable income, where deferral of profit means deferral of taxes and the enterprises will often be naturally inclined to recognise a provision to defer taxes, enterprises will generally not be inclined to recognise a provision unless it is strictly necessary to do so, as it means recognising a liability on the balance sheet and cost on the profit and loss account. However, it is still the question under what conditions this requirement is met and what can be used as proof. IAS 37.25 states that the use of estimates is essential to the preparation of financial statements and does not undermine their reliability, which is especially true for provisions. It mentions that except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. This stresses the argument that IAS 37.14 (c) should not be viewed as very limiting in recognising a provision. To my mind this should be read as that any reasonable estimate, by whatever means, is generally better than no estimate at all, which, in financial reporting is a valid approach as it concerns informing users. It should be kept in mind, that in case of determination of taxable income this is much less the case. IAS 37.38 on measurement, states that the estimates of outcome and financial effects are determined by the judgement of the management of the entity, supplemented by the experience of similar transactions and, in some cases, reports from independent experts. This makes it mostly a publication of managements’ views on the expenses. What is not mentioned explicitly is that management can have its reasons not to disclose information regarding future outflow, for example because this might lower current profit, current equity and because it might represent valuable information and might therefore be tempted to undervalue provisions. This touches the issue of completeness of the financial statements, which is generally much harder to audit than correctness.\footnote{For example, if the financial statements state that the enterprise owns 10 buildings worldwide, determining justness is basically a matter of counting until the 10 are found. Determining completeness is much harder, as this requires to check whether buildings that are not mentioned by the enterprise would be owned anyway. Generally, auditors rely on internal controls where completeness of the financial statements is concerned. However, several types of provisions do not lend themselves easily to be controlled by internal controls, making the audit of the completeness of provisions probably the hardest or most uncertain part of an audit.} This cannot always be solved by the two supplements that IAS 37.38 mentions: experience of similar transactions and reports from independent experts. First of all, a provision that is not recognised cannot always be discovered by either experience of historical evidence or independent experts. Second of all, historical records of similar transactions do not always exist either inside the company or outside and when they exist outside the company they are not always freely available (other enterprises
will often not be willing to share such information). Third of all, not all types of provisions lend themselves for assessment by independent experts. For instance the measurement of a provision for a pending court case can generally not be based on historical evidence. The opinion of independent legal experts might add some insights, but it will generally present difficulties to make a proper estimate of the measurement of such and management might not be inclined to provide more information about the case than is strictly necessary, in order to retain as good a legal position as is possible.

In the 2010 Exposure Draft, the IASB proposes that if the outflow of resources required to fulfil a liability are uncertain, an entity should estimate their ‘expected value’, i.e. the probability-weighted average of the outflows for the range of possible outcomes. According to the IASB, when the obligation is to provide a service, the outflows would be the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf and therefore not the costs that the enterprise incurs when it performs the service itself, even when it can and will. Although, in the view of the IASB, this provides a more objective measurement, I am of the opinion that it will generally not be the correct measurement when the entity is reasonably in the position to perform the work itself (which might be considerably cheaper than have a third party perform the service), which would mean that the amount of the liability is overestimated. The question remains in how far the IASB will be able to keep this ‘market-value approach’ up in the future. The IASB states that it is currently not specified in IAS 37 which costs should be included in the measurement of a liability (direct costs, indirect costs and overheads, cost-price or market value). Even though this might be true, most of this can be derived from the starting point that settlement or transfer value is the basis for measurement. A third party will, in its pricing, include direct costs, indirect costs and overheads, representing market value and not cost-price.

4.2.2.4 Catching up in later years

When the criteria for the recognition of a provision of IAS 37.14 are met, the amount recognised shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This leads to no restriction with regards to the amount that can and must be recognised as a provision, in relation to the question whether catching up can occur. Whether or not ‘enough’ provisions have been recognised in the past is not relevant for recognition in later years.


International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.36.
For example, when at the end of the year, the best estimate of the expenditure required to settle the present obligation at the end of reporting period $t$ is 100 and at the end of reporting period $t-1$, 50 was recognised where it should have been 75, then recognition at the end of reporting period $t$ is still 100, leading to a loss of 50 in the year leading up to $t$, where it should have been 25 from the perspective of performance measurement.

Other forms of catching up, such as a change in reporting system, where a change is made from a system without recognition of provisions to a system that does recognise provisions (as would be possible under sound business practice) is not possible under IFRS, since the requirements are either met (in which case a provision must be recognised) or not (in which case a provision must not be recognised).

4.2.2.5 Compensation and other connected income

There can be a relation between the expected future expense for which the provision is recognised and an (expected) inflow of resources, such as when damages have been done to a third party which are expected to lead to an outflow of resources, but for which the entity is insured and which amount is therefore expected to be reimbursed.

Two questions must be answered with regards to the future inflow:
- Is the amount to be recognised as ‘realised’, before regular rules would prescribe this?
- Is the amount to be offset against the expected expense (also known as ‘netting’ the amounts)?

IFRS states that where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when and only when it is virtually certain that that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset and therefore is not ‘netted’ with the provision itself, as this is still an obligation that the entity has towards a third party. The amount recognised for the reimbursement shall not exceed the amount of the provision.\(^{573}\) This means that IFRS takes a rather prudent approach to this as the reimbursement needs to be virtually certain before it is recognised. Also the fact that it needs to be recognised as a separate asset means that a user receives a lot more information than when the amount is to be netted. A second situation in which provisions can be connected with expected future inflows are onerous contracts. If the entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.\(^{574}\) It is implied that the provision is recognised for the expected loss, therefore the net obligation (expected economic benefits minus unavoidable costs of meeting the obligations under the contract) instead of the

574 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.66.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

gross obligation (unavoidable costs of meeting the obligations under the contract),
even though the wording is not explicit in this sense.

4.2.2.6 Mandatory or optional recognition

IAS 37.14 states that, when the criteria are met, a provision shall be recognised
and when they are not met, no provision shall be recognised. This means that
recognition of a provision is mandatory. Optionality with regards to the
recognition of provisions does not occur under IFRS. This makes sense in
standards for general purposes financial reporting. Recognition of a provision
leads to the recognition of a liability and to costs on the profit and loss account,
which means that an enterprise would generally not recognise a provision unless
it is mandatory.

4.2.2.7 Place in the system

IFRS requires the recognition of provisions mainly because they meet the
definition of a liability and therefore must be recognised on the balance sheet.
IFRS makes no reference to attribution of expenses or measurement of
performance with regards to provisions. In itself this is consistent with the
general characteristics of IAS/IFRS, which mainly focus is on the balance sheet
and less on attribution of expenses and income and performance.

4.3 German law

4.3.1 Liabilities and deductible reserves

German commercial law (the ‘Handelsgesetzbuch’) differentiates between
‘Fremdkapital’ are the resources that are entrusted to the entity by third
parties and not as risk-bearing capital (‘Eigenkapital’). This concept stems
from the idea that the credit side of the balance sheet (where liabilities and
equity are presented) shows how the debit side of the balance sheet (the assets)
is financed. ‘Fremdkapital’ is the financing that comes from external parties and
‘Eigenkapital’ is the financing by means of the enterprises own resources.

4.3.1.1 Liabilities

‘Fremdkapital’ consists of debts (‘Verbindlichkeiten’), provisions
(‘Rückstellungen’) and accruals (‘Rechnungsabgrenzungsposten’).

575 Article 266, Paragraph 3 HGB.
577 Article 266, Paragraph 3 under C HGB.
578 Article 266, Paragraph 3 under B HGB.
4.3.1.1 Debts (‘Verbindlichkeiten’)

‘Verbindlichkeiten’ are all obligations that, under normal conditions, will lead to an outflow of resources and will thus be dealt with in the paragraph on debts. Traditionally, uncertainty about the due date does not in itself turn a ‘Verbindlichkeit’ into a provision (‘Rückstellung’), as would be the case in IFRS.\footnote{580} It needs to be noted that ‘Verbindlichkeiten’ are not necessarily obligations towards third parties. Obligations towards third parties are called ‘Außenverpflichtungen’ and obligations towards the enterprise itself (thus things that the enterprise ‘owes itself’) are called ‘Innenverpflichtungen’.

For example, when at the end of the reporting period a fixed asset is damaged, such as a machine that is damaged because an employee has driven a forklift into the machine by accident. It is not possible to repair the machine before the end of the reporting period, nor is there a third party that can force the enterprise to repair the machine. Therefore no obligation towards a third party exists, but for reasons of continuity, the enterprise will evidently need to repair the machine, which will lead to an outflow after the reporting period. The cause of the expense is still the damage done before the end of the reporting period.

This means that the German approach is not strictly aimed at showing liabilities as obligations towards third parties, but more in a general sense to show the outflows that will likely take place and which are caused before the end of the reporting period.

4.3.1.2 Provisions

Provisions are dealt with in depth in Paragraph 4.3.2.

4.3.1.3 Accruals

German commercial law recognises accruals (‘Rechnungsabgrenzungsposten’).\footnote{581} These follow from the fact that a balance sheet acts as a cut-off, which is even increased by not adhering strictly to the concepts of assets and liabilities. They are caused by the principle of matching rather than that they represent actual assets or debts.\footnote{582} On the credit side of the balance sheet, accruals are defined as payments that have been received before the end of the reporting period, but which are to be attributed as revenue to the


\footnote{581}{Article 250 HGB.}

\footnote{582}{W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 82.}
period after the end of the reporting period.\textsuperscript{583} In general, German commercial law differentiates between long-term contracts, such as rent, interest etc. on the one hand and single transactions on the other. In the case of long-term contracts, when payments are received in advance, for revenue that is attributed to the future, Article 250, Paragraph 2 HGB is applicable and an accrual would need to be recognised.\textsuperscript{584} For single transactions, such as a prepayment on the sale of a good, this would be considered an ‘Anzahlung’ (prepayment).\textsuperscript{585} This means that German commercial law differentiates between two types of accruals, ‘Rechnungsabgrenzungsposten’ and ‘Anzahlungen’. This makes German law quite developed in the field of accruals when compared to, for example, IFRS. As IFRS adheres more to the concepts of assets and liabilities (meaning that an entry is only recognised when it meets the requirements of either), contrasting to German commercial law which traditionally adheres more to the principle of matching (meaning that an entry on the balance sheet can be primarily a cut-off to support the determination of profit). When three types of accruals that are close to provisions are analysed, the following applies.

\textit{Received payments for revenue that is accrued to the future}

Received payments are divided in received payments that concern revenue and received payments that do not concern revenue. Payments that concern revenue are to be recognised as an accrual.\textsuperscript{586} Received prepayments for long-term contracts, such as interest or rent, concern revenue and are therefore to be recognised as an accrual (in the sense of a ‘Rechnungsabgrenzungsposten’).\textsuperscript{587} The same applies to received payments for single transactions such as the sale of a good. An accrual must be recognised (in the sense of an ‘Anzahlung’).

\textit{Reimbursement for higher future expenses, deferral of profit}

When an enterprise has received a reimbursement for higher future expenses, deferral of profit can, in theory, follow either from the principle of realisation (no realisation means no recognised income; the income is deferred) or from the principle of prudence (future expenses taken as current cost; the cost is recognised before the expense). Article 252, Paragraph 4 HGB mentions that measurement must take place in a prudential way, which means that future risks and losses that have arisen before the end of the reporting period are to be recognised. Since the future expenses (in the increase thereof) have not actually arisen before the end of the reporting period, the principle of prudence does not

\textsuperscript{583} Article 250, Paragraph 2 HGB. Article 5, Paragraph 5 nr. 2 EStG. See C. Joisten, \textit{Mehrkomponentengeschäfte im Handels- und Steuerbilanzrecht}, Cologne: Kölner Wissenschaftsverlag, 2012, p. 92.


\textsuperscript{587} Article 250, Paragraph 2 HGB. Article 5, Paragraph 5 nr. 2 EStG. German Federal Fiscal Court 10 December 1992, \textit{BStBl II}, 1994, 158.
apply and therefore does not lead to a deferral of profit. As far as deferral of realisation goes, the amount received does not oblige the entity to anything, so deferral of profit on the basis of realisation is unlikely. No ‘floating contract’ exists, as the entity is not obliged to a future performance to the party from which the payment was received. This leads to the conclusion that a received reimbursement for higher future expenses cannot lead to an accrual. The concept of reverse matching (matching revenue to cost instead of the reverse) as it exists in rare cases under Dutch sound business practice, is not acceptable under German law.\textsuperscript{588}

**Reasonable chance of reverse transferral**

Where there is a reasonable chance of a reverse transferral of a transaction, the following applies. Under German law no general rule concerns itself with a reasonable chance of reverse transferral. Article 252, Paragraph 4 HGB states that profits are only to be taken into account when they are realised. It can be plausible that when there is enough likelihood of a reverse transferral, realisation has not actually taken place. I am not aware of specific German case-law on this subject.

### 4.3.1.2 Deductible reserves

The German commercial law (‘Handelsgesetzbuch’) deals with equity (‘Eigenkapital’) in Article 272 HGB. It defines equity as the capital to which the shareholders’ liability for the entity’s liabilities is limited towards the creditors. Reserves are part of equity and are called ‘Rücklagen’. German law recognises capital reserves\textsuperscript{589} (‘Kapitalrücklagen’), profit reserves\textsuperscript{590} (‘Gewinnrücklagen’) and statutory reserves.\textsuperscript{591} Although commercial law mentions several different reserves that must be maintained by the entity,\textsuperscript{592} it does not mention the kind of reserves that sound business practice recognises. The German income tax does recognise a roll-over relief similar to the Dutch and United Kingdom tax law.\textsuperscript{593}

### 4.3.2 Provisions

#### 4.3.2.1 Definition of a provision

Article 249 HGB does not define provisions, but it mentions the requirements


\textsuperscript{589} Article 272, Paragraph 2 HGB.

\textsuperscript{590} Article 272, Paragraph 3 HGB.

\textsuperscript{591} Article 272, Paragraph 4 HGB.

\textsuperscript{592} See for example Article 268, Paragraph 8 HGB.

\textsuperscript{593} Article 6b EStG.
for the recognition of a provision. Haas has derived a definition of a provision from German case-law:

“provisions are entries on the balance-sheet, of which the connected cost diminishes profit and of which the amount can be determined with enough probability and of which the amount is uncertain.”

The provisions of Article 249 HGB can be divided into 2 categories: uncertain obligations and internal obligations. What is striking is that whereas IFRS states that either the timing and/or amount is uncertain where provisions are concerned, Haas’ definition only mentions the uncertainty with regards to the amount, implying that when the timing is uncertain but the amount certain, the entry would not be a provision (but a debt).

Uncertain external obligations (‘ungewisse Außenverpflichtungen’)
Uncertain external obligations are characterised by the fact that they constitute an obligation towards a third party. Two subcategories exist:
1. Provisions for external obligations (‘Verbindlichkeitenrückstellungen’)
2. Provisions for onerous contracts (‘Drohverlustrückstellungen’)

From literature and case law it can be derived that the following characteristics must be met in order to recognise an uncertain external obligation:

- The amount is not reimbursed;
- The amount of the obligation can be reliably estimated;
- There is an obligation to perform towards a third party, when:
  - The existence and/or amount of the obligation is uncertain;
  - The obligation to perform is caused before the end of the reporting period;
  - It is sufficiently probable that the provision will be used.

Internal obligations (‘Innenverpflichtungen’)
Internal obligations are characterised by the fact that they do not constitute an obligation towards a third party, but are expected future outflows nonetheless. Three subcategories are mentioned in German commercial law:

- Provisions for warranties without legal obligation (‘Gewährleistungen ohne rechtliche Grundlage’);

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596 Article 249, Paragraph 1 first sentence HGB.
597 Article 249, Paragraph 1 first sentence HGB.
598 Article 249, Paragraph 1 second sentence under 2. HGB.
– Provisions for overdue maintenance (‘unterlassene Instandhaltungen’);  
– Provisions for clean-up costs (‘Abraumbeseitigungen’) without legal obligation.

For tax purposes, it has been determined in case-law that only provisions that must be recognised for the commercial accounts, can be recognised for tax purposes. Provisions for external obligations, provisions for warranties without legal basis and provisions for clean-up costs must be recognised for tax purposes when they are recognised in the commercial accounts. Provisions for obligations that are dependent on future revenue or profit cannot be recognised. Provisions for breach of patents are limited to the cases where the party claiming the rights has enforced this right or when it is highly probable that the claim will be. Provisions for work anniversaries can only be recognised when the employment has lasted at least ten years, the work anniversary celebrates at least fifteen years and is agreed in writing. The recognition for provisions for onerous contracts is explicitly forbidden for tax purposes, which is strange in itself, provided that they constitute a legal obligation. What is striking is that two out of the three ‘Innenverpflichtungen’ can be recognised under IFRS as constructive obligations. Both provisions for warranties without a legal obligation and provisions for clean-up costs without a legal obligation can constitute a constructive obligation when the enterprise has created a valid expectation in third parties that the enterprise will take its responsibilities with regards to the issue. Since the German ‘Außenverpflichtungen’ can be recognised for constructive obligations as well, there is a distinct amount of overlap between ‘Innenverpflichtungen’ and ‘Außenverpflichtungen’. The main addition of ‘Innenverpflichtungen’ lies in the provisions for overdue maintenance (‘unterlassene Instandhaltungen’).

4.3.2.2 Requirements for the recognition of a provision

4.3.2.2.1 Arising from past events

Neither German commercial law nor German tax law explicitly requires that a provision must be recognised as the result of past events. With regards to whether the obligation to perform is caused before the end of the reporting period, two general opinions exist in Germany.

600 Article 249, Paragraph 1 second sentence under 1. HGB.
601 Article 249, Paragraph 1 second sentence under 1. HGB.
602 German Federal Fiscal Court 3 February 1969, GrS 2/68, BStBl. II 1969, 291. See also W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 183.
603 Article 5, Paragraph 2a EStG.
604 Article 5, Paragraph 3 EStG.
605 Article 5, Paragraph 4 EStG.
606 Article 5, Paragraph 4a EStG.
The German tax authorities (‘Finanzverwaltung’) state that provisions can only be recognised when the obligation is:

– Legally present (‘rechtlich entstanden’);
– Caused in an economic sense (‘wirtschaftlich verursacht’).

This is also mentioned in the ‘Einkommensteuerrichtlinien’ in R 5.7 Grundsätze. The German Federal Fiscal Court however states that:

– The fact that the obligation was not caused economically before the end of the reporting period does not mean that recognition of a provision is not possible;
– The relevant economic event lies in the future.

When there is not a present obligation yet, but the obligation is caused before the date of the balance-sheet, a provision must be recognised. This means that there is no full consensus in Germany as to whether a provision must be the result of a past event. To a non-German legal scholar, the separate approaches of the German Federal Fiscal Court and the German tax office may seem awkward. Contrary to some other legal jurisdictions (such as the Dutch jurisdiction), the German legal system primarily views court cases and their outcome as a ruling in a situation between parties (‘inter partes’). Parties in similar cases are in no way bound by the court’s ruling. This means that the German tax office can hold a specific viewpoint towards legal theory even when the courts have ruled against the German tax office in similar cases. In Germany this concept is known as the ‘Nichtanwendungserlass’. This means that, even when the courts have ruled in a certain way in the past, a taxpayer might still need to go to court to force the German tax office to a certain viewpoint, contrasting its ‘Einkommensteuerrichtlinie’.

4.3.2.2.2 Attributable to the year

Neither the German commercial code (‘HGB’) nor the German income tax code (‘EStG’) mentions that a provision must be attributable to the year. There is therefore no specific criterion that the expenses must be, by economic character, attributable to the reporting period. However, the expenses may not lead to the acquisition or production of an asset (‘Wirtschaftsgut’). If the latter would be the case, no provision can be recognised.

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608 Koördinierter Länderlass 21 January 2003, IV A 6-S2137-2/03, BStBl. I.
609 The ‘Einkommensteuerrichtlinien’ are guidance rules of the German Ministry of Finance in the explanation of the German Income Tax Code.
610 R. 5.7 EStR.
612 Article 5, Paragraph 4b EStG. R. 5.7 EStR.
4.3.2.2.3 Probable outflow of resources

For the recognition of provisions for uncertain obligations (‘Rückstellung für ungewisse Verbindlichkeiten’) it is required that it is probable enough that the entity will use the provision. ‘Using the provision’ will generally mean that an outflow of resources (such as money) takes place. It is not meant as a mathematical criterion, but more as a question whether an entrepreneur would deem the future outflow probable enough to take it into account as cost in a cost-calculation (it is actually not too far from a ‘settlement value’ as used in IFRS, even though I am of the opinion that the concept of settlement value used in IFRS is not applied correctly). This means that a probability of 10% can already lead to the recognition of a provision. The German Federal Fiscal court has however decided that enough probability exists when there are more reasons in favour than against utilisation of a provision (which is actually quite close to IFRS’s ‘more likely than not’).

For tax purposes the German tax guidelines state that an expense must be somewhat likely (‘einiger Wahrscheinlichkeit’) and that the taxpayer must take the expense into account. In the case of warranties and pensions, a mathematical approach (in the sense of using percentages of probability) will be possible, since there will often be historical evidence available from the past. When no historical evidence is present, the use of percentages does not come into view. In similar cases it is enough that there is some amount of probability with regards to the outflow.

For provisions for internal obligations (‘Rückstellung für Innenverpflichtungen’) there is no explicit probability-threshold. This is not strictly necessary, as, for the recognition of such provisions, the outflow must take place either within three months after the end of the reporting period (in the case of overdue maintenance) or within twelve months after the date of the balance sheet (in the case of clean-up costs). When such an outflow does not take place within the aforementioned timeframe it means that the recognition of the provision is not allowed. The particular outflow will therefore have to be virtually certain at the moment of recognition. For tax purposes the same rule applies. Mathematical probabilities are not taken

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615 German Federal Fiscal Court 30 November 2005, BStBl II 2007, 251.
616 R. 5.7 (6) EStR.
619 Article 249, Paragraph 1 under 2. HGB.
into account, unless historical evidence exists. This also means that it is not a matter of determining whether the outflow is more likely than not.\footnote{I. Haas, \textit{Rückstellungen, Steuerrecht, Handelsrecht und IAS/IFRS}, Wiesbaden: Gaber Verlag, 2011, p. 27.}

4.3.2.2.4 Outflow

With regards to provisions for uncertain obligations (‘Rückstellung für ungewisse Verbindlichkeiten’), an outflow must be expected, both for provisions for obligations and for provisions for losses in order to lead to the recognition of a provision. For provisions for internal obligations (‘Rückstellung für Innenverpflichtungen’) the outflow must take place either within three months after the end of the reporting period (overdue maintenance) or within twelve months after the date of the balance sheet (clean-up costs).\footnote{Article 249, Paragraph 1 nr. 2 HGB.} An (expected) outflow is necessary to recognise a provision. This implies that it is not possible to recognise a provision for the deferral of revenue.

4.3.2.2.5 Obligations

German civil law differentiates between uncertain external obligations and internal obligations. Provisions for uncertain external obligations (‘ungewisse Außenverpflichtungen’) are recognised for external obligations (‘Verbindlichkeitenrückstellungen’).\footnote{Article 249, Paragraph 1 nr. 1 HGB.} For a provision for an external obligation, it is necessary that an obligation to perform towards a third party exists. This obligation can either be a legal obligation or a constructive obligation. In this setting a constructive obligation means that the enterprise cannot withdraw itself from the obligation, even when it is not legally enforceable.\footnote{German Federal Court of Justice, 28 January 1991, \textit{BB} 1991, 507.} Provisions for warranties without legal basis (‘Gewährleistung ohne rechtliche Grundlage’) are, as such, covered by Article 249 HGB.\footnote{Article 249, Paragraph 1 nr. 2 HGB.} These are, however, already covered by provisions for uncertain obligations, as those also cover constructive obligations.\footnote{I. Haas, \textit{Rückstellungen, Steuerrecht, Handelsrecht und IAS/IFRS}, Wiesbaden: Gaber Verlag, 2011, p. 45.} This means that there is some overlap. German civil law recognises provisions for onerous contracts (‘Drohverlustrückstellungen’) as a separate category of uncertain external obligations. This concerns onerous executory contracts. In general, in the case of executory contracts, the performance to be delivered in the future and the performance to be received in the future are deemed to even each other out (even though this is contrary to the principle of imparity). This means that an obligation exists (the performance to be delivered in the future, which will often imply an expected future outflow) but it is not recognised as an entry on the balance sheet. In the case where the executory contract is expected to lead to a
loss (the value of the expected outflow connected with the performance to be delivered is larger than the expected inflow connected with the performance to be received), the performances do not even each other out and the loss has to be recognised. This means that the difference (the loss) is part of an obligation towards a third party. Though there seems to be no good reason to limit the recognition of provisions for onerous contracts to the situation where a legal obligation exists, it seems highly unlikely that an executory contract will be based on a constructive obligation. It will generally be very difficult to prove the existence of both corresponding performances, when there is no legal ground. For tax purposes, the recognition of provisions for onerous contracts is not allowed.\footnote{Article 5, Paragraph 4a EStG.} The category of internal obligations (‘Innenverpflichtungen’) differs from the category above. Internal obligations are characterised by the fact that they do not constitute an obligation towards a third party, but represent an expected future expense arising from the period before the end of the reporting period nonetheless. Two subcategories are mentioned in commercial law:

\begin{itemize}
  \item Provisions for overdue maintenance (‘unterlassene Instandhaltung’),\footnote{Article 249, Paragraph 1 second sentence nr. 2 HGB.}
  \item Provisions for clean–up costs (‘Abraumbeseitigung’), without legal obligation.\footnote{Article 249, Paragraph 1 second sentence nr. 2 HGB.}
\end{itemize}

The first category concerns provisions for overdue maintenance that takes place within three months after the end of the reporting period. Therefore it does not concern obligations towards a third party, but something that the enterprise needs to do (‘owes itself’) in order to maintain continuity. The requirement that the maintenance needs to take place within three months after the end of the reporting period strongly decreases its applicability.

The second category concerns clean-up costs such as clean-up of environmental damages, that takes place in the year after the end of the reporting period. When there is already a legal or constructive obligation to clean up the damages, it does not fall into this category, but in the provisions for uncertain obligations. Therefore, in order to fall in this category, there must be no legal or constructive obligation.\footnote{I. Haas, \textit{Rückstellungen, Steuerrecht, Handelsrecht und IAS/IFRS}, Wiesbaden: Gaber Verlag, 2011, p. 20.} This will make the scope of this category rather narrow, because when there is no legal or no constructive obligation it will often be difficult to prove why the enterprise will need to recognise such a provision. This presents problems with both recognition and measurement. The requirement of an obligation towards a third party being present at the end of the reporting period is only relevant for provisions for uncertain obligations. The question is whether these can or must be present obligations, possible obligations or probable obligations. This also relates to the question whether the obligation to perform
The concept of provisions in Article 23 CCTB

has arisen before the end of the reporting period.\textsuperscript{630} The German Federal Fiscal Court states that the fact that an obligation has not arisen before the end of the reporting period does not mean that recognition is not possible.\textsuperscript{631} This implies that the obligation does not need to be present yet, but there must be a probable future obligation.

The German tax authorities, however, are of the opinion that provisions can only be recognised when the obligation is legally present and arises before the end of the reporting period.\textsuperscript{632} In itself, the opinion of the German tax authorities is more in line with current international views on what constitutes a provision with regards to the requirement of a present obligation. Whether the German tax office will uphold its past views in future cases is therefore, in my opinion, highly debatable. Provisions for obligations that are dependent on future revenue or profit cannot be recognised up until the point where that future revenue or profit is realised.\textsuperscript{633} With regards to contingency, the following applies. When an obligation is dependent on an entity’s future actions, no present obligation exists. This implies that in the case of provisions for uncertain obligations towards third parties (‘ungewisse Außenverpflichtungen’), an obligation must be present at the end of the reporting period in order to be able to recognise a provision. The German Federal Fiscal Court, however, does not rule out that a provision can be recognised when no obligation is present yet.\textsuperscript{634} This means that when an entity has control over the existence of an obligation, it will generally lead to the recognition of a provision under German law. However, it can be unclear what the exact cause of the provision is. For provisions for internal obligations this is even more so. When an entity has decided to perform maintenance on an asset in the future or expects that it will perform the maintenance, a provision can be recognised, although it will generally be possible to reverse that decision or otherwise not perform the maintenance. This means that under German law dependency on an entity’s future actions does not necessarily prohibit the recognition of a provision.

When the provision is dependent on an event outside the control of the entity itself, the following applies. Two situations can occur. The first is that an obligation exists at the end of the reporting period, but can be reversed by a future event outside the control of the entity itself. The second is that no obligation exists at the end of the reporting period, but it is known that an obligation can occur in the future, depending on a future event outside the control of the entity itself.

\textsuperscript{633} Article 5, Paragraph 2a EStG.
CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

Both situations can lead to the recognition of a provision under German law, when the entity reckons that the uncertain event will take place.\textsuperscript{635} As stated above, this puts German law somewhat out of line with the other systems, as it puts less stress on the presence of an obligation. My personal expectation is that the German approach will move more towards IFRS in this respect in the future.

4.3.2.2.6 Reliable estimate

Although German law does not specifically state so, it follows from the system that in order to be able to recognise a provision it must be possible to make a reliable estimate of the amount that is expected to flow out of the entity in the future, in relation to the provision.\textsuperscript{636} A provision for an external obligation must be quantifiable. In individual cases this means that an individual assessment of the expected outflow must take place. When similar cases have arisen in the past, historical evidence will exist and has to be used.\textsuperscript{637} When the future outflow is not quantifiable whatsoever, no provision can be recognised.\textsuperscript{638}

4.3.2.2.7 Provisions that accrue over the course of the years

German commercial law differentiates between what it calls provisions that actually accrue over the course of the years (‘echte Ansammlungsrückstellungen’) and provisions that do not accrue over the course of the years, but are nonetheless treated as if they accrue (‘unechte Ansammlungsrückstellungen’).

The first category are obligations that exist from more or less the first day of the activity that causes the obligation, but of which the expense is expected to take place in the future. These expenses do not actually accrue over the years.\textsuperscript{639}

For example, an obligation for a tenant to demolish certain parts of a building that it has built on the premises, after the contract ends.

The second category consists of obligations that actually accrue over the course of time.

For example obligations for recultivation, which increase with every year of production.\textsuperscript{640}

\textsuperscript{638} I. Haas, Rückstellungen, Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 22.
\textsuperscript{639} Article 6, Paragraph 1 nr. 3a d) EStG. I. Haas, Rückstellungen, Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 56.
For both categories however, the costs are spread over the respective years.

4.3.2.3 **Measurement of provisions**

Since the modernisation of the law on accounting of 2009, the approach towards the measurement of provisions is that what is measured is the amount that is necessary to settle the obligation. Before the year 2009 this was the amount of the expected eventual outflow. The first question that arises is what settlement is meant: at the end of the reporting period or eventual settlement in the future on an expected future settlement date? From the legal history of the 2009 legislation it can be derived that, despite the literal text, what is meant is that the eventual outflow of resources is the basis for measurement, therefore the value of the actual future settlement, which differs from IAS 37 (as IAS 37 refers to transfer or settlement value at the end of the reporting period). Just like the fact that measurement of assets used to be primarily based on historical cost, the same was applied to liabilities. This meant that expected future price-increases and interest-effects were not taken into account, as they were considered to be issues related to the future (which means that despite the fact that a provision is effectively an estimate of the future, certain parts of the expectation were left out).

Up until the 2009 law, discounting provisions to their present value was only allowed when the obligation itself contained an aspect of interest. Since the year 2009 provisions must be discounted when the expected term is more than a year. Provisions with a term of more than a year are to be measured at present value. The discount rate to be used is the average market-interest of the past seven years. The average interest of such a short time will seldom be a correct indicator for market interest in the future. What would be better is to use either current market-interest or the expectations for future market-interest. For tax purposes, an obligation to discount provisions with a term of more than a year applies when the provision is not based on an advanced payment or preliminary work. The current discount-rate to be used for tax purposes is 5.5%.

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643 Bundesrat 23 May 2008, Drucksache 344/08.
646 Article 253, Paragraph 2 HGB.
649 Article 6, Paragraph 3 EStG.
how much interest rates have dropped in recent years in the European Union, this seems to be a rather high discount rate, therefore leading to a relatively low measurement of the provision. With regards to individual outcomes that either occur or do not, the judgement of a sensible entrepreneur applies. This means that when an individual outcome will either occur or not and it is likely enough that it will occur, the full amount is taken into account. This is consistent with the fact that it seems to me that in Germany the expected outflow rather than the settlement value is measured. In the case of individual items with multiple possible outcomes (meaning that when the outflow will occur, the amount can still vary), the provision must be measured at the highest amount of the expected outflows, when all possible outcomes are as likely as the other. This, in German law, follows from the principle of prudence and is different from IAS 37. The principle of prudence also leads to that when there is a lower probability of a higher outflow occurring and a higher probability of a lower outflow, the higher amount must be taken into account. The concept of the most probable outcome, such as it exists in IAS 37, is currently not viewed as leading in German law.

As stated above, given the international developments I feel that, in the future, a shift towards IFRS in Germany is likely. With regards to groups of items (that individually might not be likely to lead to an outflow of resources, but as a group they will), whereas the main rule is that every obligation must be measured individually, similar or approximately equivalent obligations may be taken into account as a group and measured by means of a group average. This is relevant for example for warranties on identical products. For an individual product it can be difficult to assess the probability that an outflow of resources will occur, whereas this will be easier when assessed on a group-basis. Provisions for similar obligations are measured on the basis of past experiences.

For tax purposes the German Federal Fiscal Court explicitly allowed such a percentage-based provision (‘Pauschalrückstellung’). This explicit recognition is rather unique to the German system, as other systems tend to recognise the fact that a group of items combined can lead to an outflow, but it is seldom recognised explicitly as an obligation. Future price- and cost increases are to be taken into account in measuring a provision for commercial purposes. For tax

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652 Article 252, Paragraph 1 nr. 3 HGB.
653 Article 240, Paragraph 4 HGB.
655 Article 6, Paragraph 1 nr. 3a under a) EStG.
656 German Federal Fiscal Court 30 June 1983, BSBl II 1984, 263.
657 Article 253, Paragraph 1 HGB.
purposes it is explicitly disallowed to take future price- and cost increases into account.\textsuperscript{658}

4.3.2.4 Catching up in later years

From Article 249 HGB it follows that for provisions for external obligations, recognition of a provision is mandatory. This also means that when the requirements were met and a provision was not recognised when it should have, a mistake has been made. Catching up would correct this mistake and therefore, catching up would be allowed and even required. From the German tax rules no alternative treatment can be derived. Therefore catching up is both possible and required.

4.3.2.5 Compensation and other connected income

A provision under German law can only be recognised when there is no corresponding inflow to the outflow. This criterion is meant to differentiate provisions from executory contracts (‘schwebende Geschäfte’), because in the case of an executory contract there is an obligation towards a third party, but the third party also has to perform towards the entity as well.\textsuperscript{659} This criterion is more explicit than under IAS 37, although IAS 37 does not allow the recognition of provisions for executory contracts either, unless they are onerous. When an executory contract is onerous, part of the obligation towards a third party is uncompensated and therefore leads to the recognition of a provision. This is only the case for commercial law, as under tax law, the recognition of a provision for an onerous contract is not allowed.\textsuperscript{660} The latter is striking as commercial law already deals with the corresponding inflows in executory contracts. Where there is not an executory contract, but benefits are connected with the obligation that leads to the recognition of a provision, the benefits are to be deducted from the provision when the benefit does not meet the criteria of an asset.\textsuperscript{661} Apart from executory contracts, reimbursements can be received from insurance (when certain damages occur). Where IFRS is rather strict in when this can be recognised as an expected inflow and that netting is not acceptable, German law does not even allow the recognition of a provisions when a reimbursement is expected. This means that netting automatically takes place. Where IFRS states that the corresponding inflow must be virtually certain, German law does not provide guidance with respect to the amount of certainty of the inflow. From the viewpoint of users of the financial reporting this is a problematic issue. German law does not require that the reimbursement is 100% certain. This means that it can occur that the outflow has to take place but the

\textsuperscript{658} Article 6, Paragraph 1 under 3a EStG.
\textsuperscript{660} Article 5, Paragraph 4a EStG.
\textsuperscript{661} Article 6, Paragraph 1 no. 3a under c) EStG.
inflow does not. An example of this would be when the insurance company runs into financial problems and cannot reimburse.

4.2.2.6 Mandatory or optional recognition

When a provision is recognised in the commercial accounts because the requirements are met, recognition is also compulsory for tax purposes. Only provisions that are recognised compulsory in the commercial accounts can (and must) be recognised for tax purposes (provisions for which recognition is not compulsory cannot be recognised for tax purposes). This mandatory recognition (‘Passivierungsgebot’) applies to uncertain obligations (‘ungewisse Verbindlichkeiten’) and onerous contracts (‘drohende Verluste aus schwebenden Geschäfte’). This means that provisions that are not compulsory, such as the provision for due maintenance cannot be recognised for tax purposes in Germany.

4.3.2.7 Place in the system

Under German commercial law, provisions are part of liabilities (‘Fremdkapital’). Haas states that provisions for external obligations follow from the principle of realisation, whereas provisions for onerous contracts follow from the principle of imparity. The principle of realisation attributes both inflows and outflows to the moment of realisation. Provisions are primarily the result of the principle of imparity as a loss, since these are generally not attributable to a realisation-moment. I therefore do not agree that provisions for external obligations follow from the principle of realisation. This difference in view is currently under discussion in Germany, as there is no consensus whether provisions follow from the principle of realisation or from the principle of imparity or prudence. The fact that provisions lead to both an entry on the balance sheet (as a liability) and attribution of profit, leads to the question which is the primary objective of the financial reporting, the balance sheet or the determination of profit and loss, to which there is no clear answer under German commercial and tax law. Normally, for tax purposes, the determination of taxable income will lead to the profit and loss account being the primary objective. Since taxable income in Germany is derived from commercial law and commercial law shows no clear preference for the balance sheet or the profit

662 German Federal Fiscal Court 3 February 1969, BStBl. II 1969, 291.
663 Article 249, Paragraph 1 first sentence HGB. W. Schön, Steuerliche Maßgeblichkeit in Deutschland und Europa, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 182.
665 Article 247, Paragraph 1 HGB. German Federal Fiscal Court 30 January 2002, I R & I/00, BStBl. II 2003, 279.
667 C. Joisten, Mehrkomponentengeschäft im Handels- und Steuerbilanzrecht, Cologne: Kölner Wissenschaftsverlag 2012, p. 89.
and loss account, the approach is not strictly one over the other. However, the above approach towards contingent liabilities (that do not strictly need to be present obligations) implies that determination of income has (some) preference over the balance sheet in Germany.

4.4 The Dutch law

4.4.1 Liabilities and deductible reserves

Dutch tax legislation does not provide a definition of liabilities. Since determination of taxable income in the Netherlands revolves largely around the open norm of sound business practice (of which the content consists mainly of case law of the Dutch Supreme Court), case law would generally be the place to find such a definition. Neither sound business practice nor the case law that makes up sound business practice explicitly views liabilities (‘verplichtingen’) as a general category of which debts, provisions and accruals are all part. In that sense the approach differs from IFRS. The categories of liabilities (debts, provisions and accruals) do exist in Dutch tax law and are usually dealt with separately and have their own requirements.

In Dutch sound business practice a differentiation can be made between fiscal equity (‘fiscaal ondernemingsvermogen’) and fiscal liabilities (‘fiscale passiva’). Contrary to IFRS, the latter does not necessarily imply the need for a present obligation in order to be recognised. The fact that there is a difference in treatment of debts, provisions, accruals and reserves under sound business practice implies that it is possible to differentiate between those categories rather strictly. However, as will be shown in the following paragraphs, the lines between the categories are not entirely clear. It is in a way logical that similar effects occur when the development of the system of determination of taxable profit is left up to the courts. It is primarily the task of the courts to rule in an individual case. Designing a system by means of case law, in my opinion, is not the primary task of the court (even though that is how it practically works in the Netherlands), which means that while the results in the Netherlands are not specifically problematic, it is difficult to determine the system that has implicitly been created around sound business practice. The Dutch legislator has, however, in multiple instances, stated that sound business practice is an open norm, in which taxpayers have an amount of freedom to determine their taxable income (at least the timing of it), with an amount of room for interpretation. The Dutch legislator views the possible dynamics and flexibility that will occur in this way as a big advantage when compared to having to write down every last bit of

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668 See paragraph 3.5 for an introduction to the concept of sound business practice.
legislation concerning the determination of taxable business income. This has led the Dutch Supreme Court to develop a more or less systematic approach towards sound business practice, which is thought to lean heavily on a number of principles.

Without repeating the discussion that has occurred in Dutch fiscal literature, this does mean that there is an amount of legal uncertainty surrounding the determination of taxable income in the Netherlands. Some of the main advantages for this research are that the recognition of provisions under Dutch tax law is governed by sound business practice and therefore the rules have been developed around actual cases, instead of being designed beforehand and having little room to be actually tested.

Apart from that, our national and global economies have become more complex, making it more difficult to determine profit. National and international accounting standards have been developing strongly over the last decades, creating an increasing amount of rules and standards. Although it can be debated whether such an ever-increasing amount of rules is optimal, it is currently what is happening. Leaving it up to the tax courts what to do with it, is, in my opinion, a solution that is not optimal, unsystematic and unfair to the courts.

4.4.1.1 Liabilities

4.4.1.1.1 Debts

Under sound business practice, debt is defined as a legal obligation of the entity, arising from a legal relationship that is present on the date of the balance sheet. Therefore both a present legal obligation and a present legal relationship (from which the obligation follows) are required. The consequence of this definition is that debt represents an amount of resources over which the enterprise has little or no control: the amount has to be paid or paid back to a third party and will thus more or less inevitably lead to an outflow in the future.

In the past, the Dutch Supreme Court decided that, in order to recognise a debt, a reasonable chance that eventual payment will follow from a present legal obligation is enough.

The fact that a present obligation is required does not mean that the obligation needs to be immediately enforceable or otherwise due at the end of the reporting period. Enforceability in the future does not prevent the existence of a present obligation (for example a bank loan which has to be paid back at one point in the future). Doornebal concluded from case law of the Dutch Supreme Court that the obligation is also required to be sufficiently determinable and its existence must not be dependent on an uncertain future event (e.g. a condition precedent, which would make it a future debt and thus not currently recognisable; for

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672 Dutch Supreme Court 29 April 1953, ECLI:NL:HR:1953:AY3250.
example a debt that will only occur when an uncertain future event takes place). 673 ‘Sufficiently determinable’ does not mean that the exact amount needs to be known. 674 When the obligation is present, but an uncertain future event may or may not reverse this, it is still currently a debt (e.g. a conditional debt).

In 2011 the Dutch Supreme Court ruled in a case on the recognition of a debt concerning membership fees of a golf club, when the occurrence of this debt was dependent on an uncertain future event. 675 The Dutch Supreme Court ruled that in the situation where the repayment of a loan (which constitutes a debt) is dependent on a certain condition (which means that an obligation to repay only exists when the condition is met), sound business practice does not oblige to recognise a possible profit that might exist when such a conditional obligation to repay does not need to be met, even though, legally the debt would not occur until later, while the corresponding payment was already received. In this particular case, members of a golf club paid an entrance fee upon becoming a member of the club. When they would stop their membership, they would receive 70% of this fee back, on the condition that there would be at least 10 prospect-members on the waiting list. Experience showed that in the past the waiting list usually consisted of at least 10 prospect-members. The Dutch Supreme Court ruled that because of this, a debt was present from the start and the 70% would not have to be recognised as profit upon receipt (which would have been the case when no debt was present: it would simply be a 70% profit and when they member would stop in the future and the condition was met, the 70% would be cost). Note that when the member pays the entrance fee, there is no obligation to pay this amount back. A future action, over which neither the enterprise nor the member has control, will determine whether an obligation to pay part of the amount back will occur in the future.

When compared to the definition as given at the beginning of this paragraph, the difference lies in the question whether an obligation is present. From a strictly legal point of view, no obligation is present upon receipt of the amount, whereas economically, it is likely that a future outflow will occur, since it is highly likely that the conditions will be met upon ending the membership, while members enter and leave the golf club on a regular basis. Therefore an inconsistency occurs, which, in itself is not an unlikely occurrence under sound business practice, as the court decides in a specific case and not about the determination of profit in general. Although this inconsistency (no present obligation, while

673 J. Doornebal, ‘Schuld of voorziening’, NTFR-B 2010, vol. 12, p. 42-46. Dutch Supreme Court 25 July 2000, ECLI:NL:HR:2000:BI7486. Along the same lines, see B. Dieleman, Fiscale versus vennootschappelijke waardering van pensioenverplichtingen, (Serie Fiscale Monografieën nr. 140) Deventer: Kluwer, 2012, although Dieleman adds that this contingency can only be taken into account when it leads to a real probability that the settlement of the liability is uncertain. In my opinion this comes down to the fact that the contingency cannot be minor, which is in line with the principle of realism.


earlier case law required this explicitly for the recognition of a debt) occurs, there are some arguments in favour of this approach to the definition of a debt. First off all, the conditions of the repayment of the membership fee could have been worded in mirrored fashion: instead of ‘repayment when 10 prospects are on the waiting list’, it could have easily been worded as ‘repayment, unless less than 10 prospects are on the waiting list’ to the same effect. In the latter case a present obligation would exist whereas in the first it would not. No economic difference exists however. It could be stated that when the same effect would have been reached with a slight legal difference in the wording, the taxpayer should have just chosen the different wording if he desired different tax treatment. The Dutch Supreme Court, however, has let the economic effect prevail.

It is however not entirely clear whether this actually changes the definition or the way the definition is to be explained. In other words: it is unclear whether the requirement of a present obligation still exists for Dutch tax purposes to constitute an obligation. Future case law will need to show this. The former is contrary to the concept of a future obligation not being recognised. In my opinion, there is not so much a possible profit, but a possible liability present in this case. The Dutch Supreme Court seems to have mixed up the conditional obligation (that is present, but can be reversed) and the future obligation (not currently present, but can or is likely to become present in the future) in this case. A different approach, which is probably more in line with the concept of sound business practice is to approach this from the concept of prudence. Contrary to most types of provisions, the question at stake in this particular case is when an inflow should be regarded and attributed as revenue. That makes it a matter of prudential attribution and realisation. It could be argued that about this particular inflow insufficient certainty exists to attribute it as revenue when it is received. This would actually make it something of an accrual, more than a debt. The fact that no obvious relation with a specific performance by the taxpayer (either period bound or not) makes this case a bit more complex than would be the case when a specific contra-performance would exist. Therefore, although this is not exactly how the Dutch Supreme Court approaches the attribution of the inflow (wrongfully, in my opinion), the fact that the received amount is not immediately treated as revenue in this particular case, to my mind, is correct as it can be argued that the ownership of inflow is too uncertain to be perceived as realised.

There is an argument in favour of the idea that the Dutch court case of the entrance fee is a unique situation that does not alter the Dutch concept or definition of a debt, as this concerns a situation where revenue and profit is attributed. This is also an example of something that can be expected when leaving such issues up to a court. The court will seek a reasonable solution within the given facts and rules and not necessarily create a systematic approach to provisions that can be applied in all cases. The combination of these criteria leads to a situation where apparently there seems to be no clear distinction made by the Dutch Supreme Court between debts and provisions (see Paragraph
4.4.2). The presence of an obligation is not required for the recognition of a provision and it is unclear whether this is the case for debts. Since the determination of taxable profit is not dependent on the classification of an entry on the balance sheet, but rather on its effect on the revenue or costs, this will not create a problem, up until the point where different recognition- and measurement-rules apply to the different entries on the balance sheet. This is where the classification on the balance sheet influences the determination of taxable income. In the case of fixed assets and stocks of inventories for example, the classification determines whether structural depreciation can take place or not, as stocks of inventories cannot be depreciated structurally whereas fixed assets can. Since the Dutch Supreme Court has not always made a clear distinction between debts and provisions, differences in measurement are not as clear either, especially since sound business practice allows for a high level of freedom in determination of taxable income to begin with. What is also striking is that the recognition of a debt is obligatory (unless the debt is contested by the debtor or the debt is uncertain), according to the Dutch Supreme Court, whereas the recognition of provisions is not necessarily mandatory (see Paragraph 4.4.2). To my knowledge, this has never been brought before the Dutch tax courts as a problem, but that does not mean that it is a situation that should remain as it presently is.

4.4.1.1.2 Provisions

Provisions will be dealt with in Paragraph 4.4.2.

4.4.1.1.3 Accruals

Article 3.25 Dutch Income Tax Code does not define accruals, but they have extensively been dealt with in case law of the Dutch Supreme Court. Several categories of accruals can be derived from these cases. First of all, differentiation needs to be made with regards to the effect of the particular type of accrual. An accrual can either lead to the deferral of income (and thus deferral of taxes) or to the anticipation of income (and thus the anticipation of taxes). Since the effect of (tax-deductible) liabilities in general and provisions in particular is the deferral of income and therefore of taxes, accruals that lead to the deferral of income (‘transitorische winstuitstelposten’) and taxes will be the primary area of interest of this research. It should be noted in this regard that

676 It has even gone so far as that several writers have stated that the Dutch Supreme Courts has, in multiple cases, mixed up categories. See for example A.O. Lubbers in his note to Dutch Supreme Court 26 April 2002, ECLI:NL:HR:2002:AD7773. Dutch Supreme Court 23 September 2011, ECLI:NL:HR:BP7993 is not entirely clear on the subject whether it concerns a debt or a provision either.

677 Dutch Supreme Court 12 May 1920, B 2460. Dutch Supreme Court 29 June 1948, B 8530.


deferral of income can occur either because costs are recognised before the expense occurs or because inflows occur before revenue is recognised. When a taxpayer has received payments for goods or services to be delivered after the end of the reporting period, this means that the taxpayer still has to perform a service for or to deliver goods to the third party from which the payment is received. Sound business practice allows the recognition of an accrual in such cases, which allows for not yet recognising the inflow as revenue and thus deferral of profit. This requires a relation between the third party and the enterprise. The enterprise has a certain obligation to perform towards the third party, to which the third party is entitled. According to Bruins Slot, the payment may contain an element of profit. This type of entry has also been called a provision in literature.

The definitions of debts, accruals and provisions are not detailed enough to provide clear boundaries and the requirements of a provision in Dutch tax law will generally be met in a situation like the one described (the cause for the outflow arises before the end of the reporting period, the outflow is likely and a reasonable estimate of the outflow can be made). It is a matter of debate whether this is problematic. In itself, the label that the taxpayer puts on the amount (either an accrual or a provision) does not change the underlying facts. However, the recognition of a provision might not be obligatory, whereas a debt is and for an accrued this will depend on the situation (an accrual for rent, interest or salary will be obligatory, whereas an accrual for the deferral of profit when a reimbursement for future expenses is received, will generally not be). Furthermore specific measurement-rules apply to provisions that are not applicable to accruals.

In itself, an argument can be made in favour of this situation: sound business practice allows an amount of freedom in how profit is determined. This is likely to extend to how certain entries are called. When an entry can meet both the requirements of an accrual or a provision, this might imply that the taxpayer can choose what entry fits him best in the particular situation. However, this concept has, as far as I am aware off, never been explicitly recognised by either the courts or the legislator. Even when the taxpayer can choose which regime to follow for a specific entry, clear boundaries between the several entries would still be necessary.


A different situation occurs when the taxpayer has received a payment as a reimbursement for expected higher future costs that does not constitute a legal obligation. The taxpayer is therefore not obliged to perform in the future towards the third party from which it has received the payment. An example of this is when a taxpayer depends on the flow of water (such as a river) for production of electricity that is used in his enterprise. Without that flow of water, the electricity costs would increase substantially. When a third party performs in such a way that the flow of water is stopped or otherwise decreased, the taxpayer’s interests are damaged, as his future energy costs will increase. When the third party pays a lump-sum to the taxpayer for these damages, this constitutes a reimbursement for expected higher future costs, without an obligation towards this third party (depending on the contract). Under Dutch sound business practice, it is possible to recognise an accrual for the receipt of this amount, which defers taxation. The recognition of such an entry for this particular case, from an international perspective, is quite rare, as no formal obligation towards a third party exists.

The entry could have followed either one of two approaches. One possibility would have been to recognise the costs beforehand (as is the case in provisions) and the other to defer the recognition of revenue. Both lead to the deferral of profit, the first because it increases the costs before the end of the reporting period and the other because it defers recognition of revenue until after the reporting period.

The Court of Appeal of ‘s-Hertogenbosch allowed the attribution of the payment to the periods to which the expenses relate. This actually revolves around the principle of realisation (which is normally not the case for provisions) and is a rare example of reverse matching (revenue follows cost instead of the reverse). Between the payment that is received in the reporting period and the expected future outflow of resources a specific relation must exist in order to qualify for the recognition of this type of accrual. This specific relation is not easy to prove.

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685 Dutch Court of Appeals ‘s-Hertogenbosch, 8 November 1957, ECLI:NL:GHSHE:1957:AY1195. The word ‘voorziening’ (provision) is used throughout the case, which in my opinion is incorrect, at the very least under current case-law, but probably even back then. Current proof exists in the shape of Dutch Supreme Court 3 December 2010, ECLI:NL:HR:2010:BL2098.

Bruins Slot suggested that the payment may not contain an element of profit.\footnote{W. Bruins Slot, ‘Als een lelie tussen de distels: het administratiekostenreserve-arrest’ \textit{NTFR-B} 2012, vol. 3, p. 10. ‘Profit’ in this sense would be a foreseeable excess of the reimbursement over the expected expenses.} Though I agree with the argument that insofar the payment exceeds the expected outflow, it would not be a reimbursement, there is no case-law in which the courts explicitly mention this criterion. In my opinion, a profit must not be expected in the payment (the character of a reimbursement means that the payment must not be expected to exceed the expenses it aims to cover), because if, in the end the outflow turns out to be lower than the payment, a profit will eventually occur and it would still have been a reimbursement for higher future costs initially. Recognition of profit would then follow when the positive difference becomes evident. Furthermore, since the outflow is not necessarily based on an obligation that is present at the end of the reporting period, there is nothing that holds the taxpayer back from stopping all activities after the end of the reporting period and thus evading the expected outflow and therefore making a profit at a certain point. If, at a certain moment, it becomes clear that the outflows will not exceed the received inflow, it would become evident that the excess-part is not a reimbursement for future costs and therefore cannot be treated in the same way.

Deferral of profit seems impossible once profit is expected, at least for the part that constitutes profit: the excess of reimbursement over expenses (the other part can still be considered a reimbursement). Since the profit-part has no relation with any obligation or expected outflow of the enterprise, it is not a reimbursement, it has already been received and it is realised (the right to it has arisen and there is no obligation to a contra-performance). It is viewed as a deferral of revenue and this is therefore an important difference when compared to provisions, which generally deal with the anticipation of expenses.

An interesting variant of this issue has been dealt with in a fairly recent case of the Dutch Supreme Court. It dealt with the sale of an asset on a sale-and-lease-back basis, whereby part of the asset (in this case a building), could neither be sublet and nor used in the business itself.\footnote{Dutch Supreme Court 3 December 2010, ECLI:NL:HR:2010:BL2098.} The enterprise sought to recognise a provision for the risk of not being able to rent out part of the building in the future. A provision was deemed not possible as the Supreme Court deemed the risk of vacancy (and thus the loss) is thought to be attributable to the future.\footnote{The criteria for the recognition of a provisions for an onerous provision were indeed not met in this case. I am of the opinion that when the enterprise would not have been able to use the space itself and renting it out to a third part was either contractually or otherwise not possible for a fixed or indeterminate term, an onerous contract would have existed, that would have led to the recognition of a provision. This, however, is different from the risk of not being able to rent that part out. The Dutch Supreme Court has rightly decided it was impossible to recognise a provision for this risk.} Insofar part of the revenue was received for the risk of vacancy, realisation has not taken place and an accrual (‘\textit{transitorische winstuitstelpost}’) can be
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recognised. This is thus to be interpreted as a reimbursement (the part of the revenue of the sale for the risk of vacancy) for higher future costs (the part of the rent for the part of the building that is not and will not be in use by the enterprise itself). In my opinion, a provision would have been possible, if the taxpayer would have proven that subletting was not possible (for example because the rental contract did not allow subletting) and that use by the enterprise was virtually impossible as well (for example because the building only allows a type of business that is not viable anymore, for example the production of out-of-date hardware). These two variants that occur in Dutch sound business practice are interesting. They both stem from the fact that sound business practice, as applied by the Dutch tax courts, does not strictly require liabilities on the tax balance sheet to be based on an obligation, but follows a more attribution-oriented economical approach. This is however not in line with the current developments in the international accounting environment as at that level there is a tendency to shift towards IFRS. IFRS is strict in requiring an obligation to be present in a liability.

In an environment that is still globalizing, I do think that at one point this will mean that the current Dutch approach will prove to be the odd one out. It may even stretch so far that eventually recognising a provision without an obligation is no longer in line with sound business practice. This would not even be the first time that the Dutch Supreme Court takes its inspiration from IFRS.690

A third variant of the accrual deals with the situation where a sale has been made and payment has been received in respect of this sale. However, when there is a reasonable chance that the object of the sale will be transferred back in the future, it is allowed under Dutch sound business practice not to recognise profit in respect of this transaction up until the point where there is no longer a reasonable chance that the object of the sale will be transferred back in the future.691

In the case-law concerning sound business practice an accrual for the anticipation of expenses (‘transitorische anticipatiepost’) has been mentioned as well. The most common variant of anticipation of expenses is the provision, though a provision is generally not thought of as an accrual, although economically, a provision is an accrual, as it is a way of attributing future expenses to an earlier reporting period. Provisions are dealt with separately in Paragraph 4.4.2. The striking thing about the several cases that mention accruals for the anticipation of expenses is that by current Dutch standards,692 these would be considered provisions.693 As stated before, this also shows that the

CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

Dutch tax courts do not always differentiate strictly between the several types of fiscal liabilities. 694 From a theoretical point of view, it would be possible to differentiate between provisions and accruals that anticipate future outflows, such as when rent or interest is paid after the period to which they apply. This would constitute an accrual. However, the criteria for the recognition of a provision set out by the Dutch Supreme Court on 26 August 1998 695 are also met. As mentioned before, it could also be the case that certain entries can be either one of provisions and accruals and it is left up to the taxpayer how to call them and effectively choose the method of measurement. The Dutch tax courts never explicitly mentioned this issue. The entries as mentioned above are generally beneficial to the taxpayer, in the sense that they lead to the deferral of taxes. 696 The question remains whether it is optional or mandatory to recognise such accruals as mentioned above. The case-law on accruals for received payments for revenue that is accrued to the future suggests that recognition is optional (as is likely the case with provisions). 697 For accruals for reimbursement for higher future costs this also applies. 698 For accruals that apply to a reasonable chance of reverse transferral of a sale, it also seems that this is optional and not mandatory. 699 There is an amount of tension in this respect, with regards to the principle of realisation. The current opinion of the Dutch State Secretary of Finance seems to be that it is not possible to recognise unrealised profit for illiquid assets, which means that realisation of a transaction is generally both a maximum and a minimum moment of recognition. 700 Recent case law and literature that followed it 701 implied that the Dutch Supreme Court does not agree with this view and the principle of realisation might only be a maximum moment of recognition (which means that a taxpayer has the freedom

696 An exception would be when they constitute or increase an annual loss that cannot be offset and where the risk of loss evaporation occurs.
to take unrealised profit into account). In the case of 13 October 2006 the Dutch Supreme Court stated that in general, the revenue of an enterprise must be taken into account ultimately when the performance is delivered. However, an exception occurs when the uncertainties surrounding the receipt of the payment are thus that sound business practice’s prudence principle would not lead to realisation. This is the case when there is a reasonable chance of reverse transferral of the sale. Dutch Supreme Court 13 October 2006 is an exception to what application of the realisation principle would normally lead to and thus defers profit.702

4.4.1.2 Deductible reserves

Dutch tax law recognises as a separate category the tax deductible reserves of Article 3.53 Dutch Income Tax Code 2001, also known as ‘fiscale reserves’ (fiscal reserves). These are not viewed as either debts, provisions or accruals (they are thought to be part of fiscal equity).703 Contrary to the recognition of general reserves, the recognition of fiscal reserves is tax-deductible.704 Recognition is only possible when the law explicitly allows this. Dutch tax law currently allows three legal possibilities to deduct such fiscal reserves:705

1. Reserve for equalisation of costs (‘kostenegalisatiereserve’)

The reserve for equalisation of costs aims to provide a facility where future expenses, which have their origin in preceding years, can be deducted as costs in those preceding years. Of the three fiscal reserves, this is the one closest to a provision in the sense of Dutch Supreme Court 26 August 1998.706

The following criteria must be met for the recognition of a reserve for equalisation of costs:

- The expenses for which the reserve is recognised must be deductible;
- The expenses must be uneven in the sense that they are not spread evenly over the years to which they apply (there must be a peak in the expected future expenses);707
- The exploitation of the business in the year of recognition or increase gives rise to the expected future expenses;708
- There is a firm and reasonable expectation that the expense will occur in the future.709

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704 Dutch Supreme Court 18 July 1919, B 2314.
Catching-up is not allowed. This means that, contrary to the recognition of a provision, amounts that could have been deducted in the past, but have not been deducted, cannot be deducted in a later year in order to catch up.\footnote{See for example Dutch Court of Breda, 27 September 2006, ECLI:NL:RBBRE:2006:AZ1640.}

This means that two additional issues exist when compared to the criteria for the recognition of provisions (see Paragraph 4.4.2). First off all, the requirement of a peak in the expenses does not exist for provisions. Furthermore, catching up is possible when recognising a provision. A possible positive difference is the fact that for an equalisation reserve, the rules for measurement can be simpler.

However, in most circumstances it will be more beneficial to recognise a provision than to opt for an equalisation-reserve because of the two aforementioned benefits. This raises the question whether, as an effect of Dutch Supreme Court 26 August 1998, the equalisation reserve has become obsolete. First of all, Dutch Supreme Court 26 August 1998 broadened the scope of provisions, as it removed the requirement of a legal relationship for the recognition of provisions. This created an overlap between provisions and the reserve for equalisation of costs that did not exist previously. With provisions for the equalisation of costs becoming less common in financial accounting (smoothing profits is contrary to a fair view), the removal of the requirement of a legal relationship in Dutch Supreme Court 26 August 1998 and the fact that a tax-deductible fiscal reserve is a contradictio in terminis, the Dutch legislator would be better off removing the reserve for equalisation of costs from Article 3.53 Dutch Income Tax Code. To my recollection, the actual practical use of the reserve for equalisation of costs has never been researched, but it is hard to believe that it is a facility that is commonly recognised and for the taxpayers who do, the option of recognising a provision exists.

2. Reserve for re-investment (‘herinvesteringsreserve’)

Articles 3.53, Paragraph 2 and 3.54 Dutch Income Tax Code 2001 contain a facility for reinvestment called the ‘herinvesteringsreserve’, consisting of a roll-over relief for the sale of fixed assets. It is part of the three fiscal reserves that are legally allowed. When a fixed asset is sold or otherwise disposed of, the profit made on the disposal is recognised, but against it a deduction can be made as a fiscal reserve, so that in effect the profit is not taxed in the year of the disposal. It is a temporary relief that defers taxes, as the reserve must be deducted from the book-value of the asset that replaces the asset that is disposed of.

\textit{For example, when an enterprise has a machine with a book value of € 50.000 which it sells for € 75.000, it makes a profit of € 25.000. For this profit of € 25.000 a reinvestment reserve can be recognised, meaning it will not be taxed in the year in which it is realised. The enterprise replaces the machine with a}
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machine costing € 100.000. At the moment of replacement the reinvestment reserve is derecognised and instead of being taxed it is deducted from the book value of the replacement asset, which then becomes € 75.000 (and thus decreases the potential for depreciation).

The facility is a rare example of substantialism in current Dutch (personal and corporate) income tax, as it serves to not tax the sale of fixed assets that are to be replaced and therefore not damage the capital / equity of the enterprise.

The criteria for the recognition of such a deductible reserve are:

- ‘bedrijfsmiddel’: a fixed asset;
  - This criterium is mainly to exclude stocks and inventories from the facility
- ‘vervreemd’: disposed of;
- The proceeds exceed the book–value of the asset;
  - This means that a profit must be made on the sale
- When the asset from which book–value the reserve will be deducted is not depreciated or normally depreciated over a period of more than 10 years, deduction can take place when the asset for which the reserve was recognised had a similar economic function within the enterprise;
  - This means that in the case of long–term assets ‘real’ replacement must take place
- Re–investment must take place before the end of the third tax year after the year in which the disposal took place;
  - This means that only within this time frame it will be considered a replacement
- No holding period of the asset is required;
- In the case of assets that are not depreciated or normally depreciated over a period of more than 10 years, the replacement asset may be purchased in the tax year prior to the disposal of the asset;
  - This means that replacement can take place even before the good is sold
- If a replacement asset is not purchased before the end of the third tax year after the year in which the disposal of the asset took place, the amount deducted in the year of disposal shall be added to the tax base in the end of the third tax year after the disposal took place;
- The combined book–value of the assets from which the reserve is deducted cannot be lower than the book–value of the asset they replace because of the deduction alone.

When no reinvestment occurs within the facilitated period the only consequence is that the enterprise must add the recognised amount to the taxable profit. No

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712 When the disposal of the asset is the result of an intervention of the government, an exception to this rule exists.
added interest or otherwise additional negative consequence, such as a fine, is applicable. In a way this gives way to an unfair advantage to an enterprise that recognises a reinvestment reserve, but eventually does not reinvest\(^ {713} \) when compared to an enterprise that does not recognise the reinvestment reserve and immediately adds the amount to the profit in the year in which the fixed asset is sold.

An entry like the reinvestment reserve has little to do with what is generally considered to be a provision. Like a provision, it defers taxes, but it revolves around deferral of revenue (and thus is an exception to the principle of realisation), whereas a provision revolves around the anticipation of costs (and thus follows from the principle of prudence).

3. Reserve for old-age (‘oudedagsreserve’)

The Dutch Income Tax Code 2001 provides entrepreneurs with a facility to deduct an amount for the recognition of a reserve for old-age.\(^ {714} \) Since it is not unlikely that this facility will disappear within a reasonable amount of years, I will merely mention the reserve for old-age, but not go into details.

4.4.2 Provisions

Under the Dutch concept of sound business practice, the recognition and measurement of provisions has a long history, with a number of changes in approach by the Dutch Supreme Court.\(^ {715} \)

4.4.2.1 Definition of a provision

Under sound business practice, provisions are currently defined as future expenses, that originate from facts or circumstances that occurred in the period prior to the end of the reporting period and which expenses can be attributed to that period and in respect of which a reasonable amount of certainty exists that they will arise.\(^ {716} \) Unlike for example Dutch GAAP and IFRS, the Dutch Supreme Court does not define provisions as liabilities of uncertain timing or amount, which means that an overlap with other liabilities (such as accruals) can and do occur.\(^ {717} \) To illustrate this point: both debts and accruals will generally meet the criteria as set out on 26 August 1998 by the Dutch Supreme Court. However, recognition of debts, for example, is obligatory and recognition of

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\(^ {713} \) In the meantime an intention to reinvest must be present.


\(^ {715} \) For a highly detailed overview of this history, see P.F. Goes, De fiscaal aftrekbare passiva, Deventer: Kluwer, 2000.


provisions might be optional. This means that when a taxpayer recognises what is essentially a debt as a provision, because either the recognition criteria or the measurement rules fit his situation better, then the enterprise basically makes a legal choice. It would be interesting to see whether the Dutch Supreme Court would allow this to happen when a taxpayer explicitly and deliberately does this and the tax inspector does not agree.

4.4.2.2 Requirements for the recognition of a provision

The main requirements for the recognition of a provision were given by the Dutch Supreme Court in its ruling of 26 August 1998 (see Paragraph 4.4.2.1). 718

4.4.2.2.1 Arising from the past

It is required that the future expenses originate from facts or circumstances that occurred prior to the end of the reporting period. The origin can, for example, be pollution or wear and tear. 719 Determining the exact cause for the expense under sound business practice is complicated by the fact that no legal or constructive obligation is required (see Paragraph 4.4.2.2.5). This means that a range of facts that contribute to the future expense taking place can be thought of as causing the future expense (from general to specific). This makes the criterion of origin not highly limiting. When an obligation is present at the end of the reporting period, the cause of this obligation will lie before that moment, which means that the ‘arising in’ criterion is not a highly problematic issue in a system that views provisions as liabilities that represent an obligation, as for example IFRS does. In a system that does not rely on the presence of an obligation in the recognition of a provision, such as Dutch sound business practice, attribution is much more of an issue than it is under an obligation-based approach, as a present obligation will always originate in the past, whereas the lack of requiring an obligation to be present requires a different criterion. This makes the sound business criterion (see Paragraph 4.4.2.2.2) that does not occur for example in IFRS, which follows an obligation-based approach, necessary in Dutch tax law.

4.4.2.2.2 Attributable to the year

26 August 1998 the Dutch Supreme Court ruled that the expenses for which a provision is recognised are also required to be otherwise attributable to the year in which the provision is recognised. This is also known as the ‘sound business practice criterion’. 720 According to the Dutch State Secretary of Finance, 721 this

requirement is met when the expenses are not attributable to future revenue and the expenses are not costs of future years by nature, such as period bound costs. As stated in Paragraph 4.4.2.2.1, the sound business practice criterion is necessary because for the recognition of a provision in Dutch tax law, a legal or constructive obligation is not required and the arising in-criterion as such is too limited to provide proper attribution. Lubbers stated that in his opinion the sound business practice-criterion makes the arising in-criterion obsolete, because when sound business practice requires attribution to a certain year and a reasonable amount of certainty exists that the future expense will occur, the attribution will need to take place, without being hindered by the arising in-criterion.

The way the Dutch State Secretary of Finance interprets the sound business practice-criterion is that the expense must not be attributable to future revenue or be attributable to the future on other grounds, such as by its nature (as is the case with period bound costs). Therefore, it prevents expenses that need to be attributed to the future to be attributed to the reporting period. In the view of the interpretation of the Dutch State Secretary of Finance, the function of this criterion is therefore to give priority to other rules of attribution, such as the principle of matching and the attribution of period bound costs. Only when they are not deemed applicable, attribution by means of a provision is possible, which is a clear limitation of the principle of prudence. The arising in-criterion effectively requires a link to the past. In effect, this is also a limitation for expenses that are effectively attributable to the future.

In the current state of affairs, catching up of provisions is allowed, according to the Dutch State Secretary of Finance. This means that once it is determined that the expense cannot be attributed to the future, it is attributable to the past. Which reporting period in the past (the current reporting period or any reporting period in the past) is not relevant.

With the possible exception of the fact that Article 3.25 Dutch Income Tax Code requires consistency.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

The only differentiation that is made is between the past and the future; the past is not divided up in several categories.

In the view of the State Secretary of Finance, the criterion of sound business practice is a limitation. When an expense has arisen in the past, but is expected to take place in the future, only when the expense is not otherwise attributable to the future, a provision can be recognised. In the view of Lubbers the criterion of sound business practice is the concept of attribution itself: attribute the expense to the period to which it relates. In that respect I do not agree that the arising-in criterion hinders the attribution: it is a form of attribution. The arising in criterion is the dividing line between provisions and costs that relate to the future. The criterion of sound business practice creates a situation where, even when the expenses may arise from the past, when they can be attributed to the future, for example because they are effectively connected with future revenue, they need to be attributed to the future. When there is nothing connecting the expenses to that future, but they have arisen in the past, a provision can be recognised. Saying that the sound business practice criterion makes the arising in criterion obsolete, does not recognise the fact that arising-in is simply one of the forms in which sound business practice shows itself.

In this sense it could be stated that sound business practice is the only principle we need, which brings us back to square one: what exactly constitutes sound business practice? The question is therefore: is it possible that situations exist in which expenses are not attributable to the future as such, but which do not arise from the current reporting period, and therefore cannot lead to the recognition of a provision under the current criteria. What can be stated against this is the fact that the sound business criterion is in a way rather unspecific: every recognition of everything on the tax balance sheet and taxable income must be in accordance with sound business practice. It is likely that the Dutch Supreme Court issued this criterion as a safety-net and that the arising in-criterion is more specific in this regard. When determining, for example, when expenses are unavoidable or whether or not their occurrence is inside or outside the control of the enterprise, it may be tested against the ‘arising in-criterion’. In defence of Lubbers: his statement does make one think about the order of the requirements of Dutch Supreme Court 26 August 1998 and illustrates that Dutch Supreme Court 26 August 1998, although sometimes hailed as the classic Dutch court-case on provisions, suffers from the fact that the Dutch Supreme Court had to rule in a specific individual case and did not have a (part of a) tax base to develop. The Dutch Supreme Court is not a legislator, nor does it need to aspire to be so. However, with the Dutch legislator intentionally leaving the sound business practice an open norm, a legislative task has implicitly been handed to the Dutch Supreme Court. With regards to this, it must be noted that the Dutch Supreme court only used this criterion of sound business practice sparingly and quite liberally.  

G.T.K. Meussen, ‘Ontwikkelingen rondom goed koopmansgebruik in de jurisprudentie

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4.4.2.2.3 Probable outflow of resources

The third requirement mentioned in Dutch Supreme Court 26 August 1998 is that a reasonable amount of certainty (‘redelijke mate van zekerheid’) must exist that the future outflow for which the provision is recognised will take place. The Dutch Supreme Court mentions a reasonable amount of certainty as the minimum amount of certainty that must be met. The Court does not elaborate on when this minimum is met. Older case law on provisions required the presence of a proper chance (‘behoorlijke kans’). Even though the wording has changed, the general consensus in the Netherlands is that both criteria refer to the same amount of probability.

As to what defines a probable outflow of resources, the Dutch Supreme Court has mentioned in the past that this depends on the circumstances and that no general guidelines exist. Kampschöer states that it can be derived from case-law that a reasonable amount of certainty lies between 20% and 40%. Along the same lines is Goes’ interpretation that it lies between 25% and 50%. Both therefore agree that the minimum amount of required probability lies below 50%. Currently, the Dutch State Secretary of Finance holds the opinion that the criterion is only met when the chance of a future expense occurring is more likely than not (and therefore more than 50%). No definitive case law to resolve this issue currently exists. It seems that the opinion of the Dutch State Secretary of Finance (that the future expense must be more likely than not) is either influenced by IAS 37 or Dutch GAAP RJ 252 (the Dutch standard on provisions for general purpose financial reporting), which only take liabilities into account when the chance of occurring is more likely than not. Sticking this more strict criterion, that follows from a more static approach like IFRS, does not seem to be in line with the more prudential and dynamic character of sound business practice and the freedom that sound business practice offers. When that is taken into account, it is awkward that the Dutch State Secretary of Finance would hold this opinion, even though IFRS is held in high regard internationally.

Especially in individual cases it is of course generally impossible to determine exact statistical percentages of probability, but even then, there is a large difference between a minimum of 25% and a minimum of 50%. Such lack of clarity should not exist with regards to an issue like this. Even though case-law does not support the statement of the Dutch State Secretary of Finance, I do...
think there is an argument in favour of his statement. With IFRS becoming the leading set of standards in international financial reporting, any deviation from IFRS should be viable. Apart from the fact that Dutch case-law implies that lower recognition criteria might apply, I do feel that the courts will eventually decide in favour of the State Secretary of Finance’s opinion in the future, as this is becoming the general consensus towards recognition of provisions. This would be different when the Dutch Supreme Court would be willing to acknowledge that sound business practice offers more freedom than using contemporary business economics. From my point of view, retaining the original, more (sometimes overly) prudential character of sound business practice would be more in line with the ability to pay taxes than the less prudential character of IFRS. Both would be more in line when the probability would be taken into account when measuring a provision, as in Paragraph 4.2.2.3. The Dutch State Secretary of Finance gives a number of practical examples that illustrate the criterion of a reasonable amount of certainty, all without illustrating the concept of more likely than not (he therefore seems to steer away from the exact details of his remark). According to the Dutch State Secretary of Finance, future expenses for cleaning up of pollution often will not meet the criterion of a reasonable amount of certainty. A similar argument is made with regards to sabbatical leave of a shareholder-director of an enterprise. The fact that he or she has a right to take up sabbatical leave, does not in itself lead to enough certainty that the expense will actually take place. These are issues that would not be different when the required amount of probability would be, say, 25%. It would still be highly uncertain whether the actual outflow will take place. For both examples, the problem is not the probability as such. The problem lies in the fact that the probability cannot be assessed because the enterprise still has control over whether the outflow will take place or not.

4.4.2.2.4 Outflow

Not commonly mentioned as a separate criterion is the fact that since Dutch Supreme Court 26 August 1998, provisions under sound business practice revolve around future expenses and not about deferral of revenue. Entries that constitute the latter are not provisions but accruals (see Paragraph 4.4.1.1.3). Therefore, an outflow must be expected in order for a provision to be recognised. An alternative would be that Dutch Supreme Court 26 August 1998 only refers to one category of provisions (provisions based on an outflow):

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734 Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcrt. 2012, 3804. Dutch Supreme Court 4 July 1990, ECLI:NL:HR:1990:ZC4331. The description given by the Dutch State Secretary of Finance is likely to be incorrect as it mentions sabbatical leave for the director/shareholder/sole employee of a sole proprietorship. A sole proprietorship, however, has none of these, no share capital, no entity separate from its owner and under Dutch law it is legally impossible for a sole proprietor to be an employee of his own enterprise.
anticipation), but that another category also exists (provisions based on an inflow: deferral). The literal wording of Dutch Supreme Court 26 August 1998 does not rule this out, but it is unlikely that this is meant by the Dutch Supreme Court. Since such an entry can also fall under accruals, there is no need for an additional possibility in the form of a provision.

4.4.2.2.5 Obligations

In the current situation it is not required that an obligation exists or is expected in order to be able to recognise a provision under sound business practice.\(^{736}\) When the approach is followed that the balance sheet must show the liabilities of the entity and only when a provision meets the criteria of a liability it can be recognised, the requirement of a present obligation makes sense. When provisions only play a role in attributing future expenses to the period before the end of the reporting period, the requirement of an obligation is in itself superfluous, but the requirement of an obligation can still function as a cut-off for future obligations. When no obligation is required in order to recognise a provision, it is more difficult to attribute expenses to a specific period. This is why the criterion of sound business practice is necessary in the current requirements of a provision (see Paragraph 4.4.2.2.2). In the past (before Dutch Supreme Court 26 August 1998) a present legal relationship was required in order to recognise a provision.\(^{737}\) This did not equate fully to a present obligation, but there is a large amount of overlap between the two. Goes states that the requirement of a legal relationship is to be interpreted as that a legally enforceable obligation must exist at the end of the reporting period. I find it likely that, given the way IFRS/IAS has shaped Dutch GAAP in the last ten years, had the Dutch Supreme Court not removed the requirement of a present legal relationship, it would have evolved into a requirement very similar to IFRS/IAS and Dutch GAAP. The essence of the present legal relationship is that a present obligation is not strictly required, but the issue found in for example claims (the claim is present, but it is not entirely certain that an obligation is present at that point) is solved in this way.\(^{738}\) Note that IFRS solves this issue by the fact that the presence of an obligation must be more likely than not (100% certainty is therefore not required for an obligation to be deemed present) and in the common corporate tax base of CCCTB one of the explanations of the use of the concept of a probable future legal obligation is actually this situation. The former means that legal obligations can give rise to the recognition of a


provision, but that the recognition of a provision is not limited to legal obligations.

Constructive obligations can give rise to provisions as well, which was the case even before Dutch Supreme Court 26 August 1998. The criteria of Dutch Supreme Court 26 August 1998 lead to the conclusion that when an obligation is not present yet, but is expected to occur in the future and otherwise the criteria for the recognition of a provision are met, a provision can be recognised. The issue of attribution is mainly solved by the criterion of sound business practice as required by Dutch Supreme Court 26 August 1998.

With regards to contingencies and other future events the following applies. The criterion of sound business practice prohibits the recognition of provisions for expenses that are to be attributed to the future, either because they are connected to future revenue, or because they are period bound costs that relate to future periods or because they are ‘otherwise’ to be attributed to the future. The concepts of matching with future revenue and period bound costs are both conceptually clear. It is mainly the last category that inevitably leads to the question how this relates to contingencies and other future occurrences. Some difficulty occurs, because Dutch tax law does not require a present obligation for the recognition of a provision. The first question is what happens when the enterprise can avoid the expense altogether and thus has a large amount of control over whether the expense will occur or not. When approached from the viewpoint of whether an obligation exists, this is rather clear: no obligation is present at the point where that control still exists. In Dutch Supreme Court 18 December 1991 the Dutch Supreme Court stated that when ending the business leads to the non-occurrence of the expense, the expense has to be attributed to a period after the reporting period. This does not fully answer the question whether any substantial amount of control over the expense prevents the recognition of a provision, but it does imply as much. There is no good reason to disallow the recognition of a provision when ending the business would prevent the expense from occurring while in a situation where the enterprise has full control over the occurrence of the expense would lead to the recognition of a provision. The question is whether Dutch Supreme Court 26 August 1998 has changed the rules for recognition in this respect.

What Dutch Supreme Court 26 August 1998 changed was primarily that it removed the requirement of a legal relationship, or at least made clear the there was no such requirement. It also leads to the question whether an obligation is still necessary in some cases in order to recognise a provision, even when Dutch Supreme Court 26 August 1998 does not literally state this. Dutch Supreme Court 18 December 1991, in which it was decided that an expense cannot be

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attributed to a period as long as ending the business would lead to the non-occurrence of the expense, fits reasonably well in the sound business practice-criterion.

This also leads to the question whether a provision for the equalisation of costs can be recognised. An example of this is when technical maintenance in the future for a machine is necessary to guarantee that the machine will remain to work properly. This arises in the years in which the machine is used, but the entity has control over the expense up until the point where the actual maintenance takes place. This means that ending the enterprise before the maintenance is done, would let the enterprise evade the expense. Nonetheless, the Dutch State Secretary of Finance holds the opinion that this is a situation where a provision can be recognised as he argues that the criteria of Dutch Supreme Court 26 August 1998 are met.\textsuperscript{741} The criterion as mentioned in Dutch Supreme Court 18 December 1991 is debated by Goes, who states that in Dutch Supreme Court 29 August 1997,\textsuperscript{742} which deals with a provision for restructuring, it would have been possible for the enterprise not to restructure and thus ending the business would not lead to the expense.\textsuperscript{743} The Dutch Supreme Court allowed the recognition of the provision nonetheless. This implies that being able to avoid the expense by ending the business is not always a relevant criterion. In Dutch Supreme Court 26 August 1998, in which the current criteria for the recognition of a provision were first formulated, the Dutch Supreme Court made no reference to this issue in the sense that the criteria or requirements did not explicitly mention that the expense must be unavoidable. This is in a way understandable as the case itself did not revolve around this issue, but the Dutch Supreme Court could have taken the opportunity to set things straight, as it must have known it was ruling in a landmark case.

When the future expense is dependent on a future event \textit{outside} the control of the entity, this will either be a condition precedent or a conditional obligation. On 21 April 1982 the Dutch Supreme Court ruled that when a condition precedent exists and it is likely that the condition will be fulfilled (and thus the expense will have to take place), it has to be taken into account.\textsuperscript{744} This means that when there is no obligation present at the end of the reporting period, but there is an open issue dependent on a future event outside the control of the enterprise that will lead to an outflow, a provision can be recognised. This also means that the fulfilment of the future event is not seen as the relevant criterion

\textsuperscript{741} Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcrt. 2012, 3804.

\textsuperscript{742} Dutch Supreme Court 29 August 1997, ECLI:NL:HR:AA2234.


for attribution (in the sense that the arising in criterion can be met even when there is a conditional obligation and this condition is expected to be fulfilled in the future). In the case of a conditional obligation, with a condition outside the control of the enterprise, the obligation is present at the end of the reporting period, unless the condition is fulfilled in the future, which means that the obligation will be reversed. Given the economical approach that sound business practice has shown with regards to future expenses within control of the enterprise and conditions precedent, it will be possible to recognise a provision for a conditional obligation, unless the fulfilment of the obligation is so likely that it becomes unlikely that an outflow will take place in the future.

Therefore, when a future expense is dependent on a future event, whether or not within the control of the entity itself and whether or not dependent on a condition precedent or as a conditional obligation, a provision can, in principle be recognised, provided that the expense is actually caused before the end of the reporting period and as long as the occurrence of the expense itself is likely (note: this implies that the future event is not necessarily the event that causes the expense). I also refer to Paragraph 4.2.1.1.1, where I mentioned Dutch Supreme Court 23 September 2011, which is in line with the above. Since an obligation is not required, the question as to whether a present obligation exists in the case of homogenous items that are expected to lead to an outflow (such as warranties), but of which it cannot be said which transactions will lead to such outflow, is not relevant. As a multitude, an outflow is probable and thus sound business practice will allow the recognition of a provision in such cases. To my knowledge this issue (whether or not large groups of homogenous items of which it is statistically likely that one or more items will lead to an outflow can lead to the recognition of a provision) has never explicitly been brought before the Dutch tax courts.

4.4.2.2.6 Provisions that accrue over the course of years

Under sound business practice a present obligation is not required for the recognition of a provision. This leaves more room for a dynamic attribution of costs to the years, as a static obligation at the end of the reporting period is not required. Provisions that accrue over the years can therefore be recognised and attributed, given the fact that the accrual fulfils the criteria as set out in the arising in-criterion.

For example, an enterprise expects a € 100,000 expense in ten years time. It only becomes a legal obligation in year 10. The requirements of Dutch Supreme Court 26 August 1998 are met in all the ten years. It decides to attribute € 10,000 to each year. In general, this will be possible under Dutch sound business practice.

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When an obligation is required, this will mean that as long as no obligation exists, no provision can be required, even when a future expense is expected. Once an obligation is present, the obligation needs to be measured as such. This means that the equalised attribution of costs to all the years to which the expense relates will often be impossible.

The same example as above, an enterprise expects a € 100.000 expense after ten years. It only becomes an obligation in year 10. When an obligation is required for the recognition of a provision, the expected € 100.000 expense is attributed to year 10.

Under sound business practice it is however possible to attribute the expense as costs in a more equalised fashion, because of this lack of a required obligation.  

4.4.2.2.7 Reliable estimate

In Dutch Supreme Court 26 August 1998 the Dutch Supreme Court did not explicitly require that the expense can be estimated reliably in order to recognise a provision. However, in Dutch tax literature a reliable estimate is generally thought of as a requirement that has to be met. I am not aware of case law in which this criterion was at stake. The Dutch State Secretary of Finance mentions the requirement in his Resolution on provisions, although without reference to case law. Since the Resolution of the Dutch State Secretary of Finance seems influenced by IAS 37 (see Paragraph 4.4.2.2.3) it seems likely that the Dutch State Secretary was inspired by IAS 37 in this, as IAS 37 explicitly requires a reliable estimate of the future outflow. When no reliable estimate can be made, recognition is not allowed. In general purpose financial reporting, when uncertainties surround the estimate (in the sense that when recognising a provision on the balance sheet under IFRS is not possible because no reliable estimate can be made), users are informed of this in the explanatory notes. This means that despite the fact that the provision is not recognised, users have received information about the position. Contrary to IFRS or other general purpose financial accounting standards, tax law offers no solution in the explanatory notes, because tax law revolves around the taxable amount and not the explanatory notes. In tax law it is all (recognition) or nothing (no recognition), with nothing in between. Because of that, the fact that the concept of a reliable estimate is not more explicitly required in Dutch tax law and case-law is striking. Under standards for general purpose financial reporting, where the reporting entity may have less of a tendency to recognise a provision, the

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The concept of provisions in Article 23 CCTB

Concept of a reliable estimate shall not lead to an easy excuse not to recognise a provision.

For example, an enterprise expects a future outflow but some uncertainties surround the measurement of the provision. Though the enterprise might not be inclined to recognise the provision under general purpose financial reporting, simply stating that the estimate is not reliable will not lead to the enterprise being freed from the obligation to recognise the provision. When determining taxable income, a taxpayer may be inclined to recognise a provision as a relatively simple way to defer taxes and thus keep liquidity in the enterprise. This means that the concept of a reliable estimate is much more important in tax law than in general purpose financial reporting. To my mind, the Dutch Supreme Court should have included this as a requirement.

For example, an enterprise makes a taxable profit and finds a number of possible risks that might lead to a future outflow and thus will want to recognise one or more provisions, which will defer the payment of tax. The tax authorities can state that the outflow itself is too uncertain to be recognised, but it can also state that the estimate is not reliable enough.

This leaves open the issue of when an estimate is reliable enough. When a multitude of homogenous items that are produced and sold over a longer period, statistical evidence will exist as to not only the probability of occurring, but also the expected value, thus making a reliable estimate possible. In individual cases this will generally be much more difficult and highly dependent on what facts a taxpayer can bring forward and prove.749

4.4.2.3 Measurement of provisions

The amount of Dutch case law and literature focusing on measurement of provisions is rather limited. The fact that recognition and measurement are separate aspects in dealing with provisions is not at the forefront in literature and case law. In Dutch Supreme Court 26 August 1998 it is implied that the actual expected future outflow determines the measurement of the provision and not, for example, the transfer value or settlement value at the end of the reporting period, in the way for example IFRS does.750 In general, I feel that measuring the expected outflow is the superior approach, as it does not make sense to measure at settlement or transfer value unless settlement or transfer of the provision is actually the most likely option for the enterprise. Given the amount of freedom in determination of income that sound business practice generally offers and the fact that IFRS requires measurement at transfer value or

749 Often in such cases a valuator or expert will be required to assess the situation.
settlement value, it is safe to think that such measurement is possible under sound business practice as well, even when settlement or transfer is not the most likely option for the enterprise.\footnote{I refer to Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274.} This, in my opinion, is beyond question when transfer value or settlement value reflect the most likely scenario, but even when it is not, it is likely to be possible to use either as the basis for recognition as IFRS deems this a valid approach.

As stated, I do not agree with the fact that IFRS approaches the outflow in such a way, but given the way sound business practice functions, general applicability of transfer and settlement value is probable. The only valid argument against this is that transfer or settlement value in a situation where neither transfer nor settlement is to be expected is against the principle of reality, which would prohibit the use of such a method. No case law exists to confirm this. Since the general threshold of recognition seems lower under Dutch sound business practice than under IFRS, this would imply that even more uncertainties need to be taken into account when measuring the provision, as it will generally be more difficult to measure a provision when the probability is lower.

In general, Dutch sound business practice does not provide a strict set of rules for measurement of provisions, but from case-law some guidelines can be derived.\footnote{For provisions for pensions, this is somewhat different, as a lot of measurement-rules exist. Since this is highly specific and not applicable to provisions in general, this falls outside the scope of this study.} A characteristic of provisions is that the amount is not due at the end of the reporting period (otherwise a debt would need to be recognised).\footnote{As stated, I feel the most logical approach would be that no overlap should exist between debts and provisions, which also includes that one set of facts can only lead to one or the other, but the Dutch Supreme Court never explicitly stated which approach is correct.} Furthermore provisions will often not be subject to interest (as for example a loan normally is), although it is possible that an interest is applicable. For debts the Dutch Supreme Court ruled that when the present value of a debt differs more than 10% from the nominal value, present value has to be used as the basis for measurement.\footnote{Dutch Supreme Court 24 April 1991, ECLI:NL:HR:1991:ZC4575.} For provisions this has never explicitly been determined by the Dutch Supreme Court, but it is likely that the outcome would be similar if brought before the courts. With regards to determination of this present value, no percentage of interest for determining the present value is given for regular provisions. An exception is applicable for pensions and similar obligations where an interest rate of at least 4% needs to be taken into account, as this is explicitly mentioned in the Dutch income tax code 2001.\footnote{Article 3.29 Dutch Income Tax Code 2001.}

With regards to a relation between probability and measurement, the following applies. In individual items that either occur or do not occur, there is only one possible outcome when the actual outflow takes place. The most obvious way of...
measuring this is the expected outflow itself, once it is sufficiently probable that the outflow will take place. This implies that when a 60% probability exists that a € 10.000 expense will occur (and thus a 40% that no outflow will occur), measurement will be € 10.000. This also implies that when probability is 90%, measurement will be the same. The chance of the expense not occurring (40% and 10% respectively) is not taken into account at all. To my knowledge there is no case law that explicitly deals with this issue. However, since IFRS requires the use of transfer value or settlement value, this implies that probability of occurrence needs to be taken into account (even though this is not applied consistently in IFRS itself). The case of Dutch Supreme Court 8 May 1957 implies that using a method that is accepted or required by IFRS is allowed under Dutch sound business practice as well, as transfer or settlement value is not contradictory to either tax law, tax principles or the general set-up of the tax law.756

Goes already stated that the higher the probability of an expected outflow, the higher its measurement would need to be (implying that the reverse is also true), although he does not explicitly differentiate between provisions based on a large groups of homogenous items or individual cases.757 Goes does not mention case law that confirms thus. There is an argument in favour of taking the probability into account when measuring provisions, especially when transfer or settlement value is taken as the basis. Sanders takes this a step further by stating that even when probability is very low (such as 1-2%), recognition of a provision should be possible, implying that probability should weigh as a factor in measurement as well (otherwise an unrealistic situation arises, when all entries with a 1-2% probability would be measured at the full expected future outflow).758 Although his point is valid (the risks are there and 50% is as arbitrary as any other percentage), Sanders’ approach creates a lot of new problems. The probability-criterion rules out a lot of smaller risks that may or may not exist. Taking all possible risks into account creates an administrative burden for both the tax office and the taxpayer that are neither practical or desirable. Also, proving the existence of such risks will generally be problematic. Taken together, I am of the opinion that the probability-criterion is in itself valid in ruling out all these smaller issues. To individual items with multiple outcomes the following applies.

For example, when a 35% chance of an expense of € 50.000, a 25% chance of an expense of € 75.000 and a 40% chance of an expense of € 0 exists, the probability of occurring still exceeds 50% (35% + 25% = 60%), which means that an outflow is more likely than not.

756 Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274. The principle of reality can, however, prove to be a problem when using settlement or transfer value.
757 P.F. Goes, De fiscaal aftrekbare passiva, Deventer: Kluwer, 2000, p. 174 and p. 357. On p. 249, however, he mentions that probability of the future expense is not to be applied to measurement.
Measurement takes place after determining whether the probability threshold is met. It can be argued that measurement in this particular case should be € 75.000, being the highest amount (which would also be the most prudent approach). It can also be argued that measurement should be € 50.000, as this is the amount with the highest individual probability of occurring, after it has been determined that the probability exceeds 50% (thus ruling out the outcome of 0%). It can also be argued that the expected value needs to be used, which would be € 36.250 in this case and which will also likely be the value for which the enterprise would rationally be inclined to settle. However, it is likely (>50%) that an outflow will take place and when it takes place, the outcome would always be higher than € 50.000, which means that measurement of at least € 50.000 can be defended. No explicit case law exists on this issue.

From a business-economics point of view, all the mentioned methods are acceptable or at least plausible and none creates an obvious tension with the guidelines as set out in Dutch Supreme Court 8 May 1957, making them all in accordance with sound business practice. There is however some tension between the freedom that sound business profit offers on the one hand and the obvious lack of guidelines regarding such measurement on the other and neither outweighs the other beforehand. With regards to groups of similar items, on an individual basis, an outflow will generally not be likely, but when approached as a group, it can be stated that a certain percentage will lead to an outflow. It is merely not known which individual items will lead to the outflow. The approach of treating groups of homogenous items as one item is acceptable in business economics (see Paragraph 4.2.2.2.5). The question with regards to its acceptability for tax purposes has never been explicitly brought before the Dutch tax courts.

The general acceptance of warranty provisions under sound business practice implies that this approach is valid nonetheless. Therefore the probability threshold will be met in the case as mentioned. Under Dutch sound business practice, such provisions can be recognised. No guidelines for the measurement of such a provision exist. It is likely that the expected value needs to be recognised for this (generally being the amount of items sold multiplied by the probability of occurring). According to the Dutch Supreme Court, taking expected future price- and cost increases into account when measuring provisions is allowed. In a reaction to this (for budgetary reasons) the Dutch legislator introduced the predecessor to Article 3.26 Dutch Income Tax Code 2001, which does not allow future price- and costs increases to be taken into

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759 \( (25\% \times \€ 50.000) + (35\% \times \€ 75.000) + (40\% \times \€ 0) \).
760 Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

account when determining taxable profit. These amounts are only deductible in the year to which they relate.

4.4.2.4 Catching up in later years

When a provision could have been recognised but has not in the past, the question arises in how far it would be possible to catch up the non-recognised amount in a following year. Since it is not strictly mandatory to recognise a provision under sound business practice (see Paragraph 4.4.2.6) and a provision is not necessarily based on an obligation that needs to be measured, non-recognition implies a voluntary choice, which cannot easily be reversed because of the consistency that sound business practice requires in Article 3.25 Dutch Income Tax Code 2001. Case law is not entirely clear in this respect.764 The Dutch State Secretary of Finance acknowledges the issue and the lack of clarity and states that he is not opposed to catching up of amounts that could have been recognised in earlier years, but have not.765 It is however likely that this is limited by the consistency that is required by Article 3.25 Dutch Income Tax Code, especially when profit and tax management is the main reason for both recognising and not recognising the amount. This would be the case when the provision is not recognised or increased in a low-profit year and caught-up in a high-profit year.

4.4.2.5 Compensation and other connected income

The issue of compensation can be interpreted in two ways. A compensation can be required from the party with whom a contract exists. When both parties still have to perform after the end of the reporting period no provision can be recognised for the liability that stems from the contract, unless the contract is expected to be onerous. Compensation can also follow from the fact that the enterprise expects a future outflow of resources that is expected to be compensated by a third party such as an insurance company. Contrary to for example the German approach towards provisions, it is not an explicit requirement for the recognition of a provision that the future expense is expected to be uncompensated. This also follows from the fact that the compensation follows the principle of realisation (and thus is only taken into account when it can be said to be realised) and the expense follows the principle of prudence and thus is recognised when it meets the criteria for the recognition of a provision, which will generally be earlier than the realisation of the compensation. This implies that expected future compensation of the expense is not to be taken into account when recognising a provision. It can however be argued that when the compensation of the expense is very likely,

recognition of a provision would lead to the creation of a loss that does not actually occur and thus the principle of reality would lead to not taking the expense into account before realisation of the compensation. On the other hand, there is often still an element of risk in the compensation. It might not be realised yet and not netting the amount with the provision would be the better approach in such a case. To my knowledge, no case law exists on this particular subject. With regards to provisions for onerous contracts, the contra-performance (the connected inflow) also plays a role, as a provision is only recognised for the loss (i.e. the part of the expected outflow that exceeds the expected inflow).

4.4.2.6 Mandatory or optional recognition

As was already mentioned in Paragraph 4.4.2.4, under Dutch sound business practice it seems not to be obligatory to recognise a provision for purposes of determination of taxable income. This follows for example from Dutch Supreme Court 8 April 1953, Dutch Supreme Court 7 July 1982, Dutch Supreme Court 20 July 1999 and Dutch Supreme Court 26 August 1998 and seems to be the current opinion of the Dutch State Secretary of Finance. Next to case law that implies that recognition of provisions is optional in Dutch tax law, there is also some case law that implies that the recognition of provisions is mandatory when the criteria are met, such as Dutch Supreme Court 1 December 1954, and Dutch Supreme Court 25 July 2000. It is especially the latter that implies that it is currently obligatory to recognise a provision, when the expenses can only be attributed to the period before the end of the reporting period. The same issue (mandatory or optional deduction of costs) applies to impairment of assets, which follows from the same concept of prudence, only the expense lies in the past instead of in the future, is, under certain circumstances, obligatory.

In the case of impairment of assets the Dutch Supreme Court stated that when the loss of value is thus that determination of taxable profit would not be in accordance with sound business practice when it would not be taken into

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766 Goes however states that recognition of a provision is mandatory, whereas a reserve for equalisation of costs is a facility and thus optional. The wording of Dutch Supreme Court 26 August 1998, ECLI:NL:HR:1998:AA2555 suggests otherwise (‘can recognise a provision’ and not ‘is obliged to recognise a provision’).
768 Dutch Supreme Court 7 July 1982, ECLI:NL:HR:AW9544.
account. A similar argument could be made for provisions, although there is no case law to specifically back this up. The relevance of both issues (recognition of provisions and impairment of assets) lies in the fact that the offsetting of losses is limited in time in Dutch tax law, which means that losses evaporate at some point. This gives an extra dimension to the timing issue of deduction of costs and the question whether this is mandatory or not, as normally deferral of taxes and thus deduction of costs as soon as possible would seem a main question in an enterprise. Mandatory recognition of provisions is not contradictory as it may seem. Certain expenses are attributed to a specific period, such as most period bound expenses. When these are not yet paid at the end of the year to which they relate, it makes sense that recognition of a legal obligation or provision is obligatory. Other types of expenses can relate to different years via different economic views. In my opinion, it is in line with the freedom that sound business practice offers, that recognition of a provision is not necessarily mandatory. Even when recognition of provisions, in general, is not mandatory, the requirement of consistency mentioned in Article 3.25 Dutch Income Tax Code 2001 will set some limits with regards to the amount of freedom the taxpayer has in recognition of provisions and in increasing the amount of the provisions. For example, when a taxpayer is in the habit of recognising provisions for certain expected future outflows, it would be contrary to the consistency required by Article 3.25 Dutch Income Tax Code 2001 when the taxpayer would stop this in a certain year (such as when a loss occurs) and continue the earlier practice once profits are made again.

4.4.2.7 Place in the system

Under sound business practice, provisions are recognised for expected future expenses that are not attributable by means of the realisation-principle or as period-bound expenses. Provisions are therefore part of the side of the principle of prudence that deals with losses and can or must therefore be recognised when the future expense becomes likely. In itself the lack of a requirement of a present obligation for the recognition of provisions gives room for wider possibilities of attribution in Dutch income tax situations, but it also makes the approach more complex. The requirement of a present obligation is largely solved or replaced by the sound business practice criterion, but the latter also creates its own questions.

4.5 United Kingdom law

4.5.1 Liabilities and deductible reserves

4.5.1.1 Liabilities

FRS 102 defines a liability as a present obligation of the entity, arising from past events, the settlement of which is expected to result in an outflow from the
entity of resources embodying economic benefits.\textsuperscript{775} Like IFRS, FRS 102 does not differentiate explicitly between liabilities and debts (as it does not define debt). However, it is clear that liability is the overarching term that includes debts, provisions and accruals, because all three categories meet the definition of a liability. An entity shall recognise a liability in the statement of financial position when:

- The entity has an obligation at the end of the reporting period as a result of a past event;
- It is probable that the entity will be required to transfer resources embodying economic benefits in settlement; and
- The settlement amount can be measured reliably.\textsuperscript{776}

From the definition of a liability, it follows that at the end of the reporting period the outflow does not need to be due or enforceable yet. However, the obligation itself must be present.\textsuperscript{777} FRS 102, Section 22 is titled Liabilities and equity, which suggests that the standard is dedicated to those. Upon further reading, it follows from Section 22.1 that this standard establishes principles for the classification of financial instruments as either liabilities or equity and deals with accounting for compound financial instruments and does not deal with liabilities and equity in a broader sense. An obligation can either be a legal obligation or a constructive obligation.\textsuperscript{778} A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity’s actions when:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.\textsuperscript{779}

Internal obligations, such as those that are recognised under German law (such as repairs that will be necessary in the future and caused before the end of the reporting period, but which do not constitute a present obligation towards a third party), are not recognised under FRS 102. Like under IFRS, it needs to be ascertained under FRS 102 that an obligation is present and thus exists. Even though this is not made as clear as under IFRS its existence must be more likely than not. This will generally only be an issue with regards to provisions, as provisions are defined as liabilities of uncertain timing or amount.\textsuperscript{780} When the amount and timing are certain, the existence of the obligation will not be in doubt either. Differentiation can be made between several types of liabilities: debts, provisions, accruals and contingent liabilities.

\textsuperscript{775} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.15.
\textsuperscript{776} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.39.
\textsuperscript{777} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.39 (a).
\textsuperscript{778} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.20.
\textsuperscript{779} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.20.
4.5.1.1.1 Debts

FRS 102 does not provide a definition of debt in the way that for example sound business practice does, but from the criteria for the recognition of a liability it can be derived that debts are part of liabilities. To debts, Section 11 Basic Financial Instruments will generally apply. A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Debt will be a financial liability to the entity, as a financial liability is defined as any liability that is:

- A contractual obligation:
  - To deliver cash or another financial asset to another entity, or
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or
- A contract that will or may be settled in the entity’s own equity instruments and:
  - Under which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or
  - Will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

Like IFRS, FRS 102 does not provide strict dividing lines between debts, provisions and accruals or exhaustive guidance on this. This means that one enterprise may present similar liabilities as either more certain (debt, accrual) or less certain (provision) than another enterprise would. This would lead to less comparability between the two than is actually possible.

4.5.1.1.2 Provisions

Provisions are dealt with in detail in Paragraph 4.5.2.

4.5.1.1.3 Accruals

Contrary to IFRS, FRS 102 provides no description of accruals. This does not necessarily mean that accruals cannot occur as FRS 102 is not detailed to such a level that it would be impossible to name an entry accrual. It seems appropriate

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782 Financial Reporting Standard 102, Section 11 Basic Financial Instruments 11.3.
783 Financial Reporting Standard 102, Appendix I: Glossary. The same definition is given in Financial Reporting Standard 102, Section 22 Liabilities and Equity 22.3
784 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.11.
that, like under IFRS, they would be part of liabilities and therefore need to meet
the requirements of a liability.

When three types of accruals that are close to provisions are analysed in FRS 102, the following applies.

Received payments for revenue that is accrued to the future
When an upfront payment is received for services that still need to be rendered
in the future or the revenue is otherwise attributed to the future, the criteria for
the recognition of revenue in the sense of Section 23 are generally not met.\textsuperscript{785} Section 23 explicitly mentions the situation when payment is deferred.\textsuperscript{786} It does
not however mention the situation when the service or delivery of goods is
defered and payment is received upfront. An upfront payment for which
services or goods still have to be delivered would meet the definition of a
liability (a present obligation of the entity, arising from past events, the
settlement of which is expected to result in an outflow from the entity of
resources embodying economic benefits).\textsuperscript{787} Since FRS 102 does not mention or
define accruals, it remains the question whether or not to specify this particular
liability. It could be stated that, when the enterprise is uncertain when it will
deliver the goods, it would meet the criteria for the recognition of a provision of
FRS 102, Section 21. This again makes clear that the dividing line between
debts, provisions and accruals is difficult to draw and overlaps may exist.

Reimbursement for higher future expenses, deferral of profit
When the enterprise has received a payment as a reimbursement for expected
higher future expenses and no obligation towards the payer exists, no obligation
exists, neither to perform a service, deliver a good nor to perform a payment. No
liability will be present at that point. Since the criteria of FRS 102, Section 23
will be met, the full amount will be taken into consideration as a profit. There is
a certain relation between the received amount and the future. Since no liability
is present at the moment of receipt of the reimbursement, attribution of the
amount to the future is not possible from the United Kingdom perspective. This
shows the effect of a balance sheet oriented approach on the determination of
the performance of the enterprise.

Reasonable chance of reverse transferral
Since the criteria of FRS 102, Section 23 are similar to IAS 18, the conclusion is
the same as in Paragraph 4.2.1.1.3. When there is a reasonable chance that the
object of the sale will be transferred back to the seller in the future, the main
question will be whether the significant risks and rewards of ownership of the
goods have been transferred and thus revenue must be recognised. When this is
not the case, and where there is a reasonable chance of reverse transferral that this
is likely the case, the revenue is not yet considered realised. This creates a

\textsuperscript{785} Financial Reporting Standard 102, Section 23 Revenue.
\textsuperscript{786} Financial Reporting Standard 102, Section 23 Revenue 23.5.
\textsuperscript{787} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.15 (b).
situation comparable to the situation with received payments for revenue that is accrued to the future, although the revenue is not so much accrued to the future as it is uncertain and might not even accrue to the future. Therefore a liability, most likely in the form of an accrual, must be recognised against the received payment. Like IFRS, there is a lack of guidance in FRS 102 for this type of situation. The risk of this is that the interpretation of what this would mean for the transfer of significant risks and rewards may differ for situations that are basically equal.

**Anticipation of expenses**
FRS 102 does not explicitly recognise accruals for the anticipation of expenses, as it does not define accruals to begin with. When the criteria for the recognition of a liability are met, recognition of a liability is mandatory.

**Contingent liabilities**
In FRS 102 Section 2 Concepts and Pervasive Principles 2.39 two types of contingent liabilities are recognised:

- A possible but uncertain obligation; or
- A present obligation that is not recognised because it fails to meet one or both of the conditions of Paragraph 2.39, meaning that it is either not probable that an outflow of resources embodying economic benefits will be required to settle the obligation and/or that the amount of the obligation cannot be measured with sufficient reliability.

This means that a liability is contingent when it does not meet one or more of the requirements of recognising a liability. That also means that, although the name may suggest otherwise, contingent liabilities are not (yet) a liability and are therefore not recognised as liabilities. Like IFRS, the name ‘contingent liability’ is confusing as a contingent liability is no liability and cannot be recognised as such.

**4.5.1.2 Deductible reserves**

Under FRS 102 equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. How equity should be presented and which reserves are to be recognised is not defined or otherwise prescribed in FRS 102. Like under IFRS, there is no specific standard dealing with equity. The reason for this absence of specific criteria seems similar to IFRS, to which FRS bears more than a passing resemblance. FRS 102 does not establish requirements for capital maintenance and profit distribution and can be said to offer a more static than dynamic approach to the balance sheet. Measurement of assets and liabilities is an issue that gets more attention than performance or otherwise determination of annual profit. Like the Dutch and German system, a roll-over relief is available for the profit on certain sold assets.

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789 S152-159 TCGA 92.
CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

4.5.2 Provisions

4.5.2.1 Definition of a provision

FRS 102, Section 21.1 defines a provision as a liability of uncertain timing or amount. Furthermore, a number of requirements are defined in FRS 102, Section 21.4:

– The entity has an obligation at the reporting date as a result of a past event;
– It is probable (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement; and
– The amount of the obligation can be measured reliably.

As IFRS is followed in this, I refer to Paragraph 4.2.2.1 for an analysis of this definition. One of the main issues is that the criterion ‘of uncertain timing or amount’ is not defined further, which means that the dividing line between provisions and other liabilities is not clear. There is obviously a reason for differentiating between provisions and other liabilities: there is information value in calling a liability either a ‘provision’ or a ‘debt’ as an amount of uncertainty is expressed by this difference. For tax purposes this definition and these requirements are followed. In itself the differentiation between provisions and debts is not relevant for the recognition criteria and the measurement criteria are similar. Since guidance is only provided for measurement of provisions and not for most other types of liabilities, it is unknown whether differentiation exists in this regard.

4.5.2.2 Requirements for the recognition of a provision

4.5.2.2.1 As a result of a past event

FRS 102 Section 21 Provisions and Contingencies 21.4 states that the obligation of the entity must be the result of a past event. FRS 102 Section 21 Provisions and Contingencies 21.6 clarifies that this means that the obligation must not be dependent on the entity’s future actions. For tax purposes, the same criterion applies.

4.5.2.2.2 Attributable to the year

In the United Kingdom there used to be a long held rule that neither a profit nor a loss could be anticipated (known as the non-anticipation principle). Unlike Dutch sound business practice, FRS 102 Section 21 Provisions and Contingencies does not separately require that the future expense is attributable to the period before the end of the reporting year. Like under IAS 37, when an

790 Business Income Manual 46510.
791 Business Income Manual 46520.
792 BSC Footwear Ltd v Ridgway, 1971, 47 TC 495.
obligation exists at the end of the reporting period, it must be recognised on the balance sheet and an effect on the profit and loss will automatically follow. This is where the balance sheet approach makes itself felt, as performance and attribution are basically an effect of entries on the balance sheet. Obligations whose existence are dependent on the entity’s future actions do not satisfy the condition in Section 21.4 under a., no matter how likely they are to occur, even if the obligations have been laid down in a contract. The United Kingdom tax rules follow this approach.

4.5.2.2.3 Probable outflow of resources

FRS 102 Section 21 Provisions and Contingencies 21.4 under b. requires that it is probable (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement in order to recognise a provision. When this is not the case (i.e. the outflow of resources is not probable) the obligation is viewed as contingent and is therefore not recognised as a provision. As ‘probable’ is described as being more likely than not, this implies that the chance of occurring needs to be more than 50% in order to meet the criteria of a provision. The United Kingdom tax rules follow Section 21 of FRS 102. This probability-criterion is applied both on an individual level (e.g. a court case) as well as on the group level for homogenous products.

4.5.2.2.4 Outflow

From FRS 102, Section 21.4 under b. it follows that the recognition of provisions is only possible for a future expected outflow. This means that FRS 102 Section 21 Provisions and Contingencies only applies to anticipation of expenses and not to deferral of revenue. The United Kingdom tax rules follow Section 21 Provisions and Contingencies of FRS 102.

4.5.2.2.5 Obligations

FRS 102 Section 21 Provisions and Contingencies 21.4 is strict in its approach that only present obligations at the reporting date can lead to the recognition of a provision. This means that there is no room for provisions for equalisation of costs, such as for repairs and maintenance, since this would not lead to a

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794 Business Income Manual 46520.
797 Business Income Manual 46520.
798 As is evidenced by Financial Reporting Standard 102, Section21 Provisions and Contingencies 21A.4 Example 4 Warranties.
800 At some points in the past, a provision for maintenance used to be allowed though. Jenners Princes Street (Edinburgh) Ltd. v. IRC, 1998, STC (SCD) 166, which concerned provisions for future repair costs.
Chapter 4. Provisions and similar entries

Present obligation (either legal or constructive) as a result of past events. In order to recognise a provision, an obligation (legal or constructive) needs to be present, of which the entity has no realistic alternative than to settle. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement.

A constructive obligation is an obligation that derives from an entity’s actions, where by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated that it will accept certain responsibilities and as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The latter means that in order to recognise a constructive obligation, certain outward criteria must be met. It is therefore not a solely subjective criterion. An example of a provision that will generally be based on a constructive obligation is a restructuring provision.

FRS 102 Section 21 Provisions and Contingencies does not discuss the issue of the existence of a present obligation in more detail than the way IAS 37 does. From FRS 102 Section 21 Provisions and Contingencies 21.4 it does follow that an obligation must be present at the end of the reporting period in order to recognise a provision. Possible future obligations, either probable or not, cannot lead to the recognition of a provision. This is both the case when an obligation is dependent on an entity’s actions and the case when there is a possible but uncertain obligation.

With regards to contingencies and future obligations the following applies. Obligations that are dependent on an entity’s future actions do not satisfy the condition in Paragraph 21.4 under a., no matter how likely their occurrence is or whether they are contractual. In this sense it does not matter whether or not the fulfilment of the condition is within control of the enterprise or not. In the reverse case, an obligation is present at the end of the reporting period, but it can be reversed by a future event, either within or not within control of the entity. In such a situation the following applies. In itself the obligation is present at the end of the reporting period and thus a liability must be recognised. However, when reversal of the obligation by a future event is very likely, it can be stated that an outflow of resources is not likely enough to recognise a liability, even though legally an obligation exists.

Another important issue is that two categories of present obligations can occur. The first is the single obligation that is either present or not (its existence is either more likely than not or it is not). The second are the large populations of

802 Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.20.
items that, when approached as multiple single items, do not meet the criteria for recognition, as individually they do not meet the criteria for recognition. When taken as a whole, a future outflow of resources is however likely. FRS 102, Section 21 does not explicitly recognise the latter category, but the example in FRS 102, Section 21.A.4 on warranties implies that a group-approach is accepted as a ground for recognition of a provision and thus constitutes a present obligation.

4.5.2.2.6 Treatment of provisions that accrue over the course of the years

FRS 102, Section 21, like IAS 37, approaches provisions on the basis that an obligation is either present at the end of the reporting period or it is not. Provisions, like other liabilities, have to be recognised and measured in the state that they are at the end of the reporting period. They cannot be recognised before an obligation is present and once they are recognised as an obligation, they have to be measured at the then-current value. Any build-up of a provision over the course of the years is therefore dependent on the existence of the obligation and its current value at the end of the respective reporting periods. A linear approach will therefore seldom be correct or acceptable within the criteria that FRS 102 sets.

4.5.2.2.7 Reliable estimate

FRS 102 Section 21 Provisions and Contingencies 21.4 under c. states that in order to recognise a provision, it is required that a reliable estimate can be made of the amount of the obligation. Whether or not it is a rare occurrence that the amount cannot be estimated reliably is not mentioned in FRS 102, Section 21 Provisions and Contingencies. This is somewhat awkward as it is basically subjective whether an estimate is considered ‘reliable’. In my opinion, it would be better to follow IFRS\textsuperscript{807} in this regard and add that only in extremely rare circumstances, it will not be possible to make an estimate of the expected future outflow\textsuperscript{808} that is sufficiently reliable to use in recognising a provision. This also creates an amount of tension between the financial reporting on the one hand and the determination of taxable income on the other. For general purpose financial accounting the tendency will be to not recognise the provision on the balance sheet (and thus state that a reliable estimate is not possible), whereas for tax purposes it will generally be more tempting for an enterprise to recognise a provision (and thus state that a reliable estimate is possible). For tax purposes

\textsuperscript{807} See International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.25.

\textsuperscript{808} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.25 literally mentions that ‘Only in extremely rare circumstances it will not be possible to make an estimate of an obligation that is sufficiently reliable to use in recognising a provision’, but it is preferable to state that it concerns an estimate of the expected outflow than an estimate of an obligation, as it is not strictly the obligation that is measured but the expected outflow.
the criterion that only in extremely rare circumstances it will not be possible to make an estimate of the expected future outflow might actually prove to be problematic. It provides taxpayers with an advantage in recognising a provision.

4.5.2.3 Measurement of provisions

FRS 102 Section 21 Provisions and Contingencies 21.7 states that an entity shall measure a provision at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. This means that it is not the actual (expected) outflow in the future that is measured, but the settlement or transfer value at the end of the reporting period. I refer to Paragraph 4.2.2.3 for my arguments that this approach is wrong unless settlement or transfer of the liability is actually planned by the enterprise. FRS 102, Section 21.7 states that where the effect of the time value of money is material, the amount of a provision shall be the present value of the amount expected to be required to settle the obligation.

It is rather striking that, like IAS 37.36, FRS 102, Section 21 requires measurement at settlement or transfer value at the end of the reporting period, as this means that the time value of money will be recognised inherently. The present value only applies to the actual expected outflow of resources required to settle the obligation and not to the settlement or transfer value at the end of the reporting period. This means that FRS 102 Section 21 Provisions and Contingencies follows a two-sided approach, on the one hand demanding the use of transfer or settlement value at the date of the balance sheet and on the other hand using the actual expected outflow.

With regards to the recognition and measurement of provisions several categories exist. First of all, single, individual outcomes that either occur or do not. In such cases the individual most likely outcome may be the best estimate of the liability.

For example when there is a 60% chance that an expense of a € 100.000 will occur and a 40% that it will not occur. It will be measured at 100% of the expected outflow, as this is the most likely outcome.

There is an inconsistency in the fact that FRS 102 Section 21 Provisions and Contingencies 21.7 requires measurement at settlement value (the amount an entity would rationally pay to settle the obligation at the end of the reporting period). Settlement value for an obligation that is not 100% probable will not be 100%, as both parties would be willing to settle at less than 100%. Where one possible outcome (outflow is a fixed amount) exists on the basis of a single possible obligation, this means that first it needs to be determined whether the

The concept of provisions in Article 23 CCTB

obligation exists or not (more likely than not). When that is determined, the full amount of the expected obligation is recognised as a provision. When the effect of the time value of money is material, present value shall be used. \(^{811}\) Individual items with multiple outcomes are treated in the same way as individual items that either occur or do not occur. This means that where a single obligation is measured, the individual most likely outcome may be the best estimate of the liability. Even in such a case, the entity considers other possible outcomes. Where other possible outcomes are mostly higher or lower, this implies a higher or lower measurement. \(^{812}\) Therefore, it is not a strictly mathematical approach towards measurement. Since FRS 102, Section 21.7 states that settlement value is the basis. This is inconsistent as settlement value for an obligation that is not 100% certain will not be 100%. Also, there will generally not be several settlement values, but basically one value at which parties are willing to settle.

Consider the following:
10% outcome 0
10% outcome 15
10% outcome 50
35% outcome 60
30% outcome 95
5% outcome 100

The single most likely outcome is 60, as there is a 35% probability that the outcome will be 60 and the probabilities linked to the other amounts are less.

The expected value is 61, \((10\% \times 0) + (10\% \times 15) + (10\% \times 50) + (35\% \times 60) + (30\% \times 95) + (5\% \times 100)\).

When approached from the number of outcomes, most outcomes are below 60 (3 below versus 2 above), indicating that measurement must be less than 60.

In percentages, most outcomes are above 60 (35% above versus 30% below), indicating that measurement must be more than 60.

In itself a point can be made that measurement of liabilities should not be strictly mathematical, as this can imply a certainty or accuracy that is not always actually present. However, the above illustrates that at least three outcomes are possible on the basis of the text. Since FRS 102 Section 21 Provisions and Contingencies 21.7 states that the settlement value (the amount that an entity would rationally pay to settle the obligation at the end of the reporting period) is the basis, several of these outcomes are inconsistent with FRS 102 Section 21 Provisions and Contingencies 21.7, as settlement value for the obligation would rationally be 61 (being the expected value). In my opinion this creates a situation

where more clarity and guidance are called for. Either settlement value is to be determined (being the expected value of 61), the most likely outcome (being 60) or another approach, but not the inconsistent pick-and-choose method that IAS 37 currently allows. In court cases there is always an issue that the entity discloses information that might harm its legal position and therefore the estimate becomes a self-fulfilling prophecy. This is an issue that is unique to public annual accounts. The recognition as such will create an issue, but it can be stated that expected value will disclose even more information than the individual most likely outcome, as it discloses more about the range of outcomes. Tax accounts, which are confidential, do not encounter the same problem, as this is generally non-public information.

Large populations of items
The third category is where a large population of items exists, that, individually, would not meet the criteria for the recognition of a liability, as their probability would be lower than 50%. However, as a group, such as certain warranties, it is taken as a given fact that a percentage of the items will lead to an outflow, although which individual ones that will be is unknown up until the point where they become apparent, which is relatively late. In this case it is virtually impossible to differentiate between the existence of the obligation and determination of the expected value. In this situation the expected value is determined on both the expected occurrence and the expected outflows. This value will also be near the settlement value. As stated, this situation can lead to the recognition of a provision (it can constitute an obligation). In such a situation it is much more difficult to differentiate between the existence of the obligation and the determination of the expected value, as these are more intertwined than is the case in individual items. FRS 102, Section 21.7 under (a) determines that where the provision being measured involves a large population of items, the obligation is estimated by weighing all possible outcomes by their associated probabilities. Where there is a continuous range of possible outcomes and each point in that range is as likely as any other, the mid-point of the range is used (which basically would already follow from the use of the expected value).

If the same numbers apply again the situation is as follows:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>0</td>
</tr>
<tr>
<td>10%</td>
<td>15</td>
</tr>
<tr>
<td>10%</td>
<td>50</td>
</tr>
<tr>
<td>35%</td>
<td>60</td>
</tr>
<tr>
<td>30%</td>
<td>95</td>
</tr>
<tr>
<td>5%</td>
<td>100</td>
</tr>
</tbody>
</table>

The outcome in this case would be 61, as this is the expected value. The expected value is a valid approach of settlement value (on the basis that both parties have identical information). Several issues come up when that conclusion is drawn. For starters, FRS 102 Section 21 Provisions and Contingencies 21.7 (first sentence), which determines that expected value is to be used, does not
strictly relate to FRS 102 Section 21 Provisions and Contingencies 21.7 under (b) and vice versa.

Also, there is no good reason why in individual cases the best estimate should not take settlement value as its basis, especially since this is what FRS 102, Section 21.7 (first Paragraph) determines, when in the case of large populations of items settlement value would be obligatory.

If the difference between individual cases and large populations of items would lie in the fact that it would be harder to estimate the probability of the outcomes or that they are thought to be surrounded by more uncertainty, then this should be mentioned, instead of the current confusing FRS 102, Section 21.7. Even better would be to use settlement value when settlement is expected in the short run, transfer value when transfer is expected in the short run etc. What is also striking about the concept of settlement value in FRS 102, Section 21.7 is that it implies that obligations or outflows that are not more likely than not, will not need to be recognised at economic settlement or transfer value on the balance sheet. When an enterprise is confronted with a 49% chance of an outflow occurring, it will generally be just as tempted to settle the amount as when the chance is 51%, given the fact that such a detailed differentiation in percentages would actually be possible. However, an obligation that is present and which has a 49% chance of leading to an outflow actually has a settlement or transfer value. A third party would not be tempted to transfer the liability for a zero value. Therefore, when settlement or transfer value is used as a basis (which is the case in FRS 102 Section 21 Provisions and Contingencies 21.7) and the obligation is actually present, the probability of the outflow should only be an issue of measurement and not necessarily an issue of recognition. However way it is turned, this still represents useful information for the users of the balance sheet. In such a case an estimated settlement value is of much more use than presenting it at a zero value.

FRS 102 Section 21 Provisions and Contingencies 21.7 requires that the amount that is recognised as a provision, is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This is the amount that the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. When an amount is settled at the end of the reporting period, future price- and costs increases would not play a direct role, but the time value of money and the moment of the expected outflow and future increases in price would be taken into account when the settlement value is determined. The concept of settlement value also implies that obligations or outflows that are not more likely than not, do have an economic settlement value. An enterprise will generally be tempted to settle a possible obligation when a 49% chance of occurrence of an outflow exists. However, this is not recognised on the balance sheet. FRS 102 Section 21 Provisions and Contingencies 21.11 requires that the amount that is recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. According to FRS 102
Section 21 Provisions and Contingencies 21.7 this is the amount that the entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. When an amount is settled at the end of the reporting period, future price- and costs increases would not play a direct role, although the time value of money and the moment of the expected outflow and future increases in price would be taken into account when the settlement value is determined.

The question is whether events between the end of the reporting period and the moment at which the annual accounts are drawn up need to be taken into account. FRS calls these ‘adjusting events’, like IFRS does. FRS 102 Section 32 Events after the end of the Reporting Period 32.2 defines adjusting events as those events that provide evidence of conditions that existed at the end of the reporting period. Events after the reporting period include all events up to the date when the financial statements are authorised for issue. According to FRS 102, these adjusting events are to be recognised in the financial statements.

4.5.2.4 Catching up in later years

When the criteria for the recognition of a provision as formulated in FRS Section 21 Provisions and Contingencies 21.4 are met, the amount recognised shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This leads to no restriction with regards to the amount that can and must be recognised as a provision. Whether or not ‘enough’ provisions have been recognised in the past is not relevant for recognition in later years.

Other forms of catching up, such as a change in reporting system, where a change is made from a system without recognition of provisions to a system that does recognise provisions (as would be possible under sound business practice) is not possible under IFRS, since the requirements are either met (in which case a provision must be recognised) or not (in which case a provision must not be recognised).

4.5.2.5 Compensation and other connected income

FRS 102 differentiates between compensations received from third parties and onerous contracts. When the entire amount required to settle a provision (or part of it) may be reimbursed by another party (e.g. through an insurance claim), the entity shall recognise the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. The amount recognised for the reimbursement shall not exceed

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813 Financial Reporting Standard 102, Section 32 Events after the End of the Reporting Period 32.3.
814 Financial Reporting Standard 102, Section 32 Events after the End of the Reporting Period 32.4.
the amount of the provision that is recognised. The reimbursement receivable shall be presented in the statement of the financial position as an asset and shall not be offset against the provision. FRS 102 permits an expense relating to a provision to be presented net of the amount recognised for a reimbursement. If an entity has entered into an onerous contract, the present obligation under the contract shall be recognised and measured as a provision. When taken literally, this implies that only the obligation is recognised, which would be taking into account a loss that is not expected. What, to my mind, is to be recognised is the amount of the obligation, net of the amount that is expected to be received under the contract, in which case the actual expected loss is recognised on the balance sheet. The fact that this obligation is to be measured as a provision is, to my mind, faulty, as this would imply measurement at settlement value or transfer value, which comes down to a market value. However, what would need to be recognised is the actual expected expense, as the entity will generally often be able to fulfil the obligation for a lower expense than market value, as market value of the performance will generally include profit for the party that performs.

4.5.2.6 Mandatory or optional recognition

From the criteria as set out in FRS 102 Section 21 Provisions and Contingencies 21.4, it can be derived that when the criteria are met, it is obligatory for an entity to recognise a provision. For catching up of provisions (see Paragraph 4.5.2.4) this means that catching up takes the form of correction of a mistake, as, when the rules would have been applied properly, catching up would not have been necessary. However, when recognition has not or not fully taken place in an earlier year, catching up is obligatory.

4.5.2.7 Place in the system

FRS 102 Section 21 Provisions and Contingencies requires the recognition of provisions mainly because they meet the definition of a liability and thus are to be recognised on the balance sheet. FRS 102 makes no reference to attribution of expenses or measurement of performance with regards to provisions. This is in line with the more static approach seen in the United Kingdom.

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817 Financial Reporting Standard 102, A4.22. The reimbursement asset is recognised separately from the underlying obligation to reflect the fact that the entity often will continue to be liable if the third party from which the reimbursement is due fails to pay. On the other hand, the net presentation in the income statement reflects the cost to the entity and the net presentation therefore does not conflict with the Regulations.
CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

4.6 CCCTB

4.6.1 Liabilities and deductible reserves

4.6.1.1 History of liabilities and deductible reserves in CCCTB

Since the objective of this research concerns the improvement of Article 23 CCTB, the history of its development is especially relevant for this research. Compared to the other researched systems, the history of CCCTB is relatively short. The history and background of the CCCTB-proposal is described in Chapter 2, to which I refer for more details. The 2004 non-paper on the common tax base\(^819\) kick-started the creation of a Working Group that ultimately prepared working paper WP/057 ‘CCCTB: possible elements of a technical outline’\(^820\), which was a blueprint for the eventual 2011 and 2016 proposals. This working paper WP/057 was preceded by a number of meetings and working papers. One of the themes in these working papers was ‘reserves, provisions and liabilities’. Although the working papers on this theme are all high-level and do not go into detail, there are a number of remarks and conclusions in these papers that are relevant for the history of CCCTB. The downside is that because the structure and scope of these working papers is limited, it is not possible to pinpoint all issues in Article 23 CCCTB and look up their origin in the working papers. This also means that the function of the working papers as guidance or legal history is limited, even though it would be desirable to have background legal history in cases brought before the European Court of Justice. This also means that I will pinpoint the relevant aspects in the working papers instead of describing the structure, reasoning and conclusions. I will now describe the general lines of the six working papers that are relevant for provisions in order to gain insight in the thought process behind Article 23 CCTB 2016.

WP/006

WP/006 ‘Reserves, provisions and liabilities’\(^821\) mentions that provisions accelerate tax relief. It defines what a provision is and acknowledges the dependency on the definition of a liability. It states that provisions for debts and receivables are linked to the underlying assets. Provisions are associated with liabilities, whereas reserves are associated with equity, although there are examples of the latter in certain Member States that can be tax deductible or tax free. It recognises that the release of a provision is the reverse of recognition. The difference between provisions and accruals are dealt with as that in accounting a provision is a liability that is uncertain in timing or amount, whereas accruals are more certain in timing or amount than provisions are. A contingent liability is

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recognised as a possible obligation that is not yet confirmed; the company has no
control over whether or when it will be confirmed and tax relief for contingent
liabilities is deemed unlikely. Tendencies to overstate or understate provisions are
thought to be reversed in accounting and the determination of taxable income. The
International Accounting Standards are essentially principles based and less
detailed than national accounting legislation or standards, although this is not dealt
with in detail. It is also mentioned that the International Accounting Standards are
moving towards fair value, without a lot of motivation or explanation. Provisions
for debts and receivables are generally tax deductible. An interesting remark is
that the tax treatment for provisions for repairs and maintenance varies widely
among Member States, whereas provisions for product warranties are often
allowed, but the way they are calculated varies and several Member States allow
asset replacement reserves.

WP/011
WP/011 ‘Reserves, provisions and liabilities’\(^{822}\) mentions that certain entries are
considered reserves in some Member States and provisions in other Member
States and that two types of provisions related to assets are identified: fixed
assets and current assets. It acknowledges that two approaches can be followed:
a negative list or a positive list, i.e. general deductibility of provisions with non-
deductible exceptions or general non-deductibility with deductible exceptions.
At that point the Working group considered it uncertain how legal requirements
relate to legal obligations with regards to provisions.

WP/015
WP/015 ‘Reserves, provisions and liabilities’\(^{823}\) goes into more detail with
regards to the positive list versus negative list. A positive list approach would be
difficult to draw up and the general deductibility approach seems to be more
likely to fit to economic reality. It was mentioned that consistent
overprovisioning will be identifiable during tax audits, which implies that the
Working Group was not too concerned with regards to overprovisioning. It also
states that the distinction between provisions and accruals can be important only
if the latter are tax deductible. The issue is using IAS 37 as a basis was also
discussed. It was concluded that IAS 37 can be a good starting point, but IAS 37
allows both legal and constructive obligations as a basis for provisions (and the
recognition of provisions for the latter was likely deemed undesirable). It
mentions that environmental costs should be deductible. A limit on the
deductibility of provisions (e.g. deductibility of provisions for liabilities that
occur within a limited time period) could be considered and examined in more
detail. Provisions for warranty should be deductible in the eyes of the Working
Group. Fair estimates should be made either via sector specific statistical data or
experience of the company itself.

\(^{822}\) Working document of the Common Consolidated Corporate Tax Base Working Group nr.
11 of the year 2005.

\(^{823}\) Working document of the Common Consolidated Corporate Tax Base Working Group nr.
15 of the year 2005.
Provisions for bad debts should be tax deductible in order to avoid overtaxation of companies, although the fixed rate approach or traditional approach was still under discussion at that point. Tax treatment of provisions of the banking and insurance industry should be addressed separately according to a majority of the Member States.

WP/021

In WP/021 ‘Reserves, provisions and liabilities’ the Working Group acknowledged that there is a strong need for a common understanding of what should be a deductible provision and there was a preference for a clear definition based on the accounting principles. IAS 37 as a starting point was thought to create a number of issues, such as the reluctance to recognise constructive obligations and possible tax planning with provisions. The majority of Member States supported a negative list approach, which means consensus was reached that provisions should generally be tax deductible. No Member State among those who support the non-deductibility principle suggested additional criteria or commented on the IAS 37 definition of accruals. There is overlap between accruals and provisions in certain jurisdictions (e.g. clean-up) in the sense that while in some jurisdictions the recognition of certain provisions is not allowed, the same facts can lead to the recognition of an accrual. A time limit on deductibility of provisions was generally found to be undesirable. In the opinion of the Working Group, repairs and maintenance should be viewed as reserves and not as provisions, which would also apply to legally required maintenance and repairs (such as for ships and aircraft). The component approach towards provisions was unanimously rejected. It was thought that companies should be allowed to create tax deductible provisions for warranties, although measurement remains an issue. When available external data is not reliable or comparable to the examined situation, a provision cannot be created. The Working Group saw that this would create a problem for start-ups and competition; the Commission would like to encourage the Member States to consider the importance of an equal treatment of companies in relation to warranties provisions. The principle of mutual recognition is a necessity in a common tax base; a provision calculated in accordance with the requirements arising from the non-tax legislation implemented in one Member State should be recognised in the common corporate tax base of the CCCTB as acceptable for the provision deductibility even though it would impact the share of the common tax base of another Member State, but not the whole group supported this approach; most Member States, however are of the opinion that the legal obligation arising from a Member State legislation represents real cost and thus it is legitimate for the enterprise to recognise a provision. In the 2006 paper on the implementation of the Lisbon Programme, the European Commission actually acknowledged the fact that the recognition of a provision creates the possibility to save-up for an enterprise: ‘As regards provisions this also seems to satisfy the principle of ‘ability to pay’ in the sense

that deferring the recognition of a provision for clean-up costs until they are incurred – which may be when the operations have ceased – may leave the company with no profits with which to ‘pay’ for the clean-up.’

**WP/057**

WP/057 ‘CCCTB: possible elements of a technical outline’ mentions that constant reference has been made to IAS/IFRS but that it is not possible to make a formal link between the tax base and IAS/IFRS. Furthermore it states that IAS/IFRS are not allowed in all Member States and not all IAS/IFRS are suitable for tax purposes. Striking is the fact that it mentions that unless uniform treatment is explicitly provided for in the legislation, the tax base would be computed by reference to national GAAP and that this assumes that no separate tax balance sheet for CCCTB is necessary. Relevant for provisions are the following elements of a technical outline:

- When an amount arising from a legal obligation or a likely legal obligation relating to activities or transactions carried out in the current or previous tax years, such as potential warranty claims, can be reliably estimated, the expense would be deductible in the current tax year (provided that the eventual settlement of the amount would result in a deductible expense);
- Where the obligation relates to an activity or transaction which would continue over future tax years, such as an obligation in relation to final clean-up costs, the deduction would be spread over the estimated duration of the activity or transaction. Amounts deducted under the preceding paragraphs would be reviewed and adjusted on an annual basis. In calculating the tax base in future years, account would be taken of amounts already deducted and necessary adjustments made in order to prevent double deduction. A reliable estimate would be based on past experience and the factors to be taken into account would include any past experience of the company, the group and the industry.

This is already close to what would eventually become Article 25 CCCTB in the 2011 proposal. Interesting is that Member States who commented, welcome the restriction to the legal obligations regarding the deductibility of provisions (and thus not allowing the recognition of a provision for a constructive obligation).

**WP/066**

WP/066 ‘Various detailed aspects of the CCCTB’ mentions that the use of national GAAP as a last resort reference met with little support and that the alternative would be to provide within the legislation some explicit tax principles, which would be included to assist in the interpretation of the

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legislation and remove the need for reference. The suggested clause for including the Tax Principles was:

- The tax base shall be computed in accordance with the following general principles, unless otherwise stated.
  (a) The accruals principle
  (b) Profits and losses shall only be recognised when they are realised.
  (c) Transactions and taxable events shall be measured individually.
  (d) The calculation of the tax base shall be carried out in a consistent manner unless exceptional circumstances justify a change.

CCCTB does not provide a definition of liabilities, even though liabilities are mentioned in Article 21 CCTB 2016.

In WP/006 it is mentioned that in accounting, provisions are defined as liabilities of uncertain timing or amount (thus following the definition of a provision in IAS 37). Therefore the concept of liabilities is recognised in both the Working Papers as well as the proposal for a Directive on a CCCTB, but what liabilities actually are is not defined in the Directive itself. Given the former, it is not unthinkable that liabilities in the common corporate tax base of CCCTB actually are in line with the definition given in IFRS. The fact that the common corporate tax base of CCCTB uses the word ‘liabilities’ calls for a definition in the proposal for a directive itself, however. the common corporate tax base of CCCTB does not specifically recognise a concept of liabilities of which debts, provisions and accruals are part (thus as an overarching term). Since CCCTB does not require the use of a balance sheet, the function of a liability is different. It only supports the attribution of income, whereas under IFRS it primarily serves as a determining factor of what is to be recognised on the balance sheet.

4.6.1.1.1 Debts

The common corporate tax base of CCCTB also does not define debts in any way. This does not, however, mean that debts are not part of the determination of taxable profit in the common corporate tax base of CCCTB. Because of the lack of a dedicated definition, the first question is where a debt (the amount itself) fits in the system of the common corporate tax base of CCCTB. Deduction of costs, one of the main issues in this study, is either part of the model of Articles 9, 15 and 17 CCTB 2016 or part of an exception to that particular model. The model of Articles 9, 15 and 17 CCTB 2016 indicates that costs are incurred and therefore deductible when the obligation to make the payment has arisen and the amount of the obligation can be quantified with reasonable accuracy.

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829 I refer to the combination of Articles 9, 15 and 17 as a ‘model’ as together they represent attribution of expenses in its basic form in the common corporate tax base of CCCTB.
The concept of provisions in Article 23 CCTB (plus a number of additional criteria mentioned in Article 17 under CCTB 2016). The fact that the obligation to make the payment must have arisen means that once a debt occurs, in combination with an expense that is deductible to begin with, the issue can fall under Articles 8, 15 and 19 CCTB 2016. When taken literally, what is generally considered to be debt, will also fall under the definition of Article 23 CCTB 2016 concerning provisions, as a debt will normally meet the criteria of a legal obligation arising from activities or transactions carried out in that, or previous tax years, which are the basic requirements for the recognition of a provision under the common corporate tax base of CCCTB. It remains a question whether in the case of debt application of Article 23 CCTB 2016 is at all possible, as this article is an exception to the general timing of deductibility of costs. Where the amount itself is concerned, debts can, in general, arise where:

- Assets are bought;
- Services (non–assets), such as labour, is bought;
- A loan is taken;
- A provision turns into debt.

When assets are bought and the corresponding debt is not yet paid, the amount itself is deductible, when the asset lends itself for deduction. Deductibility is in itself dealt with in Article 9 CCTB 2016, though this is from the point of view of total profit and not annual profit (it deals with deductibility as such and not at what moment the amount is deductible). Article 17 CCTB 2016 deals with the incurrence of deductible costs. When goods are bought, the costs are incurred when the obligation to make the payment has arisen, the amount of the obligation can be quantified with reasonable accuracy and the risks and rewards of ownership are transferred to the taxpayer. However, the deduction of costs relating to assets are often dealt with specifically in dedicated articles, such as Article 18 CCTB 2016 on non-depreciable assets, Article 19 CCTB 2016 on stocks and work-in-progress and Chapter IV on depreciation of fixed assets. See the attachments for the texts of the articles.

Chapter IV on depreciation of fixed assets, consisting of Articles 30-40 CCTB 2016 is an exception to both Articles 9, 15 and 17 CCTB 2016 on one hand and Article 23 CCTB 2016 on the other. Contrary to Articles 22 and 23 CCTB 2016, Chapter IV does not explicitly mention that it is an exception to Articles 9, 15, 17 and 23 CCTB 2016. This makes the relation between Article 23 CCTB 2016 and Chapter IV somewhat strained. When services are bought that do not constitute assets, Article 17 CCTB 2016 applies to the deductibility of the costs.

Article 23 CCTB 2016 will generally not be applicable to the occurring debt, as the eventual settlement of the amount is not expected to result in a deductible expense, because it will already have been taken into account by Article 17 CCTB 2016. When a loan is taken, the amount itself will not be deductible, which means that the eventual settlement of the amount is not expected to result in a deductible expense. Article 23 CCTB 2016 is therefore not applicable in this
situation. The primary effect on profit will therefore be when measurement leads to increases or decreases of the value of the loan. On the basis of Articles 9, 15 and 17 CCTB 2016 it is highly unlikely that this will occur.

With regards to the situation when a provision turns into debt (when, in terms of IFRS both timing and amount become certain), from the viewpoint of Article 23 CCTB 2016, there is no structural difference between a provision and debt, as both will meet the criteria of Article 23 CCTB 2016. The expense has already been deducted when the provision was recognised. This change in character of the liability does not have a tax effect under the common corporate tax base of CCCTB. When a debtor is released from debt, he is in an economically better position than in which he was before the release of the debt. The first question is therefore whether the common corporate tax base of CCCTB recognises such a release as revenue. Since the common corporate tax base of CCCTB does not require a balance sheet to be made, this would otherwise not show. Article 7 CCTB 2016 defines the elements of the tax base as revenues less exempt revenues, deductible expenses and other deductible items. The release from a debt is not necessarily a form of ‘revenue’, unless described as such. Revenues are defined in Article 4, Paragraph 5 CCTB 2016:

‘Revenues’ means proceeds of sales and of any other transactions, net value of added tax and other taxes and duties collected on behalf of government agencies, whether of a monetary or non-monetary nature, including proceeds from disposal of assets and rights, interest, dividends and other profits distributions, proceeds of liquidation, royalties, subsidies and grants, gifts received, compensation and ex-gratia payments. Revenues shall also include non-monetary gifts made by a taxpayer. Revenues shall not include equity raised by the taxpayer or debt repaid to it’

From the literal text, it is unclear whether the release from debt falls under the definition of revenues, as it does not seem plausible that such a release would be considered proceeds of sales or any other transaction. Clarification is needed in this respect, as it is unlikely that non-taxation of the release from debt is a desirable effect. Whether or not the release of debt is taxable, depends on whether the common corporate tax base of CCCTB determines this to be revenue or profit. The release of debt is not a separate issue in the tax base itself and is therefore regulated by the general rules on determination of profit. Article 6, Paragraph 1 CCTB 2016 determines the moment when profits and losses shall be recognised. Article 7 CCTB 2016 mentions the elements of the tax base as revenues minus exempt revenues, deductible expenses and other deductible items.

The release from debt is not a proceed of a sale or of any other transaction, including the disposal of assets and rights, interest, dividends and other profits.

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830 Since further on in the tax base (from Article 7 CCTB 2016 onwards) revenues and costs are attributed mostly independent of each other, Article 6, Paragraph 1 CCTB 2016 is in fact obsolete.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

distributions, proceeds of liquidation, royalties, subsidies and grants, gifts received or compensation. The release from debt could be viewed as an ex-gratia payment. An ex-gratia payment generally takes place when the giver makes a payment without being legally obliged to do so. However, a release from debt is not strictly a payment (although the definition of revenue in Article 4, Paragraph 8 CCTB 2016 is somewhat broad by nature). Furthermore, Article 4, Paragraph 8 CCTB 2016 states that revenues shall also include non-monetary gifts made by a taxpayer. Since gifts are generally only revenue when received, it seems that what is meant is that revenues shall also include non-monetary gifts made to a taxpayer. It could be stated that the release from debt is more of a negative cost than a revenue, but that is a differentiation that is not found in other articles of the common corporate tax base of CCCTB. The interesting thing is that the common corporate tax base of CCCTB does seem to be striving for completeness by the last sentence of Article 4, Paragraph 8 CCTB 2016 (it states that revenues shall not include equity raised by the taxpayer or debt repaid to it, which would not be considered revenue or profit anyway), even though it does not explicitly include the release from debt.

Under Dutch sound business practice, there is no doubt whether the release from debt represents revenue or profit, as there is even a facility for a tax exemption for such releases from debt. IFRS and FRS have a rather broad definition of income, which means that release from debt falls under this definition, which is also the case under German tax law. Therefore, in general, there does seem to be a large amount of consensus that the release from debt forms revenue or profit. Horizontal equity actually suffers when it is not clear whether the release from debt is considered revenue. First of all, because not all enterprises are granted release from debt, meaning that the ones that are, benefit double when the release is not taxable. Such arbitrary non-taxation of ‘benefit’ is neither efficient nor neutral and therefore undesirable. In itself either taxing or not taxing the release from debt remains simple and transparent. Although it is highly unusual to not to view the release from debt as taxable income, it is not unthinkable that certain states will actually tax the release from debt under CCCTB-rules and others might not. This means that legal certainty suffers, as will enforceability. As stated before, any inconsistency or lack of clarity in the tax base creates less competitiveness and is therefore undesirable. CCCTB leaves the question unanswered whether or not the release from debt forms a revenue or profit. However, there seems to be no reason why this should not be taxed. An argument can be made for not-taxing the release from debt when an entity is in so much financial trouble that the release is necessary, but, like under Dutch tax law, this should be part of a specific facility and not be left up to interpretation and arbitrariness. Furthermore, there is no argument found in the CCCTB-Working Papers in favour of granting such a facility. Therefore the release from debt would need to be added to Article 4, Paragraph 8 CCTB 2016 as a form of revenue.

4.6.1.1.2 Provisions
Provisions will be dealt with in detail in Paragraph 4.6.2.
4.6.1.1.3 Accruals

While the common corporate tax base of CCCTB itself does not define accruals, WP/006 mentions certain characteristics of accruals.  

\[831\] It is stated in the Working Paper that the purpose of accruals is to match costs and revenue and that accruals are more certain in timing and amount than provisions are. The latter is likely a reference to IFRS, which explicitly states this about accruals.  

\[832\] The former (matching costs and revenue) seems more concerned with the determination of profit, even though in my opinion, matching costs and revenues is not a feature that sets apart accruals from other elements of the balance sheet. WP/015 mentions accruals, but does not elaborate on them.  

\[833\] Even though accruals have been mentioned in two Working Papers, they are not explicitly dealt with in the common corporate tax base of CCCTB. Therefore, the question remains how the situations that are mentioned as accruals in the other systems turn out under the common corporate tax base of CCCTB. When a taxpayer has received payments for goods or services to be delivered after the end of the reporting period, this means that the taxpayer still has to perform towards the third party from which the payment is received. The question is whether CCCTB provides for a deferral mechanism for revenues in such situations. Article 7 CCTB 2016 states that profit shall only be recognised when it is realised. The question is whether profit is actually realised when a payment has been received for goods or services to be delivered after the end of the reporting period. Article 15 CCTB 2016 states that revenues, expenses and all other deductible items shall be recognised in the tax year in which they accrue or are incurred, unless otherwise provided for in the Directive.  

Article 16 CCTB 2016 determines to which period revenue is attributed. Revenues are attributed to the period in which the right to receive them arises and they can be quantified with reasonable accuracy, regardless of whether the actual payment is deferred. The question is therefore, when a payment is received but the entity still has to perform in the future, has the right to receive the revenue arisen? Article 16 CCTB 2016 states that revenues accrue regardless of whether the actual payment is deferred, when the two criteria are fulfilled. It does not mention what happens when the actual payment is not deferred, but received in advance. It would seem that when an agreement is made that payment takes place in advance, the right to receive the payment has arisen (otherwise the payment would not have been received) and therefore Article 16

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\[832\] International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* 37.11 under (b).


\[834\] Matching is not very present in the common corporate tax base of CCCTB as revenue and costs are, as a basic premise, attributed separately.
CCTB 2016 leads to the attribution of revenue upon receipt of the amount or otherwise upon the moment when this payment should have been received. An accrual would not be recognised in this case. What remains is that the entity would still have to perform the service for which it was paid in advance. This means that the entity still has an obligation and therefore Article 23 CCTB 2016 might be applicable, which would not only lead to the recognition of revenue on the basis of Article 16 CCTB 2016 but also to the deduction of cost on the basis of Article 23 CCTB 2016. It will generally be possible to make an estimate of the value of the obligation. The main question will therefore be whether this obligation has arisen in the same year as the year to which the revenue is attributed.

For example, an enterprise receives a €100,000 prepayment in year 1 for a service it still has to perform in year 2. When the contract entitles the enterprise to the prepayment, Article 16 CCTB 2016 lead to recognition of the revenue in year 1. When the criteria of Article 23 CCTB 2016 are met, there would also be a deductible amount. As Article 23 CCTB 2016 takes settlement value as its basis for measurement, it could be stated that the other party would only be willing to settle for €100,000 in a similar case, leading to a taxable amount of €0.

It would not be a reasonable outcome from the perspective of the ability to pay taxes, if that income is attributed to the current year (and thus ‘arises’ in that year), whereas the connected expenses are attributed as costs to a future year (leading to a taxable income in year 1 and a loss in year 2. The cause of the expense is effectively the contract between the enterprise and the third party. From that starting point it would follow that the expense ‘arises’ in the same year as the revenue. However, the principle of matching is not as present in the common corporate tax base of CCCTB as it is in, for example, the Dutch or German system of determination of profit or even IFRS. That means that it fully depends on the question whether Article 23 CCTB 2016 is applicable to solve the tax issue. Even though I am of the opinion that Article 23 CCTB 2016 would still be applicable when the settlement would take place in kind instead of cash, the contra-performance of the enterprise would not lead to a deductible expense to exactly the same amount as the received payment. This means that it can only be determined from the viewpoint of settlement. When the other party has paid €100,000 it will generally only be willing to settle for €100,000 if it would be needed to translate it into a monetary amount.

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835 It can be stated that the value of this obligation is equal to the received payment. The actual cost of the performance will generally be less than the payment (which means that the entity makes a profit). However, this profit might not yet be realised, although under the common corporate tax base of CCCTB realisation is not strictly adhered to. This, although debatable, still leaves intact that an estimate of the obligation is possible either with or without the component of profit.

836 See Article 16 CCTB 2016.
There is a problem in the sense that the profit contained in the advance payment is not offset by an actual deductible expense: the performance will most often not cost the enterprise € 100,000 but effectively less. Therefore, Article 23 CCTB 2016 can, in my view, only lead to a deductible cost for the true cost of the performance (insofar it has not been deducted otherwise) instead of for the amount that has been received, unless settlement value is determined in the way I described. Therefore, the outcome does not necessarily have to lead to an unreasonable outcome, but as stated, I do not agree with the general application of settlement value in Article 23 CCTB 2016. The issue of executive contracts (contracts in which both parties have an obligation but neither one has performed yet or they have performed in equal measure), is not dealt with explicitly in Article 23 CCTB 2016. The second sentence of the first Paragraph of Article 23 CCTB 2016 states that:

*Where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom.*

It can be stated that executive contracts fall under this sentence, so that the deduction of costs will follow the attribution of revenue, instead of deductibility when the obligation or probable future legal obligation occurs. Another part of Article 23 CCTB 2016 that might be applicable to executive contracts is Article 25, Paragraph 2 under (d):

*(d) future benefits directly linked to the event giving rise to the provision shall betaken into account.*

In the case of executive contracts, this could also lead to the situation where the deduction of costs will follow the attribution of revenue, instead of deductibility when the obligation or probable future legal obligation occurs. The issue of executive contracts that is dealt with explicitly in most of the other systems (IFRS, United Kingdom FRS and the German system), is not as clear under the common corporate tax base of CCCTB. The applicability of Article 17 CCTB 2016 in this situation is questionable. In itself a payment can be in kind, but it is unclear whether the future performance of the entity can be classified as ‘an obligation to make a payment’. Neither the Working Papers, nor CCCTB itself provides any indication in this respect. Also, when an advance payment has been received, it is not a given fact that the contra-performance of the entity would be ‘due’, so that the obligation to make the payment would not have arisen yet. The conclusion is therefore that this situation can be ‘solved’ in accordance with the ability to pay taxes, when the expected future expenses are attributed to the current year, which is largely dependent on the applicability of Article 23 CCTB 2016.
In the case where a taxpayer has received a payment as reimbursement for expected higher future expenses and no obligation towards the payer itself exists, the following applies. When following the system of Articles 7, 15 and 16 CCTB 2016, the right to receive the revenue has arisen and no further obligations are due. The amount can be quantified with reasonable accuracy, because it will have been received. The revenue will be attributed to the year in which the right to receive it occurs. Since the enterprise has no legal obligation towards the payer or a third party, there is insufficient reason to recognise a provision in accordance with Article 23 CCTB 2016. The enterprise could alter or stop its business without any obligation with regards to the higher future costs. When no obligation towards a third party arises because of this received payment, neither Article 17 CCTB 2016 nor Article 23 CCTB 2016 is applicable. This means that the full amount will be taxed, despite the fact that it is received because of an expected increase in future expenses.\textsuperscript{837} This is where the lack of connection and matching shows itself in the common corporate tax base of CCCTB.

When the sale is made and the right to receive the payment has arisen and the amount of revenue can be quantified with reasonable accuracy, the mere fact that the reversal of the transaction is likely, is not an element that can be taken into account with regards to the system of Article 7, 15 and 16 CCTB 2016. Only when it would mean that the right to receive the payment has not fully arisen, realisation will not have taken place. This does not automatically follow from a reasonable chance of reverse transferral. Therefore, it does not automatically follow that realisation has not taken place from the perspective of Article 16 CCTB 2016.

\textit{4.6.1.2 Deductible reserves}

Working Paper WP/011 defines reserves as the appropriations of retained earnings, which form part of equity.\textsuperscript{838} The general consensus in the Working Paper is that the recognition of a reserve does not lead to deductible costs. The concept of the tax deductible ‘fiscal reserve’, such as is recognised under Dutch sound business practice, is not explicitly recognised in the common corporate tax base of CCCTB. WP/006 states that the purpose of reserves is often maintenance of capital. It therefore differentiates between two types of reserves:\textsuperscript{839}

\begin{itemize}
  \item Reserves that protect the entity against losses;
  \item Reserves as fiscal facilities.
\end{itemize}

\textsuperscript{838} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 11 of the year 2005.
\textsuperscript{839} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 6 of the year 2005.
However, there are similarities between certain types of deductible amounts mentioned in the CCCTB-Directive and the entries that are considered to be fiscal reserves under Dutch sound business practice.

**Reserves for equalisation of costs**
The common corporate tax base of CCCTB does not provide a reserve for equalisation of costs. The need for a reserve for equalisation of costs will usually be the recognition in advance of future expenses for maintenance and repairs and costs of survey. Since Article 23 CCTB 2016 is strict in the sense that a present or probable future legal obligation is needed in order to recognise a provision, this means that for maintenance and repairs it will be impossible to deduct costs on the basis of Article 23 CCTB 2016.\(^{840}\) WP/021 is quite clear that such a situation leads to the recognition of a non-deductible reserve and not to the recognition of a provision.\(^{841}\) This means that Articles 10, 15 and 17 CCTB 2016 are applicable to such costs and they only recognise deductibility when the obligation to make the payment has arisen. From a practical viewpoint, where the tax return is done after the tax year and the payment for which the obligation has arisen in the case of maintenance will often have been done before the end of the period, this means that the tax deduction takes place after the payment.

An alternative way of dealing with maintenance and repairs would have been the component approach to depreciation that is used in IFRS. Without much explanation, WP/021 states that this approach has been explicitly rejected by subgroup 1 for the use in CCCTB.\(^{842}\) It is likely that subgroup 1 found the component approach to depreciation too complex for application under the common corporate tax base of CCCTB.

Reserves that are obligatory and lead to the non-distribution of profit are viewed by WP/006 as having a problematic relation with the ability to pay taxes. Such reserves occur mostly with insurance companies or banks. However, the fact that the reserve needs to be recognised and profit can be distributed to a lesser extent because of this, does not automatically lead to a problem with the ability to pay taxes, as the liquidity (the assets) remains exactly the same. The lock-up does not translate fully to the liquidity itself. It just cannot be distributed as profit and for this there are good reasons, given the fact how small the relative equity in a lot of financial institutions was before the financial crisis. It only presents a problem when taxes, being costs, lower the reserves to an extent where it becomes problematic. Also, the line between an obligatory reserve and maintenance and repairs that are required to keep the company in business is very thin, as an obligatory reserve does not represent an obligation either. This

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\(^{840}\) Unless the ‘probable future legal obligation’ is the obligation towards the third party doing the repairs in the future, which is unlikely to be the case.


The concept of provisions in Article 23 CCTB

means that allowing the recognition of a tax free reserve for certain types of financial institutions such as insurance companies is unfair.

However, in the European Union, financial institutions such as banks and insurance companies have tremendous political power and employ a very present and effective lobby, which would explain the existence of Article 28 under (d) CCTB 2016, which allow the deduction of equalisation provisions of insurance undertakings established in accordance with Council Directive 91/674/EEC. It seems inconsistent that this is called a provision, when both WP/021 and Article 23 CCTB 2016 are quite clear on the subject that this is not a provision. The background for this is probably the fact that Directive 91/674 EEC, which is the basis for the recognition of such entries in the first place, calls these entries provisions. Given the fact that CCCTB aims to be a standalone tax base, it is inconsistent that entries from Directive 91/674 EEC are used in CCCTB. Furthermore, the fact that Member States can opt to allow for the recognition of provisions or reserves for equalisation of costs under the common corporate tax base of CCCTB, is limited to one specific sector of the market, whereas the need for similar tax relief can be equally high in other sectors, with equally valid arguments, (the fact that an amount of the resources has a more or less fixed destination is not unique to the insurance industry) is particularly striking and is likely to stem primarily from the political power of insurance undertakings in the European Union.

Fiscal reserves

Article 35 CCTB 2016 contains a facility for reinvestment, comparable to the one in Dutch, German and United Kingdom tax law. Contrary to Dutch tax law, this is not called a reserve, but a roll-over-relief for the replacement of assets, which probably comes from the use of the word in the United Kingdom. The word ‘relief’ suggests an otherwise unsystematic tax facility, granted to the taxpayer. The effect is however equal to the Dutch, German and United Kingdom facility: the profit on the sale of an asset is not taxed, but the depreciation base of the replacement asset is reduced by the untaxed profit. IFRS, not being a tax base, does not recognise a similar entry.

Under the common corporate tax base of CCCTB, the criteria are:

- An individually depreciable asset;
- Is disposed of;
- The proceeds exceed the book value for tax purposes;
- Re-investment must take place before the end of the second year after the year in which the disposal took place;
- In an asset used for the same or similar purpose;

843 Directive (EC) 91/674 of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (OJEC L 374/7).
844 Article 35 CCTB 2016.
845 Article 33 CCTB 2016.
An asset which is disposed of voluntarily must have been owned for a minimum period of three years prior to the disposal;

The replacement asset may be purchased in the tax year prior to the disposal;

If a replacement asset is not purchased before the end of the second year after the year in which the disposal took place, the amount deducted in the year of the disposal, increased by 10%, shall be added to the tax base in the second year after the disposal took place;

If the taxpayer leaves the group of which it is a member or ceases to apply the system provided for by this Directive within the first year, without having purchased a replacement asset, the amount deducted in the year of disposal shall be added to the tax base. If the taxpayer leaves the group or ceases to apply the system in the second year, the amount shall be increased by 10%.

The last two criteria seem inconsistent when compared to each other. When, in the first year after the disposal of the asset, it is decided or otherwise becomes clear that the asset will not be replaced, contrary to prior planning, from the text it seems impossible to add the relief to the tax base in the first year, since it states ‘if a replacement asset is not purchased before the end of the second year after the year in which the disposal took place’. This leaves no room for adding the amount to the profit in the first year, as that will still not lead to a replacement asset being purchased before the end of the second year after the year in which the disposal took place. In that situation it seems to be obligatory that the amount shall be added to the tax base in the second year after the disposal, including a 10%-increase, which seems unreasonable. When, however, the taxpayer either leaves the group or exits the common corporate tax base of CCCTB altogether in the second year, the amount of relief shall be added to the tax base in the second year after the disposal, increased by 10%.

When the taxpayer leaves the group or exits the common corporate tax base of CCCTB altogether in the first year, no increase seems to apply and adding any amount to the tax base in the second year is impossible since the common corporate tax base of CCCTB does not apply in the second year. The anti-abuse rules in Chapter XIV do not prevent this.

Since the non-increased option does not apply when the group is not left or application of the common corporate tax base of CCCTB has ended and no replacement asset is bought, this can lead to the situation where it is economically sounder to leave the group or exit the common corporate tax base of CCCTB in order to evade the 10% increase. It is clear that a non-increased option should also apply when in the first year after the sale of the asset, it becomes clear that the asset will not be replaced. A solution that is probably

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even more sound is that when in the first year after the sale of the asset, it becomes clear that the asset will not be replaced within the group, for whatever reason, an increased option for release (such as a certain percentage) should apply. The increase, at 10% after the second year seems to be relatively high, when compared to current market interest, meaning that this is a signal to the taxpayer that using the roll-over relief can never be a cheap way to defer taxes without reinvestment. This is, in my view, quite welcome and currently lacking in for example Dutch tax law. Reserve for old-age
The common corporate tax base of CCCTB does not recognise a deduction similar to the reserve for old-age under Dutch tax law. From the perspective of to whom the common corporate tax base of CCCTB applies, this makes sense. Dutch income tax law allows the recognition of a reserve for old-age, because in a situation where a business is run by a person (i.e. not a legal entity), it is impossible to recognise a pension, as there is no employment contract concluded between the person and his business, whereas this would be the case when the business was driven by means of a legal entity. Since the common corporate tax base of CCCTB does not apply to sole proprietorships and partnerships, but only to legal entities, there is no strict necessity for a similar reserve. The common corporate tax base of CCCTB does provide for a facility for the recognition of pension provisions in Article 24 CCTB 2016.

4.6.2 Provisions

4.6.2.1 Definition of a provision

In the common corporate tax base of CCCTB itself, no definition of a provision is provided. WP/006 mentions that provisions are dependent on the definition of a liability. In itself, this makes sense, when taken into account that IFRS is taken as the starting point. WP/011 defines provisions as liabilities of uncertain timing and amount, which is identical to the definition given in IAS 37. Neither CCCTB 2011 nor the common corporate tax base of CCTB 2016 repeats this definition or gives an alternative definition. WP/021 mentions ‘themes’ relevant for provisions, such as legal obligations or future legal obligations and arising from activities or transactions carried out in that or previous years. It states that the general consensus is that provisions are liabilities of uncertain timing or amount and liabilities are present obligations of an entity arising from past events.

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847 The lack of which is, in my opinion, wrong with the Dutch reinvestment reserve.
848 Article 2 CCTB 2016.
Article 23 CCTB 2016 and the common corporate tax base of CCTB as a whole do not contain a definition of a liability. However, the title of Article 23 CCTB 2016 is ‘provisions’, implying that the common corporate tax base of CCCTB acknowledges the concept of recognition of a provision. Article 23 CCTB 2016 states that where at the end of a tax year it is established that the taxpayer has a legal obligation, or probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense. This means that provisions are not defined as such, but that a certain amount can be deducted, when the criteria given in Article 23 CCTB 2016 are met. As mentioned in Paragraph 4.6.1.1.1 the lack of a definition means that Article 23 CCTB 2016 can be applicable, even when the definition of IAS 37.14 is not met (‘a liability of uncertain timing or amount’). Even when timing and amount are quite certain, Article 23 CCTB 2016 can, in theory, be applicable. This means that Article 23 CCTB 2016 has, in itself a broader range and can contain entries that are not generally thought of as provisions.

When IFRS’s definition of a liability (uncertain timing or amount) is followed, which, in short, means that the entry represents a certain future outflow of resources, which is present in Article 23 CCTB 2016 (‘any amount arising from that obligation’), the timing can be uncertain (‘eventual settlement of the amount’) as well as the amount (‘reliable estimate’, meaning that the amount does not need to be fixed in any way). What is even more present in Article 23 CCTB 2016 than in IFRS’s definition of a provision is the fact that the existence of the obligation can also be uncertain, which can be found in the ‘legal obligation, or a probable future legal obligation’. Although I feel that the ‘probable future legal obligation’ is a problematic issue and I welcomed the fact that in later, updated versions of CCCTB this has been put between brackets (indicating that it would be removed, which has not taken place in the common corporate tax base of CCCTB), it does stress the uncertainty that can be inherent to the obligation itself, although I find the way this is dealt with in Article 23 CCTB 2016 inconsistent and incomprehensible.

4.6.2.2 Requirements for the recognition of a provision

4.6.2.2.1 Arising from

Article 23 CCTB 2016 states that in order to be able to deduct an amount following from an obligation, the taxpayer must have a legal obligation or a probable future legal obligation, arising from activities or transactions carried out in that or previous tax years. This means that under the common corporate tax base of CCCTB the obligation leading to the expense must have arisen from activities or transactions carried out in that or previous tax years. Whereas Dutch sound business practice requires ‘facts or circumstances’ (therefore passive
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criteria). Article 23 CCTB 2016 requires ‘activities or transactions’ (therefore active criteria). It is not clear whether this is meant to lead to differences in practice. Article 23 CCTB 2016 implies that the entity must have undertaken an activity or a transaction in order to be able to deduct amounts under Article 23 CCTB 2016. It is unclear how this should be applied in practice. The criterion ‘arising from activities or transactions carried out in that or previous tax years’ is likely inspired by IAS 37.10 which states that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Since this wording is not a literal copy of IAS 37.10, it is open to debate how identical Article 23 CCTB 2016 and IAS 37.10 are. It can be stated that, given the fact that an alteration has taken place, this must have been done on purpose and therefore be a conscious effort to deviate. What exactly is meant by this deviation is however unclear. Practically, it is not likely that what is meant that only active causes are to be taken into account and passive are not. This would create a dividing line for which there are no proper arguments. An example of this is the following: a provision can be recognised when an employee of the entity actively damages a building in the course of his or her activities (active), but a provision cannot be recognised when an entity receives a claim for not renovating a leased building, which collapses for lack of maintenance (passive). As stated, there are no good arguments for such differentiation.

4.6.2.2.2 Attributable to the year

The tax base of CCCTB is simpler and in a way cruder than that of the other systems. Since the deduction of expenses is theoretically simpler than under the other systems, the situations that would lead to recognising an asset (accrual) under Dutch sound business practice would not have the same effect under the common corporate tax base of CCCTB. Therefore, a criterion like the ‘criterion of sound business practice’ in which an additional rule of attribution is given is not needed (or required) in the common corporate tax base of CCCTB. Attribution of future expenses to future revenue will generally not occur, as expenses will either fall under Article 17 CCTB 2016 (deduction as cost when the obligation to make the payment has arisen), or under specific exceptions such as Articles 19 or 23 CCTB 2016. The general idea of expenses that are costs of future years by nature, such as period bound costs, does not occur under the common corporate tax base of CCCTB. It can even be stated that the common corporate tax base of CCCTB mainly consists of a limited amount of strict attribution rules that do not measure performance in a specific way and only take the ability to pay taxes into account in a rather crude way. The perceived upside is that this should lead to a relatively easy-to-follow system which thus can decrease compliance costs. The downsides are that the perceived savings are offset by the fact that the common corporate tax base of CCCTB is a

852 Following the basic model of Articles 9, 15 and 17 CCTB 2016.
853 See Chapter 3.

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standalone system which necessitates a standalone determination of taxable income and in certain places the common corporate tax base of CCCTB is not very clear and might in fact not be as easy-to-follow as is implied. Mostly however, the downside of CCCTB is that its crudeness can lead to unreasonable outcomes and there is no effective way to prohibit that other than changing the directive itself.

4.6.2.2.3 **The eventual settlement of the amount is expected to result in a deductible expense**

The criterion that the eventual settlement of the amount is expected to result in a deductible expense is comparable to a similar criterion in IFRS, sound business practice and the German and United Kingdom systems. First of all, it mentions the eventual settlement and not the settlement that is used for measurement. Secondly, the question remains when a deductible expense is expected, in the sense of how probable it must be in order to be recognised. The common corporate tax base of CCCTB does not mention explicit percentages, although ‘expected’ suggests more than 50% since it can be argued that an expense is not expected when the chance of occurrence is less than 50%. This also follows from IAS 37, which requires the chance of occurring to be ‘more likely than not’ and which has been a large influence on Article 23 CCTB 2016. The expected outflow must also constitute a deductible expense, in the sense that it must have certain characteristics that make it deductible. Repayment of a loan, for example, is not deductible.

4.6.2.2.4 **Outflow**

Article 23 CCTB 2016 mentions explicitly that it revolves around expenses, as it only mentions the deduction of amounts from an obligation. Apart from that, Article 23 CCTB 2016 is to be understood as an exception to Article 17 CCTB 2016, which deals with the general rules for deduction of costs. Deferral of revenue is not dealt with in Article 23 CCTB 2016, therefore this article can only attribute expected outflows. It is therefore striking that Article 23, Paragraph 2 under (d) CCTB 2016 states that future benefits directly linked to the event giving rise to the provision shall be taken into account, which indicates that Article 23 CCTB 2016 is also an exception to the attribution of revenue in Article 16 CCTB 2016. This will be dealt with in the next paragraphs. Although Article 23 CCTB 2016 does not state as much, it can be expected that the deductible expense can be a monetary or a non-monetary amount (in kind).

4.6.2.2.5 **Obligations**

Article 23 CCTB 2016 clearly states that it only allows the deduction of expected expenses arising from legal obligations or probable future legal obligations. The first issue is that it does not allow the deduction of expected
expenses arising from constructive obligations.\textsuperscript{854} This likely has its origin in the idea that allowing the recognition of provisions only for legal obligations and not for constructive obligations leads to a clearer and less subjective criterion.\textsuperscript{855} However, this also implies that it is easy (and possible) to strictly differentiate between legal and constructive obligations, which is generally not the case. The Working Group stated that it was not convinced by the argument that constructive obligations could easily be turned into contractual obligations, but did not delve into the issue further or otherwise explained their point.\textsuperscript{856}

From a Dutch legal perspective it is particularly difficult to differentiate strictly between a constructive and legal obligation. A constructive obligation can actually turn into a legal obligation at a certain point. This means that the statement of the Working Group might actually be wrong. The second issue is that the addition of ‘probable future legal obligations’ in the common corporate tax base of CCCTB\textsuperscript{857} implies that, contrary to IFRS and United Kingdom FRS 102, a present obligation is not strictly required, although it is rather unclear what constitutes a ‘probable future legal obligation’. As it is an addition, compared to IAS 37, this would imply that it leads to an additional coverage when compared to IAS 37, but it is unclear what this addition would be. The Working Papers provide no guidance in this. It is possible that claims and warranties are meant by this.

It will not always be clear whether an actual obligation is already present, when a claim is brought before the courts, but has not been decided upon by the court. In the case of warranties the moment when an obligation can be present is even earlier. When a sale is made for which a warranty is given by the enterprise, there can be an obligation when a certain percentage of the products is faulty, but, especially in the case of large groups of homogenous items, the actual item that leads to the outflow has yet to present itself and therefore the person who will claim the warranty will not yet be known. The problem is, when these are called ‘probable future legal obligations’ and no further guidance is given, the scope will not be limited to claims and warranties.

The concept of a probable future legal obligation even hints that the ‘arising in-criterion’ is not to be understood as the obligating event (as of yet, no obligation is present when it is a probable future legal obligation). It is hard to imagine that

\textsuperscript{854} The fact this was a conscious decision is explicitly confirmed by Working document of the Common Consolidated Corporate Tax Base Working Group nr. 57 of the year 2007. See also Working document of the Common Consolidated Corporate Tax Base Working Group nr. 21 of the year 2005.

\textsuperscript{855} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 21 of the year 2005 states that the addition of constructive obligations could lead to tax planning.

\textsuperscript{856} Working document of the Common Consolidated Corporate Tax Base Working Group nr. 21 of the year 2005.

\textsuperscript{857} When compared to International Accounting Standard 37, 	extit{Provisions, Contingent Liabilities and Contingent Assets} 37.10 this is an addition.
CHAPTER 4. PROVISIONS AND SIMILAR ENTRIES

this is actually the desired effect. It seems much more plausible that in this sense no addition is meant, compared to IFRS, but only a clarification. The fact that it also fails at doing the latter is a different story. Furthermore, the combination of ‘arising from past activities or transactions’ and ‘probable future legal obligations’ is inconsistent.

The question is what makes an obligation a future obligation (instead of a present obligation). If there is an obligating event that has to take place in the future, then currently no (present) obligation exists. Still, Article 23 CCTB 2016 requires that the legal obligation or probable future legal obligation arises from activities or transactions carried out in that or previous years. This might imply that a probable obligation is present, which is dependent on a future event that is not within control of the entity itself. It could also stress the situation that occurs when a claim is made against the entity, which is expected to lead to a legal obligation, although this situation is already covered by IAS 37.\footnote{Working document of the Common Consolidated Corporate Tax Base Working Group nr. 57 of the year 2007, p. 10 mentions the ‘likely legal obligation’, such as potential warranty claims. However, these are already covered in International Accounting Standard 37’s approach to a present obligation and thus does not explain the ‘probable future legal obligation’.

An obligation can exist, while enforceability is not present (yet), but this is the case for most kinds of provisions in the other systems (these obligations would still be considered to be present under IAS 37 despite the fact that they are not yet due), so it does not lead to a practical addition. Another possibility is that IAS 37 and Article 23 CCTB 2016 do not approach the concept of an obligation in the same way.

For example, when an enterprise starts working on a quarry, which it knows it is obliged to fill up once the business either ends or the quarry is empty, this would constitute a present obligation under IFRS. It is very much possible that the common corporate tax base of CCCTB has been written from the approach that this does not constitute a present legal obligation, but it is a probable future legal obligation. It is not mentioned what the relation is between the eventual settlement of the amount being expected to result in a deductible expense and a future legal obligation being probable: both expected and probable would imply an amount of probability, but it is unclear whether this is the same amount or percentage of probability. To my mind, it is likely that it is (with both requiring ‘more likely than not’), but this is not clarified at any point in either the common corporate tax base of CCCTB itself or in the Working Papers. Thirdly, the criterion of a legal obligation also means that provisions for deferred repair and maintenance are not permitted, unless the criterion of a ‘probable future legal obligation’ would be stretched so far that they would include the expected bill after the repair or maintenance that has taken place (which is obviously not the objective, given the statements made by the working group). Provisions for restructuring are generally based on constructive obligations. It is therefore
unlikely that the common corporate tax base of CCCTB would allow the deduction of costs for future restructuring on the basis of probable future legal obligations, although, at one point the costs forming the restructuring provisions will become legal obligations.

Any requirement for an obligation to be enforceable by legal or equivalent means would refer to the *mechanism* that creates an obligation. It would not affect the assessment of *when* that obligation arises (which in effect, determines the attribution). In other words, it would not rule out obligations that would become enforceable only on the occurrence of an uncertain future event. The relationship between the obligation and the enforceability of the payment is not explicit in Article 23 CCTB 2016. At first sight, the recognition of an expense in the case of a provision is dependent on the existence of an obligation. This means that the obligating event (the event that led to the obligation) must have taken place in the year in which the amount is deducted, or in an earlier year. Difficulties arise mostly because of the criterion of a probable future legal obligation, which implies that the *obligating event* could take place in a future year, which would present a unique problem: the probable future legal obligation can, in theory lead to the recognition of a provision, but as the obligating event takes place in a future year, it cannot practically lead to the recognition of a provision. It seems unlikely that this would be the background of this ‘probable future legal obligation’. Unlike the German approach, internal obligations are not recognised in Article 23 CCTB 2016.

Legal obligations and probable future legal obligations are obligations towards third parties (it is impossible to have a legal obligation towards oneself). When an obligation is not yet present and its occurrence and therefore its existence is under the control of the entity, no obligation exists yet. Therefore the requirement of Article 23 CCTB 2016 of a ‘legal obligation’ cannot be met. It can be argued that this is what is meant by a ‘probable future legal obligation’ but this cannot be proven, as neither the working group nor the European Commission has given insight into what constitutes a ‘probable future legal obligation’. When the entity has control over the obligation, the future action to be taken by the entity prevents that the obligation arises from activities or transactions carried out in that, or previous years. In my opinion, it will be the future action that leads to the expense. Therefore, it is unlikely that when an obligation is dependent on an entity’s future actions that costs can be deducted on the basis of Article 23 CCTB 2016. The same applies when the existence of the obligation is dependent on a future event outside the control of the entity. When the obligation can be reversed by a future event within the control of the entity, it can be argued that an obligation is present. When a future reversal of the obligation is likely, either within the control of the entity or outside the control of the entity, an obligation is still present at the end of the reporting period. However, it can be argued that an actual outflow is not probable and thus no costs can be deducted as a provision, as not all the requirements are met. As is shown above, the way the common corporate tax base of CCCTB deals with obligations is an obvious problem. Apart from the fact that limiting the
recognition of a provision to legal obligations will, in my opinion, not lead to less subjectivism, the concept of ‘probable future legal obligations’ creates more problems than it solves. It is actually a worse approach than IAS 37, which has been used as a starting point for the design of Article 23 CCTB 2016, but was altered nonetheless. No guidance whatsoever to improve the practical application of Article 23 CCTB 2016 is provided. A thorough rethinking of this part of Article 23 CCTB 2016 is not only desirable but absolutely necessary.

4.6.2.2.6 Amounts that accrue over the course of the years

Article 23, Paragraph 1 under (2) CCTB 2016 states that where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. This is the only part of Article 23 CCTB 2016 that actually refers to a spread over multiple years. It is striking to refer to a spread based on matching costs with revenue in a system that is primarily based on obligations. It would make the most sense in an obligation-based approach that the obligation is measured annually and that the increase (or decrease) of the obligation as such is taken into account as a positive or negative cost. A provision would then be recognised once a legal obligation is present. The second Paragraph of Article 23 CCTB 2016 states that a reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year.

For example, an entity expects that its activities damage the environment and that it has a legal obligation to clean this up as soon as it stops its activities after ten years. It expects the cost of clean-up to be € 100.000, consisting of €50.000 fixed costs and € 5.000 variable costs annually. After one year, the obligation would be measured at € 55.000 (€ 50.000 + € 5.000) and after two years at € 60.000 (€ 50.000 + 2* € 5.000) and so on.

Spreading the costs proportionally over years is contrary to this approach.

For example, consider the numbers of the last example, it would lead to a measurement of € 10.000 after one year (€ 100.000 / 10), € 20.000 after two years and so on, which is contrary to the measurement of the actual obligations at the end of the reporting period.

The second sentence of Article 23, Paragraph 1 CCTB 2016 seems to hint at the situation where the obligation exists at a certain point, but where the build-up continues over future years. Another possible interpretation is that it refers to the case where an obligation is expected to occur in the future, but its build-up takes multiple years. The first situation is in itself purely a matter of measurement. In the case of pollution for example, the amount upon first recognition will

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859 Article 23, Paragraph 1 under (2) CCTB 2016.
generally be larger than in the following years, as the cleaning up of pollution will generally have a fixed component that occurs upon first recognition and a variable component that will continue over the years. However, WP/057 gives the final clean-up of pollution as an example of costs that are to be spread over the estimated duration, in which no notice is taken that this is contrary to the approach of Article 23 CCTB 2016 where the settlement value of the obligation is to be taken into account (directly and as such). The second situation can only occur when an obligation is not yet present, but expected in the future. This would be consistent with the concept of a ‘future legal obligation’, but it is not clear that this is what is meant. This means that the common corporate tax base of CCCTB uses a concept of a spread of costs of a future expense that is contrary to the basics of its own approach. In a full obligation-based approach, the full cost will be taken into consideration once the legal obligation is present. In an attribution-based approach, it is simply the part of the future expense that is economically connected to that particular year. The problem is that the approach mentioned in the common corporate tax base of CCCTB is currently neither. It is neither a full obligation-based approach (like IFRS), as it includes both the ‘probable future legal obligation’ and spread of costs, nor is it a full attribution-based approach (like Dutch sound business practice), as it leans heavily on the concept of an obligation. This means that problems are bound to arise with the application of Article 23 CCTB 2016. These will initially be approached differently in the different Member States, which all have different backgrounds in treating provisions and only after a period of time will the European Court of Justice decide on the issues. This means that clarity depends on several factors:
1) whether taxpayers or tax offices bring the issues to court in the first place, which is often a mere economical choice;
2) when the cases are brought before the courts and;
3) whether the European Court of Justice will decide to motivate its decision in a broader perspective.

This is, in my view, a highly undesirable situation, which could be solved by either providing more guidance by the European Commission or by clarifying the text of the article.

4.6.2.2.7 Reliable estimate

As in IAS 37, Article 23, Paragraph 2 CCTB 2016 requires that the obligation can be reliably estimated. It is not explicitly stated in the common corporate tax base of CCCTB when an estimate is reliable enough to meet this requirement. Provisions are uncertain by nature and therefore estimation and measurement will always be an issue. It seems undesirable that Member States of the European Union would require different forms and amounts of proof with regards to the reliability of the estimation. Article 23, Paragraph 2 CCTB 2016 mentions past experience as a factor in the process of estimation. Using the criteria or practices from regular financial accounting might not solve the issue.
properly. Since the tendencies of taxpayers tend to differ from the tendencies of entities preparing their commercial accounts, the end result can be different.

General purpose financial reporting leads to insights on which the users of the information can base their opinion, while accounting for tax purposes leads to a certain amount of tax payable. It will often be the case in regular accounting that entities tend to underestimate provisions. Therefore the requirement of a reliable estimate must not be taken as too limiting in the sense that entities can use it as an excuse not to recognise a provision. In that sense a rough estimate is still better than no estimate. For tax purposes, the inclination will generally be to recognise provisions as much a possible as they defer taxes. In this sense the reliable estimation is much more of a limiting factor. This is especially true since the common corporate tax base of CCCTB is meant as a standalone tax base, so that tax considerations and considerations for the commercial accounts or otherwise general purpose financial accounts have only limited overlap and leave room for separate tendencies.

The second issue is that an entity cannot always fall back on past experience, either because there is no past experience for a specific product or because the information is not available to the entity. For individual cases (as opposed to large numbers of homogenous products) this will be especially problematic. Also, when an entity is starting out with homogenous products that are not really comparable to existing products, this might lead to an entity being able to deduct less costs on the basis of Article 23 CCTB 2016 compared to an entity that has more years of experience with a certain product. This leads to something of an unfair advantage. On the other hand, when not much proof is available, taxpayers might overestimate the expected future outflow and the probability connected to it. Without proof of some sorts, national tax offices should be able to decline a taxpayer such deductions. Furthermore, entities that are just starting out generally make less profit to begin with (and will often turn a loss), which implies that it might not be that necessary to grant further deductions. Article 23, Paragraph 3 under (a) CCTB 2016 mentions that provisions shall not be deducted for contingent losses, which, although it does not define contingency, on the one hand makes sense but on the other hand creates even more tension with the concept of a probable future legal obligation.

4.6.2.2.8 Article 23, Paragraph 3 CCTB 2016

A new addition compared to the 2011 CCCTB-proposal is Article 23, Paragraph 3 CCTB 2016 which states that provisions shall not be deducted for contingent losses or future cost increases. Both show an amount of tension with the existing text of Article 23 CCTB 2016. It makes sense that contingent losses cannot be taken into account, but this increases the problems with the concept of a

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probable future legal obligation. Not taking future cost increases into account is primarily a measurement issue and therefore should have been included in Article 23, Paragraph 2 CCTB 2016.

4.6.2.3 Measurement

Article 23, Paragraph 2 CCTB 2016 states that a reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year. Since it is often unlikely that the entity will effectively settle the obligation at the end of the particular tax year, but instead will most likely pay the eventual outflow (which might take place long after the end of the reporting year in question), this is a striking issue.

For example, when an entity has an obligation of which timing and amount are uncertain, the settlement value at the end of the current reporting period might be € 70,000, whereas the nominal amount is € 100,000. Years later it becomes clear that the nominal value has to be paid. When the enterprise is not willing or in a position to settle the amount, it makes no sense to use settlement value as the basis for measurement.

Because there is only a limited active market for the trade in liabilities (this will be mostly pensions and the like) and therefore ‘market value’ is mostly a fiction for liabilities and that oftentimes settlement is not possible because one or both of the parties is not willing to settle, it would make the most sense to measure the amount of the expected future outflow and not the fictitious settlement value. It may be that settlement value is thought to be less subjective for one reason or another, but that is highly debatable, as no market value will generally be present, apart from pensions and similar entries. Article 23, Paragraph 2 under (a) CCTB 2016 states that account shall be taken of all risks and uncertainties, but that uncertainty shall not justify the creation of excessive provisions. This addition seems to be a filler, as settlement value and all relevant factors are already mentioned in Article 23, Paragraph 2 first sentence 2016. This would already include all risks and uncertainties and exclude uncertainty leading to the creation of excessive provisions. Furthermore, Article 23, Paragraph 2 CCTB 2016 gives a guideline on how to measure a present legal obligation, but not how to measure a probable future legal obligation. This also implies that it is highly unclear what a probable future legal obligation is and what its purpose is, as there are even no rules on how to measure a probable future legal obligation.

Article 23, Paragraph 2 under (b) CCTB 2016 states that if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends. Again, it is striking that the method used for measurement in Article 23, Paragraph 2 CCTB 2016 is settlement at the end of
the year, but in Paragraph 2 under (b) the term of the provision is taken into account.

The basis is either settlement value, which will, by nature, need to include an aspect of the time value of money, or the basis is the expected outflow, of which the present value is determined and thus the time value of money needs to be determined additionally. Settlement value means that the determined term of the outflow is always shorter than 12 months and that no present value would have to be taken into account. This would be different when there would be a set of rules or otherwise guidance on how settlement value is to be determined and of which present value is an aspect, but since this is not the case, Article 23, Paragraph 2 under (b) CCTB 2016 seems to be out of place. Article 23, Paragraph 3 under (b) CCTB 2016 also mentions that provisions shall not be deducted for future cost increases. Again, although I do agree with this, it is actually already dealt with in using settlement value at the end of the reporting period in Article 23, Paragraph 1 CCTB 2016. Like under the other systems, a differentiation must be made between several categories of obligations, even when Article 23 CCTB 2016 does not do so itself. First of all the issue of single, individual outcomes that either occur or do not must be mentioned.

An example of this is when there is a 60% chance that an expense to the amount of a 100 will occur and a 40% that it will not occur (leading to no outflow). Article 23, Paragraph 2 CCTB 2016 states that a reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year. Settlement value in this example would be 60 (60% x 100 + 40% x 0), as rationally both parties would be willing to settle at 60, when they would have access to full information.

The drawback of this is that the probability that the outflow will actually occur is 60% and when the outflow occurs (which is therefore probable), the expense is 100, leading to an additional deduction of 40 on the basis of Article 17 CCTB 2016 when the obligation to make the payment has actually arisen. An entity should have been able to deduct this amount from taxes at an earlier stage, thus keeping liquidity, needed for payment of the amount for which the provision was recognised, in the entity instead of flowing out as taxes and flowing back at a later stage when they are eventually deducted.

The current approach in the common corporate tax base of CCCTB is inconsistent with the ability to pay taxes. Settlement value makes that probability is to be taken into account twice: once for recognition and once for measurement. It is my opinion that, with the exception of a very few cases (such as when a settlement is actually likely at the end of the reporting period), settlement value, especially at the end of the reporting period, is not the right approach to measuring a provision. Individual items with multiple possible outcomes are also measured at settlement value. This means that the expected value must be used, whereby the outcomes that are to be taken into account
cannot be the outcomes on the longer term, but have to be taken into account at their value at the end of the reporting period.

Consider the following:
- 10% outcome 0
- 10% outcome 15
- 10% outcome 50
- 35% outcome 60
- 30% outcome 95
- 5% outcome 100

The single most likely outcome is 60, as there is a 35% probability that the outcome will be 60 and the probabilities linked to the other amounts are less. The expected value is 61, calculated as: 

\[ (10\% \times 0) + (10\% \times 15) + (10\% \times 50) + (35\% \times 60) + (30\% \times 95) + (5\% \times 100). \]

When approached from the number of outcomes, most outcomes are below 60 (3 below versus 2 above), indicating that measurement must be less than 60. In percentages, most outcomes are above 60 (35% above versus 30% below), indicating that measurement must be more than 60.

The fact that settlement value is prescribed by Article 23, Paragraph 1 CCTB 2016 implies that the best measurement would be 61 in this particular case, as the expected value is likely to be the best approach of settlement value.

Large population of homogenous items can exist, that, individually, would not meet the existence criteria (as their individual probability of leading to an outflow of resources would be lower than 50%). As a group, however, (in the case of for example warranties), it can be a given fact that a certain percentage is expected to lead to an outflow, although which individual ones will lead to an outflow of resources is unknown. The common corporate tax base of CCCTB does not explicitly state that this can constitute an obligation before an individual obligation occurs. It is therefore not clear whether the statistical evidence of large numbers can lead to a provision, although it is likely that it can.

An argument in favour of recognising a provision in such a situation (such as warranties in the case of a large amount of similar items) is that this could fall under the category ‘probable future legal obligations, arising from activities or transactions’, in Article 23, Paragraph 1 CCTB 2016. Also, Article 23, Paragraph 2 CCTB 2016 mentions that the estimate must be based on all relevant factors, including past experience of the company, group or industry. This can be read as a reference to situations where a large population of similar products exist. Article 23, Paragraph 2 CCTB 2016 does not give any guidance or direction on how evidence must be delivered. When statistical evidence must

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861 Which will generally be based on historical empirical evidence.
be presented, new entities or entities that develop new products or entities that produce or sell non-homogenous products would be facing problems delivering the right statistical evidence. Whether or not to use the weighted average method for measurement, as IAS 37 requires, is not mentioned in Article 23 CCTB 2016.

Since expected value and settlement value are generally highly compatible, it would make sense to use the weighted average method as this leads to the expected value. As to future price- and cost increases, Article 23, Paragraph 2 under (c) CCTB 2016 mentions that future events shall be taken into account where they can reasonably be expected to occur. This implies that, contrary to Dutch tax law, future price- and cost increases (as they can reasonably be expected to occur) shall be taken into account. However, Article 23, Paragraph 1 CCTB 2016 states that the cost to be deducted is the settlement value at the date of the balance sheet. In this respect, future price- and cost increases would already have been taken into account. This is the same argument that goes for the notion of present value: the use of settlement value would have required both to be taken into account anyway. Article 23, Paragraph 3 under (b) CCTB 2016 is clear in that respect: provisions shall not be deducted for future cost increases.

4.6.2.4 Catching up in later years

Article 23 CCTB 2016 does not mention the situation where the amount could have been deducted as a provision in an earlier year, but the enterprise did not do so. The fact that Article 23, Paragraph 1 CCTB 2016 mentions ‘arising from activities or transactions carried out in that, or previous tax years’, implies that, in theory, catching up would be allowed if the situation would call for it. In years following the obligating event, the enterprise would still be entitled to deduct the amount. The downside of this is that this adds an amount of subjectivity to the measurement of the performance and to the balance sheet; the enterprise would be able to steer profit in this way. This would not be the case when it would be clear that it is obligatory to recognise a provision. As stated before, Article 23 CCTB 2016 is particularly unclear with respect to whether the deduction of amounts is obligatory (see Paragraph 4.6.2.6).

The second aspect is that the second part of the first Paragraph of Article 23 CCTB 2016 determines that certain continuing activities lead to a spread of the deduction over the years, which creates a maximum to the amount that can be deducted annually. It is unclear what happens to this spread when an entity decides not to deduct in a certain year: can this lead to a higher deduction in a later year or not?

Also, the role of Article 6, Paragraph 3 CCTB 2016 is unclear in this respect. It requires consistency in determining the tax base. It can be argued that not deducting for the recognition of a provision in one year, while meeting the
criteria, would not be consistent with deducting for the recognition of a provision in the next year.

4.6.2.5 Compensation and other connected income

In Article 23 CCTB 2016 no explicit mention is made that, as a requirement, the expected outflow must be uncompensated. However, in measuring a provision, future benefits directly linked to the event giving rise to the provision shall be taken into account, according to Article 23, Paragraph 2 under (d) CCTB 2016. What is meant by ‘taking into account future benefits directly linked to the event giving rise to the provision’ is not elaborated upon further in the common corporate tax base of CCCTB. It is likely that this means that in such a case the related in- and outflow must be offset, which will decrease the amount that can be deducted. As both revenue and expense are attributed to the same period in this situation, this would create an amount of tension between Article 23 CCTB 2016 and Articles 7, 15 and 16 CCTB 2016. Article 23 CCTB 2016 requires ‘future benefits’ that would otherwise have been taken into account on the basis of Articles 7, 15 and 16 CCTB 2016, to be attributed to the period in which the provision is recognised and the amount deducted. However, Article 23 CCTB 2016 is, according to its first sentence, an exception to Article 17 CCTB 2016. Nowhere is stated that Article 23 CCTB 2016 determines when income is recognised as revenue and thus creates an exception to Article 16 CCTB 2016. No explanation for this inconsistency is given in the Working Papers. It means that deductibility is dependent on the existence of ‘future benefits’, which would constitute a rare form of reverse matching.863 With respect to the future benefits, Article 23 CCTB 2016 makes no clear distinction between parties from whom benefits are received or expected to be received. No explicit rules with regards to the recognition and measurement of onerous contracts are given, apart from Article 23, Paragraph 2 under (d) CCTB 2016.

4.6.2.6 Mandatory or optional recognition

The wording of Article 23, Paragraph 1 CCTB 2016 states that when the criteria are met, the amount arising from the legal obligation or probable future legal obligation ‘shall be deductible’. It is unclear whether this means that recognition of a provision is obligatory, as it is under IFRS, or that the entity has an option whether or not to recognise the provision and thus deduct the measured amount. Such indistinctness is particularly unwelcome in a stand-alone tax base that seeks to harmonise corporation tax in the European Union.

863 Reverse matching would technically not occur when it is only the loss (the amount by which the costs exceed the revenue) is attributed and the revenue and cost itself are attributed to the period in which the revenue occurs. However, this would technically lead to tension with Article 23 CCTB 2016 itself, as it would mean that the outflow is not taken into account fully in one step.
4.6.2.7 Place in the system

Under the common corporate tax base of CCCTB, the recognition of a provision is primarily an exception to the regular system of attribution of expenses, as required by Articles 7, 15, 16 and 17 CCTB 2016. No principle requires that a provision can or must be recognised.

4.7 Summary and comparison

4.7.1 Introduction

In this chapter provisions and entries similar to provisions have been described and analysed in detail with regards to the Netherlands, Germany, the United Kingdom, IFRS and the common corporate tax base of CCCTB. In the next paragraph a summary and a comparison are given.

4.7.2 Summary and comparison

4.7.2.1 Liabilities

All systems except the common corporate tax base of CCCTB recognise liabilities as an overarching concept for expected future outflows. IFRS and United Kingdom FRS define a liability as a present obligation of the entity, arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. This means that the main theme is the fact that a liability is a (present) obligation, therefore a future outflow towards a third party over which the enterprise has little or no control. From the viewpoint of users of financial information this provides an additional insight in the future cash-flows of the enterprise. German law does not provide a definition of liabilities (‘Fremdkapital’) but since it consists of entries that can either represent an outflow over which the enterprise has little or no control or an outflow that is expected and necessarily which follows from continuation of the business (but over which the enterprise has full or a large amount of control), the control-issue is present but not dominant. This makes it indistinct what the exact cut-off for liabilities is, which decreases the information value. It predominantly represents expected future outflows, which are matched with a year to which they are thought to relate. Dutch tax law is comparable in this sense, as it also allows the recognition of liabilities over which the enterprise has control, such as maintenance and repairs. Therefore liabilities under Dutch tax law represent expected future outflows, rather than expected future outflows over which the enterprise has little or no control. This means that additional criteria are needed to determine to which year the outflow relates.

The common corporate tax base of CCCTB does not require a balance sheet and does not recognise liabilities as such, despite what is mentioned in the working papers of the CCCTB working group. Effectively an expected future outflow
can be deducted on the basis of Article 17 CCTB 2016 or Article 23 CCTB 2016. Article 23 CCTB 2016, despite having the title ‘Provisions’ is written in such a manner that entries that would constitute other types of liabilities can theoretically fall under Article 23 CCTB 2016 as well (it is not limited to liabilities of uncertain timing or amount). The approach in the common corporate tax base of CCCTB is unique in such a manner that a comparison with existing systems is not easy. Although it is based on IFRS in some aspects, it lacks a balance sheet and is unconnected to existing systems and follows its own rules in a number of aspects. This is also an Achilles’ heel of the common corporate tax base of CCCTB as it leads to difficulties in translating the regular accounts into taxable income and therefore creates an administrative burden in itself. All systems except the common corporate tax base of CCCTB differentiate between several types of liabilities, which also follows from CCCTB’s lack of a balance sheet. IFRS, United Kingdom FRS, German law and Dutch law explicitly recognise provisions and accruals. Debts are not explicitly recognised under IFRS and United Kingdom FRS, but are part of liabilities in general. There’s no strict dividing line between provisions, accruals and other liabilities. IFRS is the most explicit in stating that provisions are liabilities that are uncertain in timing or amount, whereas accruals tend to be less certain. The fact that they all are liabilities is likely seen as more important than what type of liability they are, as no guidance is given on the amount of uncertainty needed to call an entry a provision. However, in general purpose financial accounting, the information whether a liability is certain in timing and/or amount is relevant. Stricter criteria as to what differentiates provisions, accruals and other liabilities are therefore needed. This goes for IFRS, FRS and the German system. For tax law this differentiation is essentially irrelevant, as the role of the balance sheet is quite different than under general purpose financial reporting. However, in Dutch tax law, the criteria differ for when a debt is to be recognised (which is generally obligatory) and when a provision can be recognised (which is generally optional), which makes it highly relevant to be able to determine the different types of liabilities. As stated, deduction of costs under the common corporate tax base of CCCTB follows a different regime.

4.7.2.2 Accruals

IFRS and German law mention accruals but do not elaborate on them. FRS and the common corporate tax base of CCCTB do not define accruals, although it is likely that they can be recognised under FRS. Dutch tax law is decidedly more elaborate on the theme of accruals than the other systems are. Especially in the case of accruals that lead to the deferral of income, which lead to the same effect as provisions do, a number of specific entries occur that are unknown in the other systems, but that do justice to the ability to pay taxes principle. This follows from the open norm of sound business practice, which leads to the Dutch Supreme Court being very much involved in the creation of the rules which govern the tax base in the Netherlands. The most striking is the entry that occurs when a reimbursement is received specifically for expected future expenses, but for which
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no obligation exists. Not taxing these amounts and offsetting them when the expenses occur leave the liquidity of the enterprise intact, insofar that taxing the amount would take resources out of the enterprise that are needed to pay the future expense. The other systems do not recognise a similar amount, but IFRS, FRS and German law are basically written as general purpose accounting rules, whereas the common corporate tax base of CCCTB provides tax-only rules. The fact that the common corporate tax base of CCCTB does not recognise similar entries is striking when compared to Dutch sound business practice.

4.7.2.3 Deductible reserves

Dutch sound business practice is also the only one of the researched systems that recognises deductible ‘fiscal’ reserves. The added value of these is debatable. The current scope of reserve for equalisation of costs is so limited when compared to the current rules on recognising provisions that it might as well be removed (in the sense that the current scope of provisions in Dutch tax law include the reserve for equalisation of costs). The Dutch reserve for old-age is a specific entry that does not apply to entities and is likely to be removed in the short term as well. The reserve for reinvestment is beneficial from a substance-point of view, but there is no real necessity for this to be a reserve, as both German and United Kingdom tax law and the common corporate tax base of CCCTB recognise a similar facility without needing the whole concept of fiscal reserves. Removing the whole concept of fiscal reserves from Dutch tax law would lead to less complexity in Dutch law and is therefore recommendable.

4.7.2.4 Provisions

4.7.2.4.1 Definition of a provision

IFRS and FRS define provisions as liabilities of uncertain timing or amount. A similar definition is not present in the other systems. This definition says something about the character of a provision (as it must be either uncertain in timing or in amount). This adds something to the information value of labelling an entry as a provision, but IFRS does not elaborate on what exactly constitutes uncertainty, which makes it rather hard to draw a line between provisions, accruals and other liabilities such as debts. Only when more guidance is provided as to what uncertainty in timing or amount is, is this useful. Apart from that, provisions are more or less defined by the requirements of recognition. These are not similar for all systems, but a large amount of overlap occurs. In IFRS and FRS it is striking that the uncertainty in timing or amount is not part of the requirements. This creates tension in the relation between this uncertainty and the requirements of recognition.

4.7.2.4.2 Types of provision

German law is the only one of the systems that explicitly differentiates between
two types of provisions, namely the provisions for uncertain external obligations and the provisions for internal obligations. The latter are not obligations towards third parties (under IFRS, United Kingdom FRS and the common corporate tax base of CCCTB they would not be considered obligations). Dutch tax law does not differentiate explicitly between these two types, but does allow the recognition of provisions for both types of situations, as it lacks a requirement of an obligation.

4.7.2.4.3 Requirements for the recognition of a provision

Arising from past events
All of the researched systems require the presence of a past event of some sort that gave rise to the expected future outflow. In IFRS and FRS, where an obligation is required in order to recognise a provision, this is relatively clear: this is the obligating event, the event that creates a legal or constructive obligation that results in an entity having no realistic alternative than settling that obligation. This obligation must exist independent of the entity’s future actions to be present.

Under German law, which is already less clear with regards to the role of obligations in financial reporting and determination of taxable income, this criterion is not explicitly required by law. The German tax authorities and the German Federal Fiscal Court have different views in this matter. That makes it unclear what role the relevant economic event plays in the requirements for recognition of a provision. Under Dutch tax law it is required that the future expenses originate from facts or circumstances that occurred prior to the date of the balance sheet. Since Dutch tax law does not require the presence of an obligation at the end of the reporting period in order to recognise a provision, it is not as clear as under IFRS and United Kingdom FRS that explicitly recognise the concept of an ‘obligating event’. Multiple causes lead to the eventual future outflow and thus without the requirement of a present obligation, these are all relevant past events, which effectively diminishes the role of this criterion. This creates a necessity for an additional criterion: the criterion of sound business practice, in order to be able to attribute inflows and outflows to the applicable year. It is argued that the ‘arising from-criterion’ has actually become obsolete because of this.

A similar problem occurs in the common corporate tax base of CCCTB. Article 23 CCTB 2016 states that in order to be able to deduct an amount following from an obligation, the taxpayer must have a legal obligation or a probable future legal obligation, arising from activities or transactions carried out in that or previous tax years. Since a probable future legal obligation is not yet a present obligation, the actual obligating event that created the actual obligation does not yet have to have taken place anyway. This means that a vast array of possible causes can lead up to the probable future legal obligation and this makes it a criterion that is not distinguishing enough. This could be solved by simply removing the ‘probable future legal obligations’ from Article 23 CCTB
2016. Apart from that, Article 23 CCTB 2016 requires that the obligation arises from activities or transactions carried out in that or previous years. This active form is not required in the other systems (Dutch tax law requires ‘facts or circumstances’ and IFRS and FRS require ‘past events’). The literal wording might suggest otherwise, but from a practical point of view it is highly unlikely that this is meant as a different approach.

Attributable to the year
When the presence of a present obligation is not required for the recognition of a provision, requiring an obligating event does not make sense as there will generally be a number of events leading up to the outflow and when a present obligation is not required, there will be no decisive event that leads up to the outflow. Dutch tax law therefore adds the sound business practice criterion, which states that the costs must also be otherwise attributable to the year in which the provision is recognised. This makes sense in an approach that does not require the presence of an obligation towards a third party (either legal or constructive). German law is not fully consistent in this area, as it does not require something similar. The common corporate tax base of CCCTB, in its quest for simplicity, has left out a similar criterion. This would not be a real issue when a present obligation is required. However, the inclusion of the probable future legal obligation in the common corporate tax base of CCCTB calls for a criterion like the Dutch sound business practice criterion. The downside to this is that it would add complexity to the common corporate tax base of CCCTB as attribution of expenses.

Probable outflow of resources
All the systems require that the expected future outflow is probable. Under FRS and IFRS probability means that the outflow must be more likely than not. Under Dutch tax law it is up for debate how probable this must be. The Dutch State Secretary of Finance mentions ‘more likely than not’, whereas case law and literature indicate 20-40% as minimum requirement. Under German law this might even be lower than 20%. Article 23 CCTB 2016 only states that the expense must be expected. This means that it is not clear whether it follows the German (low) probability or the approach in IFRS and United Kingdom FRS. It is likely that in the United Kingdom, ‘expected’ is interpreted as ‘more likely than not’ whereas in Germany it is interpreted as any reasonable expectancy, which can be as low as 10%. Further guidance in this respect is therefore absolutely necessary.

In all reality, with IFRS, as a globally recognised standard, recognising provisions on the basis of ‘more likely than not’, there is little reason to allow the recognition of provisions under Article 23 CCTB 2016 when the probability lies below 50%, purely for reasons of prudence. Otherwise this would open the door to overprovisioning. An issue that is underdeveloped, in all the researched systems, is the relation between probability and measurement, which is dealt with in more detail in the part on measurement described previously in this
chapter and which could provide an alternative to the current inconsistent approach towards probability and settlement value. Of the systems, only German law explicitly deals with groups of homogenous items, of which the probability of leading to an outflow is very low, but, when taken as a group, it is likely that an outflow will take place. Implicitly, all systems seem to recognise this issue, but, especially since it also leads to issues in measurement, it needs further development and guidance.

Outflow
All systems deal with provisions as the attribution to a current period of an expected future outflow. In that sense provisions are always an exception to the regular attribution of expenses. Dutch tax law recognises a type of accrual where reverse matching occurs: the future expenses are attributed to the future period, as are current inflows. This is however not a provision, but an accrual for the deferral of revenue.

Legal obligations, constructive obligations or probable future obligations
Recognition of provisions under IFRS and United Kingdom FRS mainly revolves around obligations. Both legal and constructive obligations can give rise to an obligation. Constructive obligations are obligations that are not enforceable by law, but the entity has created a valid expectation on the part of a third party that it will discharge its responsibilities towards that third party. It can be difficult to determine exactly whether a constructive obligation is present and even more, in some cases constructive obligations can in fact be or become legally enforceable at one point, depending on national law. The Dutch and German tax law systems do not primarily revolve around obligations, although both legal and constructive obligations can give rise to a liability and a provision. Only in the common corporate tax base of CCCTB constructive obligations cannot lead to the deduction of cost for a provision, as it strictly requires the presence of a legal obligation. Given the fact how difficult it can be to strictly differentiate between constructive and legal obligations, this does not necessarily help in keeping the system simple.

The main reason for not allowing a provision for constructive obligations will mainly be because they are thought to be more subjective (even though the working papers do not elaborate on this). As in IFRS several objective criteria are introduced to determine when a constructive obligation can be recognised, the arguments against the recognition of provisions for constructive obligations are not very valid, although the point can be made that the reversed tendencies in a tax base might make this a different discussion. Since enterprises in the European Union are already used to these criteria, there seems to be no harm in using the same criteria and allowing the recognition of provisions for constructive obligations. The main problem with obligations in the common corporate tax base of CCCTB is the concept of a ‘probable future legal obligation’. No guidance currently exists as to what these are. It implies that no obligation needs to be present at the end of the reporting period, which directly
creates a problem with the ‘arising in’ criterion, as it eliminates the need for an obligating event for the recognition of a provision. If it is not meant as an addition to IAS 37 and it just elaborates on the probability of an obligation being present (such as can be the case for claims), it is absolutely necessary that this is clarified. It could also mix up enforceability and the presence of an obligation, but, again, this should follow from the text. Unlikely, because of Article 23, Paragraph 3 under (a), CCTB 2016, is that it stretches the scope of Article 23 CCTB 2016 to situations where a cause for a future expense in the broad sense is present (such as an employment-contract being the cause for future restructuring costs), so that in the case of a planned restructuring the costs can already be recognised without legal obligations being already present. Since this comes very close to a provision for a constructive obligation, it is unlikely that this is actually meant. This is a part of Article 23 CCTB 2016 that clearly needs more work.

With regards to groups of homogenous items that individually do not meet the recognition criteria, but as a group do, IFRS and FRS do not explicitly recognise this as an obligation, but it can be derived from the examples that they are meant to do. Dutch tax law is not explicit in this either, but recognises these as well. German law is the only system where it is explicitly recognised as an issue and explicitly accepted. The common corporate tax base of CCCTB does not mention this possibility. On the one hand it would make sense that the common corporate tax base of CCCTB would allow the recognition of a provision for this situation, but on the other hand, there can be unwanted differences in interpretation in this. More clarity and guidance is necessary here.

With regards to contingencies two variables can occur. First of all, whether the entity has control over the contingency or not and second of all, whether the obligation currently exists and can be reversed or whether the obligation will exist in the future, depending on a future event. Under IFRS, when the existence of a possible obligation will be confirmed only by the occurrence of one or more uncertain future events, not wholly within the control of the entity, this cannot be recognised on the balance sheet as a liability. Neither can a liability be recognised in the case of a possible liability that is dependent on the entity’s future actions. In the case where an obligation is present, but which can be reversed, in principle a liability must be recognised. However, when the probability of reversal makes the outflow unlikely, it can be stated that no liability can be recognised. Under United Kingdom FRS, the same rules apply. The German and Dutch systems do not revolve as strictly around obligations as IFRS and United Kingdom FRS do. The German Federal Fiscal Court does not rule out that a provision can be recognised when no obligation is present yet. Whether or not the entity has control over the existence of the obligation, a provision is to be recognised when it is likely that the obligation will occur. Under Dutch sound business practice an obligation is not required for the recognition of a provision. In the past, a defining criterion was whether the enterprise could avoid the future expense or not. Under current case law, it is
unlikely that this is still relevant. When the entity has control over the outflow the main question is whether the future outflow is expected to take place and whether attribution to the current year can take place. When the future expense is dependent on a future event outside the control of the entity, a provision can be recognised when the eventual outflow is likely enough and the amount can be said to be arising before the end of the reporting period. Conditions have to be weighed in that regard.

Under the common corporate tax base of CCCTB, the concept of the ‘probable future legal obligation’ is what creates the problems for contingencies. When only the concept of a present obligation would be used, like under IFRS and United Kingdom FRS, this would be relatively clear. Only present obligations would lead to the recognition of a provision, given the fact that the eventual outflow is also likely enough (and therefore reversal of the obligation unlikely). The probable future legal obligation can lead to the recognition of a provision for conditional obligations, given the fact that the ‘arising in-criterion’ is met (which means that the fulfilment of the condition is not to be seen as the relevant issue that creates the ‘arising in’). The common corporate tax base of CCCTB needs to be clarified in this regard.

**Provisions that accrue over the course of the years**

An obligation-based approach for the recognition of provisions, such as IFRS and United Kingdom FRS means that an obligation is present or not and when it is present it is to be measured at its full value at that point in time. Attribution of costs is not the main issue in such an approach. Building up a provision over the course of the years is therefore only possible if this represents the increase of the actual obligation every year. This is therefore the way recognition has to take place under IFRS and United Kingdom FRS. The German and Dutch systems offer the possibility to spread the attribution of the costs over the years for provisions. In this method the more attribution-oriented side of these systems shows itself. Article 23 CCTB 2016 gives the impression of an obligation-based approach (although this is muddled by the probable future legal obligation), but surprisingly Article 23, Paragraph 1 under (2) CCTB 2016 states that where the obligation relates to an activity or transaction which will continue over future years, the deduction shall be spread proportionately. Again, this is striking, as Article 23 CCTB 2016 revolves around the presence of an obligation and measurement at settlement value.

**Reliable estimate**

All the researched systems in one way or another require that a reliable estimate can be made of the outflow or the obligation. In this conception it must be noted that for general purpose financial accounting, such as IFRS, there will be a tendency to not recognise provisions or otherwise to underestimate them as this will increase equity, decrease the liabilities and increase profit, whereas for tax purposes the tendency will be to overestimate the provision as this will defer taxes.
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Under general purpose financial accounting this is therefore not a limiting or very strict criterion. When an estimate is reliable enough is generally not a highly relevant question. However, for tax purposes this is a limiting criterion. When an estimate is reliable enough is a relevant point. Article 23, Paragraph 2 CCTB 2016 requires that the obligation can be reliably estimated. It is a standalone tax base, therefore without considerations for general purpose financial reporting. Lack of guidance in this respect is actually an issue here. Apart from that, it is unclear what is exactly meant that the obligation can be reliably estimated. It is actually the expected outflow or settlement value that must be estimated reliably. Plus, a probable future legal obligation is not an obligation yet. It would therefore be impossible to meet the criteria of Article 23, Paragraph 2 CCTB 2016 for this matter.

Measurement
Both IFRS and United Kingdom FRS state that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. As I have shown in the preceding paragraphs the use of settlement or transfer value does not make sense for most practical situations. There are inconsistencies in the way provisions must be measured and the settlement or transfer value (such as the use present value, while settlement or transfer value will always need to reflect present value) is often difficult to determine. German law is somewhat unclear in this area. Since 2009 the law requires settlement value, but legal history hints that what is meant is the eventual outflow of resources. Dutch tax law does not require the use of settlement or transfer value for the measurement of provisions. It is implied that what is measured is the actual expected outflow, although it can be argued that, as IFRS requires settlement or transfer value, both would be acceptable under sound business practice as well.

The common corporate tax base of CCCTB requires measurement at the expected expenditure required to settle the present obligation at the end of the year. Therefore settlement value is required. The same remarks that apply to IFRS and United Kingdom FRS in this situation apply to the common corporate tax base of CCCTB, with the added remark that a probable future legal obligation is not a present obligation and therefore cannot fall under Article 23, Paragraph 2 CCTB 2016, which is clearly not meant, as it would not make sense to provide measurement rules for provisions based on a present obligation and no measurement rules for provisions based on a probable future legal obligation. An additional issue with settlement value is that it implies that the probability of the actual outflow is to be taken into account when measuring the provision. This creates the question why the ‘more likely than not’-threshold is in place. When the probability is lower than that, it would be reflected in the measurement anyway. When using settlement or transfer value, taking liabilities into account below the 50%-threshold would provide more useful information on the balance sheet. This, however, creates the following problem and that is what not to put on the balance sheet, as there are all kinds of less probable
outflows that would need to be taken into account. What it does show is that both the 50%-threshold and settlement value, especially in combination, are likely not to be the optimal approach to measurement of provisions. Neither IFRS, United Kingdom FRS nor the common corporate tax base of CCCTB provide additional guidance on how to determine settlement value at the end of the reporting period. Settlement value implies that all parties have the same information (this is the transparency issue), which they seldom have. Furthermore, measurement of provisions for larger groups of items implies that they can be viewed as a whole instead of several individual items. From IFRS and United Kingdom FRS it can be derived that this is the case. The common corporate tax base of CCCTB, however, is not explicit in this sense.

_Catching up in later years_

One of the themes is what should happen when the entity has not recognised a provision in the past while the requirements to recognise a provision were already met: can or must the amounts be caught up in a later year? The systems that revolve around obligations for the recognition of obligations, IFRS and United Kingdom FRS, do not only allow catching up, but actually require that the full amounts are recognised when the requirements are met (catching up is the correction of an error in that respect). Although the German system revolves less around obligations than IFRS and United Kingdom FRS, this is the same under German law. In the Dutch system it is allowed to catch up the amount of the provision, but it is not strictly required. Article 23 CCTB 2016 implies that catching up would be allowed, as it is basically an obligation based approach. This, in combination with the fact that it is not strictly clear whether the recognition of a provision (in the sense of deducting the cost) is mandatory once the requirements are met, leads to the conclusion that this creates a large and unwanted possibility for the steering of taxable income.

_Compensation and other connected income_

When future income is connected to the outflow that the provision represents, IFRS and United Kingdom FRS are relatively prudent. The income is generally not presented as realised before it is virtually certain that it will be received if the entity settles the obligation. Apart from that, netting the asset and the provision is not allowed. Under German law, a provision cannot be recognised when the corresponding outflow is reimbursed, which is a different and less prudent approach than IFRS and United Kingdom FRS. IFRS and United Kingdom FRS are more prudent in this respect, when compared to German law, which is striking as, in general, it is the other way around. Dutch sound business practice will generally follow the principle of prudence and the principle of realisation, which comes down to the same approach as under IFRS and FRS. No specific Dutch case law exists on the matter.

The approach in Article 23 CCTB 2016 is somewhat in between IFRS and the German approach. It is not explicitly required that the expected outflow must be uncompensated. However, in measuring a provision, future benefits directly
linked to the event giving rise to the provision shall be taken into account. This suggests that these amounts must be offset or ‘netted’, although this is not exactly clear (‘taking future benefits into account’ is a particularly unclear description) and is systematically incorrect as this means Article 23 CCTB 2016 would not only attribute certain expenses but also certain inflows (as Article 23 CCTB 2016) defines itself to be an exception to Article 16 CCTB 2016. Like the German approach, it hints at taking income into account before it is realised, unless it means that only the excess of the expected future expense over the income is recognised as a provision.

Generally speaking, there is an argument in favour of this: why take a provision into account when it is expected that it will be reimbursed? On the other hand, under German law it is fully accepted that expenses and income (or better said: profits and losses) are attributed according to different principles by means of the principle of imparity. Creating an exception to this rule only makes the system more complex and less consistent. This applies even more to CCCTB, which not even attributes profits and losses as such, but attributes expenses and income separately, without much consideration for their interaction. Apart from reimbursements, compensation also plays a role in provisions for onerous contracts. This is the case in IFRS, under which the provision is recognised for the expected loss (expected benefits minus unavoidable costs of meeting the obligations). The same applies to onerous contracts under Dutch tax law. German law recognises the concept of provisions for onerous contracts, but does not allow their recognition for tax purposes. Under United Kingdom FRS, a similar approach is followed although both the wording of what is to be recognised and how it must be measured is, to my mind, not correct. The common corporate tax base of CCCTB gives no explicit rules on the recognition of onerous contracts, other than Article 23, Paragraph 2, under (d) CCTB 2016, which is distinctly unclear.

**Mandatory or optional recognition**

Under IFRS and United Kingdom FRS, when the requirements for the recognition of a provision are met, there is no doubt that a provision must be recognised. Under German law, there are categories of provisions that must be recognised and categories of provisions that can be recognised. Only the provisions of which the recognition is compulsory are allowed for tax purposes. Under Dutch tax law it is likely that the recognition of a provision is, in principle, not compulsory. However there are good arguments in favour of mandatory recognition of provisions under Dutch tax law as non-recognition would be contrary to economic reality. A similar situation occurs under Article 23 CCTB 2016. The wording of Article 23, Paragraph 1 CCTB 2016 implies that recognition of a provision (that is: deduction of the costs) is optional, although this seems somewhat against what CCCTB tries to achieve: a rules-based, straight forward, objective tax base. Provisions in particular are among the more subjective financial entries to begin with, which makes it inconsistent
to leave their recognition up to the taxpayer, as this gives the taxpayer a distinct instrument to steer its tax expenses over time.

*Place in the system and referral to principles and attribution of expenses.*

Based on this summary, a number of conclusions can be drawn. First of all, all systems except CCCTB differentiate between equity and liabilities. The common corporate tax base of CCCTB does not recognise the concept of a balance sheet, which is understandable from the perspective that it is a tax base only, but makes it hard to compare it with existing systems that not only approach the determination of profit from a performance perspective, but also from the perspective of the balance sheet (the German and Dutch system) or primarily from the balance sheet (IFRS and United Kingdom FRS). This does lead to the issue that it increases the administrative burden in this respect, as translation of existing accounts into taxable income under the common corporate tax base of CCCTB requires a lot of work. The lack of a balance sheet decreases auditability and enforceability. It also means that determining what the effect on the common corporate tax base of CCCTB is when debts, accruals and provisions are recognised under the other systems can be complex (the facts remain the same, it is primarily a question of what their effect on performance is under the different systems).

None of the systems IFRS, United Kingdom FRS, German law and Dutch law draw strict lines between the several types of liabilities: they all have grey areas between the several categories, which is striking as criteria for measurement differ between the several categories. Dutch sound business practice is by far the most elaborate on accruals and Dutch tax law is the most elaborate on tax deductible reserves. It is highly questionable whether these are actually necessary: especially the concept of tax deductible reserves is generally unnecessary and complicates the system.

With regards to provisions it shows that both IFRS and FRS are primarily oriented towards the balance sheet and focus on the presence of an obligation. German law and Dutch tax law are more oriented towards the performance of the entity, although German law has moved more towards IFRS in 2009. The common corporate tax base of CCCTB is unclear in this respect, mainly because of the addition of the ‘probable future legal obligation’.

The former also shows in the criteria for recognition of a provision. There is a large amount of overlap between all the researched systems, although the Dutch system, by lack of a requirement of an obligation, requires an element like the ‘sound business practice-criterion’, as it needs an additional attribution criterion, whereas when an obligation is required, attribution is already dealt with. This shows both the flexibility and the downside of the Dutch approach: attribution is flexible and dynamic, but also not always clear. With regards to obligations, it shows that the concept of an obligation is actually more complicated than it seems: it is sometimes difficult to differentiate between legal and constructive obligations, it is not always clear when an obligation is present and the concept
of a probable future obligation complicates the criterion even further as this clashes with the ‘arising in-criterion’. What is also striking is that the rules for measurement of provisions in all systems are either inconsistent (IFRS, United Kingdom FRS and CCCTB) or incomplete (Dutch sound business practice and German law). The concept of settlement or transfer value at the end of the reporting period is, to my mind, based on ideas that are valid in only rare circumstances in which a market value actually exists (such as can be the case for certain pensions) or when transfer or settlement of the obligation is actually planned in the short run by the enterprise. With regards to contingencies in provisions it also shows that IFRS and United Kingdom FRS are primarily focused around an obligation being present, where Dutch and German law focus more on the eventual outflow being probable or likely enough. The latter can create issues with regards to the ‘arising in-criterion’, as it creates tension as to what the actual obligating event is (and whether that is a relevant criterion or not).

The inconsistency towards the obligation-oriented approach in the common corporate tax base of CCCTB also shows in the provisions that accrue over the course of the years, which seems to be inconsistent and wrong. The fact is that the requirement of a reliable estimate plays a very different role in general purpose financial reporting (IFRS, United Kingdom FRS and German HGB) than it does in standalone tax bases (Dutch sound business practice and the common corporate tax base of CCCTB). Also, it is consistent that the systems for general purpose financial reporting require a provision to be recognised where the requirements are met. For the standalone tax bases (Dutch sound business practice and the common corporate tax base of CCCTB) this is less clear. Under Dutch sound business practice optionality of the recognition of a provision seems to be the consensus and under the common corporate tax base of CCCTB it is unclear whether recognition of a provision is optional or mandatory.

What is actually the most interesting conclusion that follow from this chapter is that the common corporate tax base of CCCTB aims to be a simple, straightforward, rules-based, standalone tax base. The fact that it is a standalone tax base that differs from the existing systems is actually complicating as it requires a separate accounting method just for the common corporate tax base of CCCTB. Although the rules in CCCTB are mostly limited in number and size and are written as rules based and are, in principle, simple. The common corporate tax base of CCCTB proves that it is actually rather hard to write a simple tax base. The amount of questions that Article 23 CCTB 2016 raises leads to the conclusion that this part of the tax base is neither simple nor straightforward. This has been acknowledged in the Presidency Synthesis Report on the bilateral discussions of 17 April 2013, as it states that the issue of basic elements of the base is one of the highlighted issues that require more work.

THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

However, among the issues that are mentioned, provisions are not present, which is striking. Several issues, especially the probable future legal obligation, are more complex than they seem and application of the rules of the common corporate tax base of CCCTB is less simple than it seems. In the following chapter the practical application of the various systems is tested, in addition to the theoretical approach of this chapter. This means that a dual basis is created for creating improvements to the common corporate tax base of CCCTB.
### 4.8 Schematic overview of the main characteristics

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<td>passiva</td>
<td>liabilities</td>
<td>N.A</td>
</tr>
<tr>
<td><strong>recognition of debts</strong></td>
<td>yes, but not as a separate category</td>
<td>yes</td>
<td>yes</td>
<td>yes, but not as a separate category</td>
<td>N.A.</td>
</tr>
<tr>
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<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>based on obligation</strong></td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
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<td><strong>obligation based on groups of items</strong></td>
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<td>yes, explicit</td>
<td>yes, implicit</td>
<td>yes, implicit</td>
<td>probable</td>
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<td><strong>types of obligations</strong></td>
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<td>legal and constructive</td>
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<td>no</td>
<td>yes</td>
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<td><strong>accruals</strong></td>
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<td><strong>tax-deductible reserves</strong></td>
<td>no</td>
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<td>yes</td>
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<td>no</td>
</tr>
<tr>
<td><strong>roll-over relief</strong></td>
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<td>yes</td>
<td>yes</td>
<td>yes</td>
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<td><strong>mandatory recognition provisions</strong></td>
<td>yes</td>
<td>yes</td>
<td>not necessarily</td>
<td>yes</td>
<td>yes, but not obvious</td>
</tr>
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<td><strong>Uncertainty in definition or criteria arising from past events</strong></td>
<td>yes, timing and amount</td>
<td>yes, amount</td>
<td>no</td>
<td>yes, timing and amount</td>
<td>no</td>
</tr>
<tr>
<td><strong>probable outflow of resources</strong></td>
<td>more likely than not</td>
<td>traditionally low, moving towards more likely than not</td>
<td>traditionally 20-40%, moving towards more likely than not</td>
<td>more likely than not</td>
<td>undefined</td>
</tr>
<tr>
<td><strong>matching over obligation</strong></td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>possible</td>
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<td><strong>measurement</strong></td>
<td>settlement or transfer value</td>
<td>expected outflow</td>
<td>expected outflow</td>
<td>settlement or transfer value</td>
<td>settlement or transfer value</td>
</tr>
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<td><strong>netting</strong></td>
<td>no</td>
<td>yes</td>
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Chapter 5 Practical application

5.1 Introduction to the five illustrative examples

In this chapter a number of illustrative examples concerning provisions are given, of which the treatment under the researched systems is analysed. The examples are chosen on the basis of the following criteria:

– Occurrence: the examples must relate to situations that are likely to occur in the lifespan of average and non-specific enterprises;
– Relating to specific requirements for the recognition or measurement of provisions.

The examples have been selected on the basis of the following criteria:

– Occurrence: the examples must relate to issues that are common in practical application.

Since IFRS is created by the IASB, which is not a public entity, but a private party that consists of preparers of financial information, users of financial information and auditors of financial information, the examples in IAS 37 are derived from practice, as it would not make sense to add guidance for cases that are rare. All of the examples used here are present in IFRS (with the exemption of maintenance and repairs as IAS 37 does not recognise these as giving rise to the recognition of a provision). United Kingdom FRS 102, which is, in several ways, a more compact version of IFRS, confirms the above by repeating the examples. The examples are also present in the case law that makes up Dutch sound business practice. More cases regarding provisions do exist in practice. However, the cases mentioned are expected to cover most of the relevant issues. This follows from the fact that IFRS deals with the issues mentioned in these examples and they are mostly covered by Dutch case law. Both the IASB and the Dutch courts depend on input delivered from practice. This means that when they deal with an issue, it is an issue that occurs in practice.

– Specific: the examples must relate to specific issues that give insight in the working of the systems and the differences between them. All of the examples relate to specific parts of the workings of recognition and measurement of provisions. Warranties relate to the concept of obligations, especially in large numbers and to constructive obligations. Onerous contracts relate both to future costs and the fact that a contract as such can constitute an obligation for which a provision needs to be recognised. Maintenance and repairs relate to the fact that some expenses have their origin in a specific year, without leading directly to an obligation towards a third party, which means that the concept of an
obligation comes into play. Furthermore, there’s an amount of build–up in such expenses in the sense that the origin is often stretched over a multitude of years. Restructuring relates to issues that are necessary from an economic perspective (in that sense similar to maintenance and repairs), but the third parties (the ones that are affected) come into play much sooner. They will start as internal obligations, then become constructive obligations and end up being legal obligations. The clean–up of pollution refers both to a certain spread over time (often pollution will build up over the course of the years) and revolve around the issue of constructive versus legal obligations.

5.1.1 Warranties

Giving warranties on products or services is common business practice among enterprises. Problems can occur with almost all types of products or services which an enterprise can deliver or perform. As this is known by customers and potential customers, a warranty can give those customers comfort to actually buy the product or service, knowing that if anything should go wrong with it, the enterprise will solve the issue without requiring additional payment from the customer. Two specific issues relating to provisions occur in the case of warranties. The first issue is the fact that often, in order to maintain a good business-relationship, enterprises offer service in the shape of returns or free repairs, without a specific legal obligation to do so. This is known as the constructive obligation. Especially in the current day-and-age it can be stated that once consumers start complaining on social media or give structurally bad reviews, this will influence the position of the enterprise, which means that there is a reason for an enterprise to maintain relations with customers. This means that the role of constructive obligations must not be underestimated.

For example, an enterprise produces and sells €1,000,000 worth of products. No formal warranty is given outside the legal requirement and a customer returns €50,000 worth of faulty products. Although no legal requirement exists for the enterprise to accept the return, it allows it nonetheless and repairs the products free of charge. These constructive obligations have a considerable economic impact.

The second issue is, when warranties are given on large numbers of homogenous products, whether a provision can be recognised on the basis of expected (statistical) occurrence of returns or repairs, instead of a legal obligation that is present (such as when the product has actually been returned or brought back for repairs). This issue also relates to how the provision must be measured.

For example, an enterprise produces €1,000,000 worth of products. Based on past information, it estimates that 2% of the products will have faults and be
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returned, which is expected to cost €10,000 in repair costs once the products are returned.

A third issue is the issue whereby warranties are not given on every product that is sold or service that is delivered, but sold separately.

For example, on a product, which costs €1,000, a consumer can buy an extended three year warranty for €100.

5.1.2 Executory and onerous contracts

When an enterprise enters into a contract, it will generally do so because it thinks this is beneficial to the business. In some cases this will eventually not be the case: the contract will cost more that it delivers. It can even be the case that an entity enters into a contract, knowing that it will lead to a loss, but enters into it nonetheless when not entering into the contract will lead to an even bigger loss. This may occur for example with building companies.

For example, a contract is entered into. The expected revenue that follows from the contract is €100,000 and the enterprise expects that it will cost €80,000 to meet the requirements of the contract and therefore expects a €20,000 profit. At one point it becomes clear that it will cost €120,000 to meet the requirements of the contract, so a loss of €20,000 is expected. A relatively easy example of this is where the contract refers to a building project.865

A more complicated example is where an employee is contracted and becomes obsolete or sick and will not deliver any more revenue or use. In that case it will often not be the cost that changes but the revenue. When the expected revenue of the contract is €100,000 and the expected cost €80,000 and the employee becomes ill and will never regain the capacity to work again after half of the contract, the expected revenue will be €50,000 and the expected cost €80,000, leading to a loss of €30,000.

Another more complicated example is where a building is leased and at one point it becomes impossible to use or sublet it and thus it will only cost money and not deliver any use. It is often difficult to determine the expected revenue from a building unless it is rented out. When an enterprise does not have any future possible use for it (either by using it or renting it out) and therefore the revenue is €0 and the cost remains €80,000, a loss of €80,000 occurs.

The first issue is whether executory contracts, i.e. contracts in which neither party has delivered its performance (such as goods or services) yet, are eligible for recognition of a provision. In itself they will constitute an obligation, but that

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865 Even onerous contracts can be entered into in order to prevent the occurrence of even higher losses.
is often thought to be offset by future revenue that is the counterpart of
the contract. Implicitly this offsetting implies that this revenue is already recognised
(and therefore realised). The second issue is that in certain cases the contracts
do not relate to a specific project, but to a longer future period, such as in the
case of period bound costs (salaries, interest, rent) that can also become onerous
contracts, but of which the relation with the future might be so strong that they
resemble (or constitute) a future loss. The third issue is that a contract,
especially in the case of period bound costs can often be split in an onerous and
non-onerous part. This is for example the case when part of a leased building
can no longer be put to future use (or is not expected to be) whereas another part
can. The fourth issue relates to measurement of a provision for an onerous
contract. The expected revenue coming from the contract can be estimated quite
easily: it will often be mentioned in the contract itself. However, determining the
cost connected to the contract will generally be much more difficult. This will
lead to questions such as whether (fixed) overhead costs need to be taken into
account, market value on the buyers’ side or market value on the sellers’ side,
market value or actual cost etc.

5.1.3 Maintenance and repairs

Future maintenance and repairs will often play a large role in the performance of
the entity. Although the fact that future maintenance that needs to take place will
generally not constitute a legal or constructive obligation up until the point
where the maintenance or repair has actually taken place, its expected future
occurrence is highly relevant for both investors and the management of the
enterprise. To investors it will be relevant information whether or not a
substantial future expense is expected. The management of the enterprise will
need to make sure that the expense can actually take place, i.e. it will need to
save up enough liquidity in order to guarantee continuity. Apart from that this
expense will often relate in a certain way to the preceding years, so it can be
stated that the expense is actually arising in those preceding years.

For example, an enterprise uses a machine, which needs an overhaul every five
years and which costs € 50,000.

The main issue with regards to future maintenance and repairs is therefore
whether an obligation exists or can exist.

5.1.4 Restructuring

Most enterprises will at one point need some form of restructuring, which will
often also include dismissal of employees. Much like maintenance and repairs,
the decision to restructure or the necessity to restructure will generally not
constitute a legal obligation up until the point where the restructuring has
actually taken place. The decision or need to restructure does however present
highly relevant information for both investors and the management of the
enterprise. It is also relevant for tax purposes as it constitutes expenses that are in a way inevitable to remain profitable in the long run. The issue therefore revolves around the concept whether an obligation is or should be required in order to recognise a provision. A constructive obligation can play an important role in this (as often the enterprise has created valid expectations in third parties). Furthermore, when a provision for restructuring is principally required or allowed, the question becomes relevant which future expenses can be recognised. Also, the question arises whether onerous contracts play a role in this.

For example, an enterprise decides to restructure in order to reduce costs. The harmonisation of pensions of certain employees will cost € 800.000. Ending the employment of other employees will cost € 1.200.000. Integration of systems will cost € 250.000 and the costs of moving will be € 160.000.

5.1.5 Clean-up and recovery

With regards to the recognition of provisions for the clean-up of pollution or recovery of the use of land, the following applies.

For example, an enterprise mines a quarry for natural resources. It expects to be able to use the quarry for ten years, after which the quarry must be recovered again by filling it with land, because of a law that is already in place. It expects that after ten years, it will cost € 1.000.000 to have a third party fill the land, of which € 500.000 are fixed costs (having a third party fill the land will cost this much, not depending on the size of the damage) and variable costs of € 50.000 annually.

The first issue is whether there is a legal obligation already present at the end of year 1 or that there is merely a valid expectation that there will be a legal obligation present when the work is finished after ten years. Also, a legal obligation will not always be present for the clean-up of pollution or the recovery of the land. However, enterprises will often clean pollution up in order to maintain a reputation for being a responsible enterprise. This means that in some cases, at best, this constitutes a constructive obligation, but not necessarily a legal obligation. Furthermore, a lot of environmental pollution will in itself lead to a legal obligation to clean-up or recover. In practice it will often not actually be cleaned up by the polluting enterprise. Governments, in general, are generally not in the position to deal with all polluted locations. Therefore an outflow might not actually be probable. Another issue is that, while such pollution will often be the effect of activities that occur over the course of the years, the costs of cleaning up will generally include a fixed component that is present as soon as any pollution occurs. This means that an even spread of the costs over the years might be in line with the measurement of performance, but does not represent the actual obligation at the end of the reporting period to do so. In the example
above an even spread would lead to an annual increase of the provision of €100,000, while the actual value of the obligation is €550,000 at the end of year 1 and €600,000 at the end of year two etc.

In the following paragraphs, treatment under the five different systems of these illustrative examples will be studied in depth.

5.2 Research of the treatment of the illustrative examples

5.2.1 Warranties

5.2.1.1 IFRS

Under IFRS, provisions for warranties are regular provisions that have to meet the criteria of IAS 37.10.

Definition
The entry must represent a liability of uncertain timing or amount (and thus have to meet the definition of a provision). For warranties this uncertainty will be the case up until they become an actual debt with certain timing and amount. This is the moment when a product has been returned, the situation assessed and the outflow certain. As long as it is not known which case will lead to a provision or to what amount, it will be a provision.

Requirements
As stated, all the criteria for the recognition of a provision will have to be met.

A. An obligation must be present

Under IFRS, the relevant obligation can be either a legal or a constructive obligation.\textsuperscript{866} This means that the fact that the enterprise has no legal obligation does not mean that it will not lead to a provision, as long as the criteria for a constructive (or a legal) obligation are met. In the case of a large group of homogenous products, the assessment of whether an obligation exists is based on the group of homogenous products and not on each individual sale.\textsuperscript{867} From Example 1 in IAS 37 it can be derived that an obligation following from a warranty can be present as soon as a sale is made.\textsuperscript{868} Since the individual transactions as such (not viewed as a group) will not lead to a probable outflow (otherwise it makes no sense to sell the particular product) it is implied that large numbers of homogenous transactions can be taken as a class of obligations for

\textsuperscript{866} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.14.
\textsuperscript{867} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.24.
\textsuperscript{868} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets Appendix C, Example 1.
which a provision can be recognised.\textsuperscript{869} In the case of an individual product, which is not part of a group of homogenous products, the assessment of whether an obligation is present is to be made at the level of the individual product. The warranty exists as soon as the sale is made and thus the obligation is present at that point as well. A specific issue is the issue whereby warranties are not given on every product that is sold or service that is delivered, but sold separately. A warranty has an economic value and can thus be split from the sale of the product or service. This means that an additional service is bought by the customer. The obligation remains the same in this case. Although IAS 18 does not explicitly mention this issue, the requirements of revenue will be met in this case. This means that both the revenue and the obligation must be recognised by the entity. I am of the opinion that in certain cases this can even become an onerous contract (see Paragraph 5.1.2.1).

B. As a result of a past event

In IAS 37, the event giving rise to the obligation is the obligating event.\textsuperscript{870} In the case of warranties on large populations of items, the obligating event is the sale of the particular product.\textsuperscript{871} This goes for both individual items and large groups of homogenous items. When the warranty is sold separately, the moment where the obligation arises is the moment when the warranty is sold.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

On the balance sheet, provisions provide useful information for users of the information, making even a rough estimate more useful than no estimate. This means that difficulties in the assessment of the probability of the outflow should not be used as an excuse not to recognise a provision. In the case of individual (non-homogenous) items, probability can often not be based on historical data (as it is not present), which means that legal and technical opinions are often needed in order to assess the probability of the outflow of resources. When the determination of the probability is determined on the population as a whole (i.e. a large group of homogenous items), it will lead to recognition of a provision earlier (i.e. when the sale is made) than when these would be assessed on an individual basis (i.e. when the product is returned). In itself this is consistent, as it provides more insight in the actual obligations and expected outflows of the enterprise, than when it would be strictly based on the individual items. In case of determination of the probability is determined on the population as a whole (i.e. a group of homogenous items), it will often be possible to assess the


\textsuperscript{870} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.

\textsuperscript{871} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets Appendix C, Example 1.
probability on the basis of past experience.\(^{872}\) This also means that when no past experience is present, assessment of the probability can be more difficult. This makes it plausible that, when the entity does not have historical evidence of its own, historical data of comparable products or comparable producers would need to be assessed, whenever available. A situation can occur when no historical data is available. In that case the probability needs to be assessed otherwise, for example by technical or legal analysis and opinion. The question can be asked whether, when a warranty is sold separately, further analysis would be necessary, as there is actually a market value of this warranty: the price for which it has been sold by the enterprise. This is especially true at the moment of recognition of the provision. Obviously, after that, re-assessment of the value will need to take place, as an enterprise can actually make an (expected) loss or profit on this. The problem with that approach is the same as with executive contracts: there is an expected profit in the amount received, otherwise it would make no business sense to sell the product.

D. A reliable estimate of the amount of the obligation can be made

As stated in chapter 4, IAS 37.14 requires that a reliable estimate of the amount of the obligation can be made. As IFRS concerns itself with setting standards for general purpose financial reporting and the recognition of a provision is generally useful information to a user of the financial report, this is not to be understood as a limiting requirement. As long as a reasonable estimate can be made, this means that a provision is to be recognised.

Measurement

In the case of a single obligation, IAS 37.40 applies, stating that the individual most likely outcome may be the best estimate of the liability, although other possible outcomes must be considered by the entity. Where the other possible outcomes are mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or a lower amount.\(^{873}\) As stated in chapter 4, this is in itself contradictory to the concept of ‘settlement value’. Where the provision being measured involves a large population of items, the obligation is estimated by weighing all possible outcomes by their associated probabilities (expected value). This means that the probability of the several possible outcomes determines the amount.\(^{874}\) In the example provided, measurement would be €10,000.

This suggests that these numbers and their probability are actually known. This will often not be the case in practice. This means that the settlement value needs to be estimated otherwise. It will generally be the case that there will be enough


information to determine what settlement value will be applicable in that particular situation. If not, the ultimate conclusion is that the requirement that a reasonable estimate can be made is not met.

5.2.1.2 German law

Definition
German law does not define provisions in the same way that IFRS does. The definition that is derived by Haas (‘Provisions are entries on the balance-sheet, of which the connected cost diminishes profit and of which the amount can be determined with enough probability and of which the amount is uncertain’), stresses that the amount of the expected outflow is uncertain. For warranties, this will generally be the case up until the point where they become a debt and the amount is certain, such as when the product is returned. Under German law, provisions for warranties (‘Gewährleistungsrückstellungen’) can be recognised on the following three bases:

1. As a provision for external obligations, when it constitutes a legal obligation;
2. As a provision for external obligations, when it constitutes a constructive obligation;
3. As a provision for warranties for which no legal obligation exists.

An overlap occurs between the latter two and as such it can be stated that Article 249, Paragraph 1 second sentence HGB (the provision for warranties for which no legal obligation exists) is not strictly necessary, as this area is already covered by Article 249, Paragraph 1 first sentence HGB (constructive obligations). Haas mentions that the addition of Article 249, Paragraph 1 second sentence HGB is primarily to explicitly allow the recognition of such provisions for tax purposes.

Unlike the other systems, explicit differentiation is made between provisions for warranties regarding:

1. Specific, individual cases (‘Gewährleistungsrückstellung’);
2. Cases based on large numbers (‘Pauschalgewährleistungsrückstellungen’);

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876 Article 249 Paragraph 1 first sentence HGB.
877 Article 249 Paragraph 1 first sentence HGB.
878 Article 249 Paragraph 1 second sentence HGB.
880 An therefore tax law has an influence on the ‘Handelsgesetzbuch’.
881 See also German Federal Fiscal Court 30 June 1983, *BStBl II* 1984, 263.
882 See also European Court of Justice 14 September 1999, ECLI:EU:C:1999:406. These must be based on past experience, probability or experiences in the particular sector of the
3. Mixed method (‘gemischte Methode’).  

Requirements

A. Legal or constructive obligation

In the case of individual claims, the obligation is thought to be present when the case has become clear, i.e. when the client has claimed for a refund or free repair. When a claim by the client is not probable, no obligation is present. In the case of large homogenous groups of items, it is possible to recognise the provision on the basis that a percentage of the items will lead to a future outflow (as a ‘Pauschalrückstellung’). This will generally mean that a provision is recognised earlier than in the case of an individual claim. When no legal obligation exists but a constructive obligation is apparent it is still possible (and when the requirements are met recognition is mandatory) to recognise a provision. This is only the case when business considerations lead to the conclusion that the enterprise cannot withdraw itself from the claim. The difficult thing about German law in this respect is that pure leniency, aimed towards keeping the good name of the enterprise intact, is deemed to be a commercial activity that is to be attributed to the future. This means that, contrary to the other systems, in the case of warranties a differentiation must be made between legal obligations, constructive obligations and pure leniency. In the case of a legal obligation a client could simply go to the courts and force the enterprise to respect his rights. In the case of a constructive obligation, no legal obligation exists, but the enterprise would have created for example a policy of replacing or repairing within a certain timeframe of the transaction. Pure leniency would be where there is no legal obligation and there is no policy to replace or repair, but the enterprise expects that it might do so anyway for certain clients. As far as I am concerned the latter would need to be attributed to the future anyway, as pure leniency is not something that can be predicted (contrary to a policy). When it can be predicted, it would not be pure leniency. Therefore, in a way, this is also a measure against recognising provisions on an arbitrary basis.

B. Quantifiable

The expected outflow must be quantifiable, which means that it must be possible to make a reasonable estimate of the expected future outflow. As I have stated before, I do not feel that this is a highly limiting criterion, but it has to be taken into account that because of the congruence, which is present in German law and

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883 German Federal Fiscal Court 17 February 1993, BStBl II 1993, 437.
884 German Federal Fiscal Court 28 March 2000, BStBl II 2002, 227.
885 See German Federal Fiscal Court 30 June 1983, BStBl II 1984, 263.
886 See German Federal Fiscal Court 6 April 1965, BStBl II 1965, 383.
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not in IFRS, an enterprise might be more inclined to recognise a provision under German law than under IFRS. It does however rule out situations of pure leniency, as mentioned under a., as these are not based on either legal obligations or constructive obligations such as ones following from company policy. When there is no legal obligation or company policy and there is just an unpredictable situation where the enterprise might show leniency in an individual case, this cannot be quantified. The concept of pure leniency is arbitrary to the point where it is not possible to make a reliable estimate of the expected future outflow.

C. Amount of the obligation is uncertain

In the case of warranties, the amount of the obligation will generally be uncertain, up until the point where the amount actually becomes due and constitutes a debt.

D. Result of past events

This is an issue on which the opinions of the German tax office and the German Federal Fiscal Court are divided (see Paragraph 4.3.2.2.2). The German tax office states that in order for a provision to be recognised, the obligation must be present and be the result of past events. The question is what needs to be present for an obligation (as an effect of the warranty) to be the result of past events. In the case of a large group of homogenous items the sale of the product is the economic cause for the obligation, provided that a certain percentage of the items that are sold will lead to an outflow of resources. The question is whether this is the same for individual items for which no historical evidence exists: is this the sale or the moment where it becomes evident that the product or service is faulty and needs to be replaced or repaired?

E. Outflow is likely

As stated in chapter 4, the probability required under German law is traditionally lower than under IAS 37. This means that with a relatively low probability (below 50%) it can still be mandatory to recognise a provision.

Measurement

Measurement will need to be based on the expected outflow of resources in the future. Especially the explicit recognition of provisions for cases based on large numbers is striking. This is an explicit recognition of provisions where an individual obligation is not yet present, but, statistically, one or more obligations (and thus outflows) will probably arise from the numbers.

For such provisions the following information is relevant for measurement:

– Actual expenses for guarantees in the past;
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

- New insights between the end of the reporting period and the preparation of the financial accounts;
- Possible reimbursements from third parties;
- Relevant warranty periods.

With regards to the above, no differentiation is made between civil law and tax law.

5.2.1.3 Dutch tax law

Definition
Although a set of requirements is formulated in case law, no specific definition for provisions is used in Dutch tax law (in the sense that it does not have a definition similar to IFRS: a liability of uncertain timing or amount; it only consist of the requirements or criteria mentioned below, which can also be viewed as a definition). This means that the differentiation on the basis of uncertainty with regards to timing and/or amount (which is what the definition in IFRS, FRS 102 and Dutch GAAP comes down to) does not follow specifically from Dutch tax law, although Dutch sound business practice does not disallow such differentiation either.

Requirements
For a provision for warranties the general criteria of Dutch Supreme Court 26 August 1998 must be met. As stated in chapter 4, it is not necessary that an obligation exists (either legal or constructive). Sound business practice does not require an obligation to be present, let alone a legal obligation, which means that constructive obligations can give rise to the recognition of a provision, when the other requirements for the recognition of a provision are met. This also means that not only in individual cases, but also when large numbers of homogenous goods are sold, the Dutch requirements for the recognition of a provision can be met. This actually follows more naturally from sound business practice than for example under IFRS, because under sound business practice an obligation is not required for the recognition of a provision in the first place.

A. A reasonable amount of certainty exists that the expense will occur

The Dutch State Secretary of Finance defines this reasonable amount of certainty as being ‘more likely than not’, i.e. more than 50%. As stated in Paragraph 4.4.2.2.3, from case law it can be derived that when the threshold is somewhat lower, recognition could still take place. In the case of large groups of homogenous items for which historical data exist on how much returns and repairs have occurred, it can be determined statistically what the expected

probability is. In the case of individual items this is generally far more difficult to assess, as often no historical data will exist. It will be up to the taxpayer to provide proof that the entry meets the probability requirement. To my knowledge, there is no specific case law dealing with what is allowable as proof and what is not. This means that in general a technical analysis and independent legal opinion will suffice.

B. The expense can otherwise be attributed to the period.

The requirement that the expense must be otherwise attributable to the period is based on two issues:

1. the (future) expenses are not attributable to future benefits;
2. the (future) expenses are not costs of the future years by nature;

The first issue will generally not be raised in the case of provisions for warranties, as the relevant benefits (the sale of the faulty product or service) actually follow from the sale of the product or service in the past. The second issue will present more complex problems, especially in the case of period bound costs. Replacement costs or assets needed to repair the product will not be costs of the future years by nature, but wages are. Often, wages are the largest cost in any repair. However, since a warranty does not make an employment contract onerous, wages cannot be included in the provision for warranties. This is different when the enterprise does not perform the repairs itself (as this would not lead to period bound costs). This also raises the question what would happen when an employee exclusively performs repairs for warranty cases. No future benefits would be attributable to his labour. It can even be stated that his employment contract is onerous (as no benefits are directly attributable to his labour). However, it can be stated that part of the revenue derived from the original sale of the product is attributable to future repairs following from the warranty, as this is a factor in the determination of the selling price. This, to my mind, makes it unlikely that the employment contract of an employee that exclusively performs repairs for warranties constitutes an onerous contract for which a provision can be recognised.

C. The expense arises from facts or circumstances before the end of the reporting period

The criterion that future expenses must arise from facts or circumstances before the end of the reporting period is not a very limiting requirement under sound business practice. When there is a transaction that led to the recognition of a provision, this is generally enough for facts or circumstances before the end of the reporting period. As stated in Paragraph 4.4.2.2.2, the sound business practice criterion, which states that the expense can otherwise be attributed to the period, is much more specific than the arising in criterion. The sound business practice criterion requires that the expense is not attributable to future revenue (this follows from the principle of matching) and that it is not part of the
future costs by nature (such as is the case for period bound expenses). The arising in criterion effectively adds little to this.

Measurement
On the subject of measurement of provisions, other than for pension provisions, only a very small amount of Dutch tax case law exists. Very little case law exists specifically on the subject of measurement of provisions for warranties. This implies that the entity has an amount of freedom on how to measure such a provision. Possible ways of measuring such a provision are the actual expected outflow (in the case of an individual item that either occurs or does not), the settlement or transfer value (since IFRS allows this, there is little reason not to allow this under Dutch tax law, since it is part of business economics) and the expected value (in the case of large groups of homogenous items).

5.2.1.4 United Kingdom law

Definition
Like IFRS, United Kingdom FRS 102, Section 21.1 defines provisions as liabilities of uncertain timing or amount. Therefore, the entry must represent a liability of uncertain timing or amount (and thus has to meet the definition of a provision). For an obligation stemming from a warranty this will generally be the case up until the obligation becomes a proper debt. As long as it is not known which exact case will lead to a provision or to what exact amount the liability exists, the liability will be a provision and not a debt. This means that provisions for warranties can become a debt (or another liability of certain timing or amount) once the timing and amount become fixed.

Requirements

Under FRS 102, provisions for warranties are regular provisions that have to meet the criteria of FRS 102, Section 21.4. The requirements are similar to the ones under IAS 37.

A. The entity has an obligation at the end of the reporting period as a result of a past event

Under FRS 102, the relevant obligation can be either a legal or a constructive obligation. Provisions for warranties are regular provisions that have to meet the criteria of FRS 102, Section 21. In the case of a large group of homogenous products, the assessment of whether an obligation exists is based on the group of homogenous products and not on each individual sale. From Example 4 ‘Warranties’ it can be derived that an obligation following from a warranty can

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889 Dutch Court of The Hague, 8 June 2011, ECLI:NL:RBSGR:2011:BR0817 is a rare example.
be present as soon as a sale is made.\textsuperscript{892} Since the individual transaction as such will not lead to a probable outflow (otherwise it makes no sense to sell the particular product) it is implied that large numbers of homogenous transactions can be taken as a class of obligations for which a provision can be recognised. In the case of an individual product, that is not part of a group of homogenous products, the assessment of whether an obligation is present has to be made at the level of the individual product. The warranty exists as soon as the sale is made and thus the obligation is present at that point as well. A specific issue is the issue whereby warranties are not given on every product that is sold or service that is delivered, but sold separately. A warranty has an economic value and can thus be split from the sale of the product or service. This means that an additional service is bought by the customer. The obligation remains the same in this case. Although FRS 102, Section 23 does not explicitly mention this issue, the requirements of revenue will be met in this case. This means that both the revenue and the obligation must be recognised by the entity.

B. As a result of a past event

In FRS 102, Section 21, the event giving rise to the obligation is the obligating event. In the case of warranties on large populations of items, the obligating event is thought to be the sale of the particular product.\textsuperscript{893} This goes for both individual items and large groups of homogenous items. When the warranty is sold separately, the moment where the obligation arises is the moment when the warranty is sold.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

In the case of individual (non-homogenous) items, probability can often not be based on historical data, which means that legal and technical opinions are often needed in order to assess the probability of the outflow of resources. When the determination of the probability is determined on the population as a whole (i.e. a group of homogenous items), it will lead to the recognition of a provision more often than when these would be assessed on an individual basis. In itself this is consistent, as it provides more insight in the actual obligations and expected outflows of the enterprise than when it would be strictly based on the individual items. When the probability is determined on the population as a whole (i.e. a group of homogenous items) it will often be possible to assess the probability on the basis of past experience.\textsuperscript{894} This also means that when no past experience is present, assessment of the probability can be more difficult. This makes it plausible that, when the entity does not have historical evidence of its own, historical data of comparable products or comparable producers would need to be assessed, whenever available. A situation can occur when no

\textsuperscript{894} Financial Reporting Standard 102, Section 21 Provisions and Contingencies 21A.4.
historical data is available. In that case the probability needs to be assessed otherwise, for example by technical or legal analysis and opinion (although FRS 102 does not specifically hint at this). The question can be asked whether, when a warranty is sold separately, further analysis would be necessary, as there is actually a market value of this warranty: the price for which it has been sold or would be sold by the enterprise. This is especially true at the moment of recognition of the provision. Obviously, after that, re-assessment of the value will need to take place, as an enterprise can actually make an (expected) loss or profit on this. The problem with this is the question whether it is market value that is to be used for measurement or the expected outflow. Settlement value will often imply the first, but that depends very much on the situation at hand.

D. A reliable estimate of the amount of the obligation can be made

As stated in chapter 4, FRS 102, Section 21.4, under (c) requires that the amount of the obligation can be estimated reliably. FRS 102 does not elaborate on this topic, but, like IFRS, United Kingdom FRS concerns itself with setting standards for general purpose financial reporting and the recognition of a provision is generally useful information to a user of the financial report. Therefore this criterion cannot be understood as a limiting requirement. As long as a reasonable estimate can be made, this means that a provision is to be recognised. No practical guidelines exist on when exactly an estimate is reliable enough and it is highly doubtful whether such rules are actually needed or wanted. It will only rarely be the case that no reliable estimate can be made.

Measurement
In the case of a single obligation, FRS 102, Section 21.7, under (a) applies, stating that the individual most likely outcome may be the best estimate of the liability, although other possible outcomes must be considered by the entity. Where the other possible outcomes are mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or a lower amount. As stated in chapter 4, this is contradictory to the concept of ‘settlement value’ mentioned in the first sentence of FRS 102, Section 21.7. Where the provision being measured involves a large population of items, the obligation is estimated by weighing all possible outcomes by their associated probabilities (expected value). This means that the probability of the several possible outcomes determines the amount.895 This implies that these numbers and their probability are actually known, which will often not be the case. Therefore the settlement value often needs to be determined otherwise. It will generally be the case that there will be enough information to determine what the settlement value will be in that particular situation. If not, the ultimate conclusion is that the requirement that a reasonable estimate can be made is not met.

5.2.1.5 CCCTB

Definition

Article 23 CCTB 2016 does not provide a definition of the word ‘provision’.

Requirements

A provision for warranties has to meet the criteria of Article 23 CCTB 2016 in order to be deductible for tax purposes.

A. A legal obligation or probable future legal obligation

A legal obligation or probable future legal obligation must be present. This is somewhat limiting as warranties can follow from constructive obligations as well. In the case of Article 23 2016, these will not lead to a deductible expense as long as they are constructive obligations. The question can be asked whether an expense following from a constructive obligation is not deductible as an expected future expense under Article 23 CCTB 2016 (as Article 23 CCTB 2016 actually anticipates costs when compared to Articles 9, 15 and 17 CCTB 2016) or that it is non-deductible altogether. Since Article 17 CCTB 2016 requires that the obligation to make the payment must have arisen, but is not as explicit as Article 23 CCTB 2016 in stating that this obligation must be a legal obligation or probable future legal obligation, it is likely that a legal obligation is not strictly necessary for the application of Article 17 CCTB 2016. This does make sense, as the expected future expense becomes an actual expense at one point, which serves a business purpose. Anticipation on the basis of Article 23 CCTB 2016 for constructive obligations might be deemed to be too subjective to be allowed, but rejection of deduction altogether would be highly unreasonable from the perspective of the ability to pay taxes. With regards to present legal obligations it is likely that a legal obligation can exist once a sale is made. This is especially the case for large groups of items, of which a history is present that shows which percentage will lead to a warranty case. The working papers mentioned in Paragraph 4.6.1.1 hint at this, but Article 23 CCTB 2016 does not explicitly confirm this. For individual items (no large groups of homogenous items, but just an individual case, such as a court case on damage created by an employee), a similar approach is not possible. Given the fact that Article 23 CCTB 2016 differentiates between legal obligations and probable future legal obligations, a legal obligation does not exist in this sense once a sale is made, based on an individual sale. On an individual level it will not be the case that a probable future legal obligation exists, as an individual product or service that is likely to lead to a warranty-case will not be sold. This means that only when a case actually is brought up by the customer and it is likely that the customer is right, a probable future legal obligation exists. Once the enterprise has acknowledged the case or a court has ruled that the customer is right, a legal obligation exists.

B. Arising from activities or transactions carried out in that or previous years
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It is the question whether it is the faulty product (even before it is sold), the sale or the claim by the customer that is the event that makes it arising from activities or transactions carried out in that or previous years. In the case of a large number of homogenous items I am of the opinion that it is the sale that fulfils the ‘arising from’-criterion, as this is the dominant transaction in this situation. In the case of individual items this is somewhat more difficult. The criteria ‘legal obligation or probable future legal obligation’ suggest that it is either clear that there is a legal obligation or it is probable that a legal obligation will be present in the future. This implies that the criteria can be fulfilled without a legal obligation present at the end of the reporting period. On the other hand, Article 23, Paragraph 3 under (a) CCTB 2016 explicitly forbids the recognition of provisions for contingent losses. It is therefore difficult to determine what the factors are that contribute to the ‘arising from’-criterion. The sale itself is most likely the driver or the cause of the expense and therefore the ‘activity or transaction carried out in that or previous years’. On the moment of the sale the criteria for the recognition of a provision are generally not met (as an obligation towards the buyer is, at that point, not probable as is an outflow of resources and the amount can likely not be reliably estimated), but that does not mean that, at a later point in time, when the other criteria are met, the obligation does not arise from that particular sale.

C. The amount can be reliably estimated

Contrary to what is the case in general purpose financial reporting, the recognition of a provision is attractive for tax purposes for an enterprise. An enterprise might therefore state that an amount can be reliably estimated in an early phase and thus create a tax deferral to which it is not actually entitled. This makes this criterion, though literally similar to the criterion in IFRS, actually more problematic in a tax base such as the common corporate tax base of CCCTB than in IFRS. Also, since the common corporate tax base of CCCTB is a stand-alone tax base, there is no connected general purpose financial reporting creating a tendency in the other direction and keeping things in check. Determining when the amount can be estimated reliably enough to meet the criterion is therefore not always an easy task. In the case of warranties it can be stated that at least some historical statistical information must be present or an actual claim, which mentions an amount. This means that in individual cases for a new enterprise an actual warranty claim must have arisen: the sale itself will be insufficient. In cases of larger numbers of homogenous items this criterion can only be met at the moment of the sale when actual historical evidence is present, either from the same product, a comparable product, the enterprise itself or a different enterprise. It can be stated that this offers an advantage to enterprises that have existed for a longer period of time, when compared to start-ups. To an extent this is true, but, in my opinion, only in the case of the sale of larger groups of homogenous items and not for individual items. On the other hand, it is not that a provision cannot be recognised, it is that the provision cannot be recognised at the moment of the sale. The latter does not take away
from the fact that it is still a relevant issue as the whole concept of provisions revolves around being able to recognise costs earlier than it would have normally been the case. It does leave the start-up enterprise with a lack of evidence. This can partially be compensated when a product is produced that already exists in the market (although the other enterprises might not always share the historical statistical information). The question is whether this is actually a competition disadvantage that needs to be solved within Article 23 CCTB 2016 or that it is a matter of delivering proof (which start-up companies will often not be able to deliver). The fact that the enterprise is not able to deliver what is needed to prove both the probability and the amount is, to my mind, not an issue that would need to be solved by tax law, as it is part of a larger issue of information disadvantage that will plague more start-up companies. It is basically a situation where start-ups are not in an equal position as an enterprise that has existed for several years.

D. Eventual settlement of the amount is expected to result in a deductible expense

With regards to warranties, the requirement that settlement of the amount is expected to result in a deductible expense is an issue that is also split into two different categories. In the case of large groups of homogenous items this is a matter of statistics: a percentage of the sale will lead to a certain outflow (a bandwidth will generally exist for minimum and maximum amounts). As stated in chapter 4, I am of the opinion that ‘expected’ is to be interpreted as referring to the same probability as ‘probable’, meaning ‘more likely than not’. In the case of large groups of homogenous items this will generally be the case. In the case of individual items this will again be a matter of proof, which can be provided by the actual claim, a legal opinion or otherwise.

Measurement
Measurement of the provision for warranties needs to be in accordance with Article 23, Paragraph 2 CCTB 2016. As stated in chapter 4, the basis for determination of the measurement is the expected expenditure required to settle the present obligation at the end of the year.\(^{896}\)

In the case of large groups of homogenous items the most relevant factor to be taken into account is the past experience of the company (or group or industry, if such information is present). This requires a statistical determination, which takes into account:

– Percentage of sales that have led to an outflow over the course of the years;
– The actual sales in the year for which the provision has to be determined;
– The expected timing of the return of the sales and outflow;
– The expected outflow per claim.

\(^{896}\) As mentioned in chapter 4, I find this an incorrect approach. However, as this is the current wording of Article 23 CCTB 2016, measurement needs to be approached in this way.
In the case of individual items it will generally be approached differently, as the provision will not be recognised at the moment of the sale, but at the moment when the claim becomes apparent. This means that what needs to be taken into account is the following:

- The claim and the amount of the claim itself;
- The legal opinion with regards to the claim;
- The expected timing of the outflow.

With this, the basics for the settlement value of a warranty claim can be determined.

5.2.2 Executory and onerous contracts

5.2.2.1 IFRS

Definition

IAS 37 deals with provisions, contingent liabilities and contingent assets. Its scope does not include executory contracts (except where the contract is onerous). An executory contract is defined as a contract under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. According to the IASB, in principle, a net asset or a net liability would arise under an executory contract if the contract is enforceable. However, the IASB states that if the contract is priced on arms’ length terms, the initial measurement of that contract would typically be zero because the rights of one party have the same market-value as its obligations to the other party. What is not taken into account in that reasoning is that in the concept of executory contracts, the idea that if the market-value of both the asset and the liability enclosed in this contract would be equal, implies that the asset can already be taken into account, which would be against the concept of realisation (although IFRS does not always strictly adhere to the principle of realisation). This would be different when the idea is that it is not the realisation that is anticipated, but the recognition of the liability that is deferred. The problem with that reasoning is that this does not show a liability that is actually present. Plus, more often than not, an enterprise will enter into a contract because it expects a profit. Therefore the actual expected outflow from the enterprise will generally be lower than the expected inflow. The idea that market value nets these amount to zero is not correct from the

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898 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.3.
900 The expected inflow and the expected outflow are not necessarily the same as the market value of assets and liabilities.
viewpoint of the enterprise in my opinion and this shows the IASB’s problematic tension between the principle of imparity and the use of market value, as it currently uses both approaches in the standards. This means that the reasoning behind not recognising executory contracts creates some tension at both the level of the asset and the level of the liability.

In the example given in Paragraph 5.1.1, with an expected revenue of €100,000 and expected cost of €80,000, this means that the market value of the expected cost must be deemed €100,000 in order to reach a net amount of zero.

However, when an executory contract is expected to be onerous (which means that the market-value of the liability and the asset do not even each other out), IAS 37 is applicable and a provision can be recognised. An onerous contract is defined as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits to be received under it. The unavoidable costs under a contract reflect the least of the cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Certain types of onerous contracts are dealt with in specific standards. Example 8 of IAS 37’s Illustrative examples illustrates the onerous contract. Not explicitly mentioned is whether future benefits are to be deducted from the costs of fulfilling the contract (although I am of the opinion that they should be: there is no good reason to only take the costs and not the connected benefits into account). IAS 37.63 determines that if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision. In itself this does not make a differentiation between long-term contracts and short term contracts.

In the example given in Paragraph 5.1.1, a cost of €120,000 to meet the requirements of a contract that delivers €100,000 revenue, a provision for an onerous contract of €20,000 will have to be recognised.

IAS 11 deals with construction contracts, which will often spread out over multiple reporting years and are thus often long-term contracts. Where, in general, contract revenues and costs shall be recognised on the basis of the stage of completion of the contract-activity, this is different when the contract is

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902 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.68.
904 International Accounting Standard 11, Construction Contracts Objective.
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expected to be onerous.\textsuperscript{905} When a loss is expected, the expected loss shall be recognised as an expense immediately. In that sense the treatment of onerous contracts under IAS 11 does not differ from the treatment of onerous contracts under IAS 37. Example 8 of IAS 37 deals with an onerous lease-contract. It concerns the situation where an entity operates a profitable factory and relocates. The entity relocates the factory to a different location and the old factory cannot be sublet or otherwise put to profitable use, while the contract continues for another four years. This is considered to be a situation in which an onerous contract exists for which a provision is to be recognised.

\textit{In the example given in Paragraph 5.1.1, where an € 80.000 rent for an unused building that cannot be sublet, a provision of € 80.000 must be recognised.}

Furthermore, IAS 37.66-69 only mentions onerous contracts as such, implying that a per-contract approach is to be used. However, a contract can consist of multiple projects, which, in principle, could have been split into several contracts. If a per-contract approach is used, it creates a differentiation in treatment between situations that are legally different (one contract versus multiple contracts) but which are economically equal. IAS 11 is more specific in this respect. When certain criteria are met, a single contract shall be treated as several separate contracts.\textsuperscript{906} The reverse can also be true, under certain conditions, a group of contracts shall be treated as a single contract.\textsuperscript{907} The above implies that it can be argued that certain contracts can be split in an onerous part and a non-onerous part. However, IFRS and especially IAS 37 is not specific enough in this respect, although I am of the opinion that there is no good reason that differences in this respect should exist between IAS 11 and IAS 37. It seems acknowledged that provisions for longer term contracts can exist under IAS 37 (and thus lead to a provision for an onerous contract which takes multiple years into account), but no reference is made to period bound costs, such as salary, interest or rent. The general measurement-rules for provisions apply to onerous contracts.

Requirements

A. An obligation must be present

From Example 8 of the Illustrative examples to IAS 37 it becomes clear that the present obligation occurs as soon as the contract is signed. As far as I am concerned, the contractual criteria do have to be taken into account, such as whether conditions apply that have to be fulfilled in order to create an actual obligation. I refer to Paragraph 4.2.2.2.5 for this.


\textsuperscript{906} International Accounting Standard 11, \textit{Construction Contracts} 11.8.

\textsuperscript{907} International Accounting Standard 11, \textit{Construction Contracts} 11.9.
B. As a result of a past event

Example 8 states that the obligating event is the signing of the contract. As I have implied above, this is only the case when no conditions apply and the obligation actually follows directly from the contract. Should any conditions apply, the condition will generally be the obligating event. Also, as long as there is an non-onerous, executive contract, no provision can be recognised.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

When a contract becomes onerous, it is likely that the settlement of the obligation necessitates an outflow of resources. An executive contract will always necessitate an outflow of resources of some kind, therefore it needs to be noted that it is the net amount that needs to be taken into account in this.

D. A reliable estimate of the amount of the obligation can be made

From the contract it will generally be reasonable easy to determine a reliable estimate of the obligation. Again, I am of the opinion that under the current wording of IFRS it is the net amount that needs to be determined and not just the outflow.

**Measurement**

As I have stated above, although IAS 37 is not very specific or clear in this respect, I am of the opinion that it must be stressed that in the case of onerous contracts it is not only the outflow that needs to be taken into account, but also the inflow. It is the difference between them that leads to the loss. Both need to be measured. Additionally, IAS 37.68 applies for measurement of onerous contracts. An onerous contract is measured at the level of the unavoidable costs of the contract. The unavoidable costs of a contract reflect the least net cost of exiting from the contract, which is the lower of the costs of fulfilling it and any compensation or penalties arising from failure to fulfil the contract.\(^{908}\) The use of the net-cost of exiting from the contract suggests that the integral cost method is applicable. Under IAS 11 Construction Contracts, overhead costs are to be taken into account, which implies that the integral cost method is obligatory for construction contracts.\(^{909}\) Interestingly, the IASB itself is of the opinion that onerous contracts arising from transactions within the scope of IAS 18 Revenue or IFRS 4 Insurance Contracts need to be measured at the future outflows arising from such contracts by reference to the costs it expects to incur to fulfil

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\(^{908}\) International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* 37.68.

\(^{909}\) International Accounting Standard 11, *Construction Contracts* 11.18 and 11.36.
its contractual obligations, rather than the amounts it would pay a contractor to fulfil them on its behalf.\footnote{IASB, Measurement of Liabilities in IAS 37. Proposed Amendments to IAS 37, (Exposure Draft ED/2010/1) 2010, p. 6.}

5.2.2.2 German law

Definition
Under German law, the concept of an executory contract is known as a floating contract (‘schwebendes Geschäft’). These are double-sided contracts, aimed at the exchange of performance, of which the one who is obliged to deliver goods or services has not performed yet.\footnote{Article 249, Paragraph 1 first sentence HGB. German Federal Fiscal Court 23 June 1997, , BStBl II 1997, 735.} The start of a floating contract is the moment when one (or both) of the parties involved has an obligation to perform and has not yet fulfilled this obligation. When both parties have performed their services, deliverances or payments, the floating contract ends.\footnote{M. Janke, Dauerschuldverträge und Grundsätze ordnungsmäßiger Bilanzierung, Wiesbaden: Gabler Verlag, 1997, p. 2.} Under normal conditions the rights and obligations following from a floating contract are not recognised in the balance sheet, because they are presumed to even out.\footnote{German Federal Fiscal Court 23 June 1997, , BStBl II 1997, 735. I. Haas, Rückstellungen Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 30. As I have stated in chapter 4, this is only the case when the asset and liability are taken at market value. When taken at the actual expected in- and outflows this will rarely be the case. Therefore it is highly dependent on what is expected from the balance sheet: showing the market values or showing the actual expected in- and outflows. The latter will generally provide the most relevant information, but generally accepted accounting principles rarely show clear preferences for either one of the approaches.} As I have pointed out in paragraph 5.2.2.1, IFRS, which follows the same presumption, this presumption will often be wrong. It presumes realisation as well as that the liability will be equal to the right to the contra-performance. This will generally not be true unless market value of both asset and liability are presumed. It is even more wrong in German law, which shows little inclination towards general application of market value.

In the example given in Paragraph 5.1.2, with an expected revenue of € 100,000 and expected cost of € 80,000, this means that the market value of the expected cost must be deemed € 100,000 in order to reach a net amount of zero.

Under German law, two situations involving a floating contract give rise to an entry on the balance sheet. Both occasions relate to the situation where the asset and liability cannot be presumed to even out. The first is when the performances do not even out because one party has already performed, while the other has not, at least not to the same extent (‘Erfüllungsrückstand’). This is actually close to an accrual (as an advance or deferred payment). Such a situation can occur
when either of the parties performs earlier or later than the other does.914 The second situation is when the value of the performance that the enterprise has to perform is higher than the value of the performance of the other party (‘Verpflichtungsüberschuss’). This effectively means that a loss is expected, for which a provision has to be recognised and thus an onerous contract exists.915 As far as I am concerned this stems not from a market value approach, but from the approach that the actual expected in- and outflow are taken as the basis. If taken purely from a market value approach this may lack an actual expected net outflow. Provisions for onerous contracts are based on the principle of imparity. This means that as a loss, they must be recognised once the loss becomes likely.916 Provisions for onerous contracts fall under the category of provisions for external obligations (‘Außenrückstellungen’).917 It can be argued that an onerous contract meets all the criteria for the recognition of a regular provision for external obligations, just like it does under IFRS. Under German law (and thus German tax law), an explicit differentiation is made between one time contracts (‘einzmalige Geschäfte’) and long-term contracts (‘Dauerschuldverhältnisse’).918

One-time contracts can be divided into the following:

Buying (‘Beschaffungsgeschäfte’)
- Goods that are bought become useless before they are delivered;919
- The market–value of bought goods drop before they are delivered;920
- The bought good concerns a performance that cannot be recognised as an asset.

Selling (‘Absatzgeschäfte’)
- Either on purpose or mistakenly the selling–price of a good or service is too low;
- A service is bought with a service (both parties perform in kind and effectively swap services).

Long-term contracts can be divided into:

919 Article 252 Paragraph 1, under 3 HGB. Article 252, Paragraph 1 nr. 4 HGB.
920 Article 253, Paragraph 4 first and second sentence HGB.
BUYING

This includes opportunity costs: when the price elsewhere turns out to be lower.

*In the example given in Paragraph 5.1.2, where an € 80,000 rent for an unused building that cannot be sublet, a provision of € 80,000 must be recognised.*

SELLING

- True loss: costs of a lease becomes higher than the revenues connected to that asset.
- Missed opportunity (possible higher revenue): is not viewed as a loss.

**A. Legal or constructive obligation**

The onerous contract itself will generally lead to a legal obligation, unless certain conditions apply. When a contract can be split into several obligations that are to be paid separately, a contract can be split into an onerous part and a non-onerous part. In any case it is not obligatory to net profits and losses for separable parts in a project. When one part of a project is onerous, a provision for onerous contracts is possible, even when, as a whole, the project is not onerous.921 In 1997 the German Federal Finance Court ruled in a case that is somewhat similar to the Dutch ‘Leegstandsarrest’.922 A pharmacy company leased a building. Part of it was for use by the pharmacy itself and part of it was sublet to a different business. The lease for the sublet part that the pharmacy paid was higher than the income it received in the form of the sublease. The pharmacy itself was profitable. The German Federal Finance Court ruled that the pharmacy (which was the taxpayer in this case) only accepted the losses from the sublet part, because *as a whole* (pharmacy and sublease) it could make a profit and therefore a provision was deemed *unacceptable*.923 In the case when a building is leased, but not in use anymore and subletting is not possible, a provision for an onerous contract is to be recognised.924 From case-law it can therefore be deduced that it highly depends on the case itself whether a contract can be split into an onerous and a non-onerous part.925

**B. Quantifiable**

What needs to be quantified is the expected net outflow from the onerous contract. This means that both the inflow and the outflow must be quantifiable. In this respect, two situations can be differentiated between. Often a contract will consist of one performance in kind and one performance in monetary

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921 German Federal Fiscal Court 19 June 1983, BStBl II 1984, 56.
923 German Federal Fiscal Court 23 June 1997, BStBl II 1997, 735.
924 German Federal Fiscal Court 25 July 2000, BStBl II 2001, 566.
amounts (the payment). It is however possible that both performances are in kind. For illustrative purposes I will take as a starting point that one of the performances is monetary.

The first situation is when the enterprise is the party performing in monetary amounts (the enterprise buys a performance from a third party and pays for it). In this case, the expected outflow is given in the contract itself. The expected inflow is in a non-monetary amount (it is in kind) and thus will be harder to translate to monetary amounts. The presumption that both performances will even each other out does not apply in this situation (otherwise it will not be an onerous contract). From the viewpoint of the enterprise the contract must be onerous. Therefore it will not always strictly be market value that must be taken into account, but the value that the performance has for the enterprise. For example, the lease of a building that the enterprise leases but does not use will have zero value for the enterprise, but might have a market value that is higher. The second situation is when the enterprise is the party receiving monetary amounts (a third party buys a performance from the enterprise and pays for it). In this situation the inflow can be quantified reasonably easy (as this will be mentioned in the contract) and the outflow will be more difficult to determine, as this is the performance that the enterprise has to deliver.

C. Amount of the obligation is uncertain

An amount of uncertainty with regards to the amount of the obligation must exist, otherwise it does not constitute a provision, but a debt. Although, to my knowledge, in none of the researched systems this is viewed as a highly limiting criterion, in the case of onerous contracts, the amount of the obligation will often be quite certain as such, when taken literally. It will mainly be the amount of the net obligation that will be uncertain. In the case when the enterprise simply has to pay for a performance, the gross obligation (the amount due) will generally be crystal clear, but the value of the expected inflow (the performance to be received) will be more uncertain. This goes vice versa for the reverse (the enterprise receives payment for a performance that it has to deliver).

D. Result of past events

The relevant past event is generally the contract itself. It will often be the case that an additional cause exists that makes the contract onerous. Some contracts start off being onerous (such as when a construction company enters into an onerous contract, knowing that it will be onerous, but in order to at least cover some of the fixed cost that it will incur no matter what) while others become onerous over the course of the contract (such as when a leased building becomes obsolete at one point because it is no longer needed, while the contract still has time remaining). Neither takes away from the fact that an onerous contract exists.
E. Outflow is likely

In the case of an onerous contract an outflow as such is virtually always likely. Therefore, it is actually the loss (the difference between the expected in- and outflow following from the contract) that must be likely. In the case of a leased building that is no longer in use and likely will not be taken in use again and cannot be sublet, the loss and outflow are likely. In the case of a building contract by the enterprise of which the calculated expenses, necessary for execution of the performance following from the contract, exceed the expected inflow, a loss is also likely.

Measurement

In principle, the measurement of onerous contracts takes place on the same basis as other provisions. As stated above, measurement of provisions for onerous contracts revolves around two issues. The first issue is that measurement must be approached from the loss, which consists of both the expected inflow and the expected outflow. Second, one part of the contract will generally be a monetary performance (the payment) and the other will be a performance in kind. Measuring the performance in kind will often be the biggest challenge. This can be approached from either the market value or the actual expected in- or outflow. I am of the opinion that the latter is the preferred approach under German law, as it revolves around the actual expense. Market value will mostly not reflect the true loss in terms of outflow (and under German law provisions are measured at the actual expected outflow and not at settlement or otherwise market value), especially since the presumption for executive contracts is that the market value of the performances will even each other out. It is unclear whether the integral cost method (taking into account certain indirect costs, such as overhead costs) can be applied.

Tax purposes

For tax purposes the recognition of a provision for an onerous contract is not allowed. This also makes it clear that provisions for onerous contracts are viewed as a separate category within the provisions for external obligations.


927 See the Apothecary-case 23 June 1997, GrS 2/93, BStBl II 1997, S.735. M. Düsemond and H. Kessler, *Rechnungslegung kompakt: Einzel- und Konzernabschluß nach HGB mit Erläuterung abweichender Rechnungslegungspraktiken nach IAS und US-GAAP*, München: Oldenbourg, 2001, p. 73. W. Schön, *Steuerliche Maßgeblichkeit in Deutschland und Europa*, Cologne: Verlag Dr. Otto Schmidt, 2005, p. 163. It is interesting to see that this case was formalised into law by Article 6, Paragraph 1, under 3a-c EStG. Since it is no longer allowed to recognise provisions for onerous contracts for tax purposes, this is only relevant for other types of provisions.

928 Article 5, Paragraph 4a second sentence EStG. R 5.7 under 7 EStR.
CHAPTER 5  PRACTICAL APPLICATION

This prohibition makes it highly important to distinguish between the several categories of provisions. Obligations to perform, that are overdue, while the other party has already performed its obligation on the end of the reporting period, can be recognised as either a debt or as a provision for external obligations. Overdue salaries, overdue rent or overdue interest all fall under this category. The same goes for independent obligations that arise from economic activities, which are not mirrored by a contra-performance.

5.2.2.3 Dutch tax law

Definition
Under Dutch sound business practice, onerous contracts can lead to the recognition of a provision. Even when the loss was already apparent before the contract was closed (as can be the case when the loss would be even bigger when no contract would have been closed), a provision can be recognised.\(^929\) Neither Dutch tax law nor the case-law concerning sound business practice defines onerous contracts. It would make sense that onerous contracts are understood to be contracts under which the expected outflows connected with a contract are higher than the expected inflows connected with that contract. This would imply that the loss is to be taken into account (expected revenue minus expected cost), thus taking into account unrealised expected future revenue for the determination of the net amount of the loss. Only a limited amount of case-law deals with onerous contracts. In a general sense, provisions for onerous contracts are regular provisions that have to meet the requirements of Dutch Supreme Court 26 August 1998\(^930\) and are part of the loss-side of the principle of prudence. This means that it concerns the attribution of the net sum of the expected inflow and expected outflow and is not approached from the net of the asset and liability (or the market value thereof).\(^931\) Executory contracts are not explicitly dealt with in Dutch case law. In general, under sound business practice, some differentiation is made between period bound expenses, following from long-term continuous contracts and non-continuous contracts that can be either long term or short term. Period bound expenses are generally attributed to the period to which they relate. It is possible to recognise a provision for period bound expenses when the contract on which the period bound costs is based is expected to be onerous.\(^932\) From case-law it can be derived that it will often be difficult to determine what the expected loss in a long-term contract is, especially when the future revenue connected to the


\(^931\) For a different opinion see the conclusion of G. Slot to Dutch Supreme Court 22 December 1993, ECLI:NL:HR:1993:ZC5550.

contract is not clear and the contract as a whole might not be onerous, but only a part of it. Non-continuous contracts for longer-term contracts regarding construction or services, from 2007 onwards are dealt with in Article 3.29b Dutch Income Tax Code, which makes the use of the percentage-of-completion method obligatory. However, the possibility to recognise a provision in the case of a contract expected to be onerous remains intact. What is striking is that the Dutch Supreme Court ruled in a case about a contract for the lease of a building that could not be used fully by the taxpayer and for which a tenant would have to be found, where the taxpayer was not allowed to recognise a provision for the risk of not finding a tenant, as this was found to be a risk that had to be determined on a year-by-year basis.

This means that in the example given in Paragraph 5.1.2, where an €80.000 rent for an unused building could not be sublet, no provision could be recognised.

What the Dutch Supreme Court did not take into account (probably because it was not claimed by the taxpayer), was that such a rental contract can in fact have a negative value and thus lead to the recognition of a provision for an onerous contract. This would have been the case if the taxpayer had proven that the building could no longer be used by the enterprise itself and subletting the building was unlikely or downright impossible. In my opinion, the value of this case is limited, as it seems to stem from an incomplete set of facts and statements provided by the taxpayer. The taxpayer based the recognition of the provision mainly on the risk that he would not be able to find a tenant for the unused part. However, Dutch Supreme Court 26 August 1998 does not give requirements based on risk, but based on probability. Risk, in itself, is too wide a denominator to lead to the recognition of a provision. Had the taxpayer recognised a provision for an onerous contract and provided evidence for the fact that it was onerous, the outcome would probably have been different. The case of Dutch Supreme Court 3 December 2010 does indicate that the split of a contract in an onerous and a non-onerous part is possible. Other case law by the Dutch Supreme Court is less clear in this respect, which creates some uncertainty. Given the fact that IFRS, as the current leading interpretation of business economics, takes a more economic approach to this (several contracts combined can be viewed as one contract and one contract can be subdivided into several parts), I am of the opinion that it is at least allowed to split a contract

937 Dutch Supreme Court 3 December 2010, ECLI:NL:HR:BL2098.
into an onerous and a non-onerous part, under sound business practice. Whether it is obligatory to split the contract into an onerous and a non-onerous part is debatable, as it is probably not even obligatory to recognise a provision in the first place. When the recognition of a provision would be obligatory, it can be stated that the principle of realism requires the split of a contract, if it has a separable onerous and non-onerous part. Jansen states that on the basis of the principle of realism, recognition of a provision for an onerous contract might be obligatory (which would be contrary to all other categories of provisions under sound business practice). Since neither the Dutch courts nor the Dutch legislator has ever acknowledged this, it would seem highly unlikely that this exception exists for provisions for onerous contracts.938

Requirements

A. Reasonable amount of certainty that the future outflow will take place

As stated above, a reasonable amount of certainty must be present that the future outflow will take place. In the case of an onerous contract, this means that the outflow is the net outflow, i.e. the part of the expected outflow that exceeds the expected inflow (the loss). From Dutch Supreme Court 3 December 2010 it becomes clear that when the taxpayer merely claims a risk exists that the loss will occur, this is generally not enough; a reasonable amount of certainty (that is: probability) that the outflow will take place must be present.

B. Criterion of origin

The criterion of origin states that the outflow must originate from facts or circumstances in the past. As Dutch sound business practice does not evolve around obligations, this is not strictly a question of what the obligating event is. It can be argued that it is the contract itself that is the origin of the loss, but, when the contract has not been onerous from the start, it can also be the circumstance that made the contract onerous. For example when a building is leased and after a couple of years the enterprise moves to a different location, while the lease-contract still has a number of years to go, the contract has become onerous because of that fact and because of the fact that at some point the enterprise moved. The contract has not been onerous from the start. The origin of the loss is therefore the move of the enterprise to the different location and not the contract itself.

C. Criterion of sound business practice

The difficulty with regards to the recognition of provisions for onerous contracts will often be to draw the line between onerous contracts and future operating

THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

losses. This revolves around the first and third requirement for the recognition of a provision; the criterion of origin and the criterion of sound business practice. The criterion of sound business practice states that the costs must not be attributable to future revenue and not be otherwise attributable to the future.\footnote{Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcr. 2012, 3804.}

In the case of an onerous contract, matching the expense (as cost) with the revenue still applies. However, there is an excess of the expense over the revenue that can therefore not be attributed to future revenue: there is no future revenue to cover it. With regards to not being otherwise attributable to the future, this mainly covers the period bound costs such as rent, interest and wages. These are attributed to the period in which the corresponding service is received, unless no service or use of the service is to be expected or the value of the period bound cost exceeds the expected use of it (making the contract onerous). This is the case when a leased building cannot be used (e.g. because the enterprise moved out) and the building cannot be sublet (effectively ruling out all possible use or inflow of resources from it). This is also the case when wages are paid, but the employee will not deliver any performance anymore, for example because he or she is chronically ill and cannot be expected to work or because a special arrangement (early-pension or similar) applies.

Measurement

When measuring a provision for an onerous contract, the expected net loss from the contract is leading, which means that an estimate has to be made of the expected inflows and outflows connected with the contract. This means that the actual expected loss is measured and not the market value of the expected inflow and outflow. Some discussion has taken place in Dutch tax literature as to what is exactly measured when recognising a provision for an onerous contract. In Dutch Supreme Court 22 December 1993, the Dutch Supreme Court decided that when an existing legal relation is expected to lead to a loss, it would not be against sound business practice to recognise a provision for that loss.\footnote{Dutch Supreme Court 22 December 1993, ECLI:NL:HR:1993:ZC5550.}

For example, when an enterprise would enter into a contract and the expected revenue that follows from the contract is €100,000 and the corresponding expected costs will be €120,000, an expected loss of €20,000 occurs. Under Dutch tax law, a provision can be recognised for this.

In his comment to that case, Slot mentions that it is not the expected loss that is to be recognised, but rather the value of the liability and the corresponding asset. When the net-value of the asset and the liability would be positive, the provision would not be recognised. Slot’s viewpoint is therefore the netting of the liability and the asset instead of determining the loss. Van der Geld, in his comment to Dutch Supreme Court 26 February 1997, mentions, that netting assets and liabilities in such a case is contrary to the principle of prudence as it does not

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939 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcr. 2012, 3804.

take into account that losses are treated differently than profits. While there is truth in Van der Geld’s remark, it can also be stated that by taking the negative net value of the contract into consideration, this is not contrary to the principle of realisation, as the revenue is not taken into account yet, but only the excess of the expected costs over the revenue. When measuring the expenses for the recognition of a provision for onerous contracts, the integral cost method is allowed, meaning that the constant part of the future general costs can be taken into account.

This particular case, Dutch Supreme Court 26 February 1997, deals with a construction contract (therefore the selling side) and not with a contract for period bound expenses (which would be the buying side). This means that virtually no case law exists on how to determine the costs connected with an onerous contract for period bound costs: whether the integral cost method is also allowed is unknown. The amount of case-law on onerous contracts with regards to period bound expenses is limited and especially limited on the question of measurement. With regards to measurement of the corresponding in- and outflow there will generally be a monetary and a non-monetary side to the contract (with the enterprise performing either the monetary or the non-monetary part). The non-monetary part will always be the part that is more difficult to measure than the monetary part. That the value of the non-monetary part is hard to measure follows for example from Dutch Supreme Court 28 January 2011. This case revolved around the measurement of the non-monetary part that would be received by the enterprise. One of the employment contracts gave the employee the right to decrease the working hours by a certain percentage while the salary would only be decreased by half that percentage.

For example, after the age of 60, an employee would be able to decrease his working hours by 40% and his salary would only be decreased by 20%. If he receives an annual salary of €50,000 for a 40 hour workweek, this would mean that his average workweek would become 24 hours and his annual pay would become €40,000.

What the taxpayer was unable to prove was that this would make the contract onerous at one point, as this would involve measurement of the value of the performance that would be received. A provision for an annual loss of €10,000 (€50,000 - 40% would normally become €30,000, but the employee receives €40,000 instead) would not be correct, as this would not take into account the revenue connected with the work of the employee in the remaining hours. The Dutch Supreme Court ruled that measurement of this would actually be so complex that it would be against the principle of simplicity to recognise a

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944 An interesting detail is that the enterprise was an accounting firm.
provision for this. To my knowledge, this was the first time that the principle of simplicity was used against a taxpayer. I do not believe that it is actually that hard to make a reasonable estimate of the value of the performance that will be received by an average employee of the average accounting firm (expected working hours in a given year x expected average productivity percentage would be a good start, with correcting factors such as the probability that the employee will still be employed at that point). Simplified, if, after reaching the age of 60, the employee would be 70% productive, in 46 weeks per year, at 24 hours per week, the connected revenue would be 70% x 46 x 24 = 772.8. If the other connected costs to the employee would be about € 15,000, the break-even point would lie around an hourly rate of € 71.17. If the expected hourly rate is below that, the contract will become onerous if the expected profits before 60 would not exceed the expected losses after 60.

5.2.2.4 United Kingdom law

Definition
Under FRS 102, executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.\(^{945}\) FRS 102 Section 21 is not applicable to executory contracts, except where the contract is onerous. An onerous contract is defined as a contract in which the unavoidable costs of meeting the obligations under it exceeds the economic benefits expected to be received under it.\(^{946}\) If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.\(^{947}\) An example of this is rent payable on vacated properties.\(^{948}\) For tax purposes, the same approach is followed, when the expected expense itself is tax deductible.\(^{949}\) FRS 102 Section 21.11A determines that if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision. In itself no differentiation is made between long-term and short term contracts. However, since Herbert Smit v Honour,\(^ {950}\) it is formally accepted that when the accounts are drawn up on generally accepted accounting principles, there is no overriding rule of tax law which denies relief for losses or expenses which will be paid in the future. FRS 102 Section 23.17-27 deals with construction contracts, which will often be contracts that concern multiple reporting years. Where in general contract-revenues and - costs shall be recognised by reference to the stage of completion of the contract activity, this becomes different when the contract is expected to be onerous. When a loss is

\(^{947}\) Financial Reporting Standard 102, Section 21 Provisions and Contingencies 21.11A.
\(^{948}\) Herbert Smith v Honour, 1999, 72 TC 130.
\(^{949}\) Business Income Manual 46540.
\(^{950}\) Herbert Smith v Honour, 1999, 72 TC 130.
expected, the expected loss shall be recognised as an expense immediately. In that sense construction contracts under Section 23 do not differ from other onerous contracts under Section 21. An onerous contract is a contract in which the unavoidable costs of meeting the obligation under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

For example, an entity may be contractually required under an operating lease to make payments to lease an asset for which it no longer has any use (and which cannot reasonably be given any other profitable use, such as by subletting the leased object). The latter indicates that a leased object that is no longer in use, but for which a contract still applies, can lead to the recognition of a provision for an onerous contract. If the rent is € 80,000 annually and the contract is in place for another two years, the amount will be the present value of the annual rent over the remainder of the contract, therefore the present value of € 160,000, unless the lessor would be willing to settle for less than that amount.

When the contract can be exited without additional costs, there will be no onerous contract per se. FRS 102 Section 21 does not mention the split of a contract in an onerous and a non-onerous part. It only relates to whether or not an entity has an onerous contract, for which the present obligation under the contract shall be recognised and measured as a provision. However FRS 102 Section 23.19 mentions criteria when within a single construction contract several assets shall be treated as separate contracts. This means that the split of an onerous contract is at least possible for construction contracts. On the other hand, when certain requirements are met, a group of contracts is to be treated as a single contract.

Requirements

A. An obligation must be present

Example 2 in FRS 102, Section 21A.2 deals with the contractual obligation to make payments for the operating lease of an asset for which it no longer has any use. The present obligation is derived from the contractual requirement to pay out resources. This contractual requirement is present as soon as the contract is signed. Insofar the entitlement to benefits from the contract is evened out by the contractual requirements, no obligation exists, but insofar the requirements

951 Financial Reporting Standard 102, Section 23 Inventories 23.23.
953 Financial Reporting Standard 102, Section 23 Inventories 23.29.
954 Financial Reporting Standard 102, Section 23 Inventories 23.20.
the benefits, an obligation exists. Although FRS 102 does not strictly mention this, the contractual criteria do have to be taken into account, such as whether conditions apply that have to be fulfilled in order to create an actual obligation. I refer to Paragraph 4.5.2.2.5 for this criterion.

B. As a result of a past event

From example 2 in FRS 102, Section 21A.2 it follows that the signing of the contract is deemed to be the past event that resulted in the obligation. As I have implied above, this is only the case when no conditions apply and the obligation actually follows directly from the contract. Should any conditions apply, the condition will generally be the obligating event.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

When a contract becomes onerous, it is likely that the settlement of the obligation necessitates an outflow of resources. An executory contract will always necessitate an outflow of resources of some kind, therefore it needs to be noted that it is the net amount that needs to be taken into account in this.

D. A reliable estimate of the amount of the obligation can be made

Again, I am of the opinion that it is the net amount that needs to be determined and not just the outflow. When the enterprise is required to pay a certain amount for a product or service for which it has no further use anymore, this is an easy estimate, as it equals the required payment. It becomes more difficult when either the enterprise has to perform a service or deliver a product or when the service or product is of less value than the payment, but more than zero. It can occur that no reasonable estimate can be made of the loss, when there is no way to determine the value of the product or service to be received.

**Measurement**

FRS 102 Section 21 relates to whether or not an entity has an onerous contract, for which a present obligation under the contract shall be recognised and measured as a provision. Example 2 of FRS 21A.2 states that an onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Though not mentioned literally, it can be derived that the amount to be measured is the excess of the unavoidable costs of meeting the obligations under the contract over the economic benefits to be received under it. This means that the liability and the ‘asset’ (although the latter does not necessarily always meet

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955 Financial Reporting Standard 102, Section 21 Provisions and Contingencies 21.11B.
the definition of an asset, it is the performance that is expected to be received, which is in itself an entitlement) are to be netted. The question is whether the integral cost of the performance can be seen as the unavoidable costs under the contract. The difference will primarily be the fixed costs that the entity will make whether or not the contract is fulfilled. These costs are unavoidable, but as unavoidable even when the contract would not have been present. This also shows in construction contracts, where FRS 102, Section 23.26 determines that when the total of the contract costs exceed the total of the contract revenue, the expected loss shall be recognised as an expense immediately, with a corresponding provision for an onerous contract. No guidance is provided on what exactly constitutes the total contract costs. General overhead, which is part of the integral cost, is unavoidable, and needs to be taken into account when the budgeting for the project takes place and thus codetermines the selling price in the contract. The words ‘total contract costs’ and especially the word ‘total’ implies an all-encompassing approach, which can include fixed overhead costs, which imply that the integral cost method is not only allowed but obligatory. Furthermore, as I have stated above, monetary amounts and entitlements that have become completely obsolete are easy to measure. Entitlements in non-monetary amounts (such as entitlement to a service), will generally be more difficult to measure.

5.2.2.5 CCCTB

Under the common corporate tax base of CCCTB no separate article is dedicated to the costs connected to an onerous contract, in the way that IFRS and the other researched systems do (Dutch sound business practice does not dedicate codified law to it, but it does occur in case law multiple times). This means that either the general approach of Article 17 CCTB 2016 is applicable or one of the exceptions, most likely either Article 22 CCTB 2016 on long-term contracts or Article 23 CCTB 2016 on provisions. When Article 17 CCTB 2016 is applied to an onerous contract, deductibility will only occur once the obligation to make the actual payment has arisen. This would mean that the loss would only be recognised once the payment of the expense is actually due, which means that anticipatory recognition of the cost, as would be the case with a provision, does not occur, considering that ‘the obligation to make the payment has arisen’ is to be interpreted as the amount being actually due. In the case of applicability of Article 17 CCTB 2016, no connection is made with revenue, in the sense that Article 18 CCTB 2016 attributes revenue without any connection to the attribution of Article 17 CCTB 2016.

Article 22 CCTB 2016 is only applicable when the contract is both long term (>12 months) and concluded for the purpose of manufacturing, installation or construction or the performance of services. Not defined is what is considered to be the performance of a service, but the combination with ‘manufacturing, installation or construction’ implies that it revolves around either manual labour or similar performances. An approach the one found in VAT (services are all
transactions that are not the transferral of a good and the transferral of a good is defined) is not present in the common corporate tax base of CCCTB. Leases might be considered to be services, but financial transactions involving interest might not be.

This means that the scope of Article 22 CCTB 2016 is not defined. Furthermore, Article 22 CCTB 2016 is written as an exception to Article 16 CCTB 2016 and not to Article 17 CCTB 2016. Article 22, Paragraph 3 CCTB 2016 clearly states that costs relating to long-term contracts shall be taken into account in the tax year in which they are incurred, which, in effect refers to Article 17 CCTB 2016. This stresses the fact that, like in Article 16 CCTB 2016, there is no connection between the attribution of revenue on the basis of Article 22 CCTB 2016 and the attribution of costs on the basis of Article 17 CCTB 2016.

Article 27 CCTB 2016 on work-in-progress might be applicable in specific situations as Article 4 under (27) CCTB 2016 defines work-in-progress as assets in the process of production for sale or in the form of materials or supplies to be consumed in the production process or in the rendering of services. The common corporate tax base of CCCTB does differentiate between long-term contracts and other contracts, by means of Article 22 CCTB 2016. However, as stated above, this only concerns the attribution of income and not of expenses. For attribution of expenses Article 22 CCTB 2016 refers to Article 17 CCTB 2016. Article 23 CCTB 2016 can also be applicable in the case of an onerous contract, as an onerous contract implies that at the end of the tax year the taxpayer has a legal obligation, arising from activities or transactions carried out in that, or previous tax years and a future outflow of resources is probable.

Article 23 CCTB 2016 is an exception to Article 17 CCTB 2016. The fact that Article 22, Paragraph 3 CCTB 2016 implies that the attribution of costs still follows the regular attribution rules, means that Article 23 CCTB 2016 is also still applicable.

The common corporate tax base of CCCTB does not refer to contracts other than long-term contracts in Article 22 CCTB 2016. Articles 16 and 22 CCTB 2016 attribute income, whereas Articles 17 and 23 CCTB 2016 attribute expenses. These attributions take place independent of each other, which means that profits and losses are not attributed as such (revenue minus expenses), but profits and losses are simply the effect of attributing income and expenses. Splitting a contract in an onerous and a non-onerous part would, on that basis, not be possible, simply because the determination of profit or loss does not take place on that level.

A possible exception to this lies in Article 23, Paragraph 2 under (d) CCTB 2016, which states that future benefits directly linked to the event giving rise to the provision shall be taken into account. Even though it is not entirely clear how to ‘take benefits into account’, the most likely interpretation is that costs relating to Article 23 CCTB 2016 and benefits directly linked to those costs are to be netted and only the excess of expected expenses over expected inflows is taken into account.
When dealing with a contract, this means that the split of a contract in an onerous and non-onerous part can still be relevant, as only the onerous part will lead to deduction of costs in the current year.

Article 23 CCTB 2016 is silent on this issue. Article 23, Paragraph 1 CCTB 2016 only mentions ‘a’ legal obligation or ‘a’ probable future legal obligation, but a contract can consist of multiple obligations, which means that a split of a contract is possible when multiple obligations can be derived from the contract. According to Article 23, Paragraph 2 CCTB 2016 measurement must be based on the expected expenditure required to settle the present obligation at the end of the tax year, minus the future benefits directly linked to the event giving rise to the provision. As stated in Paragraph 4.6.2.3, there is an inconsistency in measuring an obligation that is not expected to be settled at settlement value. Whether it is possible to take indirect costs into account when measuring such a provision (the integral method) depends on what is part of the present obligation.

The literal text of Article 23 CCTB 2016 suggests an approach where only direct costs are taken into account, as the criterion is the legal obligation or probable future legal obligation. As Article 22 CCTB 2016 refers to Article 17 CCTB 2016 and Article 23 CCTB 2016 is an exception to Article 17 CCTB 2016, there seems to be no difference between short term contracts, long term contracts or construction contracts.

Requirements Article 23 CCTB 2016

A. A legal obligation or probable future legal obligation

A contract will lead to a legal obligation or probable future legal obligation. When compared to for example IFRS and FRS, that require a present obligation, the ‘probable future legal obligation’ implies a wider scope. There is no evidence, however, that a widening of the scope was actually the idea behind the inclusion of the probable future legal obligation by the European Commission. The CCCTB-characteristic of a concise tax base that strives to leave little room for interpretation does not point in the direction of a wider scope either. Therefore, I do not think that obligations that only occur once a condition has been fulfilled and would not have led to an obligation under IFRS or FRS will lead to an obligation under the common corporate tax base of CCCTB. The later compromise versions of the proposal for a Directive suggested removing the probable future legal obligation, which has not taken place. Article 23, Paragraph 1 CCTB 2016 left the probable future legal obligation intact, but Article 23, Paragraph 3 under (a) CCTB 2016 explicitly mentions that contingent losses cannot lead to the recognition of a provision.

B. Arising from activities or transactions carried out in that or previous years

Similar to IFRS and FRS, the obligation in the case of an onerous contract, will

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957 See the Danish, Irish and Hellenic compromise proposals. See Paragraph 2.3.
have either arisen from the contract itself or from the fulfilment of a condition in
the contract (depending on whether the contract immediately leads to an
obligation or not).

C. The amount can be reliably estimated

The amount arising from that obligation will need to be reliably estimated. With
the common corporate tax base of CCCTB being a stand-alone tax base, this is a
more critical element than it is in a system for general purpose financial
reporting such as IFRS. A reliable estimate in an onerous contract will consist of
an assessment of both sides of the contract: the performance to be received by
the enterprise and the performance to be performed by the enterprise. Usually
one of these is monetary and the other non-monetary.

Any monetary amount (to be received or to be performed) is generally easy to
determine. More complex is the situation when the performance to be received is
non-monetary, although it will be possible to make at least a reliable estimate of
what the performance will cost to the enterprise. When the performance to be
performed is non-monetary, this will often present the most problems, as this
means that the enterprise must measure the value of the non-monetary
performance that they will receive. When the enterprise has no use at all for the
performance to be received, this means that the value is zero. This is for example
the case when a building is leased that the enterprise no longer has any use
whatsoever for, while subletting is contractually or practically impossible.

However the most complex to prove is when the performance has a value above
zero (as the enterprise has some use for it) but, as far as the enterprise is
concerned, below the monetary amount that the enterprise has to pay for it. It will
be highly dependent on the situation whether a reasonable estimate can be made.

D. Eventual settlement of the amount is expected to result in a deductible
expense

The criterion that eventual settlement of the amount must be expected to result
in a deductible expense is mostly an issue of what other systems call ‘total
profit’. It has more to do with the overall deductibility of the type of expense
than with the timing of when the expense is attributed as cost (‘annual profit’).

With respect to an onerous contract this refers to the question of whether the
type of expense is deductible. In the situation that has been described above,
when the enterprise leases a building for admissible business purposes (that is:
not for private use of the owner or similar purposes that clearly have no relation
with the business-goals of the enterprise) and vacates the building at a certain
point while the lease-contract still has several years left, this means that the type
of expense is in itself deductible and that eventual settlement of the amount is
expected to result in a deductible expense.

*With respect to the examples, when the expected expense that follows from a
contract exceeds the expected revenue from that contract, the criteria of Article*
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23 CCTB 2016 can be met. However, it can be stated that in such a case, whether or not the contract is onerous, the obligation relates to an activity or transaction which will continue over future tax years and the provision must therefore be spread over the estimated duration of the activity or transaction.\footnote{Article 23, Paragraph 1 second sentence CCTB 2016.} For the building contract, the loss must therefore be spread over the remaining term of the contract. With regards to a leased building or an employee that becomes obsolete, there are no activities or transactions that will continue over future years and therefore the expenses cannot be spread proportionately over the estimated duration of the activity or transaction.

Measurement
The fact that only the loss (excess of expected expenses over expected outflows) on the contract or transaction is to be taken into account follows from Article 23, Paragraph 2 under (d) CCTB 2016: future benefits directly linked to the event giving rise to the provision can be taken into account. As stated in part C. of this paragraph, measurement is less of a problem for performances to be received or performed in monetary amounts, performances to be performed in non-monetary amounts or performances to be received that have no apparent value anymore. No rules are given on how to measure the future benefits, when taking those into account. Also, no rules are given on how to determine the costs that are connected with the contract and whether it shall include indirect costs.

5.2.3 Maintenance and repairs

5.2.3.1 IFRS

Definition
IFRS does not define maintenance and repairs nor views maintenance and repairs as a specific type of expense for which a provision can be recognised.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets Part C, Example 11 Repairs and maintenance.}

Requirements

A. An obligation must be present

IFRS does not allow the recognition of a provision for maintenance, as expected future maintenance does not meet the criterion of an obligation.\footnote{International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.} Provisions for maintenance and repair are not liabilities, as it will often be likely that an expense for maintenance and repair will have to take place in the future, but the enterprise will not presently be obligated to do so. Even for maintenance that the entity is
The concept of provisions in Article 23 CCTB

Legally obliged to perform (such as the obligatory maintenance on airplanes)\textsuperscript{961} it is only when the threshold is met (e.g. hours of service) that the obligation exists.\textsuperscript{962} Even then obligation can be avoided by not meeting the hours, such as selling the asset or taking it out of service altogether when the hours are reached. In the case of maintenance and repairs no obligation is present up until the point where the party that has performed the maintenance and the repairs has sent the bill. A specific situation occurs when maintenance is obligatory, such as is the case with airplanes. Commercial airlines are obliged to perform periodic maintenance on their planes after certain hours of flight. However, it can be argued that this obligation to perform periodic maintenance does not represent a present obligation in the form that IFRS means. The airline can stop its business or take the plane out of service and no outflow will occur, making the obligation conditional on the actual hours of flight and the fact that the enterprise still will fly once the threshold is met. Only when the threshold of the hours is met and the enterprise chooses to continue its service an obligation occurs. The obligation will be either the performance of the maintenance, which will lead to an obligation to pay the bill or an illegal continuation of the service, which will lead to a fine from the government.

B. As a result of a past event

As stated under A. no present obligation occurs with regards to maintenance and repairs up until the point where the maintenance or repair actually takes place. IAS 37.19 states that it is only those obligations arising from past events existing independently of an entity’s future actions that are recognised as provisions. As long as the entity can decide to put of the maintenance or repair, no obligating event has taken place.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

In itself, an enterprise that performs scheduled maintenance and repairs damaged assets in order to keep continuity up, will be able to state that an outflow of resources is likely with the passing of time. The settlement of the eventual obligation will necessitate the outflow as well. However, the moment at which an obligation is present, as stated above, is much later than the activities that lead to the maintenance or repairs becoming necessary.

\textsuperscript{961} Airplanes are not the only machines requiring maintenance, but they are a prime example where a direct relation exists between use (such as hours of flight) and a legal obligation to perform maintenance. This direct relationship and a legal obligation to perform specified maintenance is not always the case in other types of enterprises.

D. A reliable estimate of the amount of the obligation can be made

In general, it will be possible to determine a reliable estimate of the amount that will be needed to settle the eventual obligation. This will be easier for scheduled maintenance (which can be predicted in both frequency and amount quite simply) than for unscheduled maintenance and repairs.

Measurement
IFRS deals with the effect of maintenance not as a liability, but as a measurement-issue of the asset itself (as the component-method on the depreciation of fixed assets, see IAS 16). IFRS only allows the use of the component method to recognise the effect of expenses for maintenance and repairs, unless the particular maintenance or repair would not be attributable to an entry that meets the definition of an asset and thus an asset cannot be recognised. Additionally, following the definition of an asset, this means that the expected future benefits embodied in the asset must rise when the value of the asset is increased.\(^{963}\) When the requirements are met, however, it is obligatory to use the component-method.\(^{964}\)

With regards to measurement, IAS 16 determines that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. These separate items are depreciated according to their own useful life and their own depreciation method. Because of the fact that both the cost model and the revaluation model are allowed for the measurement of assets, the component-approach applies to both methods.\(^{965}\)

Since maintenance and repairs will generally not lead to revaluation, depreciation on the basis of the cost of maintenance and repairs will generally be applicable.

The component-approach for maintenance and repairs, as required by IAS 16, has no relation with provisions other than that component-approach is also a method for the attribution of expenses as costs over multiple years. A provision tends to build up or is otherwise recognised before the expense takes place and gets released when the actual expense occurs. The component-approach does the opposite, as the expense occurs and is attributed to future years as costs. Differences between the two methods occur primarily when no more future maintenance and repairs are expected, as the depreciation will continue, but a provision will not be recognised anymore.

5.2.3.2 German law

Definition
German commercial law allows for the recognition of a provision for

\(^{963}\) International Accounting Standard 16, Property, Plant and Equipment 16.43.
\(^{964}\) International Accounting Standard 16, Property, Plant and Equipment 16.43.
\(^{965}\) International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.29.
‘unterlassene Instandhaltung’, which, when taken literally, is a provision for overdue maintenance. A provision for overdue maintenance is part of the ‘Aufwandsrückstellungen’, provisions for which no obligation towards a third party exists, even though a future outflow of resources is expected. This means that it can only occur when the maintenance does not follow from an obligation towards a third party (such as the obligation to maintain a rented object periodically). This category is covered by the provisions mentioned in Article 249, Paragraph 1 second sentence under 1 HGB, concerning expenses for maintenance insofar they take place within three months of the following book-year (which is, by all means, a rather short timeframe, making these almost accruals). These provisions concern the fixed assets (‘Anlagevermögen’). It is not required that the fixed asset itself is recognised on the balance sheet (meaning that a provision for ‘unterlassene Instandhaltung’ can be recognised for a fixed asset that is not recognised on the balance sheet). A provision for ‘unterlassene Instandhaltung’ shall be recognised for determination of taxable profit as well.

A provision for ‘unterlassene Instandhaltung’ leads to the recognition of costs in the year before the expense takes place. Since this recognition is only allowed if the overdue maintenance takes place within three months after the year’s end, the timing difference between the expense and the attribution of that expense as costs is short (making the scope and effect very limited). However, it does indicate a (limited) amount of matching the expense with the period in which the maintenance is caused. Whether this effect stems from imparity / prudence or from matching is debated in German literature, as stated in Paragraph 4.3. When maintenance is overdue, the cause for the expense lies before the moment when the expense actually takes place. From a tax perspective, this puts a taxpayer in a relatively better position to pay the expense, as the taxpayer can defer an amount of taxes. This deferral means that less resources flow out of the enterprise and thus liquidity is better than when those taxes cannot be deferred. The recognition of a provision for maintenance and repairs under German law primarily takes place because it is seen as a specific type of obligation: the internal obligation. The wording of Article 249, Paragraph 1 second sentence under 1 HGB (‘zu bilden’), implies that when maintenance is overdue and will take place in the first three months of the next year, recognition of a provision is

\[ \text{Article 249, Paragraph 1 second sentence nr. 1. HGB.} \]
\[ \text{I. Haas, Rückstellungen Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 43.} \]
\[ \text{R 5.7, Paragraph 11 EStR.} \]
\[ \text{I. Haas, Rückstellungen Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 43.} \]
\[ \text{I. Haas, Rückstellungen Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 43.} \]
obligatory. The provision for overdue maintenance is measured at the amount that the enterprise will need in order to meet the obligation. It is therefore not measured at the settlement or transfer-value, but at the actual expected amount. Article 253 HGB determines that the present value must be used for provisions with a term longer than a year. Since the term for provisions for overdue maintenance can only be a maximum of three months, present value is not applicable to this particular type of provision. Maintenance can however also be based on an obligation. When an object is rented and a specific obligation towards the lessor exists to maintain the object, then it can be argued that the provision must be recognised on the basis that it constitutes an obligation in the sense of Article 249, Paragraph 1, first sentence HGB. When there is a need for maintenance, it can also be argued that depreciation needs to take place, which would also lead to taking the effects of maintenance into account. When such a depreciation has taken place, it is not allowed to recognise a provision for this maintenance.

Requirements

A. Obligation

A provision for overdue maintenance is an ‘Aufwandsrückstellung’. These are characterised by the fact that no obligations towards third parties exist, but this situation leads to an internal obligation. This approach, whereby an obligation can be internal is unique to the German system. It is based on the thought that without this, the enterprise cannot properly continue its business and therefore owes it to itself or its continuity that the expense for maintenance takes place. This only applies to expenses that take place within three months after the end of the reporting period. Note that this applies to ‘unterlassene Instandhaltung’, i.e. overdue maintenance, with overdue meaning that necessary maintenance should have taken place before the end of the reporting period, but it has not. This implies a rather narrow scope which cannot be stretched to include maintenance and repairs in general. It does not include regular maintenance which is performed at set dates, as this would not necessarily be overdue and thus cannot be recognised unless the actual expense takes place. This has been the situation since 2009 when the modernisation of the accounting rules (‘Bilanzmodernisierungsgesetz’) has been introduced. Before that, a broader scope of ‘Aufwandsrückstellungen’ existed. Combined with the aforementioned period of three months, this does mean that the effect and scope of the provisions for overdue maintenance are very limited.

973 Article 253 HGB.
974 I. Haas, Rückstellungen Steuerrecht, Handelsrecht und IAS/IFRS, Wiesbaden: Gaber Verlag, 2011, p. 44.
975 Article 249, Paragraph 1 under 1 HGB.
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B. Quantifiable

In general, a reliable estimate can be made of an expense that is overdue and is expected to take place within three months after the end of the reporting period. Therefore, quantifying (measuring) the amount will seldom be a problem.

C. Amount of the obligation is uncertain

Contrary to a ‘Verpflichtungenrückstellung’, of which the amount needs to be uncertain, an ‘Aufwandsrückstellung’ is not an obligation towards third parties, but an obligation in the sense that the enterprise needs to maintain certain assets in order to keep in business in a proper way. Inherently this means that a certain amount of uncertainty will exist. The amount itself will generally be known, but does not have to be fixed until the point where the actual maintenance takes place.

The question whether an obligation exists is mostly a theoretical one, as this is an obligation in the sense of something that an enterprise should do to keep its business afloat. The uncertainty surrounding the existence or amount is not a highly important issue in this respect, as it will never be an ‘actual’ debt.

D. Result of past events

Given the fact that the maintenance must be overdue, this makes that the maintenance is actually the result of one or more events that took place before the end of the reporting period.

E. Outflow is likely

The ‘Aufwandrückstellung für unterlassene Instandhaltung’ can only concern provisions for necessary and overdue maintenance that is expected to take place within three months after the end of the reporting period. With such a narrow scope, an outflow will naturally be likely (once the accounts have been drawn up after the reporting period, the outflow will often already have taken place).

Measurement

Measurement of the provision will be relatively simple. Since the overdue maintenance is expected to take place within three months after the end of the reporting period, the amount will be either known or can be estimated within a certain bandwidth. Present value, different probabilities and groups of items will generally not play a role in the measurement of these provisions.

5.2.3.3 Dutch tax law

Definition

Sound business practice allows the recognition of a provision for maintenance, provided that the situation at hand meets the criteria for the recognition as
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mentioned in chapter 4. This stems mainly from the fact that no obligation is required for the recognition of a provision under Dutch tax law. Dutch tax law also allows the recognition of a tax deductible reserve for maintenance, given the fact that it meets the criteria of Article 3.53 Dutch Income Tax Code (which does not require the presence of an obligation either). Depreciation on the basis of the component-approach is also allowed, as is deducting the cost as a whole when the expense takes place. This means that several approaches can be followed. This is in line with the freedom of determination of profit inherent to sound business practice that the legislator wishes to offer the enterprise. However, it does not shed much light on the place that such entries have in the Dutch system of determination of taxable profit.

The fact that provisions are recognised follows from the Dutch generally accepted accounting practice, which is acceptable within sound business practice.\(^{976}\) The reserve for the equalisation of costs follows from codified tax law.\(^{977}\) Full deduction at once when the amount becomes due is allowed by sound business practice as well, but is decidedly less prudential (and, even though this has never been argued before the courts, might even be contrary to sound business practice, which relies heavily on the principle of prudence). Apart from this and although the Dutch Supreme Court never explicitly stated this, a provision or reserve for maintenance and repairs leads to a deferral of tax that puts the taxpayer in a relatively better position than without having the deferral, thus leaving liquidity for the actual expense for maintenance and repairs. This follows naturally from the principle of the ability to pay taxes. Contrary to most other systems, the recognition of a provision might not be obligatory under sound business practice, as long as it is applied consistently (which means that when the enterprise has a line of conduct of recognising provisions and suddenly stops doing that, for example for a tax reason, it will often be obligatory to recognise that provision). The current definition of a provision, as was first introduced in Dutch Supreme Court 26 August 1998,\(^ {978}\) is not based on obligations and can include provisions for equalisation of costs (which is essentially what a provision for maintenance and repairs is). The tax deductible reserve for equalisation of costs, when applied to maintenance and repairs, essentially shares a lot of characteristics with what would be a provision for equalisation of costs under Dutch Supreme Court 26 August 1998.

Requirements

A. Reasonable amount of certainty that the future outflow will take place

With regards to maintenance the required reasonable amount of certainty can be proven for example by historical evidence (maintenance and repairs that have taken place on the asset itself or on comparable assets), but also from for

\(^{976}\) Dutch Supreme Court 8 May 1957, ECLI:NL:HR:1957:AY2274.

\(^{977}\) Article 3.53 Dutch Income Tax Code.

example maintenance schedules. With repairs this is a different question. A repair will generally occur unexpected. It can be stated that the damage that leads directly to the repair of the asset is the direct origin. However, several other factors lead up to the breakage or damage. Since these factors are difficult to assess and measure (even on a microscopic level the information that can be gathered is not always enough to warrant a prediction) an argument could be made that a provision for repairs (as opposed to maintenance) does not meet the requirement of a reasonable amount of certainty, because of the unpredictable nature of repairs, unless an estimate based on large numbers can be made. However, I think that this would be against the concept of sound business practice. Similar to warranties, it cannot always be pinpointed where and when the exact cause for an expense is, but on the whole (on a more general level), repairs are eventually necessary for most assets. The real difficulty lies more in measurement than in the amount of certainty that a future outflow will take place.

B. Criterion of origin

The criterion of origin requires that the cause for an expense lies before the end of the reporting period. In the case of maintenance it is clear that the spread over the years is in line with the criterion of origin, as either the passing of time or the use of the asset will directly lead to the future maintenance. As stated above, repairs are a more difficult issue here, as it is difficult to pinpoint what the exact origin of a repair is. It can be argued that this is the breakage or damage itself (meaning that no provision can be recognised until the breakage or damage has taken place), but the breakage or damage itself is often caused by the misconstruction of the product, the use of it or the passing of time. That means that, as far as I am concerned, when breakage cannot reasonably be expected (for example: a brick wall is normally not expected to break unless someone does something to it to break it or an earthquake takes place and can last for a very long time when maintained properly), a provision cannot be recognised. When for example it is known that the production of the bricks was faulty and reparation will likely need to take place at one point, this is different and repairs can be expected. Assets with moving parts, such as engines will also lead to repairs at some point, which means that this is close to unscheduled maintenance, although maintenance can also take place in order to prevent repairs. I am of the opinion that the criterion of origin under sound business practice needs to be viewed as having a wide scope. This means that either misconstruction, use or the passing of time can all be the origin of a repair and thus not limit the recognition of a provision.

C. Criterion of sound business practice

The criterion of sound business practice states that the costs must not be
attributable to future revenue and not be otherwise attributable to the future. Maintenance will only be attributable to future revenue insofar there is a connection between the two, which will rarely be the case (maintenance of assets will mean that the activities of the enterprise can continue, which means that there is a theoretic relation between the two, but this does not mean that the expenses are attributable to the future; this would be different when it is not strictly maintenance but improvement). The criterion of being otherwise attributable to the future will mostly relate to period bound costs of which salaries are the most likely to be relevant in this case. This means that there might actually be a difference between maintenance and repairs that are expected to take place in-house and maintenance and repairs that are expected to be performed by third parties. When it is expected to take place in-house a large part of the expected expenses will involve salaries. These salaries are essentially period bound costs and to be attributed to future years. They are not part of an onerous contract. This means that the criterion of sound business practice, in my opinion, does not allow the recognition of a provision for maintenance and repairs insofar the expenses are salaries of employees of the enterprise itself.

**Measurement**

To the measurement of a provision for maintenance and repair, the criteria as mentioned in Paragraph 4.4.2.3 apply. This means that, depending on the expected timing of the future expense, present value can apply. As stated above, the inclusion of period bound costs, such as salaries, will be prohibited by the criterion of sound business practice.

**5.2.3.4 United Kingdom**

**Definition**

FRS 102 does not define maintenance and repairs nor does it view maintenance and repairs as a specific type of provision. This used to be different in the past.

**Requirements**

A. An obligation must be present

Like IFRS, FRS 102 does not allow the recognition of a provision for maintenance and repairs, as this does not meet the requirement of an obligation. Provisions for maintenance and repair are not liabilities, as it may be likely that an expense for maintenance and repair will have to take place in the future, but the enterprise will not be presently obligated to do so. Even for

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979 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcrt. 2012, 3804.

980 Jenners Princes Street (Edinburgh) Ltd. v. IRC, 1998, STC (SCD) 166, which concerned provisions for future repair costs.

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Maintenance that the entity is legally obliged to perform (such as the obligatory maintenance on airplanes) it is only when the threshold is met (e.g. hours of service) that the obligation exists. The obligation can be avoided by not meeting the hours, such as selling the asset or taking it out of service altogether. In the case of maintenance and repairs no obligation is present up until the point where the party that has performed the maintenance and the repairs has sent the bill. A specific situation occurs when maintenance is obligatory, such as is the case with airplanes. Commercial airlines are obliged to perform periodic maintenance on their planes after certain hours of flight. However, it can be argued that this does not represent a present obligation in the form that FRS 102 means. The airline can stop its business or take the plane out of service and no outflow will occur. Only when the threshold of the hours is met and the enterprise chooses to continue its service, an obligation occurs. This will be either the performance of the maintenance, which will lead to an obligation to pay the bill or an illegal continuation of the service, which will lead to a fine from the authorities.

B. As a result of a past event

As stated under A. no present obligation occurs with regards to maintenance and repairs up until the point where the maintenance or repair actually takes place. FRS 102, Section 21.6 states that obligations that will arise from the entity’s future actions (i.e. future conduct of its business) do not satisfy the condition of a present obligation, no matter how likely the future actions are to occur and even if they are contractual. As long as the entity can decide to put off the maintenance or repair, no obligating event has taken place.

C. It is more likely than not that the entity will be required to transfer economic benefits in settlement

In itself, an enterprise that performs scheduled maintenance and repairs damaged assets in order to keep continuity up, will be able to state that an outflow of resources is likely with the passing of time. The settlement of the eventual obligation will necessitate the outflow as well. However, the moment at which an obligation is present, as stated above, is much later than the activities that lead to the maintenance or repairs becoming necessary.

D. The amount of the obligation can be estimated reliably

In general, it will be possible to determine a reliable estimate of the amount that will be needed to settle the eventual obligation. This will be easier for scheduled maintenance (which can be predicted in both frequency and amount relatively easy) than for unscheduled maintenance and repairs.

Measurement

Again, airplanes are not the only example of this, but they do provide a good example of maintenance that simply must be performed after a number of hours-in-use, otherwise the plane is not allowed to fly anymore.
FRS 102 deals with the effect of maintenance not as a liability, but as a measurement-issue of the asset itself (as the component-method on the depreciation of fixed assets, see FRS 102, Section 17.16). FRS 102 only allows the use of the component method to recognise the effect of expenses for maintenance and repairs, unless the particular maintenance or repair would not be attributable to something that meets the definition of an asset and thus an asset cannot be recognised (meaning that the expense is recognised as cost and not as a component of an asset). Additionally, following the definition of an asset, this means that the expected future benefits embodied in the asset must also rise when increasing the value of an asset.\textsuperscript{983} When these requirements are met, it is obligatory to use the component-method.\textsuperscript{984}

With regards to measurement, FRS 102, Section 17.6 determines that each part of an item of property, plant and equipment with a cost that is significant in relation to the total costs of the item shall be depreciated separately. Additionally, FRS 102, Section 17.7 states that a condition of continuing to operate an item of property, plant and equipment (e.g. a bus) may be performing regular major inspections for faults, regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous major inspection is derecognised. This makes that expenses for maintenance and repair, insofar they can be added to the carrying amount of an asset, are depreciated by means of the component method. For tax purposes (BIM 46900) this same approach is followed.\textsuperscript{985} These separate items are depreciated according to their own useful life and their own depreciation method. Because of the fact that both the cost model and the revaluation model are allowed for the measurement of assets, the component-approach applies to both methods. Since maintenance and repairs will generally not lead to revaluation, depreciation on the basis of the cost of maintenance and repairs themselves will generally be applicable. The component-approach for maintenance and repairs, as required by FRS 102, Section 17, has no relation with provisions other than that it also leads to an attribution of expenses as costs over multiple years. A provision tends to build up or is otherwise recognised before the expense takes place and is derecognised when the actual expense occurs.

The component-approach does the opposite, as the expense occurs and is attributed to future years as costs. Differences between the two methods occur primarily when no more future maintenance and repairs are expected, as the depreciation will continue, but a provision cannot be recognised. FRS does not refer explicitly to the role that such a system has in the determination of profit. The fact that a provision cannot be recognised for maintenance and repairs under FRS 102 follows from the way liabilities are defined. It does not

\textsuperscript{983} Financial Reporting Standard 102, Section 2 Concepts and Pervasive Principles 2.15, under (a).
\textsuperscript{984} Financial Reporting Standard 102, Section 17 Investment Property 17.16.
\textsuperscript{985} Business Income Manual 46900.
so much follow from the determination of profit, as well as that provisions and
deductible reserves do not lend themselves for maintenance under IFRS.
If major components of an item of property, plant and equipment have
significantly different patterns of consumption of economic benefits, an entity
shall allocate the initial cost of the asset to its major components and depreciate
each such component separately over its useful life.

5.2.3.5 CCCTB

Definition
The common corporate tax base of CCCTB provides only a limited amount of
definitions, either in a separate article or in the articles of the tax base itself.
Maintenance and repairs are undefined as well. Whether or not a provision can
or must be recognised for maintenance and repairs is merely a question of
whether the criteria mentioned in Article 23 CCTB 2016 (and thus tax can be
deferred) are met. If this is not the case, the basic system of Articles 6, 15 and 17
CCTB 2016 applies which comes down to recognising the expense as cost as
soon as it becomes due.

Requirements

A. A legal obligation or probable future legal obligation

Maintenance and/or repairs do not constitute a legal obligation, until the point
where the maintenance or repairs are actually performed (and thus Articles 6, 15
and 17 CCTB 2016 will apply). It can be argued that the ‘probable future legal
obligations’ that Article 23 CCTB 2016 mentions can include future
maintenance and repairs (at one point the repairs and the maintenance will lead
to an obligation once it has taken place), but it seems unlikely that this is what is
meant by a probable future legal obligation, as this would create a somewhat
subjective entry that is not characteristic for the common corporate tax base of
CCCTB in general. The performance of maintenance and repairs as such (in the
sense that an authority can oblige an enterprise to perform maintenance and/or
repairs) only is a legal obligation in very rare cases. The difficulty is that it
cannot be ruled out that a provision can be recognised for this either.
It could be argued that some forms of maintenance (such as airplanes and ships)
are mandatory (as they are obliged by law) and that these cases would therefore
constitute a legal obligation and thus Article 23 CCTB 2016 could be applicable.
However, like under IFRS, this would only be the case when all the
requirements and thresholds for the obligation would be met, such as the amount
of hours-in-use,\(^986\) because only at that point a legal obligation is present. Even
then, there is often a possibility of not performing the maintenance and/or
repairs, for example by not using the asset anymore.

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\(^{986}\) In the sense that the engines of an aircraft are required to be overhauled reaching a certain
amount of hours in use.
Article 23, Paragraph 1 second sentence CCTB 2016 states that where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. Even though I am opposed to this way of measurement or allocation in an obligation-driven approach, I am of the opinion that Article 23, Paragraph 1 second sentence CCTB 2016 relates to the situation where a legal obligation is present, but some connection remains between future activities or transactions and the expenses related to that obligation. This means that it is not applicable to future maintenance and repairs as no obligation or provision is yet present. How a probable future legal obligation relates to future activities and whether Article 23, Paragraph 1 second sentence CCTB 2016 is applicable cannot be determined from the current text.

B. Arising from activities or transactions carried out in that or previous years

Since Article 23 CCTB 2016 does not apply to maintenance and repairs as long as they do not constitute a legal obligation or probable future legal obligation, the obligating event (‘arising from activities or transactions carried out in that or previous years’) is neither present nor relevant.

C. The amount can be reliably estimated

Since Article 23 CCTB 2016 does not apply to maintenance and repairs as long as they do not constitute a legal obligation or probable future legal obligation, the question whether the amount can be reliably estimated is not relevant.

D. Eventual settlement of the amount is expected to result in a deductible expense

Since Article 23 CCTB 2016 does not apply to maintenance and repairs as long as they do not constitute a legal obligation or probable future legal obligation, the question is whether eventual settlement of the amount is expected to result in a deductible expense. The former means that the attribution of the expense for maintenance and repairs is governed by Articles 6, 15 and 17 CCTB 2016. The expense is deductible as cost when the obligation to make the payment has arisen, the amount of the obligation can be quantified with reasonable accuracy and the significant risks and rewards of ownership are transferred (in the case of goods) or the services have been received by the taxpayer (in the case of services). The common corporate tax base of CCCTB does not allow the recognition of any tax deductible reserve, including maintenance and repairs.

*Measurement*

Depreciation takes place on the basis of chapter VI of the common corporate tax base of CCCTB, which allows application of the component-approach. For example, deemed useful lives of certain types of assets (buildings, long-life...
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tangible assets other than buildings and intangible assets) are given and these assets are to be depreciated on a straight-line basis. Measurement under Article 17 CCTB 2016 is relatively easy as one of the criteria is that the amount of the obligation can be quantified with reasonable accuracy. It makes sense that the same estimate is also the amount that is deducted when all the criteria of Article 17 CCTB 2016 are met. As one of the other criteria of Article 17 CCCTB is that the obligation to make the payment must also have arisen, there will generally be little time between the moment at which the expense can be deducted as cost and the actual payment. This means that using present value does not come into question. When Article 23 CCTB 2016 is applicable, which can be the case with maintenance obliged by law in rare cases, the regular measurement issues as described in Paragraph 4.6.2.3 apply. What is not clear is the relation between the fact that an obligation must be present (Paragraph 1), in order to be able to deduct costs for a provision in the first place and the requirement that where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. The latter only seems to take into account legal obligations that are present and not probable future legal obligations. Therefore, this would not apply to most maintenance that is required by law, as the build-up occurs before the obligation is present and not after (once the threshold is met, this is the obligation).

5.2.4 Restructuring

5.2.4.1 IFRS

**Definition**
IAS 37.10 defines restructuring as a programme that is planned and controlled by management and materially changes either:
- (a) The scope of a business undertaken by an entity; or
- (b) The manner in which that business is conducted.

IAS 37.71 explicitly states that a provision for restructuring costs is only recognised when the general recognition criteria for provisions, as set out in IAS 37.14, are met.

IAS 37.70 gives four examples of events that may fall under the definition of restructuring:
- (a) Sale or termination of a line of business;
- (b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- (c) Changes in management structure, for example, eliminating a layer of management;
- (d) Fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations.
A. An obligation must be present

A provision for restructuring will mostly follow from a constructive obligation, according to the IASB.\textsuperscript{987} It is not unthinkable that certain legal obligations are part of a restructuring provision (such as when for example a binding agreement exists to restructure), but since IFRS allows the recognition of a provision for either category, the exact differences between legal and constructive obligations is not delved into by IAS 37, as it is not problematic.

IAS 37.72 determines that a constructive obligation to restructure arises only when an entity:

a) Has a detailed formal plan for the restructuring identifying at least:
   i) The business or part of a business concerned;
   ii) The principal locations affected;
   iii) The location, function and approximate number of employees who will be compensated for terminating their services;
   iv) The expenditures that will be undertaken;
   v) When the plan will be implemented; and

b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.\textsuperscript{988}

Unlike for example Dutch GAAP, IFRS is rather strict in its approach that an obligation must be present at the end of the reporting period and not after the reporting period but before the accounts are drawn up. No exception is made for provisions for restructuring.

B. As a result of a past event

From IAS 37.72 it follows that two past events are important in the recognition of a provision for restructuring: a detailed formal plan for the restructuring \textit{and} a valid expectation in those affected that the enterprise will carry out the restructuring. The upside of these criteria is that it is in itself quite clear when a provision for restructuring must be recognised. The downside, however, is that it leaves a lot of control over when a provision must be recognised in the hands of the enterprise itself. Even when it is economically viable or maybe even necessary to restructure, the enterprise is not obliged to recognise this in the


\textsuperscript{988} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.72.

\textsuperscript{989} Dutch Richtlijnen voor de Jaarverslaggeving, Standard 252.416. This allows the recognition of a restructuring provision when some of the criteria are met after the end of the reporting period but before the accounts are drawn up.
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form of a provision. On the other hand, economic necessity is not a criterion in the recognition of a provision, which means that within the current system, that recognises only assets and liabilities (and equity as the difference between them), stretching the concept of a liability even beyond constructive obligations is impossible.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

Like all provisions, it must be likely that the settlement of the obligation necessitates an outflow of resources. As stated above a provision for restructuring will mostly be based on a constructive obligation, of which two criteria must be met: a detailed plan and an expectation raised in those affected. The latter will generally be the deciding factor in the question whether a constructive obligation is present. In this expectation lies the necessary outflow of resources. Since the presence of an obligation is so intertwined with the outflow, I do not feel that this criterion is a highly limiting factor in the recognition of a provision for restructuring.

D. A reliable estimate of the amount of the obligation can be made

Since most provisions for restructuring are based on a constructive obligation and IAS 37.72 requires a detailed formal plan for the restructuring in which the expenditures that will be undertaken need to be mentioned, it will generally not be an issue to make a reliable estimate of the amount of the obligation.

Measurement

IAS 37.80 confirms that only direct expenditures arising from the restructuring, which are both necessarily entailed by the restructuring and not associated with the ongoing activities of the entity can be recognised as a provision for restructuring. Measurement of restructuring provisions is dealt with in IAS 37.80. This states that a restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

   a) Necessarily entailed by the restructuring; and
   b) Not associated with the ongoing activities of the entity.

Costs for retraining or relocating continuing staff, marketing or investment in new systems and distribution networks cannot be included in a restructuring provision. Identifiable future operating losses up to the date of a restructuring are not included in the provision, unless they relate to an onerous contract. For the rest, the general measurement criteria of IAS 37 apply. A restructuring

990 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.81.
provision shall not include future operating losses, as a provision for future operating losses is explicitly not allowed.\textsuperscript{991}

When costs for restructuring are divided into common occurring categories, such as harmonisation of pensions and employment terms or ending employment, costs of integration and costs of moving, the following applies.

A. Harmonisation of pensions and employment terms or ending employment

In itself an outflow of resources embodying economic benefits in settlement will be present, as required by IAS 37.14. More difficult to ascertain is whether a present obligation as a result of a past obligating event is present. Depending on the terms of the plan for restructuring, a present obligation can be present at the end of the reporting period. The obligating event can be unclear for some aspects. When the harmonisation of employment terms and pensions lead to higher wages and contributions to pension plans, the obligating event will be the passing of time and performance of the employees in the future (unless the increase in wages and pensions lead to an onerous contract). If the employees do not perform in the future, such as when they quit their job, the costs will not occur, making these future operating expenses, for which the recognition of a provision is not possible as the obligating event lies in the future. Costs that are not connected to future performance, such as a back-service for pensions or a current compensation for a future decrease in wages, would constitute a present obligation for which the obligating event has taken place before the end of the reporting period.

\textit{This means that a provision must be recognised for the € 800.000 harmonisation of pensions of employees and the € 1.200.000 for the ending of the employment of certain employees in the example, if these costs are not connected to future performance.}

B. Costs of integration

With regards to costs of integration, the criterion of a probable outflow of resources embodying economic benefits in settlement can be met. The question will mainly be whether a present obligation as a result of a past obligating event will exist. First of all, the criteria of IAS 37.72, namely the existence of a detailed plan and a valid expectation raised in those affected, must be met. This will generally mean that a provision can be recognised. However, for it to be a restructuring provision, the criteria of IAS 37.80 have to be met as well. Costs of integration will generally be necessarily entailed by the restructuring and not be associated with the ongoing activities of the entity (thus meeting the requirement).

\textsuperscript{991} International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.64.
This means that a provision must be recognised for the costs for the integration of systems of € 250,000.

A possible exception occurs when the costs of integration would be part of an onerous contract. It is not unthinkable that costs of integration, such as compensation, follow from a specific contract, which means that a provision for an onerous contract would also be an option. This can for example be the case when certain employees would receive compensation packages that would lead to the whole contract becoming onerous. With the hiring of advisors this is less likely.

C. Costs of moving

Costs of moving will lead to an expense and will often arise from an earlier period. They will generally meet the requirements of IAS 37.80, as they are necessarily entailed by the restructuring and not associated with the ongoing activities of the entity.

This means that a provision can be recognised for the € 160,000 costs of moving in the example.

5.2.4.2 German law

Definition

German law does not give a specific definition for provisions for restructuring or restructuring as such and neither does German literature. It is generally understood that a restructuring is an alteration in the structure of the enterprise, in whatever form or shape. As German law differentiates between three categories of provisions, which cannot all be recognised under German tax law and which can all three be relevant in case of a restructuring, a further analysis must be made of this. Although in itself it can be stated that restructuring can be an internal obligation (‘Innenverpflichtung’) and therefore lead to the recognition of an ‘Aufwandsrückstellung’, it is generally accepted in Germany that such a provision cannot be recognised since Article 253, Paragraph 2 HGB was deleted in 2009. A provision for an onerous contract (‘Rückstellung für drohende Verluste aus schwebenden Geschäften’) can be relevant when for example employment-contracts or lease-contracts become worthless following relocation of the business. The problem with this is the fact that under German tax law provisions

992 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.82.
994 Rückstellungen für ungewisse Verbindlichkeiten, Rückstellungen für drohende Verluste aus schwebenden Geschäften, Aufwandsrückstellungen.
for onerous contracts are not allowed. This means that the type of provision that is most likely to be actually recognised for restructurings is the provision for uncertain obligations (‘Rückstellungen für ungewisse Verbindlichkeiten’) of Article 249 and Article 5 under (1) and Article 4a EStG.995

Requirements

A. Legal or constructive obligation

Since provisions for restructuring are part of the Verbindlichkeitenrückstellungen: provisions for uncertain obligations towards third parties, this means that an obligation towards a third party must be present. In certain cases a provision for certain obligations must be recognised in the case of restructuring insofar a social plan is present. This is the case when the enterprise has informed the works council about the planned restructuring (which resembles the criterion found in IAS 37.72 that the entity has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it).996 It is also the case when the works council is informed after the end of the reporting period but before the financial accounts are drawn up and filed (which differs from IAS 37 as the latter only allows the recognition of such a provision when the criteria of IAS 37.72 are met at the end of the reporting period). In those cases it is required that the enterprise has decided to restructure or that the necessity of taking measures that would lead to the obligation of drawing up a social plan was already present at the end of the reporting period. The necessity of changing the business is in itself insufficient to recognise a provision. The provision for restructuring is primarily viewed as a constructive obligation and is not part of the onerous contracts (‘Drohverlustrückstellungen’), so that the criteria for onerous contracts do not apply, but neither does the prohibition of the German Income Tax Code (EStG) of recognising a provision for onerous contracts. The latter also means that it is possible to recognise provisions for restructuring under German tax law, whereas this would not have been possible if it was viewed as an onerous contract.997

B. Quantifiable

The criteria for the recognition of a provision for restructuring and specifically as a constructive obligation, are not as strict as those found in IAS 37.72. The works council must be informed, but it does not require the amount of detail found in IAS 37.72. In practice, the works council will require that at least the same information as mentioned in IAS 37.72 will be provided, meaning that the

995 See also R 5.7, Paragraph 9, first and second sentence EStR.
996 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.72.
997 Article 6 EStG. R 5.7 Paragraph 9 under 5 EStR.
amounts and financial effects are known. This means that the amount of the provision will be quantifiable.

C. Amount of the obligation is uncertain

When restructuring is planned, in general there will be at least some uncertainty with regards to the amount that will be eventually needed for the restructuring.

D. Result of past events

The cause of a provision for restructuring can be either the decision to restructure (this is the actual obligating event) or, in a somewhat broader sense, the necessity of a restructuring itself, when it can be objectively determined.\textsuperscript{998}

E. Outflow is likely

The determination whether the outflow is likely enough is more of a material assessment than a mathematical exercise under German law. More arguments must exist in favour of recognition than against recognition. If only a possibility exists, than this is not enough. A situation must exist where management cannot simply reverse its plans for restructuring.

\textit{Measurement}

With regards to the measurement of provisions Article 253, Paragraph 1 second sentence HGB states that the amount must be in accordance with sound business judgement (‘vernünftiger kaufmännischer Beurteilung’), which effectively means that neither under- nor overestimation is desirable or allowed. However, it does leave room for judgement and it does have to be read in the light of the still present prudence in German accounting. What needs to be estimated is the amount which frees the entity of the obligation.

Costs for restructuring are divided into common occurring categories, such as:

A. Harmonisation of pensions and employment terms or ending employment

The first question that has to be answered is whether harmonisation of pensions and employment terms or ending employment would constitute a regular provision or a provision for an onerous contract, as the latter is a specific category that cannot be recognised under German tax law. Article 249 HGB does not specifically answer this question, but it can be stated that approaching the provision for restructuring from the viewpoint of an onerous contract is useless for tax purposes, as recognition of a provision for an onerous contract is not allowed for tax purposes. In that case, like IFRS, Dutch GAAP and FRS, the criteria of a

\textsuperscript{998} W. Hartung, ’Die Sozialplanrückstellung als Beispiel für die Bilanzierung und Bewertung eines Einzelrisikos’, \textit{Betriebs-Berater} 1988, p. 1421.
present obligation, as a result of a past obligating event, expected to result in an outflow of resources, must be met. The main difference is that under German law the probability-threshold of the eventual outflow might be lower than under IFRS, Dutch GAAP and FRS, following from the fact that German law traditionally seems to adhere to the principle of prudence to a larger extent. This means that, like the other systems, the obligating event is likely to be the bottleneck. When the harmonisation of employment terms and pensions lead to higher wages and contributions to pensions in the future, the obligating event will be the passing of time and the performance of the employees in the future and therefore no provision can be recognised for that. If they do not perform in the future, for example because they quit their job, neither the expense nor the obligation will occur. When the payment concerns for example an additional instant payment for back-service in pensions or a current compensation for a decrease in wages, this would be different once a constructive obligation is present. In that case a provision can be recognised for the € 800,000 mentioned in the example.

B. Costs of integration

When a compensation has to be paid following from the fact that some parts of the enterprise have become obsolete, generally the criteria of Article 249 HGB will be met. It is unlikely that this would be limited to an onerous contract; it is far more likely that the criteria for a regular provision will be met. The main question will be whether a present obligation exists, which will depend on the actual situation. Since German law does lead to the recognition of provisions for both legal and constructive obligations, this will generally be the case for both the costs of compensation for employees whose contract ends, as well as necessary costs of hiring advisors. As the provision for restructuring is in itself a provision for an obligation, it implies an attribution of a future expense to the current reporting period. Like most provisions, this follows from the effect of the imparity principle / prudence principle, even though there is current debate in Germany whether provisions follow from the principle of prudence or from the principle of matching. With regards to measurement, the regular measurement-rules of Article 253 Paragraph 1 second sentence under 2 HGB and Article 6 Paragraph 1 under 3, 3a and 6a EStG apply. The German rules on income tax (‘EStR’) provide some guidance on the recognition and measurement of provisions in R 5.7 Rückstellungen.\footnote{R 5.7 Rückstellungen EStR 2005.} This means that the expected settlement amount primarily determines the measurement of the provision. The ‘Restrukturierungsrückstellung’ is therefore primarily the reflection of a social plan or part thereof and will therefore consist mostly of expected salary costs or similar outflows, such as early pensions.

C. Costs of moving

Costs of moving will lead to an expense and will often arise from an earlier
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period, as the necessity and the decision to move will have occurred before the actual move. They will generally meet the requirements of or the recognition of a provision, as they are necessarily entailed by the restructuring and not associated with the ongoing activities of the entity.

This means that a provision can be recognised for the € 160.000 costs of moving in the example.

5.2.4.3 Dutch tax law

Definition
Neither Dutch law nor Dutch case-law gives a definition of a restructuring.\textsuperscript{1000} This means that every part of a restructuring must meet the criteria of Dutch Supreme Court 26 August 1998 in order to recognise a provision.\textsuperscript{1001} In the case of restructuring, Dutch tax law accepts either the recognition of a provision, the recognition of a cost equalisation reserve or recognition as a regular cost (when the expense occurs) for the costs associated with restructuring.

Requirements
Additional guidance to the criteria that follow from Dutch Supreme Court 26 August 1998 has been issued by the Dutch State Secretary of Finance in 2004, which is updated every couple of years.\textsuperscript{1002} The current guidance of 2010 does not include provisions for restructuring, whereas the original guidance dating from 2004 does. It is unlikely that the 2004 guidance on restructuring-provisions would not apply anymore (I am not aware why exactly this was omitted in later issues of the guidance provided by the Dutch State Secretary of Finance, but it is not uncommon that at one point the guidance is deemed to be well-known and is not included in new decrees; it is unlikely that these viewpoints of the Dutch State Secretary of Finance are no longer applicable).

The 2004 guidance splits the costs of restructuring as follows

- Harmonisation of pensions and employment terms
- Costs of integration
- Costs of moving

When compared to IFRS and FRS, what is most striking is that the criterion of an obligation is not present. Although this provides an amount of flexibility and freedom, it also makes the application of the other criteria harder, as it leads to the necessity of the so-called criterion of sound business practice, which is more difficult in its application than the criterion of a present obligation.

\textsuperscript{1002} Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, \textit{Stcr}. 2012, 3804.
The relatively detailed examination in IFRS and FRS whether a constructive obligation exists (mainly consisting of a detailed plan and the expectation that is created with the persons who will be affected by the plan) does not occur in the same way in Dutch tax law.

A. The expense arises from facts or circumstances before the end of the reporting period

The expense must arise from facts or circumstances before the end of the reporting period. This can create issues with regards to both the costs of moving employees and material and as well as costs of integration.

B. A reasonable amount of certainty exists that the expense will occur

As Dutch sound business practice lacks the criteria mentioned in IAS 37 for determining whether a constructive obligation exists (an obligation is not required anyway under Dutch sound business practice), it will be more difficult to assess whether there is a reasonable amount of certainty that the expense will occur. It can even be stated that without a detailed plan and an expectation in those affected, a reasonable amount of certainty that the expense will occur can still exist, when the board has formally decided to restructure.

C. The expenses can be attributed to the period otherwise as well (criterion of sound business practice)

The criterion of sound business practice is necessary because the criterion of a present obligation was effectively removed from the requirements for the recognition of a provision by Dutch Supreme Court 26 August 1998. Expenses for the harmonisation of pensions and employment terms expenses are thought not to meet the third criterion, as it would lead to a provision for higher future wages, which are period bound costs attributable to future years. In my opinion this interpretation by the Dutch State Secretary of Finance is too narrow. Wages are period bound costs and are to be attributed as period bound costs (that is: to the year in which the service is received) up until the point where an onerous contract exists. When that point is reached, the recognition of a provision is allowed. Therefore, the additional question is whether there is any relation between the wages and future revenue. When no or little revenue is connected to the wages and the enterprise will not benefit in any way from the payment of the wages, an onerous contract can occur. When the costs of harmonisation and employment terms are higher than the expected benefits, the recognition of a provision for an onerous contract is allowed. It can however be very difficult to assess the expected loss from such contracts. The Dutch Supreme Court ruled that when it is highly complex to assess the expected loss

1003 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcr. 2012, 3804.
from such contracts, a provision is not allowed, following from the principle of simplicity. Another aspect is the unavoidability of the expense. A current back-service or compensation made necessary by the restructuring (for example because employment terms are altered and a compensation is paid for the loss of certain rights) would lead to unavoidable costs that are not related to future performances, whereas increases in future performances would. This means that current back-services and other compensations that actually occur once the restructuring takes place are not attributable to future revenue and thus a provision would be possible for these expenses.

**Measurement**

To provisions for restructuring, general rules for measurement of provisions apply. A provision for restructuring will often have a short term range. This means that issues that could otherwise lead to bigger differences in measurement compared to Dutch GAAP (or IFRS), such as discounting and the disallowance of not taking future increases in wages and / or prices into account, have less effect.

A. Harmonisation of pensions and employment terms or ending employment

Expenses for the harmonisation of pensions and employment terms expenses are thought to not meet the third criterion, as it would lead to a provision for higher future wages, which are period bound costs attributable to future years. In my opinion this interpretation by the Dutch State Secretary of Finance is too narrow. Wages are period bound costs and are to be attributed as period bound costs (that is: to the year in which the service is received) up until the point where an onerous contract exists. When that point is reached, the recognition of a provision is allowed. Therefore, the additional question is whether there is any relation between the wages and future revenue. When no or little revenue is connected to the wages and the enterprise will not benefit in any way from the payment of the wages, an onerous contract can occur. When the costs of harmonisation and employment terms are higher than the expected benefits, the recognition of a provision for an onerous contract is allowed. It can however be very difficult to assess the expected loss from such contracts. The Dutch Supreme Court ruled that when it is highly complex to assess the expected loss from such contracts, a provision is not allowed, following from the principle of simplicity. Another aspect is the unavoidability of the expense. A current

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1006 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcrt. 2012, 3804.

back-service or compensation made necessary by the restructuring (for example because employment terms are altered and a compensation is paid for the loss of certain rights) would lead to unavoidable costs that are not related to future performances, whereas increases in future performances would. This means that current back-services and other compensations that actually occur once the restructuring takes place are not attributable to future revenue and thus a provision would be possible for these expenses.

B. Costs of integration

Costs of integration consist of closing parts of the enterprise that have become obsolete in any way. This will lead to expenses one way or another, such as the expenses of hiring advisors or compensation paid to employees whose employment contract has ended. According to the guidance provided by the Dutch Secretary of State, this will generally meet all three requirements for the recognition of a provision.1008

C. Costs of moving

Future expenses of moving personnel and material from one location to another, connected to the restructuring, do not have their origin in the current year, according to the Dutch State Secretary of Finance.1009 Reference is made to earlier case-law for this.1010 In general it can be stated that this criterion is not approached very formally by the Dutch Supreme Court. It is not even required that the formal decision to restructure has already been made.1011

5.2.4.4 United Kingdom

Definition

FRS 102 defines restructuring as a programme that is planned and controlled by management and materially changes either:
(a) the scope of a business undertaken by an entity; or
(b) the manner in which that business is conducted.1012

This definition does not differ from IAS 37.10.

1008 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcr. 2012, 3804.
1009 Decree Dutch State Secretary of Finance of 11 November 2004, CPP2004/814M. This decree has been replaced by Decree Dutch State Secretary of Finance of 6 August 2010, DGB2010/3706M, Stcr. 2012, 3804.
1012 Appendix I: Glossary.
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Requirements

A. An obligation must be present

A provision for restructuring costs is only recognised under FRS 102 Section 21.11D as a constructive obligation. A constructive obligation to restructure arises only when an entity:

a) Has a detailed plan for the restructuring, identifying at least:
   i) The business or part of a business concerned
   ii) The principal locations affected
   iii) The location, function and approximate number of employees who will be compensated for terminating their services
   iv) The expenditures that will be undertaken
   v) When the plan will be implemented
b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.1013

For tax purposes this approach is followed as well.1014

B. As a result of a past event

From FRS 102, Section 21.11D, like IAS 37.72, it follows that two past events are key in the recognition of a provision for restructuring: a detailed formal plan for the restructuring and a valid expectation in those affected that the enterprise will carry out the restructuring. The upside of these criteria is that it is in itself quite clear when a provision for restructuring must be recognised. The downside, however, is that it leaves a lot of control over when a provision must be recognised in the hands of the enterprise itself. Even when it is economically viable or maybe even necessary to restructure, the enterprise is not obliged to recognise this in the form of a provision. On the other hand, economic necessity is not a criterion in the recognition of a provision, which means that within the current system, that recognises only assets and liabilities (and equity as the difference between them), stretching the concept of a liability even beyond constructive obligations is impossible.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

Like all provisions, it must be likely that the settlement of the obligation necessitates an outflow of resources. As stated above a provision for

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1014 Business Income Manual 46535.
restructuring will mostly be based on a constructive obligation, of which two criteria must be met: a detailed plan and an expectation raised in those affected. The latter will generally be the deciding factor in the question whether a constructive obligation is present. In this expectation lies the necessary outflow of resources. Since the presence of an obligation is so intertwined with the outflow, I do not feel that this criterion is a highly limiting factor in the recognition of a provision.

D. A reliable estimate of the amount of the obligation can be made

Since most provisions for restructuring are based on a constructive obligation and FRS 102, Section 21.11D requires a detailed formal plan for the restructuring in which the expenditures that will be undertaken need to be mentioned, it will generally not be an issue to make a reliable estimate of the amount of the obligation.

Measurement

FRS 102, Section 21 lacks a rule comparable to IAS 37.80 on measurement of provisions for restructuring. IAS 37.80 states that a restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

a) Necessarily entailed by the restructuring; and
b) Not associated with the ongoing activities of the entity.

Given how similar IAS 37 and FRS 102 Section 21 are and the fact that IAS 37.80 merely clarifies IAS 37 and does not necessarily add to or deviate from the rules, the clarification seems applicable to provisions for restructuring under FRS 102 as well.

A. Harmonisation of pensions and employment terms or ending employment

In the case of harmonisation of pensions and employment terms, in itself an outflow of resources embodying economic benefits in settlement will be present, as is required by FRS 102, Section 21.4. More difficult to answer is whether a present obligation as a result of an obligating event arising from the past, is present. Depending on the terms of the plan for restructuring a present obligation can exist at the end of the reporting period. However, the obligating event can be unclear. When the harmonisation of the terms of employment and pensions lead to higher wages and contributions to pensions in the future, the obligating event will be the passing of time and the performance of the employees in the future. If they do not perform in the future, for example because they quit their job, no present obligation will exist anymore. When it concerns for example a back-service in pensions or a current compensation for a decrease in wages, this would constitute a present obligation, as this does not concern future performances by the employee.

B. Costs of integration
With regards to costs of integration, FRS 102, Section 21 is less detailed with regards to the subject of restructuring provisions than IAS 37 is. In itself the criterion of a probable outflow of resources embodying economic benefits in settlement will be met, like it would be under IAS 37. The question will be whether a present obligation as a result of a past obligating event exists. First of all, the criteria of Section 21.6 must be met, which means that a detailed plan and a valid expectation raised in those affected must be present. This will generally mean that a provision can (and must) be recognised. However, for it to be a restructuring provision, the criteria of Section 21.11C must be met, which is basically the application of Section 21.6. Costs of integration will generally be necessarily entailed by the restructuring and not be associated with the ongoing activities of the entity. Unlike IFRS, FRS 102, Section 21 does not state that there is a possible exception for when the costs of integration would be connected to an onerous contract.

C. Costs of moving

Costs of moving will lead to an expense and will often arise from an earlier period. As FRS 102 lacks guidance similar to IAS 37.80, but it is likely that FRS 102 does not aim to be different in this respect, costs of moving will generally meet the requirements, as they are necessarily entailed by the restructuring and not associated with the ongoing activities of the entity.

5.2.4.5 CCCTB

Definition
The common corporate tax base of CCCTB does not define restructuring provisions or mention them in any form. Therefore the question remains in how far a plan for restructuring can lead to the deduction of costs under Article 23 CCTB 2016.

Requirements
The regular system of attribution of expenses (Articles 9, 15 and 17 CCTB 2016) does not leave room for anticipating future expenses for restructuring, as the obligation to make the payment must have arisen, which will generally not be the case for expected future restructuring-expenses. Article 23 CCTB 2016 on provisions seems the most likely place for a provision for restructuring.

A. A legal obligation or probable future legal obligation

Unless a binding contract exists, the entity will not have a legal obligation to restructure, which rules out most of the applicability of Article 23 CCTB 2016 to restructuring. The ‘probable future legal obligations’ of Paragraph 1 provides the most room for the applicability of Article 23 CCTB 2016 to restructurings, but as stated in Paragraph 4.6.2.2.5, this remains a highly debatable issue, as
there are no clear boundaries to the probable future legal obligations and this criterion might even be removed in the definitive directive. It is not likely that the ‘probable future legal obligations’ were added with provisions for restructuring in mind, as most provisions for restructuring will be based on constructive obligations and it has been a clear decision not to open Article 23 CCTB 2016 to provisions for constructive obligations. Therefore the applicability of Article 23 CCTB 2016 to most expected future expenses related to restructurings is unlikely, even though the expense arises from the year in which the decision to restructure is taken. From the working papers it follows that it was a conscious decision not to recognise provisions for constructive obligations and therefore it would seem highly unlikely that restructuring provisions can be recognised under the common corporate tax base of CCCTB, when a constructive obligation exists (see Paragraphs 5.2.4.1 on IFRS and 5.2.4.2 on United Kingdom FRS for this: provisions for restructuring are generally thought to follow from a constructive obligation and there is no reason to think that this is different under the common corporate tax base of CCCTB). Therefore, only when a legal obligation exists (such as an onerous sale of part of the business) and the other criteria of Article 23 CCTB 2016 are met, this would lead to the deduction of costs on the basis of Article 23 CCTB 2016 for a provision for restructuring. When the entity has both a detailed plan and has raised a valid expectation amongst those affected by the plan that it will carry out the restructuring, this will in itself not be enough to recognise a provision, since this does not yet constitute a legal obligation and the common corporate tax base of CCCTB does not allow the recognition of a provision for constructive obligations. This means that while Article 23 CCTB 2016 does not cover constructive obligations, an even more arbitrary criterion (the ‘probable future legal obligation’) is present in the common corporate tax base of CCCTB, which creates a highly undesirable grey area. Insofar the restructuring would lead to a contract becoming onerous, it is likely that under Article 23 CCTB 2016 the recognition of a provision would be applicable (see Paragraph 5.2.2.5 for the applicability of Article 23 CCTB 2016 to onerous contracts). It can be argued that if the harmonisation of pensions and employment terms is expected to result in a deductible expense, the amount can be reliably estimated and the expenses arise from activities or transactions carried out in that or previous tax years (the restructuring plan). It is however unclear when this constitutes a legal obligation or probable future legal obligation, as required by Article 23, Paragraph 1 CCTB 2016. As stated, the concept of what constitutes a probable future legal obligation remains highly unclear and in my opinion does not cover this area. Compared to the Dutch, German and UK systems and IFRS, which all accept constructive obligations as a liability, recognition of such a provision under Article 23 CCTB 2016 will occur relatively late, because it will be relatively late when an actual legal obligation occurs. When compensation has to be paid to employees following from the fact that some parts of the enterprise

have become obsolete, it is doubtful whether and when the criteria of Article 23 CCTB 2016 will be met. The ‘arising-in’ criterion will generally be met, as will the criteria of a reliable estimate and deductibility. However, whether a legal obligation or a probable future legal obligation is present will depend on the situation as such. As stated before, it is unclear what constitutes a probable future legal obligation, but a legal obligation to pay compensation to employees can follow directly from a restructuring, depending on applicable law and the contract(s) between parties. The expenses of hiring advisors during the restructuring will generally not meet the criteria of Article 23 CCTB 2016 (they do not constitute a legal obligation beforehand, even though these expenses are economically connected with the decision to restructure). These expenses will therefore be attributed by Articles 9, 15 and 17 CCTB 2016.

B. Arising from activities or transactions carried out in that or previous years

In most situations where a restructuring is planned, it will not be possible to apply Article 23 CCTB 2016 to the expenses connected to the restructuring. When a legal obligation follows from a restructuring, it will need to arise from activities or transactions, carried out in that or in previous years. This can be the case when the decision to restructure has led certain contracts to become onerous (such as moving the business from one location to another and vacating the property without finding new use for the property).

C. The amount can be reliably estimated

When restructuring, generally the objective will be to eventually improve profit, revenue, or cash flow. This means that there will always be a financial expectation that management has of the restructuring. This is in a way contrary to most other provisions where the financial effect will follow from the occasion. With restructuring, the financial effect will usually be decisive in whether the restructuring takes place or not. This means that a reasonable estimate of the outflow will be present.

D. Eventual settlement of the amount is expected to result in a deductible expense

This is a matter of total profit: the type of expense must be deductible in character. With restructurings, this will generally be the case.

Measurement

Since it will generally not be possible to recognise a provision for restructuring, measurement is not arrived at.

A. Harmonisation of pensions and employment terms or ending employment

Costs related to the harmonisation of pensions and employment terms or ending employment cannot be deducted up until the point that they either constitute a
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legal obligation on the basis of Article 23 CCTB 2016 or when the obligation to make the payment has arisen on the basis of Article 17 CCTB 2016.

B. Costs of integration

With regards to costs of integration, the same applies, the costs cannot be deducted up until the point that they either constitute a legal obligation on the basis of Article 23 CCTB 2016 or when the obligation to make the payment has arisen on the basis of Article 17 CCTB 2016.

C. Costs of moving

With regards to the costs of moving, the same applies, the costs cannot be deducted up until the point that they either constitute a legal obligation on the basis of Article 23 CCTB 2016 or when the obligation to make the payment has arisen on the basis of Article 17 CCTB 2016.

5.2.5 Clean-up and recovery

5.2.5.1 IFRS

Definition

Provisions for the clean-up of environmental damage are regular provisions that have to meet the criteria of IAS 37, which means that there must be

– A legal or constructive obligation;
– Likely that settlement of the obligation necessitates an outflow of resources;
– A reliable estimate of the amount of the obligation can be made.

IAS 37 itself does not provide further guidance on the recognition of provisions for the clean-up of environmental damage, but in the examples of the implementation guidance, the clean-up of contaminated land is covered.\textsuperscript{1016} No strict definitions are provided.

Requirements

A. An obligation must be present

IAS 37 IE Examples 2a and 2b cover both options in company policy that can lead to the recognition of a provision:

– To clean up environmental damage, even when there is no legal obligation to do so;
– To clean up environmental damage, as soon as legislation to clean up is

\textsuperscript{1016} International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets  IE Examples 2a and 2b.
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virtually certain to be enacted.

The first situation only constitutes a constructive obligation when the criteria for the recognition of a constructive obligation are met. This is the case, for example, when the enterprise has an environmental policy that is widely published and has a record of honouring that policy. The second situation constitutes a legal obligation from the moment that the legislation is virtually certain to be enacted.

In the example given, there is a legal obligation to repair the environmental damage after the enterprise is done with the area. This means that a legal obligation is present.

B. As a result of a past event

The obligating event is the contamination of the land. This is the relevant past event. It can also be that when the contamination takes place, no obligation to clean up exists while at a later moment either new law enters into force or the enterprise changes its policy with regards to the clean-up of contamination. This means that it is the introduction of the new law that creates a legal obligation at that point.

In the example the past event is actually the first moment when the enterprise digs into the quarry. That is the moment when the obligation is present. The ongoing activities increase the measurement of the provision.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

IFRS deals with contamination in an example in which an outflow embodying economic benefits in settlement is probable, which implies that this is in itself not a criterion in which problems are likely to arise. However, contamination is not always acted upon by governments, either because it goes by unnoticed or because governments do not have the means necessary to enforce this. This means that probability might be more of an issue than it is given credit for by IAS 37 or the illustrative examples. When a legal obligation exists, but the government does not enforce it, this means that the obligation is merely theoretical and no settlement of the obligation will be likely and thus a provision cannot be recognised because not all the requirements are met.

D. A reliable estimate of the amount of the obligation can be made

When an enterprise knows that a certain contamination has taken place and either law or policy obliges the enterprise to clean up the contamination or otherwise restore the environment, it will often not be possible to determine exactly how much contamination is present and how much it will cost in the
future to clean it up. However, it will mostly be possible to make at least a reliable estimate of the amount of the obligation.

**Measurement**

No specific guidance is given with regards to the measurement of the costs of clean-up. Contamination or other environmental damage will often be built-up over the course of the years. The question will arise how the corresponding eventual expense is to be spread over the years. IFRS does not explicitly recognise the concept of matching and leaves little to no room for equalisation of profit. The obligation itself is to be measured every year, which means that, when the cost of clean-up is equal when either one or ten years pass, the obligation is recognised in year one and, apart from actualisations and mutations in price / inflation no build-up takes place and the cost is not spread evenly over the years, even when it effectively applies to all the years. Although I am of the opinion that this means that the performance of the enterprise is not shown properly, it is consistent with an obligation-driven approach that favours the balance sheet over the profit and loss account.

5.2.5.2  German law

**Definition**

Provisions for the clean-up of environmental damage (‘Rückstellungen für Umweltschutzverpflichtungen’) are not defined as such, but are part of the provisions for external liabilities (‘Rückstellungen für ungewisse Verbindlichkeiten’). The provisions for future clean-up of contamination (‘Rückstellungen für Abraumbeseitigungen’) can also be applicable.

**Requirements**

A provision must be recognised for future expenses that are connected with the future clean-up of contamination. The three-month period that applies to provisions for overdue maintenance (‘Rückstellungen für unterlassene Instandhaltung’) is not applicable to provisions for future clean-up of contamination (‘Rückstellungen für Abraumbeseitigungen’). The expense must take place somewhere in the twelve months after the end of the reporting period in which the provision was recognised. When based on an obligation to clean-up, however, a ‘Verbindlichkeitenrückstellung’ must be recognised and not an ‘Aufwandrückstellung’, as there is an obligation towards third parties and not an internal obligation. In this situation the term of the provision can also be longer than twelve months.\(^{1017}\) The fact that provisions for the clean-up of environmental damage are part of provisions for external liabilities means that the following criteria apply.

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In the example, there is a legal obligation to restore the quarry when the enterprise is done with it after ten years. This means that a ‘Verbindlichkeitenrückstellung’ must be recognised and therefore the twelve-month limit of the ‘Rückstellung für Abraumbeseitigungen’ is not applicable.

A. Legal or constructive obligation

As German civil and tax law allows the recognition of provisions on the basis of both legal and constructive obligations, which means that both the situation where law requires the clean-up and the situation where the entity has a policy to clean-up the contamination can meet the requirement of a present obligation.

In the example, a legal obligation is present.

B. Quantifiable

The fact that the expected future outflow must be quantifiable means that a reasonable estimate can be made of the future outflow rather than that any exact amounts can be determined (which will generally not be the case with the clean-up of contamination). In the case of general purpose financial reporting there can be a tendency amongst enterprises to state that estimation and quantification is not really possible, in order to not have to recognise the amount on the balance sheet. However, for an expert, it will generally be possible to make a reasonable estimate of the amount needed to clean-up the contamination, which means that this criterion is not very limiting in the recognition of a provision. On the other hand, it must still be a reasonable estimate. This means that when an enterprise deems it fitting to lower its taxes by recognising a provision for the clean-up of contamination, its estimate must still be within the boundaries of reality. When an enterprise mines a quarry, it will be in a reasonable position to determine the costs of restoring the site.

C. Amount of the obligation is uncertain

With regards to contamination, it will in most cases be clear whether an obligation exists, in the sense that an enterprise will know whether it produced contamination that it is required by law to clean-up or has a policy which requires the contamination to be cleaned-up. The amount of the obligation will often not be certain. It will be possible to make a reasonable estimate, but only when the clean-up actually takes place, it becomes clear how much the actual outflow will be.

Since the example concerns an obligation to clean up after ten years, the exact amount will be uncertain at this point.
D. Result of past events

Either the contamination itself or later changes in law or policy will lead to the obligation to clean-up and thus are the past events that have resulted in the obligation.

E. Outflow is likely

The outflow must be likely, which means that either a policy must exist of which the enterprise has shown that it will follow it or the type of clean-up, required by law, is actually enforced. A lot of contamination takes place without governments knowing or being able to enforce the clean-up. This means that this will generally be the limiting requirement. It will be difficult to prove that the outflow is actually likely.

Measurement

In the case of an ‘Aufwandrückstellung’, no spread over the years can take place, as the maximum term is twelve months. This also rules out the application of a discounted value. Therefore, measurement of this type of provision is primarily dependent on the actual expected outflow. In the case of a ‘Verbindlichkeitenrückstellung’ regular measurement-rules apply, which means that present value can be applicable. With regards to the question how to attribute this concept in the case of multiple years, it must be taken into account that under German law the principle of prudence applies and therefore a spread of the attribution of the costs will only occur when the actual expected outflow increases every year.

5.2.5.2 Dutch sound business practice

Definition

No specific definition of clean-up of contamination exists. For clean-up of contamination, a provision is only allowed when the criteria of Dutch Supreme Court 26 August 1998 are met.\(^{1016}\) Contrary to the other researched systems, sound business practice leaves a large amount of freedom for the taxpayer on how to determine his taxable profit.\(^{1019}\) The recognition of a provision is likely to be optional, as long as it is not contrary to consistency. What must be noted is that it is also possible to recognise a reserve for equalisation of costs, which has a similar effect in attribution future expenses to the year in which they are caused. See Paragraph 4.4.1.2.

\(^{1019}\) For examples that sound business profit leaves a large amount of freedom in determining how to deal with expenses for contamination, see Dutch Supreme Court 18 December 1991, ECLI:NL:HR:1991:ZC4849 and Dutch Supreme Court 11 April 2001, ECLI:NL:HR:2001:AB1004.
A. The expense arises from facts or circumstances before the end of the reporting period

More specific, this means that the environmental damage must be caused by the business activities of the enterprise before the end of the reporting period.

*In the example, the mining of a quarry leads to the eventual expense. As soon as these activities have started, there is a future expense that arises from facts or circumstances before the end of the reporting period.*

B. A reasonable amount of certainty exists that the expense will occur

Whereas the probability of the expense is not always the most debated issue with regards to the recognition of a provision, this is different in the case of clean-up of contamination. The Dutch State Secretary of Finance has stated that, even when a legal obligation to clean up environmental damage or contamination exists, the fact that most environmental damage is not cleaned up (either because it’s not discovered or because national, provincial and local governments do not always have enough ways to enforce such laws), means that the reasonable amount of certainty that the expenses will occur is not automatically present in such cases.\(^{1020}\)

*In the example, the enterprise must therefore prove that the outflow is likely. This will be the case when either there is a strict enforcement policy by the authorities or when the enterprise has a track-record that shows that it fills up the quarries once the activities are over. When neither is present, proof will be hard to deliver.*

C. The expenses can be attributed to the period otherwise as well (criterion of sound business practice)

This criterion mainly consists of two criteria:

- The expenses cannot be attributed to future revenue
- The expenses are not to be attributed to future years by character

\(^{1020}\) Dutch Secretary of State, Decree of 6 August 2010, *DGB2010/3706M*. It needs to be taken into account that it was actually the fear of overprovisioning in the case of the clean-up of environmental damage that led to the proposal of new law when Dutch Supreme Court 26 August 1998, ECLI:NL:HR:1998:AA2555 led to the conclusion that recognition of a provision without the presence of a legal obligation was actually possible. See Parliamentary Papers II 1999-2000, 26 821, no. 3, MvT, Paragraph 2. Although this fear proved to be unfounded, it is easy to see that this was a valid argument, as it was known that a lot of unresolved environmental damage exists that will likely not be removed by the enterprises. On the other hand, enterprises will often not be tempted to acknowledge the fact that such damage exists and is caused by them, even when it provides a tax break.
Whether contamination can be attributed to future revenue depends on the system that is applied. Contamination will generally occur in the course of business and can be either systematic or unsystematic. Contamination is unsystematic when it is not automatically caused by certain activities; i.e. it can happen, but will not systematically be a side-effect of an activity and thus cannot be predicted. An example of this is the BP Deepwater Horizon oil spill of 2010. Such contamination is a side-effect of the production of oil, but a unit of oil will not necessarily lead to a unit of contamination, in the sense that there is no direct relation between the amount of production and the amount of damage. In itself, accidents like this will happen every now and then (meaning that the recognition of a provision can come into view). On the other hand, the amount of predictability is so remote when compared to the production, that the relation between the two cannot lacks predictability. Such contamination is, in my opinion not attributable to future revenue, but also not to current revenue. This means that I am of the opinion that for damages such as the BP oil spill of 2010 a provision could not have been recognised in the years before 2010. Contamination is systematic when it is possible to attribute a unit of contamination to a unit of production. Of such contamination it can be stated that the clean-up of contamination is part of the costs of production and thus can be attributed to future revenue. In my opinion, sound business practice leaves an amount of freedom to the taxpayer in how costs of goods sold are to be determined. That, to my mind, leaves it mostly up to the taxpayer whether or not contamination, even when systematic, should be attributed to future revenue. On the other hand (and there is no specific case law on this) I feel that it is at least defendable that no provision can be recognised for systematic contamination as it is attributable to future revenue. With regards to the second criterion, this is mainly aimed at period bound costs, such as rent, salaries and interest. It can play a role when an entity is planning on cleaning-up the contamination itself, which means that a large part of the expense will involve salaries. Unless it can be proven that these salaries are part of an onerous contract, it will be impossible to recognise a provision for that part of the expenses.

Measurement

The freedom that sound business practice offers also applies to measurement. In my opinion it is possible to either measure the obligation as it is at the end of the reporting period (which is in line with IFRS) or to evenly spread the costs over the years to which the obligation applies, given the fact that there is a relation between the future years and the future expense. The latter will generally be the case in what I previously called ‘systematic contamination’ in which there is a

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1021 In April 2010 the BP-owned Deepwater Horizon oil rig exploded and sank, upon which a sea-floor oil gusher flowed for about three months, resulting in what is thought to be the largest accidental oil spill ever. It illustrates that even in a mature sector that has numerous measures against environmental damages are in place, it proves that it can never be ruled out that certain materials used are defective and can break, resulting in extraordinary damage.

somewhat given relation between production and contamination, i.e. that the contamination will occur when production takes place and not that there is just a chance that the contamination will take place at a point in the future (and of which I stated that it might be contrary to the criterion of sound business practice).

In the example, there is a relation between the activities and the expense. In my opinion, attributing €100,000 to each year for ten years is in line with sound business practice, as each year contributes as much as the other year to the eventual future expense, from a matching point of view. A more interesting question is whether it would be possible to attribute €550,000 to the first year and €50,000 to each of the following years. Since this is basically the approach of IFRS and it is a realistic approach as well (the obligation at the end of the year is actually €550,000), I am of the opinion that this would also be in line with Dutch sound business practice.

5.2.5.4 United Kingdom law

Definition
Provisions for the clean-up of environmental damage follow the regular criteria set out by FRS 102. FRS 102 Section 21 does not provide further guidance on the recognition of provisions for the clean-up of environmental damage and contrary to IAS 37, the contamination of land is not covered in the examples either.

Requirements

A. An obligation must be present

Although FRS 102 does not provide examples like IAS 37 IE examples 2a and 2b, the underlying principles and definitions are virtually identical and thus the cases represented in the examples would have a similar outcome under FRS 102.

These examples cover both options in company policy that can lead to the recognition of a provision:

- To clean up environmental damage, even when there is no legal obligation to do so;
- To clean up environmental damage, as soon as there is legislation to clean up is virtually certain to be enacted.

The first situation only constitutes a constructive obligation when the criteria for the recognition of a constructive obligation are met. This is the case, for example, when the enterprise has an environmental policy that is widely published and has a record of honouring that policy. The second situation constitutes a legal obligation from the moment that the legislation is virtually certain to be enacted.
In the example given, there is a legal obligation to repair the environmental damage after the enterprise is done with the area. This means that a legal obligation is present.

B. As a result of a past event

The obligating event is the contamination of the land. This is the relevant past event. It can also be that when the contamination takes place, no obligation to clean-up exists while at a later moment either new law enters into force or the enterprise changes its policy with regards to the clean-up of contamination.

In the example the past event is actually the first moment when the enterprise digs into the quarry. That is the moment when the obligation is present. The ongoing activities increase the measurement of the provision.

C. It is likely that the settlement of the obligation necessitates an outflow of resources

Contamination is not always acted upon by governments, either because it goes by unnoticed or because governments do not have the means necessary to enforce this. This means that enough proof must be provided in order to prove that relevant probability exists to recognise a provision.

D. A reliable estimate of the amount of the obligation can be made

When an enterprise knows that certain contamination has taken place and either law or policy obliges the enterprise to clean-up the contamination, it will often not be possible to determine exactly how much contamination is present and how much it will cost in the future to clean it up. However, it will mostly be possible to make a reliable estimate of the amount of the obligation.

Measurement

No specific guidance is given with regards to measurement of the costs of clean-up. Contamination or other environmental damage will often be built-up over the course of the years. The question will arise how the corresponding eventual expense is to be spread over the years. Like IFRS, FRS 102 does not explicitly recognise the concept of matching and leaves little to no room for equalisation of profit. The obligation itself is to be measured every year, which means that, when the cost of clean-up is equal when either one or ten years pass, the obligation is recognised in year one and, apart from actualisations and mutations in price / inflation, no build-up takes place and the cost is not spread evenly over the years, even when it applies to all the years. With regards to measurement, the obligation must be measured, which means that spreading the costs over multiple years is only allowed when this reflects the actual annual increase of the obligation.
5.2.5.5 **CCCTB**

**Definition**

Neither Article 23 CCTB 2016 nor any other part of the common corporate tax base of CCCTB, explicitly mentions a provision for clean-up costs. For the recognition of a provision for clean-up costs, the normal criteria of Article 23 CCTB 2016 will have to be met.

**Requirements**

A. **Legal obligation or probable future legal obligation**

A legal obligation to clean up or a probable future legal obligation to do so must exist. A possible interpretation of the probable future legal obligation is that when the enterprise is obliged to clean up or restore the damage it has done, but that only becomes an issue when the enterprise is done with the work and has to restore, this is actually the probable future legal obligation meant by Article 23, Paragraph 1 CCTB 2016. It might also be applicable to situations where a law does not yet exist, but the passing of a new law, requiring contamination to be cleaned up is probable.

*This would mean that from years 1-9 in the example a probable future legal obligation is present, which leads to the recognition of a provision.*

B. **Arising from activities or transactions carried out in that or previous years**

Since Article 23 CCTB 2016 requires a legal obligation or probable future legal obligation to be present in order to recognise a provision and states that these must arise from activities or transactions carried out in that or previous years, the relevant event will be the contamination itself and not the law or future law, unless the law is put into place after the contamination has taken place.

*In the example, the eventual expense arises from mining the quarry.*

C. **A reliable estimate of the amount can be made**

The common corporate tax base of CCCTB does not give guidance on when an estimate is reliable enough (statistical methods, third party opinions, educated guesses), but neither do the other systems. Of most types of contamination it will be possible to either make a reasonable estimate (for example based on prior experiences) or have a third party expert make an estimate.

*In the example, the enterprise’s expectation is that it will cost € 1.000.000 to reconstruct the quarry.*

D. **Eventual settlement of the amount is expected**
The expectancy of occurrence of the expense leads to similar questions. There are a lot of laws in power that require pollution, contamination or environmental damage to be cleaned up or restored, whereas the actual clean-up or restoration is more limited. This means that in order for eventual settlement of the amount to be expected, either enforcement by the government must be clear (such as when a government enforces the clean-up of a certain type of pollution or contamination or when it has actually written the enterprise that clean-up is required) or the enterprise has a strict policy to clean-up pollution. The latter seems similar to the constructive obligations in for example IFRS, but it is not. Under Article 23 CCTB 2016 a legal obligation or probable future legal obligation must always be present and the company policy can prove that the eventual settlement of the amount is expected.

**Measurement**

With regards to measurement, it would be expected that what is measured is the actual obligation at the end of the reporting period, given the approach that Article 23 CCTB 2016 follows. However where the obligation relates to an activity or transaction which will continue over future tax years, Article 23, Paragraph 1 CCTB 2016 requires that the provision shall be spread proportionately over the estimated duration of the activity or transaction, which means that, unless the activities or transactions will not continue over future tax years, the attribution of expenses shall be spread over the course of the years instead of measuring the actual obligation at the end of the reporting period. When the activities or transactions will not continue over future tax years, the actual obligation shall be measured.

### 5.3 Summary and conclusions

In this chapter a number of regularly occurring situations that are generally associated with provisions are analysed. From this application, the following can be derived.

With regards to *warranties*, which can follow from either legal obligations or constructive obligations, it is most striking that only the common corporate tax base of CCCTB does not allow the recognition of a provision for a constructive obligation. Furthermore, apart from the German system, none of the systems explicitly mentions that large groups of homogenous items can lead to the presence of an obligation and probable outflow, but the examples given in IFRS and United Kingdom FRS imply that they can under these two systems. Dutch sound business practice also leaves room for this. The common corporate tax base of CCCTB, however, does not make this explicit in Article 23 CCTB 2016, gives no examples or other guidance and no case-law exists at this point, which illustrates the stand-alone character of the common corporate tax base of CCCTB. In the case of measurement of provisions for warranties for individual items, the measurement is largely inconsistent in most systems. Especially IFRS and United Kingdom FRS are quite explicit in their use of settlement value on the one hand, while measuring provisions for warranties for individual items at
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their full value (which does not include the probability in measurement, which will always influence settlement value in practice). A similar issue arises in Article 23 CCTB 2016.

With regards to onerous contracts, both IFRS and United Kingdom FRS recognise the concept of onerous contracts and provide a relatively large amount of details with regards to onerous contracts. What is interesting is that they both imply that executive contracts are thought to even each other out, which can only be true when both are measured at market value. However, the concept that a balance sheet shows market values might have been relevant at the start of IFRS, but under the current insights even the IASB does not adhere to this thought anymore. With regards to contracts they both approach these economical as the split in parts or combination of contracts are possible. German tax law does not allow the recognition of provisions for onerous contracts altogether, which is a bit odd when compared to IFRS and FRS, which view a provision for an onerous contract as a regular provision and not as a specific category. Dutch sound business practice does allow the recognition of a provision for an onerous contract in the determination of taxable income. It implies that executive contracts are not to be taken into account. However, this cannot follow from the thought that both are measured at market value. Strictly speaking, under the principle of prudence, the liability should be recognised, whereas the corresponding asset cannot, which effectively leads to a loss in the year when the enterprise enters into the contract. The fact that this is disallowed will follow from the principle of realism: the transaction does not effectively lead to a loss, so recognition of a loss is not allowed. More specific it can also be stated that the expenses that are incurred are done so because of the principle of matching, leading to an attribution of the expenses to the future. The common corporate tax base of CCCTB does not provide a lot of insight on how to deal with onerous contracts. Article 22 CCTB 2016 does provide some insight with regards to the attribution of revenue connected to the contract, but is limited to specific situations and Article 23 CCTB 2016 is fully silent on the issue. When approached from the viewpoint that Article 23 CCTB 2016 took IAS 37 as its starting point and is not specifically addressing onerous contracts, it can be derived that a provision for an onerous contract is simply part of the general provisions meant by Article 23 CCTB 2016. This means that a provision for an onerous contract can be recognised. Interestingly, the required spread of the costs over the future of Article 23, Paragraph 1 second sentence CCTB 2016 do require a spread instead of deducting a loss once it occurs when the activities or transactions continue in the future. It is unlikely that a provision for a non-onerous executive contract can be recognised, even though the common corporate tax base of CCCTB is not balance-sheet based in the way IFRS is and does not strictly adhere to the principle of matching, also because future expected inflows connected with the outflow must be taken into account. This means that measurement is the reason why they cannot be recognised and not the concept of executive contracts itself. How this shall be measured is however not made explicit in the common corporate tax base of CCCTB.
Maintenance and repairs is another future expense that is foreseeable and has its origin in years before the expense takes place. For general purpose financial reporting this means that a provision for this would provide useful information to users of the financial report and for tax purposes it makes sense to recognise a deductible cost early on in order to let the enterprise save up for the maintenance or repair. However, since all systems but sound business practice require an obligation to be present, this limits the possibility to recognise a provision for maintenance and repairs. IFRS and UK FRS do not allow this altogether. German law solves the issue by means of the ‘Innenverpflichtung’ (the obligation of the enterprise that it has to itself in order to keep continuity up). In a way this is a peculiar item and not consistent. Dutch sound business practice does not require the presence of an obligation and so the recognition of a provision for maintenance and repairs is possible. However, under Dutch tax law the reserve for equalisation of costs is also possible for certain types of maintenance and repairs and therefore an overlap between the reserve and provision exists. Whereas most of the other systems do not allow any type of profit deferral for maintenance and repairs, Dutch tax law allows for two different types. The common corporate tax base of CCCTB is more difficult in this respect. The requirement of a legal obligation will rule out most of the provisions for maintenance and repairs, but a probable future legal obligation might leave the possibility open. However, it is unlikely that this effect is what is meant by Article 23 CCCTB 2016. The problem is that this leaves possibilities open that can lead to a different application in the different Member States.

Restructurings will, under IFRS and United Kingdom FRS, generally be based on constructive obligations. Recognition on the basis of a legal obligation will mean that recognition takes place rather late in the process, when the plans of management will have turned into certain legal obligations (although the exact moment when the constructive obligation becomes a legal obligation will often be hard to identify). The only system in which this means that no provision can be recognised relatively early on, is the common corporate tax base of CCCTB, as constructive obligations cannot lead to a provision under the common corporate tax base of CCCTB. As all the other systems allow the recognition of a provision for restructuring this strikes me as odd, as restructurings are a) quite common and b) almost sure to lead to deductible expenses, while there is a distinct argument in favour of such provisions in the case of restructuring. Therefore, it makes no sense to burden an enterprise with taxes first, which it can reclaim later, after the expenses have taken place. In itself, something can be said in favour of not allowing the recognition of provisions for constructive obligations because of the inherent subjectivity that they bring. However, I do believe that IFRS has shown that it is very well possible to limit this by adding specific criteria that have to be met.

Clean-up of contamination caused by the enterprise will generally either be required by law or law that is very likely to enter into force in the short term or policy of the enterprise itself. Since the latter constitutes a constructive obligation, the recognition of a provision will not be allowed by Article 23 CCCTB 2016. The future clean-up of contamination is also a probable
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Explanation for the probable future legal obligation. Under all systems it will be an issue that the expense must be probable. In practice there is a large amount of contamination that is not cleaned-up. Therefore mainly when the enterprise can show that it has a policy to clean up contamination (to which it has adhered) or that the local government has a policy of enforcing existing law, enough probability will exist. With regards to measurement, the spread of the cost over the years is highly dependent on how the contamination takes place. The more it is possible to link a unit of production with a unit of contamination, the more likely it is that a spread over the costs over the years is required. More in general it can be stated that Dutch sound business practice, while trying to offer more freedom to the taxpayer, by removing the requirement of an obligation, is not necessarily doing the taxpayer a favour, as the criterion of sound business practice (which is a necessary addition when removing the attributing criterion of a present obligation) is in practice much more difficult to apply than the requirement of an obligation. Applying this approach under the common corporate tax base of CCCTB (meaning: removing the requirement of an obligation in favour of a ‘sound business criterion’) would make the common corporate tax base of CCCTB more complex and difficult to apply (and thus likely leading to unwanted differences in practical application in the different Member States of the European Union), while adding no noteworthy advantages, in my opinion. I am of the opinion that it will therefore be better to either clarify or remove the ‘probable future legal obligation’ from Article 23 CCTB 2016 than to remove the whole concept of an obligation or legal relationship in the way it has happened in the Netherlands.
### 5.4 Schematic overview of the main characteristics

<table>
<thead>
<tr>
<th></th>
<th>IFRS</th>
<th>German tax law</th>
<th>Dutch tax law</th>
<th>UK tax law</th>
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<td></td>
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<td>no</td>
<td>no</td>
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<tr>
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<td>yes, limited extent</td>
<td>yes</td>
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<td>both</td>
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</tr>
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Chapter 6 Analysis of the issues found

6.1 Introduction and general issues

6.1.1 General issues
In Chapters 4 and 5 several issues with regards to the treatment and recognition of provisions in the common corporate tax base of CCCTB have been found. These range from somewhat random but conscious choices (e.g. the treatment of constructive obligations) to obvious problems ("shall be deductible") and what are likely to be unforeseen effects (the build-up of provisions that spread over time and measurement of provisions at settlement value). In this chapter the issues found are gathered, grouped and discussed, whereby reference is made to the normative framework of Chapter 2 and, where possible, to the outlines of the systems mentioned in Chapter 3. A number of general remarks apply. The common corporate tax base of CCCTB is basically a rules-based, standalone tax base and I am of the opinion that it should be just that. Whereas I have a tremendous respect for the work that has been done by the Dutch Supreme Court with regards to Dutch sound business practice, where a set of principles and a century of case-law have proven that even an open norm (or better said: an absent norm) can function quite well in the tax law of a modern Western economy, this setting is far from ideal. The development of such a body of case-law, the time and money it consumes and the inefficiencies it creates when different Member States can apply the principles differently for a long time when the case-law is under development are not desirable in the European Union. Apart from that, it is unpractical to have to reread case law instead of structured rules which are designed for their purpose, as opposed to of having the purpose to end a particular conflict, as is the situation with case-law. More or less full congruence, as is the case in German law, is not a bad option, when there would be a proper general set of rules available to fulfil that duty. IFRS does not currently fulfil that role as it is not the general standard for the general purpose financial reporting of non-listed enterprises. The European Accounting Directive is in itself a good starting point for this and it is mandatory in all the Member States, but it suffers from the fact that the European Union on the one hand supports the use of IFRS and even requires its use in certain cases, but on the other hand has its own set of rules which therefore do not seem to be the golden standard for accounting in the European Union. The fact that the latest version of the European Accounting Directive was published in 2013, while the proposal for a Directive on CCCTB was first published in 2011, has probably meant these introductions were out of line with each other. If the introduction dates were reversed, this might have been different and the

European Accounting Directive might have had a larger influence on the common corporate tax base of CCCTB than it did. Another issue, more specific to Article 23 CCTB 2016, is that Article 23 CCTB 2016 mentions the word ‘provision’ which is generally the word used for the entry on the balance sheet. The title of Article 23 CCTB 2016 is therefore badly chosen in a way and ‘future expense attributable to past activities or transactions’ would likely be a better title for the Article. This also brings back the issue of a mandatory balance sheet. In our modern times, double entry bookkeeping is the norm in financial reporting and accounting (and so it has been for several centuries) and this underlies every form of administrative accounting, either digital or not (although the latter will be a rarity amongst the multinationals targeted by the European Commission for the use of CCCTB anyway). With regards to the common corporate tax base of CCCTB two things can happen:

– The existing financial reporting will be used and a bridge between the profit under CCCTB and the existing financial reporting will be made;
– Separate, stand-alone financial reporting will be made for tax returns under CCCTB.

Inevitably, this means that a balance sheet will always underlie the measurement of profit under the common corporate tax base of CCCTB. A balance sheet will always be present, with it either being formally required or not. A balance sheet also serves as a part of the checks and balances within double entry bookkeeping. This means that both for the taxpayer and the tax authorities, a balance sheet increases the reliability of the numbers presented, instead of simply being an administrative burden. If the European Commission would reconsider its stance on the necessity of a balance sheet, this would actually serve the objectives of CCCTB better, as it would improve auditability and enforceability. It would also help to clarify the title ‘Provisions’ of Article 23 CCTB 2016. With regards to the approach to provisions, I am of the opinion that with CCCTB being a robust and simple stand-alone tax base, with its own particular objectives, the concept of provisions in Article 23 CCTB 2016 should not be approached as a general average between Member States. As some Member States do not allow the recognition in their own national determination of taxable income, this inevitably leads to political negotiation about parts of Article 23 CCTB 2016 and reaching a middle-ground, while the question should be how Article 23 CCTB 2016 can serve the objectives as well as possible. Also, political consensus can often be reached easier when a rule is not very clear, so that every party can read its own agenda into it. This can lead to lack of clarity and worse, as European Directives tend to be a bit high level and no too detailed, it can lead to differences in implementation across Member States. This stresses the issue of simplicity and clarity in the rules of Article 23 CCTB 2016.

On the issue of definitions, the following applies. Keeping the Directive simple and compact is instrumental in keeping the administrative burden low. This means that when providing definitions in a Directive, the question must always be asked whether this is absolutely necessary and where it must be defined.
(whether or not in a separate article reserved for definitions). Words that are crucial in the common corporate tax base of CCCTB but which are not defined, will be implemented and explained in accordance with the national law of Member States. When this is undesirable, a definition must be provided in the Directive itself. When a definition applies to several articles, the most sensible way is by means of a separate article dealing with definitions.

The common corporate tax base of CCCTB contains such an article in Article 4 of CCCTB 2016.

The delivery of evidence will also often remain an issue. In the case of individual items which are not based on numbers, such as court cases, this will generally be based on estimates, which shall be based on the opinions of external experts if discussions should arise. Exactly how this evidence should be delivered is basically for the courts to decide; I do not believe in the added value of providing general additional rules for this in the common corporate tax base of CCCTB. The enterprise claims that it can deduct amounts from the tax base so it should deliver evidence. In the case of large populations of items, such as the production of homogenous goods, statistical evidence might exist, when there is a history available of these or similar products, either inside or outside the enterprise. This creates the problem that an enterprise that has such information (either because it has produced certain goods for some time or because it has market-information about similar products), has a competitive advantage over enterprises that do not. In itself, this is how the market works (some parties have more information than others, which makes them incomparable from a tax perspective) and this is inherent to how provisions work: it allows the deduction of an expected future outflow. When the expectation of the future cannot be supported by any information, it is too subjective to allow a deduction. The mere fact that one enterprise can provide proof while the other cannot is a difference that tax law does not need to solve.

A bigger problem is the fact that also this leads to the situation that it will be very difficult to recognise a provision based on large numbers for truly new products, simply because there is no actual history. In some cases, the cost calculation of a product will take into account returns or guarantees, but oftentimes it will not. This means that it can be stated that start-ups and innovative enterprises are at a competitive disadvantage and that, in my opinion, does present a problem, as innovation is one of the presumed drivers of the economy in the European Union and should therefore be promoted instead of the reverse. It is clear that this is something that is part of the deliverance of evidence and while it is not normally the task of (tax) law to describe how proof can be delivered, it is important that some form of help is provided here. This can essentially be reached in one of the following ways:

- Allowing a fixed percentage of costs to be deducted as a provision
- Providing the evidence for the enterprise
- Easing the rules of proof
What needs to be taken into account is that provisions represent a timing issue which makes it temporary. The shorter the term, the less the perceived advantage of recognising a provision.

Allowing a fixed percentage of certain costs to be deducted as a provision creates a big ease for taxpayers, but the relation with economic reality can become too thin. The creation of a database in which data is collected with regards to the relation between the production and sale of certain products and the outflow of money is in itself possible, but not realistic in the short run. What could work is a temporary facility. When a product is introduced for which for example a patent is introduced, a maximum-percentage can be deducted for a certain period. In three years it should be clear whether or not the sale of the product leads to certain provisions. Certain freedom is given in allowing a maximum percentage. At the end of the third year the provision should meet the regular criteria.

For example, this would look as follows. A company has developed a new product and holds a patent for this. In the first three years, the costs of goods sold connected to the annual revenue derived from this is € 1.000.000. It can recognise up to € 10.000 provision annually. At the end of the third year, it needs to be able to prove that it meets the requirements for the € 150.000 provision and otherwise it will have to derecognise the amount.

Further empirical research would have to be done in order to assess what a reasonable percentage would be, which factors should be included and whether this should be a sector-specific percentage. The assessment of such a percentage falls outside the scope of this research. For now, I will assume that 1% is a reasonable percentage for this.

This could look like this:

Article 23 Provisions

4. Notwithstanding paragraph 1, when an enterprise introduced a new product and holds a patent or similar right for this product and cannot determine the statistical probability that the sale of the product will lead to a legal obligation arising from activities or transactions carried out in that, or previous tax years or the amount arising from that obligation, it can deduct 1% of the costs of the new products sold under this article in the year in which the products are sold in the three years after which the first product has been sold under the patent or similar right. At the end of the third year after which the first product has been sold under the patent or similar right, the requirements of paragraph 1 must be met and any amount deducted that cannot be deducted under paragraph 1 will need to be added to the profit of that third year.
With regards to proof itself, there is a distinct difference with regards to the question who has the burden of proof: the taxpayer that has to prove that he is entitled to the deduction or the tax authorities that have to prove that he is not. In my opinion, keeping rules of proof equal for all taxpayers is better than creating differences in that regard. In the light of the fact that Article 9, Paragraph 3 CCTB 2016 introduced an additional tax benefit for costs for research and development, start-ups and innovative enterprises already get treated preferentially.

6.1.2 Recognition and measurement

Furthermore, it needs to be clear that the two main issues in any article dealing with entries in financial reporting are recognition and measurement. Recognition deals with the question if and when the entry is taken into account and measurement deals with the question to what amount. Both need to be dealt with extensively. They also have an interaction. Several other aspects can come into play as well.

6.2 Recognition

With regards to the recognition of provisions under Article 23 CCTB 2016, several issues have come up. The first issue that came up was the fact that the wording of Article 23 CCTB 2016 can be both interpreted as leaving the deduction of the amount connected to the provision optional as well as mandatory.

6.2.1 ‘Shall be deductible’

In paragraph 4.6.2.6 I concluded that the wording that Article 23, Paragraph 1 CCTB 2016 uses (‘shall be deductible’) can either be interpreted as that it is mandatory to recognise a provision (‘shall’) or that it is optional (‘deductible’) to recognise a provision. It is an issue that is not mentioned or dealt with further in the working papers or the compromise proposals. This is especially important since, whereas Article 43 CCCTB 2011 allowed unrestrained carry forward of losses, the later compromise versions introduced restraints on the carry forward of losses, which was retained in Article 41 CCTB 2016. It is especially this aspect, the possibility of not being able to offset certain losses or to offset them in the far future that makes it an important issue whether or not recognition is mandatory. Mandatory recognition of a provision in combination with restraints on carry forward of losses creates a situation where it can be less attractive for an enterprise to recognise a provision. In itself, the offset of losses as part of the consolidated tax base is one of the prime political issues that surrounds CCCTB. Therefore, limitations on the carry forward of losses means that the losses are carried forward into the future even further, which means that despite mandatory recognition, the connection between the event that led to the provision and the taxable amount that it eventually decreases is very limited. Various methods of
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interpretation can be applied to the analysis. The first aspect follows from the definition of ‘profit’ and ‘loss’ in Article 4 Paragraphs 8 and 9 CCTB 2016.

‘profit’ means an excess of revenues over deductible expenses and other deductible items in a tax year;

‘loss’ means an excess of deductible expenses and other deductible items over revenues in a tax year;

Article 7 CCTB 2016 effectively follows the same approach as Article 4 CCTB 2016. Article 9 CCTB 2016 defines deductible expenses. From this, it can be deduced that what is deductible shall be deducted: deductible expenses can only influence profit when they are deducted from revenue. Therefore it seems to be implied that the word ‘deductible’ means that these expenses must be deducted (this is a matter of attribution to a certain year and therefore part of the determination of annual profit). On the other hand, it can be stated that the word ‘deductible’ might only indicate what character an expense must have and an entity can choose to either deduct it or not.

For example: business-related expenses are deductible and non-business-related expenses are not.

Articles 4 and 10 CCTB 2016 seem to hint at annual profit (‘in a year’ and ‘a proportional deduction’), whereas Article 7 CCTB 2016 does not and Articles 9, 12 and 14 CCTB 2016 hint at total profit.

Article 15 CCTB 2016 states that: Revenues, expenses and all other deductible items shall be recognised in the tax year in which they accrue or are incurred, unless otherwise provided for in this Directive.

This implies that when an item is deductible, it needs to be recognised in the year in which it is incurred and Articles 17 CCTB 2016 onward determine when a deductible item is incurred. This leads me to conclude that CCCTB determines what items are deductible and when they are deductible, the common corporate tax base of CCCTB determines when they are incurred and thus attributed. When read in this light, it means that the words ‘shall be deductible’ actually mean that recognition of the provision and deduction of the cost must take place in the year when the criteria of Article 23 CCTB 2016 are met.

There are actually several places where wording similar to ‘shall be deductible’ is used.

– Article 9 CCTB 2016 on deductible expenses uses the wording ‘shall be deductible’
– Article 11, Paragraphs 3 and 4 CCTB 2016 on allowance for growth and investment uses the wording ‘shall be deductible’
– Article 13, Paragraphs 1 and 2 CCTB 2016 uses the wording ‘shall be deductible’
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– Article 18 CCTB 2016 on non–depreciable assets also uses the wording ‘shall be deductible’
– Article 19, Paragraph 1 CCTB 2016 on stocks and work–in–progress uses the wording ‘total amount of deductible expenses’
– Article 21, Paragraph 3 CCTB 2016 on financial assets and liabilities held for trading uses the wording ‘shall be deducted’
– Article 23, Paragraph 1 CCTB 2016 on provisions uses the wording ‘shall be deductible’
– Article 25, Paragraph 1 CCTB 2016 on bad debt deductions uses the wording ‘a deduction shall be allowed’
– Article 28 part (d) CCTB 2016 on technical provisions of insurance undertakings uses the wording ‘shall be deductible’
– Article 32, Paragraph 1 CCTB 2016 on entitlement to depreciate uses the wording ‘shall be deducted’
– Article 34 CCTB 2016 on timing uses the wording ‘shall be deducted’
– Article 35, Paragraph 1 CCTB 2016 on rollover relief for replacement assets uses the wording ‘shall be deducted’
– Article 39, Paragraph 1 CCTB 2016 on exceptional depreciation / exceptional decrease in value uses the wording ‘may deduct’
– Article 41, Paragraph 1 CCTB 2016 on losses uses the wording ‘may be deducted’
– Article 45, Paragraph 1 CCTB 2016 on long–term contracts on entering the system uses the wording ‘shall be added or deducted’
– Article 46, Paragraph 1 CCTB 2016 on provisions and deductions on entering the system uses the wording ‘shall be deductible’
– Article 47 CCTB 2016 on pre–entry losses uses the wording ‘may be deducted’

This means that several wordings are used for allowing or obligating a deduction of expenses:

– Shall be deductible
– Deductible expenses
– Shall be deducted
– A deduction shall be allowed
– May deduct
– May be deducted

The words ‘shall be deducted’ indicate mandatory deduction. All the other wordings, except ‘shall be deductible’ imply an option to deduct the expense. The fact that both obligatory and optional wordings are used sheds no further light on what is meant by ‘shall be deductible’. Strange enough, the wording ‘shall be deductible’ is actually added in several places to the 2016 proposal. Of the other systems researched (IFRS, German, United Kingdom and Dutch tax law), all systems but Dutch tax law have a system where recognition of provisions is mandatory. Dutch tax law is not fully clear in this respect. In some cases the recognition of provisions is likely to be mandatory under Dutch tax
law, whereas in others optional recognition is implied. Dutch tax law, like the common corporate tax base of CCCTB, is basically a stand-alone tax base, whereas IFRS, German law and United Kingdom law are either standards for general purpose financial reporting or are based on and linked to standards for general purpose financial reporting. In general purpose financial reporting, it makes sense that the recognition of a provision is obligatory, whereas in tax law this is different (a taxpayer will, in most cases, have enough tendency to recognise a provision, as this will lead to a deferral of taxes when otherwise profit is made). When a taxpayer does not recognise a provision, while it would be perfectly legal to do so, he will have his reasons for this. One of the reasons can be not wanting to increase a loss even further, which will be especially relevant in systems, such as Dutch tax law, where carry forward of losses is limited in time and losses can evaporate because of this. Although probably not meant as such, non-mandatory recognition of provisions and limited carry forward in the Dutch tax system are actually in line with each other, although it can be stated that when an enterprise is in the habit of recognising provisions and it stops doing so merely for the reason that it fears that it is creating losses that will evaporate in the future, there will actually be a problem with regards to the required consistency. Since losses can evaporate under Dutch tax law, this means that the issue of mandatory or optional recognition is highly relevant under Dutch tax law (which makes the fact that it is actually not fully clear even more interesting).

With regards to the normative framework, the following applies. Double taxation can occur when mandatory recognition of provisions exists and the carry forward of losses is limited. Under the current plans for the common corporate tax base of CCCTB, evaporation of losses after a fixed amount of time is not part of the system, which means that optional recognition of provisions is preferable, but mandatory recognition will not lead to actual double taxation. This is different when the criteria of Article 41, Paragraph 3 CCTB 2016 are met, as this leads to an evaporation of losses when the activities are sold and the activities are changed. For provisions, however, their recognition was based on the fact that a legal obligation is present. Even though it is understandable that abuse of offsetting losses is countered by Article 41, Paragraph 3 CCTB 2016, when the activities are changed and ownership has been sold, if a provision was recognised and is still present, the outflow will still take place and would not have led to a reduction of the tax base, as the amount has been deducted already. Therefore, an exception should be possible for provisions that are recognised, but have not led to deduction.

With regards to the administrative burden or compliance costs no specific issues arise. Mandatory recognition of provisions in combination with limited carry forward of losses might lead to enterprises taking fewer risks in order not to have to recognise provisions. Although not fully correlated, there is a relation between taking risks and growth of an enterprise. This means that growth-friendliness might actually decrease when recognition of provisions is mandatory. Vertical or horizontal equity are not connected to this issue.
Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States whether provisions are to be recognised mandatory or optional varies. This is always a risk with uncertain positions, but is not unlikely to happen in this case. It does not support the choice for either optional or mandatory recognition itself. Effectiveness refers to the question whether a tax base can achieve its basic objectives. Uncertain positions will generally be ineffective, unless it is specifically meant as being unclear in order to get parties (tax authorities and tax payer) to discuss the outstanding issues. In the context of CCCTB this would be highly undesirable. The concept of simplicity, transparency and certainty relates more to the fact that the current text of Article 23 CCTB 2016 leaves too much room for interpretation and is therefore neither simple, transparent nor certain. Whether the eventual outcome is an optional or mandatory recognition, either option is simpler and more certain than the current text. In terms of consistency and coherence, the wording of the common corporate tax base of CCCTB in general leaves much to be desired, given what is analysed above. More consistency and coherence will be achieved by improving the wording, with regards to deductibility. In general, optional deduction of costs is something of a rarity in CCCTB to begin with. This means that mandatory recognition would be more consistent, but that would lead to the issues mentioned above. The issue of flexibility relates more to the fact that rules need to be changed or able to adapt to developments in practice quickly enough. This is in itself an issue that does not relate directly to the question whether recognition of provisions is or should be mandatory or optional. Enforceability would also benefit from the fact that it is clear whether recognition of a provision is optional or mandatory. As stated above, mandatory recognition in combination with limited carry forward of losses creates a situation where enterprises might be inclined to take fewer risks, in order to avoid having to recognise provisions. With regards to competitiveness, it would therefore make more sense to allow optional recognition of provisions. Apart from the question whether recognition is mandatory or optional, one of the problems with the current wording is its vagueness. The differentiation between mandatory and optional recognition would improve when only the words ‘shall be deducted’ and ‘may be deducted’ are used, as the words ‘shall be deductible’ are not clear in themselves and finding their meaning in CCCTB is a complex and unnecessary work. From the wording of the general system of the common corporate tax base of CCCTB, especially Article 4 Paragraphs 8 and 9 CCTB 2016 and Article 15 CCTB 2016 it can be derived that the word ‘deductible’, in the context of attribution of expenses (‘incurrence’), needs to be read as that the amount is to be deducted in the year in which it meets the requirements set by the common corporate tax base of CCCTB. This means that under the current proposal recognition is most likely mandatory. This is in line with IAS 37 (this is actually a part where tax law and general purpose financial reporting can and sometimes must differ, so a differentiation would have been feasible), but the limited carry forward of losses creates a situation where a taxpayer would be at
risk of losses being set off many years after the actual expense or even evaporate, which means that an argument against mandatory recognition follows from that aspect.

Recommendation
The aspect of a voluntary recognition of a provision can be clarified rather easily by altering the phrase ‘shall be deductible’ to ‘shall be deducted’ (mandatory) or ‘may be deducted’ (optional). With CCCTB increase of competitiveness and innovation is strived for, but it also limits the offsetting of losses which points in the direction of an optional recognition. On the other hand, there is little freedom offered in the determination of taxable income in the common corporate tax base of CCCTB overall. This does make sense in a tax base, as taxable income is simply the outcome of facts and circumstances in a year that leads to the most equality of tax payers and as little tax planning as possible. This means that recognition should be mandatory in my opinion, although obvious and unreasonable double taxation following from that should be dealt with.
An issue would be to solve the effective double taxation that occurs when a provision is recognised, but the loss of which it is part, evaporates because of Article 41, Paragraph 3 CCTB 2016 and the obligation for which the provision was recognised is still present. In itself this could be solved by recognising the amount again, but problems occur because the provision is part of the loss and is not a standalone issue. It must therefore be determined how to keep track of this.

1. Amount of the provision was lower than the loss

In year 1 a loss of € 100.000 occurred. A € 50.000 deduction has taken place for the recognition of a provision on the basis of Article 23 CCTB 2016. The loss evaporates in year 2 on the basis of Article 41, Paragraph 3 CCTB 2016.

No problem would occur here when the amount would be recognised again in year 2. This is not unreasonable when the amount is still expected to flow out of the enterprise.

2. Amount of the provision was higher than the loss

In year 1 a loss of € 50.000 occurred. A € 100.000 deduction has taken place in year 1 for the recognition of a provision on the basis of Article 23 CCTB 2016. The loss evaporates in year 2 on the basis of Article 41, Paragraph 3 CCTB 2016, because another company acquires a participation in the taxpayer and there is a major change of activity of the acquired taxpayer.

A € 50.000 deduction has already taken place. Therefore, only € 50.000 can be deducted after the loss evaporates on the basis of Article 41, Paragraph 3 CCTB 2016.
Article 23 CCTB 2016

5. Insofar Article 41, Paragraph 3 leads to the evaporation of a loss, while the criteria of Article 23 are met at the end of the reporting year and the amount has already been deducted, a deduction can take place to the extent that the expected future outflow has not effectively decreased the taxable base of any year.

6.2.2 Obligations

One of the key issues around which the concept of provisions revolves is the concept of an obligation, both what it constitutes and why the recognition of provisions should revolve around this concept (and not simply follow the concept of an expected future expense that arises before the end of the balance sheet, which would be in accordance with the concept that income and expenses should be attributed to the period to which they relate). Although the common corporate tax base of CCCTB does not answer either of these questions, the question when an obligation is present is, in my opinion, basically a question when the enterprise loses control over a future expense. For example, as a citizen I have to stop before a traffic light. This is a general duty, which follows from traffic law. It does however not, in itself, lead to an obligation where a third party may rightfully expect me to pay money in the future. This outflow only becomes probable when I pass a red traffic light, while I was checked (and thus will be fined). This is where I lose control over an eventual future outflow. As long as I do not pass a red traffic light, I have full control over whether or not the future expense can take place. The moment when I pass it, I lose control. A similar issue arises when an enterprise starts working on a quarry. As long as no shovel has hit the ground, the enterprise can stop its business and will not need to pay any expenses with regards to filling up the landfill. As soon as the first shovels hit the ground, an obligation is present to fill up the landfill, however small the damage may be. The fact that measurement will be different depending on how much work has taken place on the quarry, does not take away the fact that at a certain point an obligation is present.\footnote{The fact that it is not likely that the enterprise will stop its business for a long time does not take away the fact that it no has control over the question whether or not it must repair the landfill. This also relates to the fact that an obligation in this sense represents an obligation towards a third party. The internal obligation, as known in German law, is not an obligation in this sense, as the control over the future expense remains. This is also why maintenance and repairs cannot be viewed as an obligation, even though it is clear that a future expense becomes likely when certain fixed assets are used (or even when the time passes). Maintenance and...}

The fact that it is not likely that the enterprise will stop its business for a long time does not take away the fact that it no has control over the question whether or not it must repair the landfill. This also relates to the fact that an obligation in this sense represents an obligation towards a third party. The internal obligation, as known in German law, is not an obligation in this sense, as the control over the future expense remains. This is also why maintenance and repairs cannot be viewed as an obligation, even though it is clear that a future expense becomes likely when certain fixed assets are used (or even when the time passes). Maintenance and...
reparations generally lead to an obligation when there is a party that has started to perform the maintenance and/or repair, because at that point the enterprise no longer has control over whether or not the future outflow will take place. Neither IFRS nor United Kingdom FRS allow the recognition of a provision for maintenance and repairs, but both are much more strict in their obligation-driven approach than the common corporate tax base of CCCTB is (neither allows the recognition of a provision for ‘probable future legal obligations’ and neither allows or requires that, in measurement, the deduction for the obligation shall be spread proportionately over the estimated duration). Also, under IFRS and United Kingdom FRS, especially the maintenance-aspect is partly covered by the component approach in the method of depreciation (which accelerates depreciation in most cases), for which the common corporate tax base of CCCTB offers no alternative. German tax law only allows a very small possibility of recognizing a provision for maintenance and repairs and seems to be moving in the direction of a strict obligation driven approach towards provisions, much like IFRS. Dutch tax law actually offers two possibilities for the recognition of a liability for future expenses, both a fiscal reserve, as part of a legal possibility in Dutch tax law and a provision based on the open norm of sound business practice. This means that the recognition of a provision for maintenance and repairs is not common in the other researched systems, but having a form of facilitation is present in all the other systems. The common corporate tax base of CCCTB is the only system that contains no facility at all for expected future costs of maintenance and repairs. The recognition of a provision for maintenance and/or repairs would not decrease the heavy administrative burden for the enterprise, as it differs from the regular system of deduction of costs. However, allowing such a recognition would be for a good cause and therefore as such does not take away from being in line with the general objectives of CCCTB. The possibility to recognise provisions for maintenance and/or repair will not simplify the tax base of CCCTB. It would slightly increase the certainty when it is made explicit whether or not future expenses for maintenance and/or repairs can fall under the ‘probable future legal obligation’ or not (or when the ‘probable future legal obligation’ would be deleted from Article 23 CCTB 2016 altogether).

From the viewpoint of the ability to pay taxes and how the other researched systems deal with maintenance and repairs, it can be stated that there are good arguments in favour of some form of facility for the recognition of future costs of maintenance and repairs. The common corporate tax base of CCCTB currently contains none which leads to the question whether it would make sense to create a facility.

Several options exist:

- Allow the recognition of a provision under Article 23 CCTB 2016. This can actually be based on the ‘probable future legal obligation’, with some additional guidance;
- Allow a depreciation–facility to use the component approach and thus defer taxes;
CHAPTER 6 ANALYSIS OF THE ISSUES FOUND

- Allow a separate, stand-alone, facility, much like the ‘roll-over relief’ of Article 35 CCTB 2016;
- Allow no deferral of taxes for maintenance and repair.

Since the ‘probable future legal obligation’ should, in my opinion, be removed and when it is not, has a distinct boundary problem (as it is very unclear what a ‘probable future legal obligation’ is), this would only work when it is clearly defined what a probable future legal obligation is. This definition should be part of Article 4 CCTB 2016. Creating a facility within the depreciation for a component approach would increase the complexity of depreciation under the common corporate tax base of CCCTB (as more detailed rules would be necessary), while, in its current form, depreciation under the common corporate tax base of CCCTB is relatively simple. It would also lead to the question how far the component-approach would stretch. Often, maintenance and repair represent an important component. Currently, only improvement costs (maintenance and repair are generally not improvement costs) are depreciated as a form of component, albeit as if they are related to a newly acquired fixed asset. Since improvement costs represent an entirely different issue, this is not comparable. The creation of a separate, stand-alone, tax deferral like the roll-over relief, suffers from the problem that roll-over relief occurs when a profit is made. Creating a simple-yet-effective alternative that creates a tax deferral is actually not that easy. Simplicity would be achieved by a fixed amount, but that would have the distinct downside of crudeness. A fixed percentage of the investment itself would also be simple, but might still be very crude, as not all investments require the same amount of investments or repairs. Any specific and targeted facility would lead to additional complexity (such as the estimates that need to be made), decreased enforceability and legal certainty. This leads to the final alternative, simply not offering anything in the way of a facility for maintenance and repairs. This means that the liquidity needed for the maintenance and repairs, both of which are necessary for the continuity of the enterprise, is decreased by taxes that will be returned after the investment in maintenance and repairs. This inevitably leads to the question of what to do with maintenance and repairs that are required by law. In itself, the same principle applies, but several mechanisms occur in practice. For airplanes, generally, the amount of hours of flight determines when service is required by law. If maintenance is required after 1,000 hours of flight, the first hour does not inevitably lead to the outflow and neither does every hour until and including the 999th hour. At the 1,000th hour the entity has an obligation to perform the necessary maintenance, but an outflow is only probable as long as management will continue to want to fly the plan. If the plane is kept on the ground, there might be an obligation, but an outflow can still be unlikely. When the 1,000th hour has been flown, it is likely that the maintenance and repairs will follow very shortly after that, which means that the role of a provision is limited as well.

1025 Article 36 CCTB 2016.
This means that maintenance and repairs will rarely lead to a provision on the basis of Article 23 CCTB 2016 (deduction of the expense will mostly just follow Article 17 CCTB 2016). A spread where every hour would lead to a certain increase in the provision\textsuperscript{1026} is in line with matching but not with the obligation-driven approach that underlies the current Article 23 CCTB 2016 (but also IAS 37, for example). It does not need to be certain which distinct elements within a group lead to an obligation (it can remain anonymous), for an obligation to be present, as long as it is (statistically) expected that certain parts will lead to an outflow of resources and the enterprise does not have full control over this. See also Paragraph 6.2.3. The question of why such a mechanism as an obligation is (or should be) in place, is basically a matter of objectivity. There are a lot of situations where a future outflow is caused before the end of the reporting period and thus for which economic attribution can be reasonable (in the sense that the future outflow can be attributed to an occurrence before the end of the reporting period). However, this would generally be based on subjective expectations that can often not be measured. The mere expectation of management that a future outflow will take place after the end of the reporting period and which is caused before the end of the reporting period will often be too subjective to take into account, especially when the enterprise still has control over the future expense.

As I will show in the following paragraphs, Article 23 CCTB 2016 in its current form creates tension in this approach, for example by including the ‘probable future legal obligation’ and the required spread over the years, but this does not take away from the fact that the obligation-based approached prevails and, in my opinion, should prevail.

6.2.3 Large groups of homogenous items and obligations

In Paragraph 4.6.2.2.5. I mentioned that Article 23, Paragraph 1 CCTB 2016 requires the presence of a legal obligation or probable future legal obligation. Of the two, the ‘legal obligation’ is a relatively clear concept and the ‘probable future legal obligation’ is not (see below for this issue). When a large group of homogenous items is produced and sold, it can often be statistically identified that a certain percentage of these will be faulty and lead to a future outflow. In

\textsuperscript{1026} For example, when the expense is € 100,000 after 1,000 hours of flight, every hour flown would increase the provision by € 100.
itself this meets the criteria for the recognition of a provision, although at the moment of the sale no formal obligation exists (it is not known which of the individual items will lead to the outflow, but it is almost certain, or at least probable, that some will). The question is whether this still meets the requirement of a legal obligation, since the individual, identifiable items do not meet that requirement as such. Article 23 CCTB 2016 does not elaborate on this issue. As stated, the common corporate tax base of CCCTB does not provide a definition of a provision, but uses the word ‘obligation’ in several places:

- Article 17 under (a) CCTB 2016: the obligation to make the payment has arisen
- Article 17 under (b) CCTB 2016: the amount of the obligation can be quantified with reasonable accuracy
- Article 23 CCTB 2016: several places

From the common corporate tax base of CCCTB itself it cannot be derived that a ‘legal obligation’ also includes a large group of homogenous items. It does not state whether it must be known which item will lead to an obligation or whether a group of items can be viewed together. What can be stated, however, is that this issue might be covered by the ‘probable future legal obligation’. In the case of large groups of homogenous items, probability will be present, as well as the fact that the legal obligation will occur in the future (and is at the moment of recognition still unknown).

There are two problems regarding this argument. First of all, the concept of a ‘probable future legal obligation’ is not clarified anywhere in the common corporate tax base of CCCTB itself or the public Working Papers. As a large uncertainty surrounds the probable future legal obligation, it is a guess whether this is the case. Second of all, the later compromise proposals have all suggested that the probable future legal obligation will be removed.\(^{1027}\) Since it is not likely that the compromise proposals meant to remove obligations derived from a large group of homogenous items, this indicates that this was not part of the ‘probable future legal obligation’. IFRS, United Kingdom FRS and Dutch sound business practice do not specifically address the issue of large groups of homogenous items, but they all implicitly recognise that large groups of homogenous items can lead to the recognition of an obligation and that it does not need to be known which exact item will lead to the outflow at the time of recognition of the provision. German law is, to my knowledge, the only system that explicitly recognises this with the concept of the ‘Pauschalrückstellung’. From this it follows that it is actually quite common to recognise provisions on the basis of an obligation derived from a large group of items, even though from a theoretical point of view it requires some implicit choices as to what an obligation is and how identifiable it needs to be.

In itself there is no risk of double taxation related to this issue. It can be stated that not recognising the statistical probability of an outflow in large groups of items only leads to a relatively late moment of recognising costs (and thus

\(^{1027}\) See Paragraph 2.3 for an overview of the compromise proposals.
deferring the taxes). It could be argued that this in itself represents a form of overtaxation, but that, to my mind, would be stretching the issue to an extent that is not feasible. There is no decrease of the heavy administrative burden to be gained from recognising the statistical probability of an outflow in large groups of items and neither will it diminish tax compliance costs. Being able to recognise provisions for the statistical probability of an outflow in large groups of items leads to a relatively early moment of recognising costs (and thus deferring the taxes). For an enterprise this would make it somewhat more attractive to increase its production or introduce new products. This would make it somewhat more growth friendly. Competitiveness is not increased by uncertainties. Therefore, stating whether the recognition of such provisions is allowed or not is actually beneficial to competitiveness. Furthermore, allowing enterprises to defer taxes when they expect an outflow will increase the liquidity of enterprises, making them more competitive. In a way it can be stated that large groups of items of which the occurrence of an outflow can be statistically determined will occur mostly in larger enterprises, as they have more statistical data available for the faults in their production. This makes this type of obligation likely more relevant for larger enterprises and enterprises that produce homogenous products. In a way this means that there is some difference between smaller and larger enterprises, but punishing larger enterprises for having more data available would also not be growth friendly. The most pressing issue with regards to efficiency and neutrality relates to the fact that if the tax authorities of one Member State accept the recognition of provisions for the statistical probability of an outflow in large groups of items and the tax authorities in another Member State do not, it can lead enterprises to choose for residency of the former Member State, which is highly undesirable with regards to efficiency and neutrality. In itself, effectiveness is not harmed by choosing to either recognise these types of provisions or not. It is mainly problematic where it is not clear whether this type of obligation is accepted or not. Explicitness with regards to the recognition of these provisions will increase certainty.

In terms of consistency and coherence, the current wording of Article 23 CCTB 2016 leaves the issue open with regards to large groups of items. More consistency and coherence would be achieved by improving the wording, with regards to whether the statistical probability of an outflow can constitute a provision. In general it can be stated that determining whether an individual obligation exists is generally simpler than determining whether a group of items can contain a certain risk of an outflow without knowing the party to whom the obligation will eventually exist, as the latter is systematically more complex (it always needs larger numbers). However, this always will need to be supported by statistical evidence. In practice, when the statistical evidence is present, this will make auditable and enforceability simpler than in individual cases. The above stems from the idea that an enterprise will want to recognise a provision.

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1028 Provided that there is enough statistical evidence to warrant a provision in the case of a new product.
However, when it does not want to recognise a provision (such as when it expects losses to evaporate, see Paragraph 6.2.1) the question is whether it is easy for a tax authority to enforce such recognition. This means that it will need to ascertain whether the obligation exists or not. This will generally present a problem, but this is a problem that is inherent to provisions: it is easier to ascertain whether an entry that is presented is actually present, than to ascertain whether an entry that is not presented should be presented. This means that enforceability is likely to be more difficult in this respect. The conclusion is that it is quite common in the researched systems to (implicitly or explicitly) acknowledge that in the case of large groups of homogenous items an obligation can be present, even when it is not known which specific individual item will lead to the eventual outflow. However, it does not follow naturally from the current wording of the proposal for a directive and thus clarification would be needed in that respect. The whole issue can be solved via the ‘probable future legal obligations’-concept, but since this is a sentence unknown in the other systems and not defined in the common corporate tax base of CCCTB itself, clarification is still needed in order to guarantee consistent application in the different Member States of the European Union. The normative framework indicates that it is primarily beneficial to clarify whether the risks inherent to large groups of items can lead to a provision and that allowing such provisions would be even more beneficial. The only real drawback is that it increases some of the complexity both for the taxpayer and the authorities when the recognition of provisions for large groups of items, but that does not stand up against the benefits of being able to recognise such provisions.

**Recommendation**

Depending on what is meant by the ‘probable future legal obligation’ and whether this encompasses the large groups of homogenous items, two possibilities exist. First of all, it can be added that in the case of groups of homogenous items for which it can be statistically proven, based on prior experience inside or outside the entity, that an outflow will occur, this can lead to an obligation being present. Preferably, this will be part of a definition of an obligation, added to Article 4 CCTB 2016.

A different option is to clarify ‘probable future legal obligations’ to the extent of encompassing probabilities that can be calculated statistically in the case of large groups of homogenous items. Since I have a preference for the removal of the ‘probable future legal obligations’ altogether, this option is not the option that I prefer. The recommendation for a text follows further on in this chapter.

**6.2.4 Article 17 CCTB 2016**

Both Article 17 and Article 23 CCTB 2016 include the word ‘obligation’ and it needs to be assessed whether this is the same concept. Article 17 CCTB 2016 requires that an obligation to make the actual payment has arisen.
Article 23 CCTB 2016 states that by way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense. A definition of an obligation can apply to both Article 17 and 23 CCTB 2016 as both refer to an expected outflow of resources over which the enterprise no longer has the overriding control and towards a third party and is present at the moment when the expense is deducted. The main difference between the two is that Article 17 CCTB 2016 strictly requires that the obligation to make the actual payment must have arisen. As stated before, this needs to be understood as the payment being due.

6.2.5 Executive contracts and obligations

One of the issues that occur when obligations are taken as the starting point for provisions, is the question what happens when an enterprise enters into a contract. A contract will generally have two sides: one side makes the enterprise entitled to a certain right and the other side creates an obligation for the enterprise to perform in either a monetary or non-monetary way towards the other party.

Article 16 CCTB 2016 states that revenues accrue when the right to receive them arises and they can be quantified with reasonable accuracy, regardless of whether the actual payment is deferred. In the case of such an executive contract, I am of the opinion that this should be approached as the mirror-image of Article 16 CCTB 2016: for the other party, the right to make the payment must have arisen. This means that the contract will often not directly lead to revenue, based on Article 16 CCTB 2016, creating an impairment, as the performance that the enterprise needs to perform will be deductible when the criteria of Article 23 CCTB 2016 are met. This is when Article 23 Paragraph 2 under (d) CCTB 2016 will apply: “future benefits directly linked to the event giving rise to the provision shall be taken into account”. The difficulty in dealing with executive contracts mainly lies in the aspect of measurement, which is dealt with in a later paragraph.

6.2.6 Definition of an obligation

What is currently lacking in the common corporate tax base of CCCTB is a definition of an obligation, in line with the above. Such a definition is needed because some Member States do not allow the recognition of provisions for tax reasons altogether and might therefore not be familiar with the concept, while others, such as German law, allow the recognition of provisions for ‘obligations’ that are not strictly obligations.

This means that the objectives of CCCTB are served better by including a definition of an obligation.
The following should therefore in my view be added to Article 4 CCTB 2016

An obligation is present when an outflow of resources either in monetary or non-monetary amounts is expected, at the moment when the expense is deducted, towards a third party and over which the enterprise no longer has the overriding control. Large homogenous groups of items can lead to an obligation when it is probable that a percentage of these items will lead to such an outflow, when all the other requirements are met.

6.2.7 Probable future legal obligation

When compared to IAS 37, it is unclear what is meant by the addition of probable future legal obligations in Article 23 CCTB 2016. IAS 37 requires the recognition of a provision when an obligation is present (which is the case for all liabilities). Nowhere in the CCCTB Working Papers is it stated that this approach would need to be any different in the recognition of provisions under the common corporate tax base of CCCTB (and thus what would later become Article 23 CCTB 2016). Which problem the European Commission aims to solve by the inclusion of a ‘probable future legal obligation’ in the requirements for the recognition of a provision is not mentioned. In reality, the types of obligations allowed to lead to the recognition of a provision under the common corporate tax base of CCCTB are more limited when compared to IAS 37, as CCCTB does not allow the recognition for constructive obligations, whereas IFRS does (see below). Therefore, the creation of an additional category of ‘probable future legal obligations’ in Article 23 CCTB 2016 is striking and it is not apparent what types of situations are meant by this. Without further guidance this can open the door to the undesirable recognition provisions and arbitrariness across the Member States of the European Union.

It must be noted that in the later compromise proposals, it was suggested that the ‘probable legal obligation’ would be removed from Article 25 CCCTB 2011, which ultimately did not happen in Article 23 CCTB 2016. Article 23, Paragraph 1 CCTB 2016 states that ‘where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible’. At no point in the common corporate tax base of CCCTB or the Working Papers, it is mentioned what a probable future legal obligation is. Since this wording is an addition to the text of IAS 37, this implies a certain conscious decision to alter the starting point. With regards to this alteration, two possibilities exist:

a. Only a clarification of the text is meant, which makes the ‘probable future legal obligation’ merely a form of further guidance. Several examples

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1029 See Paragraph 2.3 for an overview of the compromise proposals.
come to mind for which the words ‘present legal obligation’ might not be the most accurate way to describe the situation, but for which a provision can generally be recognised:

1) **Warranties for large numbers of homogenous items at the moment of sale**
   It is not yet known which item sold is faulty and will be returned, but it is probable that some will be returned. Strictly taken, there is not yet an identifiable legal obligation at the moment of the sale. IAS 37 already takes this type of obligation into account without needing the addition of a ‘probable future legal obligation’.

2) **A legal claim that has been made against the entity**
   For this claim it is probable that an outflow will eventually be required, but it is not until the court has ruled that the obligation strictly becomes a legal obligation. IAS 37.16 implies that at this point an obligation is already present, but it can be argued whether this is technically the case.

b. The ‘probable future legal obligation’ is meant as an addition to IAS 37

1) **Repairs and maintenance**
   Since repairs and maintenance only lead to a legal obligation when the actual repair or maintenance takes place, but its origin lies in the use of the respective asset, it would be good from the viewpoint of attribution of costs to attribute the costs to the period in which the maintenance takes place, without adhering to the concept of a present obligation (hence the future legal obligation). In some Member States, such as the Netherlands, it is actually allowed to recognise a provision on this basis. However, this would go against the idea of an obligation-driven concept of provisions and at no point the Working Papers give any indication that this would be a desirable effect (if anything, the reverse is true). This makes it highly unlikely that this is included in the scope of ‘probable future legal obligations’.

2) **Contingent liabilities (dependent on future actions of the entity)**
   Another possibility is that the ‘probable future legal obligations’ are meant to allow the recognition of contingent liabilities (liabilities

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1030 See Paragraph 6.2.3.
1031 The guarantee can be viewed as being the obligation, which can be measured, but this requires a certain outlook.
dependent on future actions of the entity), when the eventual outflow and
the fulfilment of the contingency is likely enough.
This comes down to a very informal approach of a provision, effectively
ruled out both the requirement of a present obligation and the obligating
event (‘arising in’). Since this goes against the concept of a simple tax
base with simple rules, I find it very hard to believe that this is what the
European Commission envisioned and thus very unlikely that this is
meant by a ‘probable future legal obligation’. Also, the addition of
Paragraph 3 under (a) that provisions shall not be deducted for contingent
losses, does not hint in this direction.

3) Provisions that build up over the course of the years
In some cases an obligation is not present yet, but only when a certain
threshold is met (in this sense it is a contingent liability). When this
threshold is met an obligation is present and a provision needs to be
recognised, but as long as the threshold is not met, no obligation is
present and thus no provision can be recognised.
An example of this is a specific tax that is due when a certain amount of
profit, expenses, revenue or production is reached. Say that when 100
production is reached, a tax of 10 is due. When in Year 1 and Year 2 the
production is 60, this means that the tax is due in Year 2 (when reaching a
production of 100) and thus an obligation does not exist at the end of
Year 1, even when the production in Year 1 is 60% of the economic cause
of the expense. It can be argued that at the end of Year 1 a provision of 6
should be recognised when it is probable that the additional production of
40 will be reached.
Recognition could take place on the basis of the ‘probable future legal
obligation’, as at the end of Year 1 there is actually a probable future
legal obligation and the eventual outflow can be stated to be arising from
activities or transactions carried out in Year 1. However, as much as this
might make sense with regards to the matching principle and be in line
with the literal wording of Article 23 CCTB 2016, this approach is out of
line with the common corporate tax base of CCCTB in general and the
Working Papers and this leads to a broader scope of provisions than the
scope of IAS 37.

4) Misinterpretation of the legal obligation
It is not unthinkable that the concept of ‘probable future legal obligations’
stems from a misinterpretation of the difference between recognition and
measurement. For example, when a mining-enterprise is obliged to fill up
a quarry after the exploitation has ended, two views can be taken:

- As soon as the first mining activity has taken place an obligation to
landfill the quarry occurs and thus a legal obligation is present from
the start (the amount is due once the exploitation ends, making it
extremely a timing issue);
– The obligation occurs when the exploitation ends (there is no obligation as long as there is no end to the exploitation).

The difference is that in the second view the concept of a probable future legal would be necessary to be able to recognise a provision from the start and thus deduct costs. This case also seems to relate to Article 23, Paragraph 1 second sentence CCTB 2016 on the situation when an obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. The inconsistency however is that an obligation actually exists from the start of the activities and thus no probable future legal obligation is needed in order to be able to recognise such a provision. The rest is just a matter of measurement.

The former means that it is more likely that the European Commission wanted to clarify the requirements of IAS 37 than to expand the scope. Where it would have had the situation of b. 4) in mind, it would simply not have interpreted the concept of an obligation correctly. However, when following the literal text, some expansion of the scope occurs, especially for provisions that build-up over the course of the years in combination with a certain threshold. Since it cannot be ruled out that this will lead to a divergent application among the various Member States, this presents a problem. The risk is therefore that, in clarifying a certain issue, the European Commission has created an additional problem. None of the other researched systems use a wording that is comparable to the ‘probable future legal obligations’ of the common corporate tax base of CCCTB. As stated above, it is likely that the addition of a ‘probable future legal obligation’ is merely a clarification of the wording of IAS 37.14. United Kingdom FRS Section 21 is also based on IFRS and uses the same requirements for the recognition of a provision as IAS 37.14 does. From this, it follows that it is unlikely that this clarification is a necessity. The meaning of the words ‘probable future legal obligations’ does not relate to overtaxation or double taxation and neither does it relate to the administrative burden or tax compliance costs for enterprises. Increasing growth- friendliness is not at stake here. Horizontal equity is also connected to this issue. The fact that it is not certain which situations fall under ‘probable future legal obligations’, can lead to arbitrariness up until the point where the European Court of Justice has ruled on what does and what does not fall under probable future legal obligations. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States on what does and what does not fall under probable future legal obligations. Effectiveness, the problems surrounding the ‘probable future legal obligations’ stand in the way of reaching certain objectives that the European Commission
Chapter 6  Analysis of the Issues Found

wants to meet with CCCTB, amongst which simplicity, transparency, certainty, efficiency, neutrality and horizontal equity. This means that it presents a problem with regards to effectiveness. The concept of simplicity, transparency and certainty relates to the fact that the ‘probable future legal obligation’ of Article 23, Paragraph 1 CCTB 2016 leaves too much room for interpretation and is neither simple, transparent nor certain because of this. The concept of a ‘probable future legal obligation’ is not consistent with both the fact that Article 23 CCTB 2016 otherwise has an obligation-driven approach. Enforceability would benefit from the fact that it is clear what does and what does not fall under the probable future legal obligation. Furthermore, as mentioned in Paragraph 6.2.7, the concept of a probable future legal obligation implies that although certain obligations or liabilities are contingent (dependent on one or more uncertainties outside the control of the entity), recognition of a provision is still possible. This creates an amount of tension with the requirement that the obligation must arise from activities or transactions carried out in that, or previous tax years, which opens the door to the recognition of future losses. It suggests that the obligating event can be split in two parts:

- One part relating to activities or transactions carried out in that, or previous tax years, which does not go so far as to create an obligation;
- Another part relating to something that is expected to happen in the future and which leads to the obligation becoming perfect.

Article 23, Paragraph 3 under (a) CCTB 2016 prohibits the deduction of a provision for contingent losses, which means that, even when a probable future legal obligation includes contingent liabilities, deduction is prohibited by Article 23, Paragraph 3 under (a) CCTB 2016. As guidance or further clarification to the concept of a probable future legal obligation implies that although certain obligations or liabilities are contingent (dependent on one or more uncertainties outside the control of the entity), recognition of a provision is still possible. This creates an amount of tension with the requirement that the obligation must arise from activities or transactions carried out in that, or previous tax years, which opens the door to the recognition of future losses. It suggests that the obligating event can be split in two parts:

- Leave the current text of Article 23, Paragraph 1 CCTB 2016 intact;
- Leave the current text of Article 23, Paragraph 1 CCTB 2016 intact and provide additional guidance;
- Remove the ‘probable future legal obligation’ from Article 23, Paragraph 1 CCTB 2016;
- Remove the ‘probable future legal obligation’ from Article 23, Paragraph 1 CCTB 2016, but provide other additional guidance.

Of the four possibilities, I find the first one the least desirable. The current text creates unwanted problems and leaving it intact is, in my opinion, not in line with the objectives of the European Commission. The third option removes the root of the problem, by removing the ‘probable future legal obligation’. However, the European Commission seems to find it necessary to add
The concept of provisions in Article 23 CCTB

something in comparison to IAS 37.14. The fact that the guidance itself is not correct does not mean that guidance is not necessary. This means that either the ‘probable future legal obligation’ must be replaced by additional guidance or that additional guidance is needed while the ‘probable future legal obligation’ stays in place. In my opinion the ‘probable future legal obligation’ takes a wrong starting point. What is most likely meant is the situation mentioned under b. 4): a misinterpretation of an obligation. This would not even need additional guidance. It just needs removal. When the situation mentioned under a. 1) of a. 2) is meant, it needs to be clarified that when a claim is made against the entity or when, based on statistics, a certain percentage of the goods sold is faulty and will be returned, an obligation is present at the end of the reporting period. Since all the necessary facts are present before the court rules in the case and thus the only thing the court does is ascertaining this, the obligation is already present at the end of the reporting period. The latter is the implicit viewpoint of the IASB in IFRS: the obligation is or can be present before the court has ruled. This is a point of view that is more economic than legal per se.

What needs to be taken into account is that, in IFRS, this represents information that a user will need to know. If a claim is made against the entity and it is more likely than not that the court will not rule in the entity’s favour, this is relevant information that needs to be on-balance rather than off-balance. This means that the user’s entitlement to information outweighs the problematic relation between the claim and the non-recognition of contingent liabilities. The question is whether this is the same for a tax base with an obligation-driven concept of provisions such as the common corporate tax base of CCCTB. By adding the ‘probable future legal obligations’ the European Commission has, in my opinion, addressed this issue, either knowingly or unknowingly, and has given a positive answer to the recognition. I personally feel that the ruling of a court is more constructive in the creation of the legal obligation than it is given credit for under IFRS. There is still a dependency on a future event over which the entity has little or no control: the ruling by a court in the civil law case. For provisions based on the sale of large groups of items a similar argument can be made. If an obligation-driven concept is used for a provision, I feel that additional guidance is necessary, but this should relate to the fact that a present obligation is deemed to exist when the requirements are met, which does not include the court ruling or the effective return of goods. By using the words ‘probable future legal obligation’ it is implied that the actual obligation does not yet exist, but is dependent on an uncertain future event. This means that the words ‘probable future legal obligation’ cannot be used for this. This leads to the conclusion that the fourth option is the best one: remove the ‘probable future legal obligation’ from Article 23, Paragraph 1 CCTB 2016, but provide other additional guidance on what a present obligation is.

Recommendation
As stated, removal of the words ‘probable future legal obligation’ from Article 23, Paragraph 1 CCCTB, while providing other additional guidance on what a
present obligation is, in my view, is the best option here.

Article 23

By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense.

(a) a contract;
(b) legislation;
(c) an administrative act of general nature or addressed to a specific taxpayer;
(d) another operation of law.

Where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. Amounts deducted under this Article shall be reviewed and adjusted at the end of every tax year. In calculating the tax base in future years account shall be taken of amounts already deducted.

An obligation is deemed to exist when:
- a claim is made against the taxpayer and it is probable that the court will rule against the taxpayer;
- a large group of homogenous products is sold and on the basis of statistic evidence it is probable that a percentage of these products will be returned.

Preferably, the latter is solved in Article 4, when the concept of what an obligation is, is defined there.

6.2.8 Constructive obligation

Differentiation between legal and constructive obligations may not be as easy as is implied by the common corporate tax base of CCCTB, therefore defeating the purpose of the differentiation. In Paragraph 4.6.2.2.5 I mentioned that Article 23 CCTB 2016 specifically only allows the recognition of legal obligations or probable future legal obligations. For the problems surrounding the probable future legal obligations, I refer to the paragraph above. This means that it is not possible to recognise a provision for a constructive obligation, even when all the other criteria are met. Constructive obligations occur for example in the case of guarantees and restructuring. In a system where both legal and constructive obligations can give rise to a provision, a strict differentiation between legal and constructive is not highly relevant and mainly theoretical. For example: when a company operates both an official guarantee scheme and is lenient when the
strict terms of the guarantee are not met, all will be part of a provision for the

For example, if, at one point, the company will refuse to keep to its published policy, it is likely that the courts will overrule this, which would make this a legal obligation.

An additional problem is that, because legal procedures are expensive, companies are often in a more comfortable position than the customer, which means that the question whether or not a customer will bring the case before the courts will depend on several uncertain factors. This means that it is often difficult to differentiate between legal and constructive obligations and not allowing the recognition of constructive obligations might not lead to less provisions being recognised, but can increase uncertainty. Both aspects actually raise the question why constructive obligations are left out of Article 23 CCTB 2016. Neither Articles 4 CCTB 2016 nor 23 CCTB 2016 nor the common corporate tax base of CCCTB as a whole provide a definition of an obligation or a legal obligation. Previously, I made a suggestion for including a definition of an obligation in Article 23 CCTB 2016 or Article 4 CCTB 2016. IAS 37 makes a difference between a legal and a constructive obligation in IAS 37.10, in the following way:

A legal obligation is an obligation that derives from
(a) A contract (through its explicit or implicit terms);
(b) Legislation; or
(c) Other operation of law.

A constructive obligation is an obligation that derives from an entity’s actions where:
(a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
(b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
As stated, in a lot of cases, what will seem to be a constructive obligation can in fact be a legal obligation. This will often be the case for warranties that are not contractual but of which the established pattern of past practice or published policies will lead to implicit terms of a contract, but this is an aspect that is highly dependent on national civil law. The clean-up of environmental damages, when no legal obligation to clean up exists, will generally be a constructive obligation as well. Strict enforcement of the policy by authorities will often not be possible. All of the other researched systems allow or require the recognition of provisions for constructive obligations. As most of the researched systems are either standards for general purpose financial reporting (IFRS) or have their basis in general purpose financial reporting (the United Kingdom and German tax law), this is not surprising, as in general purpose financial reporting there is often little risk of over-recognition of provisions (the recognition of a provision implies a negative impact on the general purpose financial reporting). The Dutch system, however, being the most stand-alone of the researched systems, still allows the recognition of provisions on the basis of a constructive obligation.

The common corporate tax base of CCCTB is clearly the odd one out here. What must be noted is the political problem. The United Kingdom and Germany represent very large economies in the European Union with big political influence, but there are jurisdictions in the European Union that currently do not accept the recognition of provisions for constructive obligations or do not accept the recognition of provisions altogether. In the creation of CCCTB, and especially Article 23 CCTB 2016 on provisions, the European Commission seems to have strived for an average between Member States, in order to gain political consensus. While it is politically understandable to approach the issue like this, the big danger is that it leads to an inconsistent whole (which the common corporate tax base of CCCTB has become in some respects). When this is the case, failure of reaching the initial objectives becomes very likely.

Therefore, creating a consistent body of work, that can reach its objectives, but might be more difficult to get initial consensus for, is preferable to treating the tax base as a negotiable object with interchangeable objects. Because of the fact that the scope of constructive obligations is relatively narrow, there is generally no heavy administrative burden connected to its recognition. However, as all the researched systems, including IFRS, do allow the recognition of provisions for constructive obligations, this means that in the bridge between the various national general purpose financial reporting and the common corporate tax base of CCCTB, provisions for constructive obligations that do not overlap with legal obligations will need to be removed from the tax base. Similarly, the non-recognition of provisions for constructive obligations is not an issue that leads to heavy administrative burdens or high tax compliance costs. Still, it is a difference between the researched systems and the common corporate tax base of CCCTB, which needs to be removed from the tax base in the bridge between the systems and CCCTB. Growth-friendliness relates to in

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how far the tax base creates incentives for an enterprise to start or expand business. A wider range of possibilities to recognise provisions is always in a way helpful in increasing growth-friendliness. The question is whether this is specifically achieved by allowing provisions to be recognised on the basis of constructive obligations. Constructive obligations are based on the idea that when no legal obligation exists, but the enterprise has created a valid expectation towards a third party that it will take up its responsibilities, there actually is a present obligation between the enterprise and a third party. While there is no direct relation between this and growth, there is likely to be an indirect relation between the willingness of an enterprise to meet its responsibilities, either when it is legally obliged to or not, and the growth of an enterprise. This will nevertheless have a limited effect. Also, the fact that the non-recognition of constructive obligations rules out large part of the possibility of recognising provisions for restructuring, also creates a reversed tendency to restructure, which impacts growth-friendliness in a negative way. These effects should not be overestimated, but they are there nonetheless. Horizontal equity, i.e. that individuals in similar situations should pay the same amount of tax, might be connected to this issue. The fact that it will depend on the applicable jurisdiction whether certain obligations are constructive or legal, while the underlying facts are the same, creates a certain amount of arbitrariness. While these situations are not a 100% similar (the jurisdictions differ and application itself should be the same for all taxpayers), there is an inherent inequality to this. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. While the effect of this might be limited with regards to this issue, the fact that the line between constructive and legal obligations is not strictly the same among the Member States does lead to differences when the former cannot lead to the recognition of a provision and the latter can. While this is an indirect effect (the differences in treatment stem from differences in civil law), it creates a difference in the eventual tax treatment nonetheless. This also leads to the conclusion that the difference in treatment between legal and constructive obligations creates a situation that is not completely in line with the objectives of the European Commission with regards to the common corporate tax base of CCCTB, making CCCTB less effective than it could be. With regards to simplicity, transparency and certainty, at a first glance, it seems simpler and more certain to leave out constructive obligations, as they might be perceived as leaving too much room for subjectivity and thus creating less certainty, as the boundaries are less clear than for legal obligations. As mentioned above, the fact that the boundaries between legal and constructive obligations can be unclear, depending on the civil law of the Member State it concerns, can actually increase uncertainty instead of solving it. Enforceability can, at first sight, be thought to be easier when it comes to only allowing the recognition of provisions for legal obligations and not for constructive obligations. However, as stated above, IFRS has shown that it is very well possible to create objective and enforceable criteria for the recognition of constructive obligations. Enforceability can even suffer in this respect when an obligation is somewhere
between a legal and a constructive obligation. When the recognition of a
constructive obligation is allowed, this creates a safety net which prevents the
dividing line from being an issue. A lot of constructive obligations are in fact
enforceable obligations, when push comes to shove.\(^{1035}\)

Allowing the recognition of provisions for constructive obligations also
increases the auditability and enforceability for the tax authorities who would
otherwise have to concern themselves even more with foreign civil law. This is a
general problem in the common corporate tax base of CCCTB (and for all
international tax), but determining the exact boundary between legal and
constructive obligations is a complex and unnecessary problem for foreign tax
authorities. On the other hand, IFRS, in my opinion, has shown that it is possible
to create clear boundaries and objective rules for when an obligation is a
constructive obligation. Apart from expanding the scope of Article 23 CCTB
2016 (which I view as a benefit), this would also solve the fact that there is a
grey area between constructive and legal obligations. Furthermore, the
combination of disallowing the recognition of provisions for constructive
obligations and allowing (or likely: requiring) the recognition of provisions for
‘probable future legal obligations’ is in itself not consistent or coherent. Most of
what can be argued against recognition of provisions for constructive obligations
can be argued against probable future legal obligations: the inherent subjectivity
and the uncertainty it brings. Since the concept of an obligation is not something
that distinctly changes over time or because of technical developments,
flexibility is not really at stake. The only thing is that the dividing line between
legal and constructive obligations may shift over time in certain jurisdictions.
When the arguments in favour of recognising provisions for constructive
obligations are weighed against the arguments against it, the following occurs.
There are a number of aspects to take into account:

- differentiation between constructive obligations and legal obligations;
- subjectivity;
- role in general purpose financial reporting versus taxable income;
- budgetary aspects;
- role within the common corporate tax base of CCCTB.

With respect to the first aspect, it is difficult to strictly differentiate between
constructive obligations and legal obligations. When it is taken into account that
some constructive obligations are, in fact, enforceable and therefore legal
obligations, this leads to two conclusions. The first conclusion is that there is a
limited difference between legal and constructive obligations in practice and
rejection of the recognition of provisions for constructive obligations likely
increases complexity and makes enforceability and auditability more difficult
because tax authorities will have to concern themselves more specifically with
foreign civil law. The second aspect is that constructive obligations can, in

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THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

theory, lead to a high amount of subjectivity, which is undesirable in a
harmonised tax base that aims to be simple and equal.
On the other hand, the widespread use of IFRS, which contains a number of
additional criteria for assessing when a constructive obligation is present, has
shown that it is possible to allow the recognition of constructive obligations in
the financial reporting, while keeping subjectivity within reasonable limits. This
is an argument in favour of allowing the recognition of constructive obligations.
The third aspect addresses the difference between general purpose financial
reporting and determination of taxable income. In general purpose financial
reporting the fact that an enterprise has a policy to replace, repair or refund
faulty products, is relevant information for a user. It says something about
expected future outflows and it says something about how an enterprise deals
with its customers. In the determination of taxable income, this aspect is less
relevant.
The most relevant issue is that when a certain expense is very likely to take
place, it is not in line with the ability to pay taxes to tax the full profit (i.e.
without deduction for the likely expense) and allow a deduction at a later point
(when the expense has actually taken place). This is also an argument in favour
of recognition of provisions for constructive obligations. The policy is
comparable to an obligation in the sense that it also creates an additional and
present requirement next to that requirement of arising before the end of the
reporting period and the expected future outflow.
Budgetary aspects have not been addressed specifically by the Working Papers
or otherwise underlying documents. It has therefore not been made public
whether budgetary aspects play a role in this. It is still a timing aspect (in the
end the full taxes will be paid) and budgetary aspects are not specifically
mentioned in the objectives of CCCTB as such. When the role of constructive
obligations within the common corporate tax base of CCCTB is taken into
account, there are generally little arguments against the recognition of
constructive obligations in Article 23 CCTB 2016. Therefore, what remains is
the question, when this is all put together, why would the European Commission
leave something out so explicitly, when there are more theoretical arguments in
favour of recognition than against it? The answer may simply be the fact that a
number of Member States do not allow the recognition of provisions in the
determination of taxable income altogether, and thus a political middle-ground
has been found in allowing the recognition of provisions, making Article 23
CCTB 2016 an ‘average’ between the Member States. While it is understandable
that these things happen, the arguments pro recognition outweigh the arguments
against recognition.

Recommendation
The recommendation is therefore to allow the recognition of provisions for
constructive obligations. This can be solved relatively easy in Article 23 CCTB
by adding ‘or constructive’ before the word obligation. In order to remove the
subjectivity from the concept of ‘constructive obligation’, the IFRS-definition of
A constructive obligation will need to be added to the definition of an obligation in Article 4 CCTB.

A constructive obligation is an obligation that derives from an entity’s actions where:

(a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

It also means that the second sentence of Article 23 CCTB 2016 will need to be removed as does the word ‘legal’.

6.2.9 Probability

The amount of certainty or probability regarding the existence of the obligation is not mentioned in Article 23 CCTB 2016 and it is unclear what the relation is between the eventual settlement of the amount being expected to result in a deductible expense and a future legal obligation being probable. In Paragraph 4.6.2.2.3 I concluded that one of the requirements for the recognition of a provision under Article 23 CCTB 2016 is that the eventual settlement of the amount is expected to result in a deductible expense. The question is when this is ‘expected’: this implies an unmentioned amount of probability. Over the course of the years and between different states different amounts of probability were used as a requirement for the recognition of a provision, ranging from very little (such as the German law in the past; this is associated with the principle of prudence) to relatively high (such as current IFRS, which uses the words ‘more likely than not’).

The same is true for the use of the word ‘probable’ which is also used in Article 23 CCTB 2016. What ‘probable’ is also not explained in any way. It also leads to the question whether ‘expected’ and ‘probable’ are interchangeable (and thus mean the same thing). The common corporate tax base of CCCTB uses the word ‘expected’ in several places:

– Article 22, Paragraph 1 under (b) CCTB 2016 on the term of a long–term contract;
– Article 23, Paragraph 1 first sentence CCTB 2016 on recognition of a provision;
– Article 23, Paragraph 2 first sentence CCTB 2016 on measurement of the provision;
– Article 23, Paragraph 2 under (c) CCTB 2016 on future events;
– Article 26, Paragraph 1 under (b) CCTB 2016 on the effectiveness of a hedge.

At no point is the word ‘expected’ defined, even though it is mentioned in five places in the common corporate tax base of CCCTB. The first question is
whether the word ‘expected’ means the same thing in all these articles. Of the five, three are two-dimensional: they are based on an occurrence or a non-occurrence (the first, the second and the fourth). For example, Article 23, Paragraph 1 first sentence CCTB 2016: the amount is either expected to result in a deductible expense or not. The third and fifth do not need to be based on two outcomes (although they can), as they will often be based on several sets of outcomes. For example, Article 23, Paragraph 2 first sentence CCTB 2016: the expected expenditure required to settle the present obligation at the end of the tax year needs to be determined. The expected expenditure can, for example, be based on the mean of multiple outcomes.

This indicates that there is a difference between the aspect ‘expected’ in recognition of a provision and in measurement of the provision. In the recognition of a provision ‘expected’ means that any outflow of resources is expected. The amount itself is not relevant for the recognition (the amount, or an estimate thereof, only becomes relevant in measurement). Article 23 CCTB 2016, however, does not differentiate clearly between recognition and measurement. This means that the common corporate tax base of CCCTB itself offers no further guidance on what the word ‘expected’ means. From the use of the word, it can be derived that there are at least two different interpretations of it in the proposal itself, with neither having been clarified further.

The word ‘probable’ is only used in Article 23, Paragraph 1 CCTB 2016 when referring to the probable future legal obligations. What is striking however is that the German text of Article 23 CCTB 2016 uses the word ‘voraussichtlich’ for both the word ‘expected’ and the word ‘probable’. This implies that the words expected and probable relate to the same amount of certainty and it is merely a form of inconsistent use of words. However, it still does not answer what the amount of certainty is. IFRS and United Kingdom FRS determine that the outflow is probable when it is more likely than not that it will occur.\footnote{International Accounting Standard 37, \textit{Provisions, Contingent Liabilities and Contingent Assets} 37.23. Financial Reporting Standard 102, Section 21 \textit{Provisions and Contingencies} 21.4.} This is generally understood as having a probability of over 50%. German law, following from the principle of prudence, traditionally required a very low threshold, but currently several viewpoints exist. Case law on Dutch sound business practice suggests a probability of at least about 30%. This means that no consensus exists between the researched systems.

With Article 23 CCTB 2016 based on IAS 37, the approach in IFRS is the most sensible to apply, but since there is no formal relation between the common corporate tax base of CCCTB and IFRS, this is an interpretation that has no formal basis. With regards to the recognition of a provision, the word ‘expected’ primarily indicates the dividing line between recognition and non-recognition. This is therefore one, supposedly identifiable, point. It can be stated that this should at least be, for example, 30% or 50%. In itself this provides a clear dividing line. When there is a threshold under which recognition is not allowed and above which recognition is required, the desire for a fixed percentage is understandable as it is clearer than using a word like ‘expected’, ‘probable’ or
CHAPTER 6  ANALYSIS OF THE ISSUES FOUND

‘likely’. The problem is that, while in certain large groups of homogenous items, where some history on outflows occurring is available, and thus it can be statistically determined what probability is expected, in individual cases it will generally be impossible to differentiate between, say, 49% and 51%. Since it is undesirable that the recognition is limited to cases where it can be statistically determined how large the probability is (as this would generally rule out the recognition of a provision for an individual case), it would make no sense to desire mathematical proof as standard in Article 23 CCTB 2016 in every case. Statistical evidence should be allowed as proof though. This still leaves open what ‘expected’ means. Whether or not the probability can be determined mathematically, there is still a principal difference between a required probability of 10%, 30% or 50%. In itself the question what is meant by the word ‘expected’ is not directly relevant for the prevention of overtaxation and double taxation, as there is no distinct risk of either overtaxation or double taxation connected to it.

The administrative burden can be increased by requiring a lot of proof for determination when an outflow is ‘expected’. However, this gives no answer to the question what is meant by ‘expected’. This also means that what is meant by the word ‘expected’ does not directly relate to compliance costs, although it can increase the compliance costs. Being able to recognise a provision in a situation where an enterprise is profitable creates a deferral of taxes for the taxpayer. Although taking risks, growth and provisions do not fully correlate, a certain relation between them is likely to exist. This means that being able to recognise a provision in such a situation is likely to be beneficial to an enterprises willingness to take risks and thus create growth. Since this is one of the objectives connected to CCCTB, a lower threshold will be beneficial in this regard, meaning that the word ‘expected’ will need to be interpreted as being a relatively low threshold. The issue of competitiveness relates to more or less the same issue as growth-friendliness. Enterprises would benefit from a liberal approach to provisions in the sense of having a low threshold (‘expected’). However, this does lead to questions with regards to equality. Why would two enterprises who are in exactly the same position, apart from one aspect in the form that one has a slight expectation that a future expense might occur, be treated differently? This supports the idea that only when there is a very serious chance (such as over 50%) a deduction should be allowed in the form of the recognition of a provision. On the other hand, horizontal equity in relation to the word ‘expected’ can also be relevant in the aspect that situations that are virtually equal (49% vs. 51% probability) are treated very differently, as under IFRS the former would not and the latter would lead to the recognition of a provision. However, with any percentage, arbitrariness will occur. This would only be different if the probability is taken into account in measurement of the provision, which I will deal with in the part on measurement.

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1037 Imagine a lawyer estimating the outcome of a certain court case: it will generally not be possible to mention certain percentages.

1038 These type of percentages can virtually only occur in situations where larger populations occur.
The question with regards to efficiency and neutrality in this regard can play a role when the word ‘expected’ is not applied uniformly among Member States and thus can influence investment decisions with regards to location. This also does not say which amount of probability can be considered ‘expected’, but it does mean that the issue will need to be resolved. Any uncertainties in the common corporate tax base of CCCTB will be contrary to its objectives. The uncertainty regarding the word ‘expected’ is the main issue at stake here, which also relates to simplicity and transparency. With regards to consistency, the problem is also that the words ‘expected’ and ‘probable’ are both used in the common corporate tax base of CCCTB and neither is defined. Enforceability would also benefit from such clarification as rules that are decidedly unclear do not add to enforceability. The former means that this issue can only be improved and not be perfected in the current approach. What can be improved is that the word ‘expected’ in relation to the recognition of a provision is to be defined further. The normative framework leads to the conclusion that more clarity is desirable in this issue as the first step. The aspects of competitiveness and growth-friendliness relate to a relatively low threshold, whereas equality leads to an argument in favour of a somewhat higher threshold. The researched systems are not harmonised or uniform in this sense: the Dutch and German systems imply a lower threshold than IFRS and the United Kingdom system do. The question is how these must be weighed against each other. Worldwide, a tendency to move towards IFRS is ongoing. This means that in generally accepted accounting principles, the concept of ‘more likely than not’ will be the basis for ‘expected’ or ‘probable’. There is however no formal connection of the common corporate tax base of CCCTB to IAS 37. There is also no guidance to be found in the common corporate tax base of CCCTB itself. It is however difficult to imagine that the word ‘expected’ will imply a threshold far below 50%. An alternative would be to recognise any provision (regardless of its probability) and solving the issue in the expected value in measurement. An outflow that only has a low probability of occurring would be measured at a lower amount than an outflow that has a large probability of occurring, provided that the amount of outflow itself would be similar. There are two inherent downsides to this. First of all, this approach is at this point in time highly uncommon, especially where it concerns individual items. This will undoubtedly create an increased administrative burden that cannot be offset against a perceived benefit for Member States or tax payers. As the common corporate tax base of CCCTB is and strives to be a stand-alone tax base, I do not feel that this is the overarching problem. Second of all, political fear will arise that it will open the door to taxpayers wanting to recognise provisions for every type of risk or any possible outflow that might occur, however remote they are, which might burden the tax offices beyond what is reasonable in this respect. This is also a problem, as this still requires a bottom-number below which no provision can be recognized.

For example, when the probability of € 100.000 outflow is 40%, measurement is € 40.000 and when the probability is 60%, measurement is € 60.000.
recognised and it increases the administrative burden for both governments and taxpayers.

**Recommendation**

As stated before, an approach in which recognition and measurement of a provision are combined is not practically possible at this point, even though I find this preferable. The words ‘expected’ and ‘probable’ in the common corporate tax base of CCCTB should be defined in more detail. The most sensible option would be to define this as being ‘more likely than not’, where in the case of large groups of homogenous items statistical evidence needs to be delivered, once the population is big enough to validate such an approach. This would only be different if the probability is taken into account in measurement of the provision, which I will deal with in the part on measurement.

6.2.10 ‘Activities or transactions’

In paragraph 4.6.2.2.1 I found that there is a distinct deviation from IAS 37 in Article 23, Paragraph 1 CCTB 2016 by the use of the words ‘activities or transactions’. The question is whether this deviation implies a change from IAS 37 or not. As a second issue, the words ‘activities or transactions’ are used twice in Article 23, Paragraph 1 CCTB 2016. The question is whether the words mean the same thing twice or not and whether this presents a problem. The words ‘activities or transactions’ or ‘activity or transaction’ are mentioned twice in Article 23 CCTB 2016.

…where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense.

Where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom.

The first occurrence of ‘activities or transactions’ relates in effect to expenses that are derived from activities or transactions from the past, whereas the second relates to activities and transactions that continue in the future. The first criterion is a requirement for recognition, whereas the second concerns measurement (at that point it has already been identified that a provision shall be recognised, but the amount of annual deduction, i.e. measurement, still has to be determined). Therefore, the question is whether these are two identical concepts. As stated in Chapter 4, there is not much in favour of thinking that, in recognising a provision, the words ‘arising from activities or transactions’ mean anything else
than ‘facts or circumstances’ (as found in for example IFRS). In the concept of
where the obligation relates to an activity or transaction which will continue
over future tax years, the deduction shall be spread proportionately over the
estimated duration of the activity or transaction, having regard to the revenue
derived therefrom, this relates to actual activities or transactions. It is harder to
imagine revenue that is not derived from activities or transactions than expenses
that are not derived from actual activities or transactions. Any revenue will
require either activities or transactions (and generally both) whereas expenses
can occur without any real activities or transactions. Simply the passing of time
can lead to certain expenses. The question is what happens when no revenue is
connected to the activities or transactions that continue over future tax years.
When activities or transactions are still performed, but no revenue is connected
to these, Article 23, Paragraph 1 third sentence in itself leaves room for spread
of the deduction, as it only requires having regard to the revenue derived
therefrom. This means that when there are expenses connected to future
activities or transactions but which do not produce revenue, there is a tension
between the recognition of a provision for an onerous contract and the spread
over the future. This is not unexpected, because there is a tension between the
concept of recognising a provision for a legal obligation in combination with a
spread of these same expenses over the future anyway. With an a contrario
reasoning, this would mean that no provision can be recognised when an
obligating event can occur in a more passive way than ‘activities or
transactions’.

For example: when the sale or production of a faulty product triggers the
guarantee, this clearly is either an activity (the production of a faulty good) or a
transaction (the sale of a faulty good). When a law firm gives an incomplete
legal opinion (an important issue is overlooked), this does not clearly follow
from an activity (it follows from a non-activity), although the process as a whole
can be viewed as a transaction.

When an entity is obliged to clean-up up environmental damage, this will follow
from an activity (the production-process that led to the contamination).
However, when the obligation follows from additional legislation entering into
force later than the actual contamination (and which can lead to a deductible
expense), the expense does not follow directly from an activity or a
transaction by the entity itself, which implies that Article 23 CCTB 2016 is not
applicable.

The Dutch so-called ‘crisis-tax’ which was introduced during the year 2013 created an
additional wage tax of 16% for any wages over € 150.000, payable before April of the
following year, for every employee making more than €150.000. Under Dutch GAAP and
IFRS this would create a debt and not a provision (as neither the amount nor the timing
was uncertain at the end of 2013), but under the common corporate tax base of CCCTB
this would meet the criteria of Article 23 CCTB 2016, although the ‘activities and
transactions’ might mean otherwise.
The same can be said of onerous contracts. Most contracts are not entered into with the aim of being onerous. There is usually an event that makes the contract onerous afterwards, which does not need to be an activity or transaction. That leads to the question whether there is an argument in favour of allowing the recognition of a provision for ‘activities or transactions’, while refusing such for less active ‘passive events’. In my opinion such a differentiation is first of all very hard to make (it would create a grey area of situations that could be either one) and second of all, leads to no clear advantage for either party. It is the expected outflow that is to be attributed and whether or not the cause is an activity, a transaction or any other past event is, in my opinion, irrelevant. This also leads to what the effect on Article 23, Paragraph 1, second sentence CCTB 2016 will be, as this states that where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom. In recognition, the concept of an active form like ‘activities or transactions’ is different than in measurement. In recognition ‘facts and circumstances’ would suffice, whereas the latter would not express what needs to be expressed in measurement. The same wording is used in Article 46 CCTB 2016 which states that provisions and bad-debt deductions shall be deductible only to the extent that they arise from activities or transactions carried out after the taxpayer opted into the system provided for by this Directive. Article 63 CCCTB 2011 uses a similar wording: expenses covered by Articles 25, 26 and 27, which are incurred in relation to activities or transactions carried out before a taxpayer entered the group but for which no provision or deduction had been made under the applicable national corporate tax law shall be deductible only against the apportioned share of the taxpayer, unless they are incurred more than five years after the taxpayer enters the group.

This means that the wording is used explicitly in three places, neither of which provides any content to the issue at stake. IFRS refers to ‘past events’ in relation to the recognition of liabilities (of which provisions are part). The spread of expenses over future years in relation to activities or transactions that continue in the future is not a concept that is possible under IFRS, as under IFRS it is the amount of the present obligation that is measured (and to its full amount at that point in time, which leaves no room for additional matching). The same applies to United Kingdom FRS 102. Dutch sound business practice requires that the future expense originates from facts or circumstances that occurred prior to the end of the reporting period for the recognition of a provision. Although a spread of expenses over the future is possible under sound business practice, this is linked to whether or not these costs are attributable to the future (as is the case with period bound costs or costs that have ‘use’ for the future). Since Dutch sound business practice adheres more to the concept of matching than it does to

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1041 International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets 37.10.
the ‘true and fair view’ of the balance sheet and it leaves a certain amount of freedom to the taxpayer in how to determine taxable income, this does make sense.

The common corporate tax base of CCCTB is much more rules based and is less based on matching and has taken a large amount of inspiration from IFRS. The German ‘Handelsgesetzbuch’ does not refer explicitly to the obligating event, which means that the German approach does not show any particular preference for either a passive or an active approach. This means that none of the researched systems recognises either of the concepts of ‘activities or transactions’ in the way that the common corporate tax base of CCCTB does or uses the same wording. The basic problem, as is the case with more problems with Article 23 CCTB 2016, is that the wording ‘activities or transactions’ raises questions as to their meaning, as arbitrariness is a big risk. Clarification will be beneficial to growth-friendliness, enforceability and the administrative burden. It will also ensure horizontal equity in the European Union. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States varies. This can be an issue with regards to ‘activities or transactions’, especially when the activities relate to the future. Since there is an uncertainty in the question to what ‘activities or transactions’ relates, simplicity, transparency and certainty suffer to a certain extent.

‘Activities or transactions’ are mentioned twice in Article 23 CCTB 2016, whereas one is a criterion for recognition and relates to the past and the other is an element of measurement and relates to the future. This means that consistency and coherence can also suffer.

Effectiveness of the common corporate tax base of CCCTB will therefore be increased when these issues are clarified. However, this means that the principles do indicate that the issue must be solved, but not how. The first conclusion that can be drawn is that, insofar Article 23, Paragraph 1 third sentence CCTB 2016 remains intact (as it is contrary to the obligation-driven approach suggested by the first sentence of Article 23, Paragraph 1 CCTB 2016), it needs to be part of measurement (and therefore of Article 23, Paragraph 2 CCTB 2016) and not of Paragraph 1. Furthermore, it is far from clear that ‘activities or transactions’ mean the same in the two places in CCCTB where they are mentioned. With regards to the recognition, the use of the words ‘facts and circumstances’ are preferred above ‘activities and transactions’. With regards to measurement, the combination of recognition of a provision for a legal obligation is always going to present problems. The suggestion under the current text is that for recognition an obligation-driven approach is used, whereas for measurement this is not the case.

Recommendations
Article 23

1. By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out facts or circumstances occurring in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense.

(a) a contract;
(b) legislation;
(c) an administrative act of general nature or addressed to a specific taxpayer;
(d) another operation of law.

Where the obligation relates to an activity or transaction which will continue over future tax years, the provision shall be spread proportionately over the estimated duration of the activity or transaction.

Provisions under this Article shall be reviewed and adjusted at the end of every tax year. In calculating the tax base in future years account shall be taken of amounts that have already been deducted pursuant to this Article.

2. A reliable estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present legal obligation at the end of the tax year, provided that the estimation is based on all relevant factors, including past experience of the company, group or industry. In estimating the amount of a provision the following shall apply:

(a) account shall be taken of all risks and uncertainties, but uncertainty shall not justify the creation of excessive provisions;
(b) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;
(c) future events shall be taken into account where they can reasonably be expected to occur;
(d) future benefits directly linked to the event giving rise to the provision shall be taken into account.
(e) where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom.

6.3 Measurement
6.3.1 Present value

Article 23, Paragraph 2 under (b) CCTB 2016 on present value is out of line with the system of a settlement value as required by Article 23, Paragraph 2 CCTB 2016. Article 23, Paragraph 2 under (b) CCTB 2016 determines that if the term of the provision is 12 months or longer and there is no discount rate agreed upon, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends. As Article 23, Paragraph 2 CCTB 2016 already mentions that measurement of the provision needs to be at the value for which the obligation can be settled at the end of the reporting period (which will take into account a discount for the term at which the eventual payment would have taken place), it seems out of place that Article 23, Paragraph 2 under (b) CCTB 2016 mentions the fact that the provision shall be discounted. When parties settle a liability, this would already take into account the time value of money (no party would settle without taking into account the time value of money).

In IAS 37 the same inconsistency can be found, as is the case in United Kingdom FRS 102 Section 21.7. German law does not require measurement of the provision at the amount for which it can be settled at the end of the reporting period, but at the discounted value of the actual expected outflow (even though the current text does imply otherwise, see paragraph 4.3.2.2). Dutch tax law is not as specific in whether settlement or transfer value or the actual expected outflow is to be recognised. Therefore, it is highly likely that the inconsistency in Article 23 CCTB 2016 has its roots in IAS 37, which would make sense as IAS 37 is the starting point of the design of Article 23 CCTB 2016. However, there is no need to repeat any design flaws of IAS 37. As stated, Article 23, Paragraph 2 CCTB 2016 already states that a reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year.

The question that arises is how to determine this settlement value. Both the probability of occurrence and the term of the expected outflow will need to be taken into account. It can even be stated that an estimate needs to be made of how much relevant information is present at the party which holds the rights to the obligation, as this influences the expected expenditure required to settle the present obligation at the end of the tax year. Note that in most situations this approach would not be in line with reality to begin with: the expected expenditure required to settle the present obligation at the end of the tax year is most often a fiction: in case the amount would be settled at the end of the tax year no provision needs to be recognized anymore. Article 23, Paragraph 2 under (b) CCTB 2016 (discounting the amount if the term of the provision is 12 months or longer) can either be meant as a clarification of Article 23, Paragraph 2 CCTB 2016 first sentence (if settlement value is to be determined, this is how to take the aspect of the time value of money into account), or as a separate rule.
(not formally connected to the settlement value), the latter of which would mean inconsistency. Since the starting point of Article 23 CCTB 2016 is the amount at which the obligation can be settled at the end of the tax year, it theoretically makes no sense to add Article 23, Paragraph 2 under (b) CCTB 2016, as the term of the settlement that amounts at the end of the reporting period is always less than twelve months, as a given. Still, this could just be faulty wording. When Article 23, Paragraph 2 under (b) CCTB 2016 would be viewed as additional rules or guidance for determining the settlement value at the end of the tax year, it implies the following:

- When the actual expected settlement date (the actual expected outflow and not the fictional settlement date given in Article 23 CCTB 2016) is thought to be less than twelve months after the end of the tax year, the time value of money (and thus a ‘discount’) can be ignored in determining the settlement value;
- When a discount rate is agreed upon between the two parties involved and the actual settlement date is expected to be more than twelve months after the end of the tax year, the agreed upon discount rate applies to the determination of the settlement value at the end of the tax year;
- When no discount rate is agreed upon between the two parties and the actual settlement date is expected to be more than twelve months after the end of the tax year, the yearly average Euribor–rate for obligations with a maturity of 12 months applies to the determination of the settlement value at the end of the tax year.

This still leaves the question open whether settlement value should be used in measurement of the provision in the first place. However, when settlement value at the end of the reporting period is to be used, using a proper version makes the most sense. The question with regards to how to apply present value in combination with settlement value is a matter of consistency and not a matter of overtaxation or double taxation (or even undertaxation). Measurement of provisions, especially when present value and/or settlement value need to be determined, will always create some administrative burden for enterprises. The consideration here is whether the measurement under IAS 37 can also be applied to Article 23 CCTB 2016, which would at least decrease the burden to some extent, for enterprises that have to report under IFRS. Article 23 CCTB 2016 differs from IAS 37 in this respect and therefore creates an administrative burden. IAS 37 only requires the use of the present value where the time value of money is material and provides no given discount rate.

In a tax base, the issue of when to use present value and what the discount rate is are welcome as a given, as materiality and the determination of the discount rate open the door to arbitrariness and administrative burdens in themselves. The fact that the settlement value is in itself a present value (and therefore cannot be discounted in itself any further) is not recognised in Article 23 CCTB 2016. This

\[1042\] Note that in the compromise proposals that were written after the initial proposal the use of 12-month Euribor is contested. See Paragraph 2.3 for an overview of the compromise proposals.
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

is likely mostly a matter of clarification and does not present an administrative burden for the enterprise as such. The same argument applies to the question with regards to the compliance costs for enterprises. In itself, the fact that the measurement under IAS 37 cannot always be applied directly to the common corporate tax base of CCCTB, is justified by the fact that CCCTB is a tax base and requires rules that are simpler and more clean-cut than the more user information-oriented rules of general purpose financial reporting standards. Clarification of the relation between settlement value and present value would be welcome, but it does not represent a matter of high tax compliance costs for enterprises. Efficiency and neutrality will only be an issue when the interpretation among Member States on how to deal with present value and/or settlement value under Article 23 CCTB 2016 varies, as this might influence the decision on what location suits a particular enterprise best. The issue with regards to present value and settlement value does not take away the effectiveness of the common corporate tax base of CCCTB; it is mainly an issue that needs to be clarified. Article 23 CCTB 2016 would become simpler when this issue would be clarified, as the current wording leads to questions with regards to the application of measurement. Legal certainty would thus improve slightly as well. Transparency is not an issue at stake here. The current wording is not consistent and coherent with regards to measurement. Discounting a settlement amount at the end of the tax year does not make sense. Enforceability can be improved as the current wording represents a lack of clarity in the rules. Article 23, Paragraph 2 under (b) CCTB 2016 is, in its current wording, contrary to the first sentence of Article 23, Paragraph 2 CCTB 2016. The fictional measurement of the expected expenditure required to settle the present obligation at the end of the tax year would already take the term of the actual outflow into account and therefore present value. However, since no other guidelines for the determination of the settlement value at the end of the tax year are present, guidance is in itself welcome. The fact that 12 month-Euribor is to be used in determination of the discount factor, when no agreed discount rate is present, is straightforward and simple. The fact that when the expected term is less than 12 months, the discount factor can be left out is acceptable for reasons of simplification as well. This means that when clarified as guidance, Article 23, Paragraph 2 under (b) CCTB 2016 makes sense. within the current system. Using settlement value at the end of the tax year as the basis is still not the optimal system in my opinion.

Recommendation
In measuring a provision the following shall apply:

if the expected term of the provision expense is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the
Chapter 6  Analysis of the Issues Found

course of which the tax year ends shall be used to factor in the time value of money in the determination of the measurement of the expected expenditure at the end of the tax year;

6.3.2 Integral cost method

Article 23 CCTB 2016 implies that the integral cost method is not to be applied. Among the other questions of measurement, such as whether to use the expected outflow or the settlement value at the end of the reporting period, is the question whether or not to use the integral cost method in this measurement. This is especially apparent in a situation where the performance that the enterprise has to perform is not monetary, but in kind.

For example, when an enterprise receives a claim to restore a building it destroyed, it makes a difference whether or not the enterprise measures this at the amount it would cost when the enterprise would restore this itself (this can be quite realistic when, for example, the enterprise is a building company itself) or whether it would have to contract a third party to do this.

This leads to the question whether the enterprise must measure the amount at what it expects that it would cost when a third party performs the activity or what it would cost when it performs the activity itself. With regards to such measurement, no comparable definition or wording of comparable articles in CCCTB is present with which Article 23 CCTB 2016 can be compared. Article 23, Paragraph 1 CCTB 2016 merely states that ‘any amount arising from that obligation which can be reliably estimated shall be deductible’. Article 25, Paragraph 2 CCCTB 2011 states that ‘A reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry’. The wording of Article 23, Paragraph 2 CCTB 2016 is similar, but not identical ‘A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present legal obligation at the end of the tax year, provided that that estimation is based on all relevant factors, including past experience of the company, group or industry’. What can be derived from Article 23, Paragraph 2 CCTB 2016 is that settlement value at the end of the reporting period, will be the amount that a third party will require to perform the performance in kind, in order to transform this to a monetary amount. The price that the third party requires will be built up as follows:
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

- Direct costs\textsuperscript{1043} materials and/or labour
- Indirect costs\textsuperscript{1044} non-directly attributable costs that need to be covered by the total of the revenue or margin
- Profit\textsuperscript{1045}

Beyond question is the fact that whatever method of measurement is used, the direct costs will be part of the basis for measurement of the provision. When an entity can perform the performance itself, the main difference between settlement value and the actual expected expenditure will be the profit mark-up. The second question is therefore: can the indirect costs be added to the basis for the measurement of the provision and if so, to what amount. In itself, when the current text of Article 23 CCTB 2016 is analysed, inclusion of indirect costs seems possible under the current text, as this would be included in settlement value. But, because I do not find the settlement value to be correct (and in this respect: the part that relates to the mark-up for profit is plain wrong), the question is: is it necessary to include indirect costs in the provision of a tax base such as the common corporate tax base of CCCTB? The indirect costs generally represent fixed costs (costs that do not increase or decrease by an increase or decrease of activities): their inclusion in pricing is to make sure that the fixed costs, such as management, are \textit{covered} by the price, next to the direct costs. When an additional number of products is made, the indirect costs, as a whole tend not to be increased.

\textit{For example:}

- \textit{Direct costs per product} \( \text{€} 10 \)
- \textit{Total indirect costs per annum} \( \text{€} 1.000 \)
- \textit{Total expected production} \( \text{€} 500 \)

This means that, when determining the price or cost of the product, it would be reasonable to include 2 for indirect costs (as 500 x € 2 = € 1.000 and this would cover the indirect costs), so that the (average) price per product needs to be above € 12 in order to make a profit. If, in addition to the above, some repairs or replacements are expected, this would not increase the total indirect costs. This comes down to: should the future indirect expenses be attributed to an earlier tax year? I am of the opinion that indirect costs cannot be viewed as ‘arising from the obligation’ as is required by Article 23, Paragraph 1 first sentence CCTB 2016, which means that they cannot be recognised in the measurement of the provision, when the enterprise itself is planning to perform and what is measured is the actual expected outflow. On the other hand, a mark-up for indirect costs would be present when Article 23, Paragraph 2 CCTB 2016, in the sense of settlement value, would be taken into account, as

\textsuperscript{1043} Costs that increase instantly when the production is increased.
\textsuperscript{1044} Costs that do not increase instantly when the production is increased.
\textsuperscript{1045} Excess of revenue over costs.
settlement value implies a third party market price (which would include both a mark-up for indirect costs and profit). The IASB states that it is currently not specified in IAS 37 which costs should be included in the measurement of a liability (direct costs, indirect costs and overheads, cost-price or market value).\footnote{IASB, Measurement of Liabilities in IAS 37. Proposed Amendments to IAS 37, (Exposure Draft ED/2010/1) 2010, p. 19.}

In my opinion, despite the fact that the IASB states that it is not specified in IAS 37 whether indirect costs and overheads should be included in the measurement of a liability (and thus of a provision), it is at least implied by the requirement that settlement or transfer value is used for measurement of liabilities, that in measuring a provision, this includes indirect costs, as settlement or transfer can generally only imply a market value (including indirect costs and a mark-up for profit). The same approach follows from the United Kingdom FRS 102. For Dutch sound business practice, there is only limited case law on this subject. From the case Dutch Supreme Court 26 February 1997\footnote{Dutch Supreme Court, 26 February 1997, ECLI:NL:HR:1997:AA2080.} it can be derived that when measuring an onerous contract on which a loss is expected, a provision can be recognised for the constant part of the future general costs. This means that indirect costs can, in fact, be recognised in such a case in measuring a provision. The reasoning behind this is that against this part of the future costs, no future revenue can be expected (which makes these costs useless and on the loss side of the principle of prudence). In my opinion, this approach is technically wrong. In determining a proper market price, the indirect costs are divided over the expected production. It will generally not be the case that the indirect costs are attributed beforehand, in the process of budgeting, to problematic issues that lead to a provision. The reason behind this attribution of costs is to seek coverage for these indirect costs, which only makes sense for products which the entity expects it will be paid for. Also, the fact that a part of the indirect cost is not covered does not make the contract onerous. This is only the case if the other attribution of indirect cost does not provide enough coverage.

For example

- Direct costs per product € 10
- Total indirect costs per annum € 1,000
- Total expected production € 500

If the entity would encounter a problem and has to produce 10 additional units in order to meet a warranty, there would still be enough coverage for the indirect costs, which means that none of the indirect costs represents an onerous contract. If the products that are needed for the warranty (meaning that no payment is expected for them) cannot be produced additionally (for example because 500 is the maximum annual production), the 10 will come out of the
production of 500, meaning that there is $10 \times 2 = 20$ less coverage for the indirect costs. The question is whether this makes any part of the indirect costs an onerous contract. First of all, the indirect costs also apply to the other 490 products. These do not only contain coverage for indirect costs, but also contain a mark-up for profit and thus there will still be profit. Second of all, such an incident does not make the contract as a whole onerous, as the following year the issue might be different. However, with the Dutch Supreme Court having ruled in this way, indirect costs can actually be recognised as part of a provision for an onerous contract. Because of the fact that the Dutch Supreme Court has built its reasoning around the concept of useless costs, the question remains open whether in the case of a claim before the civil court whereby the enterprise will have to perform in kind, the same applies. I see no objection to the reasoning that the indirect costs also become useless in a situation like this (it is essentially no different than in the case of an onerous contract). Under German law Article 253, Paragraph 1 second sentence HGB applies, which mentions the necessary ‘Erfüllungsbetrag’, to which the judgment of the sound businessman applies. It does not go into further detail whether indirect costs shall or can be taken into account. This means that this is a part of the measurement of provisions in which there is still a lot of work to be done. The other researched systems are mixed in their views. This also means that the ideas behind them do not provide solid reasoning on which Article 23 CCTB 2016 can be based. Whether or not to take indirect costs into account when measuring provisions is not a matter of overtaxation or double taxation. It concerns costs that will be taken into account at one point. The question is whether, when there is a reason to accelerate direct costs, there is also a good reason to take indirect costs into account. The main topic here is measurement of a provision. There is always an amount of administrative burden and compliance cost connected to measurement of provisions where direct costs are concerned. Whether or not to take indirect costs into account does not add much to this and such accounting will already be part of the management accounting of the entity. Any possibility to take more provisions into account or to a higher amount will create a tax deferral that keeps liquidity intact and thus be friendly towards growth. In itself this is more or less a fact, but there is no specific aim in this, which makes this a weak argument with regards to the question whether indirect costs can or must be taken into account when recognising a provision. Horizontal equity is not specifically connected to this issue. Only when it would remain unclear whether or not indirect costs can be taken into account, arbitrariness can occur and thus horizontal equity can suffer, as application of the rules might be different from one Member State to another. The same argument goes for efficiency and neutrality. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States on whether or not indirect costs can be taken into account when measuring a provision under Article 23 CCTB 2016 varies, as this might influence the decision on what location suits a particular enterprise best. Measurement of provisions, especially when it concerns indirect costs is not a simple matter as such. Article 23 CCTB 2016, by
not referring to this and requiring settlement value as the basis for measurement does little to improve this. It also leads to an amount of uncertainty. Enforceability will also suffer from the fact that the common corporate tax base of CCCTB is not clear in how to take indirect costs into account: an unclear rule will generally present problems for both the taxing authorities and the taxpayer. A problematic paradox occurs when a multitude of Member States need to agree on a certain rule. When there is an inherent vagueness to it, each Member State can recognize and interpret this in its own light. In itself this leads to an easier and quicker consensus than to have to bargain about every detail. The problems however start when the rules are applied, as such a consensus is only semi-harmonisation, as it leaves too much room for interpretation and this arbitrariness can occur when Member States apply the rules differently. This means that there are a number of issues with regards to measurement and indirect costs which can harm the effectiveness of the common corporate tax base of CCCTB. This is no different from other parts of CCCTB that present issues, but it needs to be addressed nonetheless. With regards to measurement of provisions under Article 23 CCTB 2016 and the question whether indirect costs should be included in this recognition, the following applies.

First of all, this requires some understanding as to what indirect costs are. I have defined indirect costs as costs that would be taken into account when determining the cost of a product (e.g. as in determining the price), but that do not directly lead to a marginal increase in costs when the production rises. Furthermore, it takes some effort to determine whether indirect costs are to be taken into account when measuring a provision under Article 23 CCTB 2016. In my opinion, under the current text, which requires the use of settlement value, this would lead to taking indirect costs into account, insofar a third party would make these indirect costs part of the price. The other researched systems provide little insight in whether or not to take indirect costs into account: IFRS (and United Kingdom FRS 102) leaves some room for interpretation here, as does German tax law. The Dutch approach, in my opinion, is wrong, as the main characteristic of indirect cost (the fact that it is not variable and not directly attributable to part of the production) is denied and this would only occur when the indirect costs are part of an onerous contract (which requires the proceeds and costs of the whole contract to be analysed). The principles underlying CCCTB show no real preference for either taking indirect costs into account or not, but they do imply that a choice between one and the other must be made. In my opinion, the way that the common corporate tax base of CCCTB approaches costs, the fact that Article 23 CCTB 2016 is an exception to Article 17 CCTB 2016 and the fact that the indirect costs are still covered by regular sales (and therefore an issue with Article 23, Paragraph 2 under (d) CCCTB, means that there is no good reason to take indirect costs into account when measuring a provision under Article 23 CCTB 2016. When the indirect costs as a whole prove to be onerous, a provision for an onerous contract might apply, but not partly in measurement of other provisions. This is different when Article 23 CCTB 2016 would remain to adhere to the concept of settlement value in its
THE CONCEPT OF PROVISIONS IN ARTICLE 23 CCTB

approach (which I do think would be wrong though). From that approach it would follow that indirect costs would need to be taken into account.

Recommendation
Apart from the fact that settlement value needs to be removed from Article 23 CCTB 2016, it needs to be clarified that indirect costs are not to be taken into account. To Article 23, Paragraph 2 CCTB 2016, the following needs to be added:

*In measuring the expected expense, indirect costs that occur independently of the facts or circumstances that gave rise to the obligation and thus do not arise from that obligation shall not be taken into account.*

6.3.3 Settlement value

Article 23, Paragraph 1 CCTB 2016 differentiates between two types of obligations that can give rise to the recognition of a provision:

- Legal obligation;
- Probable future legal obligation.

Article 25, Paragraph 2 CCCTB 2011 states that

*A reliable estimate shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry. In measuring a provision the following shall apply:...’

Article 23, Paragraph 2 CCTB 2016 is similar, but not identical

*A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present legal obligation at the end of the tax year, provided that that estimation is based on all relevant factors, including past experience of the company, group or industry. In estimating the amount of a provision, the following shall apply: ‘*

A legal obligation at the end of the tax year is a ‘present obligation’ / ‘present legal obligation’ and thus falls under Article 23, Paragraph 2 CCTB 2016. A probable future legal obligation, by nature, is not a ‘present obligation’ or ‘present legal obligation’ and, because of the current wording, cannot fall under Article 23 CCTB 2016. However, in both cases the provision needs to be measured. Article 23, Paragraph 2 CCTB 2016 only refers to the present obligation at the end of the tax year with regards to measurement. This leaves the question open how to measure a provision based on a probable future legal obligation. Since Article 23, Paragraph 2 CCTB 2016 bases the measurement of a present legal obligation on the expected expenditure required to settle the present obligation at the end of the tax year, it would technically not even make
CHAPTER 6 ANALYSIS OF THE ISSUES FOUND

much sense to determine settlement value at the end of the reporting year without the obligation being present at the end of the reporting year. It would mean that the settlement value would need to be determined without an obligation being present. None of the other systems recognise the ‘probable future legal obligation’ as giving rise to a provision, at least not in the literal sense. Therefore, measurement of the probable future legal obligation is a problem that is unique to the common corporate tax base of CCCTB. Given the inconsistency in Article 23, Paragraph 2, under (b) CCTB 2016, there are indications that recognition and measurement of provisions in Article 23 CCTB 2016 is actually flawed in several places.

It is likely that it has not been a conscious decision that Article 23, Paragraph 2, first sentence CCTB 2016 only requires measurement at the expected expenditure required to settle the present obligation at the end of the tax year, while Article 23, Paragraph 1 CCTB 2016 requires the recognition for provisions for both present obligations and probable future legal obligations. This would explain the fact that Paragraph 1 requires the recognition of a provision for both legal obligations and probable future legal obligations (i.e. obligations that do not exist at the end of the tax year), while Paragraph 2 only provides guidance on measurement of a present obligation.

A probable future legal obligation will, by nature, not have a value at which it can be settled at the end of the tax year, or at least a highly theoretical one. A probable future legal obligation is a problematic concept to begin with, but measurement would be more consistent when the value of the expected outflow and not the settlement value at the end of the tax year would be the basis. The issue at stake here is that there are no explicit measurement rules in Article 23 CCTB 2016 for the probable future legal obligation in Paragraph 2, whereas the recognition itself is required by Paragraph 1. This is an omission and not a cause of overtaxation or double taxation per se. The whole concept of a probable future legal obligation itself does little to diminish the administrative burden for enterprises. The fact that the measurement rules for probable future legal obligations are omitted is not a matter of a heavy administrative burden for enterprises. The removal of probable future legal obligations from Article 23, Paragraph 1 CCTB 2016 would solve this, as this would delete the problem altogether. Growth-friendliness is improved if rules are free of errors and omissions. In that sense solving the issue with regards to measurement of probable future legal obligations will increase growth-friendliness. Any omission of measurement rules is likely to lead to arbitrariness up until the point where the European Court of Justice has ruled on what does and what does not fall under future legal obligations. This is the same for the omission of measurement rules for provisions based on probable future legal obligations. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States on how to measure provisions based on probable future legal obligations under Article 23 CCTB 2016 varies, as this might influence the decision on what location suits a particular enterprise best. A tax base is less effective when there is an omission in measurement rules. In that respect, clarification of how to measure a provision for a probable future legal
obligation is welcome. Providing rules for the measurement of provisions based on probable future legal obligations creates a situation that is simpler in the sense that it provides rules where the current Article 23 CCTB 2016 lacks these rules. This will also improve legal certainty, consistency, coherence and enforceability. It is highly likely that this issue has been overlooked by the European Commission. It is not an issue that is present in the other researched systems, but it will lead to several problems. The wording of other Articles in the common corporate tax base of CCCTB do not provide any guidance for a solution and neither do the other researched systems, as they do not recognise a similar concept.

The issue can be solved in several ways:
- Elimination of the ‘probable future legal obligation’;
- Providing measurement rules for both legal obligations and probable future legal obligations;
- Measurement of both categories of provisions at the discounted value of the actual expected outflow.

Elimination of the probable future legal obligation from Article 23 CCTB 2016 altogether would solve the issue. Given the fact that the compromise proposals propose the removal of the probable future legal obligation from Article 23 CCTB 2016, this is the preferred option. Providing measurement rules for both legal obligations and probable future legal obligations would also solve the issue. Removing the concept of settlement value would solve another main issue and would lead to measurement of the actual expected outflow, which is also better than the current rules, because a probable future legal obligation might not even have a settlement value at the end of the reporting period. When settlement value would not be removed, a fiction would need to be created whereby it is clarified that the settlement value precedes the actual obligation.

Recommendation
Given the former, the removal of settlement value would be my preferred option.

Article 23

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present legal obligation at the end of the tax year, provided that that estimation is based on all relevant factors, including past experience of the company, group or industry. In estimating the amount of a provision, the following shall apply:

(a) account shall be taken of all risks and uncertainties, but uncertainty shall not justify the creation of excessive provisions;
(b) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;

(c) future events shall be taken into account where they can reasonably be expected to occur;

(d) future benefits directly linked to the event giving rise to the provision shall be taken into account.

6.3.4 Future benefits

If future benefits directly linked to the event giving rise to the provision shall be taken into account this leads to a conflict with Article 6, 15 and 16 CCTB 2016. In Paragraph 4.6.2.5 I stated that Article 23 CCTB 2016 does not explicitly mention that, as a requirement, the expected outflow must be uncompensated. However, in measuring a provision, future benefits directly linked to the event giving rise to the provision shall be taken into account, according to Article 23, Paragraph 2 under (d) CCTB 2016. It remains unclear what is meant by ‘taking into account future benefits directly linked to the event giving rise to the provision’. It is likely that this means that in such a case the related in- and outflow must be offset, which will decrease the amount that can be deducted. Only if there is an excess of the outflow over the inflow, this would lead to a deduction. The interesting thing is that this would create an amount of tension between Article 23 CCTB 2016 and Article 6, 15 and 16 CCTB 2016, as Article 23 CCTB 2016 somehow requires ‘future benefits’ that would otherwise have been taken into account on the basis of Article 6, 15 and 16 CCTB 2016 to be attributed to the period in which the provision is recognised and the amount deducted. However, Article 23 CCTB 2016 is, according to its first sentence, an exception to Article 17 CCTB 2016. Nowhere is stated that Article 23 CCTB 2016 determines when income is recognised as revenue and thus creates an exception to Article 16 CCTB 2016. Therefore the first question is whether Article 23, Paragraph 2 under (d) CCTB 2016 is acceptable in Article 23 CCTB 2016 to begin with. The second question is, when it is deemed an acceptable part of measurement in Article 23 CCTB 2016, how to rephrase it.

Neither IFRS nor United Kingdom FRS 102 allows future benefits connected to the provision to be taken into account, in the sense that it does not allow netting of one with the other. Income is generally not presented as realised before it is virtually certain that it will be received. Netting the asset and the provision is also not allowed. Although no specific case law on the matter exists, Dutch sound business practice will follow the same lines (Dutch sound business practice does recognise the concept of hedge accounting, which also involves netting assets and liabilities. German law, on the other hand, does not allow the
The concept of provisions in Article 23 CCTB

recognition of provisions when and insofar the expected outflow is expected to be reimbursed. Thus, no specific consensus exists in this regard. What actually happens under the common corporate tax base of CCCTB is that only the excess of expected future outflows over expected inflows is attributed, which means that only that excess part is attributed in accordance with Article 23 CCTB 2016 (and thus in exception to Article 17 CCTB 2016) and this is in accordance with what Article 23 CCTB 2016 states: it is an exception to Article 17 CCTB 2016. In itself the common corporate tax base of CCCTB tends to attribute inflows and outflows separately, to which this is a rare exception. Only taking into account the excess does make sense. Attributing all the outflows to an early moment and all the connected inflows to a later moment creates a situation of deferral of taxes for which no real argument exists. This offsetting creates a slightly more complicated tax base than simply attributing inflows and outflows separately, does not decrease compliance costs and complicates enforcement somewhat. With regards to the issue of taking future benefits into account when recognising provisions, three alternatives exist:

- Not allowing the deduction of the outflow, which comes down to removing Article 23 CCTB 2016 altogether;
- Only allowing deduction of the excess part, which Article 23 CCTB 2016 currently does;
- Allowing deduction of the full amount without having regard to any connected inflow.

The first one, in my view, does not make sense: there are good arguments in favour of recognising provisions as such, both from the perspective of general purpose financial reporting as from the perspective of a tax base. The third one, allowing the deduction of the full amount without taking into consideration the connected inflow does not seem realistic, although the common corporate tax base of CCCTB differentiates from the principle of matching in general. The second option is therefore the most fitting. Another question is the certainty of the future benefits. Since they effectively block the recognition of a provision for the amount that they are recognised, this is a relevant question. For example, when an employee becomes ill or a building is no longer in use, there is a legal obligation present at the end of the reporting period and an expected future outflow. What must be determined is whether future benefits must be taken into account in this respect. The performance of an employee or the use of a building is, in my opinion, a future benefit. When there is absolutely no possibility of the employee getting well or the building being used or sublet again, this is relatively easy: no future benefits can occur and therefore there are no future benefits that can be taken into account. But if there is a probability that the future benefits will occur, they should be taken into account. Since Article 23 CCTB 2016 takes outflows into account when they are probable (‘more likely than not’) it is most consistent to take the future benefits into account when they are probable. The second question is: who will need to deliver proof? The
taxpayer that the future benefits are not probable or the tax authorities that they are probable.

Because of the inherent vagueness that occurs here, requiring that the tax authorities prove that the future benefits are probable, leaves the tax authorities with a mostly insurmountable problem. They will rarely be in the possession of enough information to determine whether future benefits are probable, as this is mostly inside information of the taxpayer. Since a taxpayer will generally enter into contracts because they are beneficial, it is the taxpayer who wants to deduct an amount and because the taxpayer actually has the information to determine whether or not future benefits are probable, it should be the taxpayer who has the burden of proof. Article 23, Paragraph 2 under (c) CCTB 2016 mentions that future events shall be taken into account where they can reasonably be expected to occur, which hints in the same direction, but leaves too much of the issue open (are ‘future benefits’ a species of the genus ‘future events’, is ‘reasonably expected’ similar to ‘probable’ or ‘expected’, who has the burden of proof).

Recommendation

Alter Paragraph 2 under (d)

(e) probable future benefits directly linked to the event giving rise to the provision shall be taken into account. Probable future benefits shall be deemed to be directly linked to the event giving rise to the provision, unless the taxpayer proves otherwise.

6.3.5 Measurement of future benefits

Article 23 CCTB 2016 contains no rules of measurement for the future benefits mentioned in Article 23, Paragraph 2 under (d) CCTB 2016. Article 23, Paragraph 2 under (d) CCTB 2016 requires that future benefits directly linked to the event giving rise to the provision shall be taken into account. Paragraph 2 is the paragraph on measurement of provisions and thus focuses on the measurement of the expenses. However, by requiring the effective netting of the measurement of the future expenses with the future benefits, or only allowing the deduction of the excess of the future expenses over the future benefits, this also implies measurement of the future benefits. Apart from the fact that it is not clarified what is meant by ‘taking future benefits into account’ (see paragraph 6.3.4), it is not clear how to measure these future benefits, such as whether there is an expected or present value to be taken into account or the actual expected outflow. Article 23, Paragraph 2 CCTB 2016 does not state whether these future benefits, when they are netted with the future expense, should be measured on the same basis as the future expenses, as it only refers to a reliable estimate of the expected expenditure required to settle the present obligation at the end of the tax year.

Four approaches can be followed:
The future benefits are measured on the basis of Article 16 CCTB 2016, being the basis for the accrual of revenues;

The future benefits are measured on the basis of Article 20 CCTB 2016, the main article on valuation;

The future benefits are measured on the same basis as the future expenses;

The future benefits are measured at their nominal value.

Article 16 CCTB 2016 ‘Accrual of revenues’ merely states that revenues accrue when the right to receive them arises and they can be quantified with reasonable accuracy, regardless of whether the actual payment is deferred. No specific method of measurement can be derived from this. Article 20, Paragraph 1 (a) and (b) CCTB 2016 can both apply: for the purpose of calculating the tax base, transactions shall be measured at:

(a) The monetary consideration for the transaction, such as the price of goods or services;

(b) The market value where the consideration for the transaction is wholly or partly non-monetary;

Either can apply in my opinion, depending on the facts of the case, as Article 23, Paragraph 2 under (d) CCTB 2016 is not limited to either monetary or non-monetary considerations. In the case of a monetary consideration, using the nominal value is implied, without any discount for the time value of money. In the case of a non-monetary consideration market value is to be applied, which implies that present value is taken into account (as this is what would happen on the market). When future benefits shall be measured at their nominal value, this is a relatively easy calculation (as it means that no discount will have to be applied). However, this would lead to a situation where the expected expenses are determined on the basis of a discounted value and the expected benefits on a nominal basis, which would decrease the deductible excess. It would make the most sense to use the same basis for the measurement of both the future expenses and the future benefits. IAS 37 and United Kingdom FRS Section 21 do not allow netting of assets and liabilities, unless very specific circumstances apply. When netting is applied it would still mean that the asset and the liability are measured on their own individual terms. Dutch sound business practice gives only limited rules for netting, which occurs mainly in the case of hedging. It is not unthinkable that where there is a very tight relation between the expected future expenses and expected future benefits the principle of reality will lead to netting of both.

The measurement of future expenses and future revenue concerns a timing aspect. This can influence the liquidity of the enterprise (the more tax deferral, the better liquidity), but in itself this does not lead to double taxation or

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overtaxation. The whole concept of Article 23, Paragraph 2 under (d) CCTB 2016 will lead to deviations from IFRS and national GAAP in most cases anyway and thus it is highly unlikely that the administrative burden will be decreased by the method of measurement of the future expenses. Neither will the solution to this issue diminish the high tax compliance costs for enterprises. Since Article 23, Paragraph 2 under (d) CCTB 2016 states that future expenses directly linked to the event giving rise to the provision shall be taken into account, but not how and at what value, this is an omission. Any increased clarity or solving of an omission will lead to an increase of growth-friendliness, but it is not something that will lead to growth per se. Equity is not specifically connected to this issue, but it is not unthinkable that when the future benefits are measured on a different basis than the expected outflow, the tax treatment of a taxpayer that does not have to deal with these future benefits will be inexplicably different from taxpayers that do have to deal with these future benefits. The same issue applies when different Member States measure these future benefits in different ways, which is not unrealistic when no rules are provided and different methods can apply. Efficiency and neutrality relate to the fact that taxes should not lead to a distortion of investment decisions based on location. This will only be an issue when the interpretation among Member States on whether or not indirect costs can be taken into account when measuring a provision under Article 23 CCTB 2016 varies, as this might influence the decision on what location suits a particular enterprise best. Both simplicity and legal certainty suffer from the lack of rules for measurement of future benefits in provisions. Providing rules for measurement for the future expenses and stating that future benefits should also be taken into account, but not providing rules for measurement of these future benefits is not consistent or coherent. Any lack of rules will lead to a decreased enforceability. Enforceability will benefit from clarity with regards to the measurement of future benefits directly linked to the event giving rise to the provision. The omission of guidance or rules for measurement of future benefits in provisions therefore harms the effectiveness of Article 23 CCTB 2016. In itself, the idea that expenses and benefits that show a high amount of connectedness need to be netted and treated as one amount makes sense, even though it goes against the basic idea in the common corporate tax base of CCCTB, where revenues and expenses are attributed separately. When they are treated as one amount, measurement should be identical as well. This means that the rules for measurement of the provision mentioned in Article 23, Paragraph 2 CCTB 2016 should apply to the netted amount.

Recommendation
(d) future benefits directly linked to the event giving rise to the provision shall be taken into account. The probable future benefits shall be measured in accordance with the measurement of the expected outflow.
6.3.6 Reimbursements for future higher costs

Received reimbursements for future higher costs are fully taken as profit under the common corporate tax base of CCCTB. As mentioned in paragraph 4.6.1.1.3, when a taxpayer receives a reimbursement for future higher costs, meaning that on the one hand future higher costs are expected (such as increased electricity bills), but the taxpayer receives an up-front reimbursement from, for example, the party that caused the expected higher use of electricity, this will be taxed under the common corporate tax base of CCCTB in the year in which the right to receive the reimbursement has arisen because of Article 16 CCTB 2016. This is especially the case when there is no actual obligation for the taxpayer connected to the receipt of the amount. This is where the lack of matching costs with revenue really shows. Application of Article 23 CCTB 2016 cannot lead to a deductible expense beforehand (as it is unlikely that the probable future legal obligation includes future electricity bills). Like the effect of not allowing a provision for maintenance and repairs, this means that the entity is harmed in its ability to save up for expected future expenses. The mechanism is the same: no tax deferral is granted, the enterprise incurs the expense and afterwards a tax deferral is granted. Recognising a provision beforehand would help decrease this effect. In a legal obligation-driven approach, this only happens when the expected future expense already represents a legal obligation, which, in the case of maintenance and repairs or received reimbursements will be rarely the case. When there is an obligation to use the money for this purpose (and an obligation to pay back the amount would occur when the amount is not used for its intended purpose), it can be stated that either the right to receive the payment has not occurred to the full extent yet or a legal obligation in the sense of Article 23 CCTB 2016 exists. Neither of these issues is fully clear though and requires a large amount of interpretation of Article 23 CCTB 2016. This means that an upfront payment, intended to be a reimbursement for future expenses is generally taxed in the year in which it is received.

Under the common corporate tax base of CCCTB, the concept of saving up liquidity for expected future expenses and its importance for a taxpayer is only rarely taken into account, although it is recognised in the Working Papers. The provisions of Article 23 CCTB 2016 and the roll-over relief of Article 35 CCTB 2016 are two of the few examples of this. This means that on the one hand the concept of allowing saving up for expenses by allowing a tax break is recognised, but on the other hand, it is rare that a facility is created. Of the other research systems, only Dutch sound business practice explicitly allows the deferral of taxes for upfront received payments. Dutch sound business relies very heavily on principles and court decisions, which leaves more room for such an approach. The issue at hand concerns a timing aspect. This can influence the liquidity of the enterprise (the more tax deferral, the better liquidity), but in itself this does not lead to double taxation or overtaxation. Whether or not a deferral

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of taxes is created for received upfront payments is not an issue related to diminishing the heavy administrative burden for enterprises, apart from the fact that the recognition of a provision would slightly increase the administrative burden. Similarly, the deferral of taxes for received upfront payments is not an issue related to high compliance costs for enterprises. The recognition of a mandatory provision would lead to an increase of compliance costs. Being able to save up for future expenses, instead of having to finance the expense beforehand and being able to deduct them from taxable income afterwards would help growth instead of hurting it.

This is basically the same issue as the issue about maintenance and repairs, with the difference that in this case there is actual money received upfront. The approach of expected future expenses is not fully consistent and coherent. Article 23 CCTB 2016 itself creates a number of issues and Article 35 CCTB 2016 (roll over relief) is virtually a stand-alone facility. Both are based on the idea that an enterprise should not be taxed in relation to an amount that it will need to pay out foreseeably in the future. In itself the current rules are simple, transparent and certain with regards to this issue. This makes them enforceable as well. The only question is whether the expected future costs could fall under the ‘probable future legal obligation’, as the future expenses are actually caused before the end of the reporting period. The issue with regards to received payments for future expenses relates to the competitiveness of enterprises in the European Union. Since it decreases liquidity at an unfortunate moment, it can decrease the competitiveness of enterprises in the European Union. There is a distinct argument in favour of a tax payer being able to save up for an expected future expense and receiving a tax deferral for that reason. The current rules only have limited possibilities for that in the first place. The other researched systems mostly do not allow any form of tax deferral in case a reimbursement is received for expected future expenses, unless it meets the requirements of a provision or it is not realised yet. Although there is an inherent unreasonability in this, the difference between, for example, 23 CCTB 2016 and an upfront reimbursed amount is that an inflow occurs before the outflow. The liquidity is already present. Therefore, an additional facility for this would complicate the tax base in an undesirable way.

Recommendation

None

6.3.7 Prevention of excessive provisions

Article 23, Paragraph 2 under (a) CCTB 2016 concerning the prevention of excessive provisions is unnecessary clutter. Article 23, Paragraph 2 under (a) CCTB 2016 states that in measuring a provision account shall be taken of all risks and uncertainties. However, uncertainty shall not justify the creation of excessive provisions. Article 25, Paragraph 2 CCTB 2011 already states that a reliable estimate shall be the expected expenditure required to settle the present
obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry. Article 23, Paragraph 2 CCTB 2016 is similar, but not identical.

Article 23, Paragraph 1 CCTB 2016 states that any amount arising from that obligation which can be reliably estimated shall be deductible. This means that there is no explicit differentiation between the criteria for recognition and the criteria for measurement. If ‘a reliable estimate’ would have been solely a criterion for recognition, it would have been a different situation and a separate remark for measurement would make sense, but Paragraph 1 states that ‘any amount arising from that obligation which can be reliably estimated shall be deductible’, which means that recognition and measurement are intertwined. Since ‘risks and uncertainties’ as mentioned in Article 23, Paragraph 2 under (a) CCTB 2016 are ‘relevant factors’ as mentioned in Article 23, Paragraph 2 first sentence CCTB 2016, the fact that ‘account shall be taken of all risks and uncertainties’ is an unnecessary addition. The other aspect, ‘uncertainty shall not justify the creation of excessive provisions’ is not mentioned as such elsewhere in Article 23 CCTB 2016 (meaning it is not a double entry). However, since Paragraph 1 already states that ‘any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense’, this already covers the fact that uncertainty shall not justify the creation of excessive provisions. I refer to the above for my conclusion on how to interpret the word ‘expected’ in CCCTB.

With that in mind, the creation of excessive provisions is altogether not allowed in the first place, which means that Article 23, Paragraph 2 under (a) CCTB 2016 adds nothing to the rest of the text or Article 23 CCTB 2016. Since this aspect refers to a very specific wording of Article 23 CCTB 2016, this is not comparable to the other systems. However, IAS 37.42 states that the risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision. IAS 37.43 mentions that uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. Given the high amount of similarities in the wording, this implies that these parts of IAS 37 were the inspiration for Article 23, Paragraph 2 under (a) CCTB 2016.

The question is, however, whether these additions belong in Article 23 CCTB 2016. There are a number of differences between the common corporate tax base of CCCTB and IFRS. IFRS consists of elaborate standards, whereas the common corporate tax base of CCCTB consists of short laws without guidance, which implies that additions, guidance and double entries are more common in IFRS than in the common corporate tax base of CCCTB. United Kingdom FRS 102, which is also based on IFRS, does not repeat IAS 37.42 and IAS 37.43, even though FRS 102 is much more elaborate than the common corporate tax base of CCCTB. This also indicates that these entries are unnecessary. Furthermore, given the fact that IFRS is more elaborate and the principle of prudence and provisions have been subject of several debates in the IASB, it is understandable that for political reasons, IAS 37.42 and IAS 37.43 were added,
even though, strictly speaking, they do not add to the existing requirements and rules. This does not mean that the common corporate tax base of CCCTB should repeat them. As the wording in Article 23, Paragraph 2 under (a) CCTB 2016 is simply a ‘filler’ there is nothing relevant about it and it does not refer to the principles underlying CCCTB other than that removing it would make Article 23 CCTB 2016 simpler and clearer. Article 23, Paragraph 2 under (a) CCTB 2016 is clutter that can be removed from the text. The argument that it does not really hurt the tax payer, while true, does not take into account the fact that a Directive, or any other part of law, is to be kept simple and concise, which is especially true for the common corporate tax base of CCCTB. This means the unnecessary clutter must be removed as much as possible. While Article 25, Paragraph 2 under (a) CCTB 2016 does not have a particular negative effect, it does not add anything to Article 23 CCTB 2016 either, not even clarification.

Recommendation

The recommendation consists of the removal of Article 23, Paragraph 2 under (a) CCTB 2016 altogether.

Article 23

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry. In measuring a provision the following shall apply:

(a) account shall be taken of all risks and uncertainties, but uncertainty shall not justify the creation of excessive provisions;
(b) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;
(c) future events shall be taken into account where they can reasonably be expected to occur;
(d) future benefits directly linked to the event giving rise to the provision shall be taken into account.

6.3.8 Measurement in the case of large numbers of items is not explicitly recognised

As mentioned in paragraph 6.2.3, there are no criteria for the recognition of an obligation based on large homogenous groups of items, while it is likely that they can be recognised. Rules for measurement of such obligations are not present either. Article 23 CCTB 2016 takes settlement value as its basis, which often can be determined more easily for large groups of homogenous items than for individual items (the statistical information is already present). As the other
systems are generally implicit in their recognition of obligations based on large groups of homogenous items, their guidance on measurement of obligations based on large groups of items is limited as well. Dutch sound business practice, for example, gives no guidance in this respect. IFRS takes the best estimate of the expenditure required to settle the present obligation, the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

In IAS 37.39 an example is included, covering the warranty on goods sold, of which the manufacturing defects become apparent within the first six months of purchase. It states that if minor defects were detected in all the products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result. In the entity’s past experience and future expectations indicate that, for the coming year 75 percent of the goods sold will have no defects, 20 percent of the goods sold will have minor defects and 5 percent of the goods sold will have major defects. The expected value of the cost of repairs is \((75\% \times 0) + (20\% \times 1\text{m}) + (5\% \times 4\text{m}) = 400,000\). The same approach is followed under United Kingdom FRS 102 and German tax law. This expected value is the basis for measurement of liabilities based on numbers.

Measurement of provisions does represent an administrative burden for an enterprise. It will often not be among the heavier administrative burdens or higher compliance costs, but clarification of the rules at least gives an enterprise enough guidance of what to do and when. Growth-friendliness does not relate to a large extent to this issue. The issue does not relate to horizontal equity other than that improved clarity will increase the equality between enterprises in the European Union. This issue relates mostly to certainty, or the current lack thereof. The issue is mostly related to the fact that the use of settlement value is not consistent at times and there is no current recognition in the common corporate tax base of CCCTB that large groups or populations of items can lead to an obligation that cannot be traced to a single individual item and these obligations must be measured as well. The fact that the issue is not fully covered and not fully consistent leads to a decreased enforceability. Enforceability would therefore be improved by covering this issue. Although any clarification is beneficial, it is unlikely that it will lead to huge improvements of the competitiveness of enterprises within the European Union or the European Union as a whole. Since the current situation is not fully in line with a number of the principles, improvements of this will lead to improvement of effectiveness of the the common corporate tax base of CCCTB. For large groups of homogenous items settlement value can be determined easier than for most individual items, as long as there is a history or other way of determining the numbers. Settlement value would also be in line with the actual expected outflow, which will often not be the case for individual items. For example, in the case of large groups of homogenous items, a 5% chance of expenditures can be translated to an amount quite easily, even though it will not be known which items will lead to an outflow. A lower or higher actual outflow can actually occur, but a complete non-occurrence will be rare (the standard deviation can
even be determined). In the case of an individual item, a 60% chance to an outflow can still lead to an outflow of €0 when the outcome is either a set amount or zero. It can also lead to the full amount to be paid. It will never be 60% x the amount, unless the enterprise will actually settle the amount. This means that in the case of individual items (which includes non-homogenous groups of items) settlement value is only the expected value when the enterprise plans to settle the amount with the third party. When it is not planned to be settled, the expected value does not necessarily equal settlement value.

**Recommendation**

Recommendation is therefore to include the use of the expected outflow and not the settlement value, unless settlement is expected or otherwise equal to expected value.

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry. In measuring a provision the following shall apply:

(a) When the enterprise expects to settle the amount within six months after the end of the tax year the expected expenditure shall equal the amount at which the enterprise expects to settle the amount.

(b) Where the expected expenditure involves a large population of items, measurement takes place by weighing all possible outcomes by their associated probabilities.1050

(c) account shall be taken of all risks and uncertainties. However, uncertainty shall not justify the creation of excessive provisions;

(d) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;

(e) future events shall be taken into account where they can reasonably be expected to occur;

(f) future benefits directly linked to the event giving rise to the provision shall be taken into account.

### Future events and settlement value

In paragraph 4.6.2.3 I mentioned that Article 23, Paragraph 2 under (c) CCTB 2016 states that in measuring a provision future events shall be taken into account where they can reasonably be expected to occur. Because Article 23, Paragraph 1 and 2 first sentence CCTB 2016 state that any amount arising from

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1050 See also International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* 37.39, second sentence.
the obligation which can be reliably estimated shall be deductible and a reliably estimated amount shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors. The latter means that no additional taking into account of future events is needed or possible (future events are relevant factors in determining settlement value).

In itself this refers to the same problem dealt with in paragraph 6.3.7 above. Article 23, Paragraph 2 first sentence CCTB 2016 requires the use of settlement value at the end of the tax year, whereas it is unclear whether the second sentence is an addition or guidance. Furthermore, Article 23, Paragraph 2 under (c) CCTB 2016 consists of both an inclusion and exclusion. First of all, it implies that future events shall be taken into account (which is an inclusion), but, second of all, only where they can reasonably be expected to occur (which is an exclusion or limitation). Settlement value at the end of the tax year would already require the taxpayer to take into account future events where they can reasonably be expected to occur. Since Article 23, Paragraph 2 under (c) CCTB 2016 does not add any further specifics, it is merely a filler and as I stated before, in a tax base that strives to be clear and simple, fillers should be removed. Since this is an issue that revolves around the specific wording in the common corporate tax base of CCCTB, there is nothing comparable in Dutch sound business practice or German law, as these do not refer to settlement value at the end of the tax year or reporting year as the basis for measurement of a provision. IFRS does make a similar reference, which is likely to have been the inspiration for Article 23, Paragraph 2 under (c) CCTB 2016. IAS 37.48 states that future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur, which is basically the same issue as in Article 23, Paragraph 2 under (c) CCTB 2016. While I think that the wording of IAS 37.48 is preferable to the wording of Article 23, Paragraph 2 under (c) CCTB 2016, I have the same issues with IFRS’s approach, as IAS 37.36 states that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the obligation at the end of the reporting period (which, in my opinion, is seldom the right criterion). This will already include relevant future events, which means that IAS 37.48, IAS 37.49 and IAS 37.50 are guidance for the application of IAS 37.36. When the best estimate is the expenditure required to settle the obligation at the end of the reporting period, this will not necessarily include, for example, expected future changes in technology (IAS 37.49) as I do not think this will necessarily play a role when settling a dispute at the end of the reporting period. This is the same for possible new legislation (IAS 37.50), which will not necessarily influence this. It will only be relevant when parties seeking to settle a dispute at the end of the reporting period would take this into account.

While there is no direct issue of diminishing the heavy administrative burden for enterprises related to Article 23, Paragraph 2 under (c) CCTB 2016, there is an issue of keeping the amount of legislation as compact as possible (which is at least beneficial to diminishing the heavy administrative burden for enterprises).
As there is no direct relevance or added value evident in Article 23, Paragraph 2 under (c) CCTB 2016, it is superfluous. The same issue applies to decreasing high tax compliance costs for enterprises, any obsolete legislation should be removed, which therefore also goes for Article 23, Paragraph 2 under (c) CCTB 2016. Article 23, Paragraph 2 under (c) CCTB 2016 does not make Article 23 CCTB 2016 highly complex or uncertain. Article 23, Paragraph 2 under (c) CCTB 2016 is merely a superfluous part of Article 23 CCTB 2016. Either its inclusion or its exclusion will not influence the enforceability. It simply does not add anything to the article, which means that Article 23 CCTB 2016 can be even simpler than it currently is, without losing anything. In keeping CCCTB as such consistent and coherent, it makes sense to remove any unnecessary articles or paragraphs. It would be too far-fetched to state that Article 23, Paragraph 2 under (c) CCTB 2016 in its current form decreases competitiveness and thus removal would increase competitiveness of an enterprise within the European Union or the European Union as a whole. Article 23, Paragraph 2 under (c) CCTB 2016 is effectively mere guidance, but it is not specific enough to add to the content of the text. It is probably inspired by IAS 37, but where IAS 37 contains a lot of guidance, Article 23, Paragraph 2 under (c) CCTB 2016 is a rule and thus needs to be either specific and useful or should be removed. It does not touch upon the principles very heavily, other than that obsolete rules should be removed, in order to keep the directive as short and simple as possible.

Recommendation
Removal of Article 23, Paragraph 2 under (c) CCTB 2016.

Article 23

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present obligation at the end of the tax year, provided that the estimate is based on all relevant factors, including past experience of the company, group or industry. In measuring a provision the following shall apply:
   (a) account shall be taken of all risks and uncertainties. However, uncertainty shall not justify the creation of excessive provisions;
   (b) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;
   (c) future events shall be taken into account where they can reasonably be expected to occur;
   (d) future benefits directly linked to the event giving rise to the provision shall be taken into account.
6.4 Assorted technical issues

6.4.1 Relation with long-term contracts

Article 23 CCTB 2016 is written as an exception to Article 17 CCTB 2016, but it is unclear whether it is an exception to Article 22, Paragraph 3 CCTB 2016. Article 22, Paragraph 3 CCTB 2016 states that costs relating to long-term contracts shall be taken account of (CCTB 2011) / deductible (CCTB 2016) in the tax year in which they are incurred. Since the incurrence of deductible expenses is dealt with in Article 17 CCTB 2016, as part of the general attribution rules of the common corporate tax base of CCCTB, this means that Article 22, Paragraph 3 CCTB 2016 is, at best, a clarification that in the case of long-term contracts, where revenues relating to a long-term contract shall be recognised, for tax purposes, at the amount corresponding to the part of the contract completed in the respective tax year (see Article 22, Paragraph 2 CCTB 2016). This does not apply to expenses: the attribution of expenses still follows the general rule of Article 17 CCTB 2016. Article 22, Paragraph 3 CCTB 2016 does not add anything new to the common corporate tax base of CCCTB. This means that it is merely guidance. The question is what this means for the application of Article 23 CCTB 2016 in the case of the long-term contracts of Article 22 CCTB 2016. The main question is whether Article 23 CCTB 2016 can be applicable to the long-term contracts of Article 22 CCTB 2016: a long-term contract is one which complies with the following conditions (2016 text):

(a) it is concluded for the purpose of manufacturing, installing or constructing or for performing of services;

(b) its term exceeds, or is expected to exceed, 12 months.

This means that it is not merely the term of the contract that determines whether it is a long-term contract in the sense of Article 23 CCTB 2016, but it also depends on the type of service. Article 22, Paragraph 3 CCTB 2016 states that costs relating to long-term contracts shall be taken into account / deductible in the tax year in which they are ‘incurred’. Article 17 CCTB 2016 determines when a deductible expense is ‘incurred’. This means that Article 22, Paragraph 3 CCTB 2016 implicitly refers to Article 17 CCTB 2016. Article 23 CCTB 2016 does not literally state that it is an exception to Article 22 CCTB 2016, but the reference to when costs are incurred in Article 22 CCTB 2016 means that Article 23 CCTB 2016 is an exception to when costs are ‘incurred’ and thus an exception to Article 22 CCTB 2016.

In a situation where normal revenue (not derived from a long-term contract) occurs and a provision is recognised for expenses related to it, there would be a spread between the recognition of the revenue in tax year $t$ and the recognition of the provision at point $t-1$ or earlier. In the case of a long-term contract, the revenue would be spread over the years $t$, $t+1$, $t+2$ etcetera and because of the
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provision, the costs would still be attributed to point t-1 or earlier.\textsuperscript{1051} This means that in the case of long-term contracts under the common corporate tax base of CCCTB, the spread between revenue and expenses might become even bigger than in the case of revenue that is not connected to a long-term contract. My opinion about this is that, although this is against the principle of matching, this is an approach that is explicitly chosen in the common corporate tax base of CCCTB: revenue and costs are attributed apart from each other. Article 22 CCTB 2016 is written primarily as a way to attribute the revenues related to a long-term contract and not to attribute expenses related to the contract. The other researched systems do not differentiate between certain types of onerous contracts in the sense of short-term or long-term. The German ‘Handelsgesetzbuch’ allows the recognition of provisions for onerous contracts, while German tax law forbids this. IFRS, FRS and Dutch sound business practice all allow the recognition of provisions for onerous contracts. This means that no arguments for differentiation between certain types of onerous contracts can be derived from the other systems. The only issue that would lead to overtaxation or double taxation is when the recognition of a mandatory provision and thus the incurrence of costs is so many years before the recognition of the connected revenue that the incurred losses would evaporate (when the recognition of the provision leads to a loss and there are no other profitable activities within the enterprise).

The main problem with long-term contracts and the attribution of revenue and costs under the common corporate tax base of CCCTB is the deviation from IFRS. This is however a problem with the common corporate tax base of CCCTB as such and not merely with the system contained in Articles 17, 22 and 23 CCTB 2016. The same issue goes for the cost of compliance. Horizontal equity would also only play a role when losses can and do evaporate, which is not currently the case. The way Articles 17, 22 and 23 CCTB 2016 are structured around each other is not very simple or transparent. In itself they are not uncertain or incoherent and can be enforced. Article 22 CCTB 2016 refers to costs being incurred, which refers to Article 17 CCTB 2016 and while Article 23 CCTB 2016 states that it is an exception to Article 17 CCTB 2016. The relation between Article 22, Paragraph 3 CCTB 2016 and Article 23 CCTB 2016 can itself be derived from the current rules. There is some room for improvement though, which means that either Article 22 CCTB 2016 or Article 23 CCTB 2016 must be altered in a way to mend this. Several options exist:

- Article 22, Paragraph 3 CCTB 2016 can be removed altogether. Article 22, Paragraphs 1 and 2 CCTB 2016 only refer to revenue and the separate attribution of revenues and costs is characteristic to the tax base of CCCTB as a whole. The downside of this option is that Article 22, Paragraph 3 CCTB 2016 acts as a form of guidance, which would

\textsuperscript{1051} Article 23, Paragraph 1 second sentence CCTB 2016 also plays a role in this attribution of revenue and expenses.
disappear altogether when removed, whereas the upside is that text that is not strictly necessary is removed;

– Article 22, Paragraph 3 CCTB 2016 can also refer directly to Article 17 CCTB 2016, stating that ‘Costs relating to long-term contracts shall be taken account in accordance with Article 17 CCCTB’. This would also solve the issue with regards to the fact that Article 23, Paragraph 1 CCTB 2016 states that it is an exception to Article 17 CCTB 2016, but would create some tension between Articles 22 and 23 CCTB 2016, as it would lead to the question whether a reference to Article 17 CCTB 2016 also includes an exception to Article 17 CCTB 2016 mentioned in Article 23 CCTB 2016;

– Article 23, Paragraph 1 CCTB 2016 can be altered in such a way that it clarifies the fact that it is an exception to Article 22, Paragraph 3 CCTB 2016, which would come down to ‘By way of derogation from Article 17 and Article 22, Paragraph 3…’;

– Article 23, Paragraph 1 first sentence CCTB 2016 could also refer directly to the costs being ‘incurred’ which it presently does not do. By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be incurred in that year, provided that the eventual settlement of the amount is expected to result in a deductible expense.

The simplest solution would be the last one, to alter Article 23, Paragraph 1 CCTB 2016. This would also solve the issue of mandatory or optional recognition.

**Recommendation**

*By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be incurred in that year, provided that the eventual settlement of the amount is expected to result in a deductible expense.*

6.4.2 Contracts

6.4.2.1 General issues

In Paragraph 4.6.2.5 and Paragraph 5.2.2.5 I concluded that application of the common corporate tax base of CCCTB in the case of onerous contracts leads to several problems. Non-onerous executory contracts also lead to certain issues under the common corporate tax base of CCCTB. The specific issue with a
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The percentage-of-completion method spreads revenue or profit of contracts with a term of over 12 months over the applicable years. It is opposed to the completed-contract method in which the revenue is attributed to the moment when actual realization has taken place. The former therefore shows the performance in all the years when relevant activities take place, whereas the latter only shows the performance in the last year.

contract is that it generally contains both a performance that the entity has to deliver (generally a form of outflow) and a performance to which the entity is entitled (generally an inflow). Under most systems of accounting, entitlements (the performance to be received) are attributed in a different, often more prudent, way than liabilities (the performance to be delivered). CCCTB, in general, attributes these performances separately, while they are obviously connected, their values might not be equal, the performances might not both be monetary and part of the performance will often be delivered by employees, who have their own long-term contracts. Furthermore, contracts can sometimes be split into several subcontracts with their own performances and entitlements. First of all, under the common corporate tax base of CCCTB several articles can apply to contracts and all bring specific issues. The regular system of Articles 16 and 17 CCTB 2016 can apply, in which case revenue and cost are attributed separately. Revenue will be attributed to the period in which the right to receive the revenue arises and it can be quantified with reasonable accuracy, whereas the connected cost will be attributed to the period in which the obligation to make the payment has arisen, the amount of the obligation can be quantified with reasonable accuracy and, in the case of trade in goods, the significant risks and rewards of ownership over the goods have been transferred to the taxpayer and, in the case of supplies of services, the latter have been received by the taxpayer. This means that, although there is an economic connection between the inflow and the outflow, the attribution takes place separately and can therefore be to different periods.

With regards to executory contracts (contracts that an entity has entered into, but of which neither of the contract parties have started work or to an equal extent), the common corporate tax base of CCCTB leaves no other room than simply applying Articles 16, 17, 22 and 23 CCTB 2016. Article 22 CCTB 2016 is an exception to the timing of the revenue of Article 16 CCTB 2016, but not to the timing of the costs. It is basically an application of the percentage-of-completion method, but strictly to the revenue. The effect is that the taxable profit is anticipated, by attributing revenue to an earlier period than Article 16 CCTB 2016 generally would. It only applies to certain types of contracts (manufacturing, installation or construction or the performance of services). The other requirement is that the term exceeds, or is expected to exceed 12 months. Whereas under general purpose financial reporting it is beneficial to the enterprise to apply such a rule (as it shows profit earlier than realised), for tax purposes such a rule is primarily beneficial to the authorities (as this means tax is anticipated instead of deferred). Article 23 CCTB 2016 can require the anticipation of costs, but only insofar they exceed the revenues connected to it, which leads to the following issues:
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- How strong must the connection between that revenue and cost be (as otherwise the common corporate tax base of CCCTB does not tend to attribute revenue and cost in connection)?
- How must the third sentence of Article 23, Paragraph 1 CCTB 2016 (spread of costs over the future) and part (d) of Article 23, Paragraph 2 CCTB 2016 (spread of revenue over the future) be interpreted in relation to each other?
- Is there a limiting effect of time? Or otherwise a suspensive condition?
- In this respect: is there a connection to a future performance (such as is the case with period bound costs)?
- What constitutes costs in this respect? Only direct costs or also indirect costs?
- How shall costs be measured?
- Can a contract be split into an onerous and a non-onerous part?

Unfortunately nowhere in the common corporate tax base of CCCTB the words ‘onerous contract’ or ‘executory contract’ appear. The word ‘contract’ appears in:

- Article 5 CCTB 2016 Permanent establishment
- Article 19 CCTB 2016 Stocks and work-in-progress
- Article 22 CCTB 2016 Long-term contracts
- Article 32 CCTB 2016 Entitlement to depreciate
- Article 45 CCTB 2016 Long-term contracts on entering the system
- Article 50 CCTB 2016 Long-term contracts on leaving the system
- Article 62 CCCTB 2011 Long-term contracts on entering the group
- Article 102 under (c) CCCTB 2011 Items deductible against the apportioned share

These articles, in themselves, add little to the concept of onerous contracts or executory contracts.

As stated, several articles can apply to contracts. Contracts generally consist of a part (future) revenue and a part (future) expenses (which translates to an asset and a liability). Under Article 16 CCTB 2016 and Article 17 CCTB 2016, there is no such thing as an onerous contract or executory contract, as revenues and expenses are attributed separately. Since most systems of accounting take matching costs with revenue as a basic principle, the common corporate tax base of CCCTB represents a thoroughly different approach, by not attributing revenue and cost as a combination, but separately. However, in some of the exceptions, revenues and costs are not separated as stated above. This is where an onerous contract can come into view. When the contract is split into the
performance to be performed by the enterprise (performance $P$) and the performance to be received (performance $R$), the following questions occur:

6.4.2.2 The performance to be performed

When is the performance to be performed eligible for recognition as a provision under Article 23 CCTB 2016?

Performance $P$ can lead to the recognition of a provision when there is:
- a legal obligation or a probable future legal obligation;
- arising from activities or transactions carried out in that, or previous tax years;
- an amount arising from that obligation which can be reliably estimated;
- eventual settlement of the amount is expected to result in a deductible expense.

The biggest issue in this regard will be whether:
- a legal obligation or a probable future legal obligation is present;
- the legal obligation arises from activities or transactions carried out in that, or previous tax years.

The question is whether a legal obligation is present. This will depend on the terms of the contract, but as long as there is no uncertain future event on which the existence of the legal obligation is dependent, this is possible. As stated before, a probable future legal obligation could also be present, but I do have a lot of concerns with regards to this type of obligation. The question whether it arises from activities or transactions carried out in that, or previous tax years is equally dependent on the terms of the contract. In some cases the obligation will be present as soon as the contract is signed. In other cases the obligation will be present depending on a future event.

This means that in the first case, the obligation arises directly from the contract and in the second situation from the future event. In the case of long term contracts, such as employment contracts, the obligation to pay wages will depend both on the factor time and the fact that the employee performs his or her work. When the employee does not perform, generally no obligation to pay the wages will exist (no work equals no pay), unless an exception occurs. The obligation is therefore contingent. This means that only by means of the probable future legal obligation, a provision can be recognised. When the employee is sick or otherwise not able to perform his or her duties at any point in the future (either the sickness will prevent any work being done or it is certain that the work that the employee had to perform simply is not there anymore), the enterprise will in some case be obliged to still pay the wages, but there is no longer a service to which the enterprise is entitled. This definitiveness, in my opinion, takes away the contingency: the obligation is in itself fixed, while the moment of when the payment is due is only dependent on the factor time, making it a present or probable future legal obligation.
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It also means that the obligation arises from the fact that the employee becomes sick or the part where he or she works becomes obsolete (although an employee becoming sick is not strictly an activity or transaction, as is literally required by Article 23 CCTB 2016, but the signing of the underlying contract is). Also, there are no expected future benefits in the sense of Article 23, Paragraph 2 under (d) CCTB 2016. This means that in a case like that, I feel that a provision can be recognised on the basis of Article 23 CCTB 2016. With a lease, a similar effect can occur. In itself the lease of a building will constitute an obligation, dependent on the factor time. The payment will become due with the passing of time, unless the building is no longer fit to be used. In that case, there are no future benefits that can offset the expected outflow and the expected outflow can qualify under Article 23 CCTB 2016. Note that this can only be the case when there is no expected future benefit that can be offset with the building. In my opinion this means, for example, that the building cannot be sublet and is unfit for further use in the enterprise.

6.4.2.3 Measurement of the performance to be performed

How shall the performance P be measured? The performance that the enterprise has to perform represents a liability / an obligation. The question is how this shall be measured. The main questions in this respect are:

– should measurement be based on the actual expected outflow or based on market value (such as settlement or transfer value);
– shall direct costs or indirect costs be taken into account;

When the performance to be performed consists solely of a payment by the enterprise, it is relatively easy to determine measurement, whereby the main question is whether the present value needs to be determined (and Article 23, Paragraph 2 under (b) CCTB 2016 gives an answer to this question, I refer to paragraph 6.3.1). When the performance is in kind, the question arises whether to use the actual expected outflow or the market value. The wording of Article 23 CCTB 2016 suggests that the liability shall be measured at settlement value (which is generally not in kind and therefore a market value). When the obligation following from a contract is compared to for example a claim, the obligation following from a contract in kind can be lower than the settlement value would be, whereas in the case of a claim this might be reversed. This can be summarised as follows:

Claim
– presence not necessarily 100% probable A
– expected outflow B
– settlement value A x B
– settlement value < expected outflow

Obligation from a contract
– presence generally 100% probable
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– expected outflow (performance)
– settlement or market value based on third party pricing will be entirely different
– settlement value > expected outflow

This means that the basis for measurement is different in both cases, as the scope and background is different. In the case of onerous contracts settlement or market value can lead to overprovisioning, as this can lead to a measurement that is too high. Again, I find the use of the settlement value inadequate in this situation. The type of inadequacy in contracts is different from the type that I find problematic in for example claims. For the second part, whether indirect costs can be attributed as well, the following applies. Article 23 CCTB 2016 is basically silent on the issue, but when it is taken into account that Article 23, Paragraph 1 CCTB 2016 requires the use of settlement value and in my opinion any settlement value will take indirect costs into account, I find that, even though I am opposed to the use of settlement value in Article 23 CCTB 2016, the question whether measurement includes indirect costs is basically answered by this. Apart from that, I do feel that taking indirect costs into account does not do the concept of a provision justice, as this leads to taking cost into account that are not part of the actual expected outflow that is the basis for the provision. See paragraph 6.3.2.

6.4.2.4 Split of a contract

Can a contract be split into an onerous and a non-onerous part Article 23 CCTB 2016 merely requires that ‘a’ legal obligation or ‘a’ probable future legal obligation’ must be present. It does not refer to the possibility of making divisions within the legal obligation. This means that it depends on the contract whether there is one or whether there are multiple legal obligations. The current wording leaves no room for splitting a contract in an onerous and a non-onerous part when there is just one obligation. The question is whether such splitting is actually desirable. Splitting a contract in an onerous and a non-onerous part would create an additional possibility for an enterprise to create a provision. For tax reasons this is not strictly necessary, as there is no actual loss: when the contract as a whole would not be onerous, but only when split, economically there is no real loss in that specific contract.

How strong must the connection between that revenue and cost be (as otherwise the common corporate tax base of CCCTB does not tend to attribute revenue and cost in connection)? How shall part (d) of Paragraph 2 (spread of revenue over the future) be interpreted in this respect?

Basically, within the system of the common corporate tax base of CCCTB there is little to connect the obligation (either monetary or in kind) with the revenue or any other contra-performance. The common corporate tax base of CCCTB
attributes revenue and costs differently and separately. The concept of an onerous contract takes the difference between the expected inflow and the expected outflow as the basis for recognition of a provision. The connection between revenue and cost is only mentioned in Article 23, Paragraph 2 under (d) CCTB 2016 as: future benefits directly linked to the event giving rise to the provision shall be taken into account. Within the concept of an onerous contract, the words ‘future benefits directly linked to the event giving rise to the provision’ imply that there is a connection between the costs attributed by Article 23 CCTB 2016 and revenue. The problem is that the words ‘shall be taken into account’ leave a lot to be desired with regards to how the attribution shall take place. Article 23 CCTB 2016 defines itself as an exception to Article 17 CCTB 2016, which implies that it can only attribute costs. With regards to onerous contracts this means that it cannot attribute the (unrealised) revenue, but only the obligation. ‘Shall be taken into account’ will, in this light, mean that the excess of cost is attributed by Article 23 CCTB 2016 and not the income itself.

For example:

| Expected future benefits of the contract | 100 |
| Expected future costs of the contract   | 120 |

If this becomes apparent in Year 2, whereas in Year 1 both amounts were equal, the amount to take into account is -20 and not 100 revenue and 120 cost, as the latter would create tension with Article 16 CCTB 2016.

Determining when benefits are ‘directly linked to the event giving rise to the provision’ might not always be an easy question to answer. Often, a contract will consist of a benefit and an obligation and in such a situation it will be relatively easy to determine the benefits that are directly linked to the event giving rise to the provision, as they both stem from the contract. I am of the opinion that when a contract leads to an obligation for which the entity has insurance coverage, that an amount paid by the insurance company in connection with this will also be considered to be directly linked to the event giving rise to the provision, which will often mean that the provision cannot be recognised (as all expenses will be covered by the insurance).

6.4.2.5 Spread of costs over the future

How shall the spread of costs over the future be interpreted? Often, contracts will contain both obligations and rights or entitlements that relate to the future. An employment contract will generally relate to activities that are to be performed by the employee and a lease will relate to a building or other asset that is in use. The third sentence of Article 23, Paragraph 1 CCTB 2016 states that where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the
estimated duration of the activity or transaction, having regard to the revenue derived therefrom.

When applied to employment contracts or lease contracts, the following applies. When an employment contract is entered into, the monthly payment will relate to the monthly activities that the employee performs. As long as this is the case, the third sentence of Article 23, Paragraph 1 CCTB 2016 will prevent a provision from being recognised, as the deduction will need to be spread over the estimated direction of the activity or transaction, i.e. the employment contract. However, when the employee becomes obsolete, but remains entitled to the salary or becomes sick and remains entitled to the salary, there will be no activity or transaction which will continue over future years (the contract itself could be viewed as a transaction that continues over future years, but in my opinion, this is not the right interpretation) and there will be no revenue derived from those activities or transactions. A similar effect will occur when a leased building becomes obsolete. There will be no activity or transaction which will continue over future years connected to future years (as stated, the contract itself, even though it concerns essentially period bound costs, will not be the relevant transaction) and there will be no revenue in connection with the activities or transactions.

Where rent is the payment for a lease, interest is the payment for a loan. It will generally be easier to determine when a leased building no longer has any use in the enterprise than to determine when a loan no longer has any use in the enterprise. Since it concerns money, it will generally be possible to use the money for a purpose, whereas a building might not be. Therefore a provision with regards to a contract concerning a loan will be rare under Article 23 CCTB 2016. With regards to the revenue derived from activities or transactions, mentioned in Article 23, Paragraph 1 third sentence CCTB 2016, it must be noted that Article 22 CCTB 2016 can thus influence the timing of the deduction of costs under Article 23 CCTB 2016, as Article 22 CCTB 2016 states that the percentage-of-completion method must be used for long-term contracts, under certain circumstances. The other researched systems all recognise and elaborate on onerous contracts, although it is striking that for tax purposes German tax law does not allow the recognition of provisions for onerous contracts. Provisions following from onerous contracts will be among the more complex types of provisions, but the possibility to recognise them are generally in favour of the taxpayer. Although Article 23 CCTB 2016 could be more explicit with regards to its treatment of onerous contracts, the high compliance costs are not strictly an issue that arises under this. The possibility to recognise provisions for onerous contracts will, in some case relate to being able to recognise a tax deferral when certain risks have been taken. When a building has been leased or employees hired for a more risky part of the enterprise, the possibility to create a tax deferral is generally welcome and will have a positive influence on the willingness to take risks. Horizontal equity might be connected to this issue. The fact that it is quite complex to determine whether a provisions can be recognised for onerous contracts might lead to arbitrariness up until the point where the European Court of Justice has ruled on what does and what does not fall under
probable future legal obligations. Efficiency and neutrality will only be an issue when the interpretation among Member States on how to treat onerous contracts under Article 23 CCTB 2016 varies, as this might influence the decision on what location suits a particular enterprise best.

The same applies to certainty and enforceability. A number of issues arise with regards to onerous contracts. All the researched systems recognise the concept of onerous contracts and provisions for onerous contracts (even though German tax law explicitly forbids the recognition of such provisions). This also stems from the fact that either implicitly or explicitly, all the systems recognise some form of matching or otherwise attributing revenue and costs in a more or less connected way. The common corporate tax base of CCCTB is quite different in this respect and attributes revenue and costs basically on a stand-alone basis. This means that the approach towards onerous contracts follows less naturally from the rules themselves. Nowhere in the proposal for the common corporate tax base of CCCTB is the concept of an onerous contract mentioned. This leads to the first issue: when a contract is thought to be onerous, which Articles of the proposal for the common corporate tax base of CCCTB apply to it? Articles 17 and 18 CCTB 2016 attribute revenue and cost separately, meaning that it is not the loss as such that is attributed. As onerous contracts would be mostly an issue in longer term contracts, Article 22 CCTB 2016 comes into view, but Article 22 CCTB 2016 only provides an alternative attribution of revenue; it leaves the attribution of costs intact, which means that it creates absolutely no link in the attribution of revenue and costs. Article 23 CCTB 2016, which is an exception to the attribution of costs and not to the attribution of costs, creates a dependency of the attribution of costs on the attribution of revenue. The exact extent of Article 23, Paragraph 2 under (d) CCTB 2016 is however not given. It states that ‘future benefits directly linked to the event giving rise to the provision shall be taken into account’, which leads to the question what is meant by directly linked. With regards to onerous contracts, I am of the opinion that this should be interpreted as including the benefits directly following from the contract (the performance to be received), but also for example insured amounts. Determining the exact boundaries of being ‘directly linked’ is not easy and probably undesirable. Furthermore, the application of Article 23 CCTB 2016 means that it must be researched whether an obligation is present (provided the ‘probable future legal obligation’ is likely to be removed from Article 23 CCTB 2016). The main determinant in this respect, in my opinion, is that when time is the only relevant contingent factor, an obligation can exist. This is for example the case when it is certain that an employee must be paid a certain salary without the employee being obliged to deliver any more performance, such as when he is terminally ill. Article 23, Paragraph 1 third sentence CCTB 2016 provides an additional aspect to this. It states that ‘where the obligation relates to an activity or transaction which will continue over future tax years, the deduction shall be spread proportionately over the estimated duration of the activity or transaction, having regard to the revenue derived therefrom’.

When there is only the factor time to be taken into account (such as described above: the employee is sick and will not perform in return for his salary), there
is in fact no activity or transaction that can be the basis for a proportional spread over the estimated duration. When there would still be a performance to expect, there would be an activity or transaction that would continue and thus would form the basis for a proportional spread over the future. This also follows from the application of Article 23, Paragraph 2 under (d) CCTB 2016. This means that with regards to period bound costs, as long as there would be a performance to expect (as an activity or transaction) no provision can be recognised. The fact that the contract is onerous is in itself not enough. In that sense it differs from for example sound business, which states that as long as the contract for period bound costs is onerous, a provision can be recognised.

With regards to the question whether a contract can be split into several parts, unless the contract is basically a combination of contracts combined into one (thus consisting of several distinct obligations), it is neither possible under the current wording of Article 23 CCTB 2016 nor is it necessary from the perspective of the ability to pay taxes to allow or require contracts being split into several parts when certain ‘parts’ can be deemed to be onerous. From the principles no other specific issue comes forward than the fact that more clarity with regards to how to deal with onerous contracts under the common corporate tax base of CCCTB mean that a higher degree of compliance with the principles would occur.

Recommendation

Article 23 Paragraph 2 under (d) CCTB

future benefits directly linked to the event giving rise to the provision shall betaken into account. Only the excess between the reliable estimate of the expected expenditure and the future benefits shall be recognised as a provision.

Paragraph 1, add as a new fourth sentence or add to Article 4 CCTB

An obligation can be constituted by an expected future outflow contingent only by time and not linked to future activities or transactions, which includes the situation where the taxpayer is not entitled to any future performance to be received.

6.5 Conclusion to the chapter

In this chapter I analysed the issues found with Article 23 CCTB 2016 and suggested several improvements. In the following chapter I will bring these together to a final article on the deduction of provisions.
Chapter 7. Analysis of the issues found and proposals for amendments

7.1 Introduction

On 26 October 2016 the proposal for a common consolidated corporate tax base was relaunched. In the article on provisions, only very slight alterations were made, which did not really improve the text of the original proposal.

Article 23 Provisions

1. By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has a legal obligation, or a probable future legal obligation, arising from activities or transactions carried out in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense.

   For the purposes of this Article, a legal obligation may derive from any of the following:
   (a) a contract;
   (b) legislation;
   (c) an administrative act of general nature or addressed to a specific taxpayer;
   (d) another operation of law.

   Where the obligation relates to an activity or transaction which will continue over future tax years, the provision shall be spread proportionately over the estimated duration of the activity or transaction. Provisions under this Article shall be reviewed and adjusted at the end of every tax year. In calculating the tax base in future tax years, account shall be taken of amounts that have already been deducted pursuant to this Article.

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure required to settle the present legal obligation at the end of the tax year, provided that that estimation is based on all relevant factors, including past experience of the company, group or industry. In estimating the amount of a provision, the following shall apply:

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1053 Commission document 685 of 2016, final version.
1054 Commission document 121 of 2011, final version.
(a) account shall be taken of all risks and uncertainties, but uncertainty shall not justify the creation of excessive provisions;

(b) if the term of the provision is 12 months or longer and there is no agreed discount rate, the provision shall be discounted at the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends;

(c) future events shall be taken into account where they can reasonably be expected to occur;

(d) future benefits directly linked to the event giving rise to the provision shall be taken into account.

3. Provisions shall not be deducted for the following:
   (a) contingent losses;

   (b) future cost increases.

In the light of the suggestions made in the compromise proposals, which have not been followed to the full extent, this is a disappointment. This also means that virtually all of the remarks made about and suggestions made for Article 25 CCCTB 2011 are still relevant. In this chapter I will gather the remarks and suggestions of the previous chapter and form them into one article on provisions. After that I will check this article with the remarks made in chapter 1. I will conclude the chapter with a final conclusion and look at the future of CCCTB.

7.2 The suggestions combined

The remarks combined lead to the following text

Article 23 Provisions

1. By way of derogation from Article 17, where at the end of a tax year it is established that the taxpayer has an obligation, arising from facts or circumstances occurring in that, or previous tax years, any amount arising from that obligation which can be reliably estimated shall be incurred in that year, provided that the eventual settlement of the amount is expected to result in a deductible expense.

Provisions under this Article shall be reviewed and adjusted at the end of every tax year. In calculating the tax base in future tax years, account shall be taken of amounts that have already been deducted pursuant to this Article.
CHAPTER 7. ANALYSIS OF THE ISSUES FOUND AND PROPOSALS FOR AMENDMENTS

2. A reliably estimated amount as referred to in paragraph 1 shall be the expected expenditure, provided that that estimation is based on all relevant factors, including past experience of the company, group or industry. In estimating the amount of a provision, the following shall apply:

(a) When the enterprise expects to settle the amount within six months after the end of the tax year the expected expenditure shall equal the amount at which the enterprise expects to settle the amount.

(b) Where the expected expenditure involves a large population of items, measurement takes place by weighing all possible outcomes by their associated probabilities.

(c) If the expected term of the expense is 12 months or longer and there is no agreed discount rate, the yearly average of the Euro Interbank Offered Rate (Euribor) for obligations with a maturity of 12 months, as published by the European Central Bank, in the calendar year in the course of which the tax year ends shall be used to factor in the time value of money in the determination of the measurement of the expected expenditure at the end of the tax year.

(d) Probable future benefits directly linked to the event giving rise to the provision shall be taken into account. Only the excess between the reliable estimate of the expected expenditure and the future benefits shall be taken into account. Probable future benefits shall be deemed to be directly linked to the event giving rise to the provision, unless the taxpayer proves otherwise. The probable future benefits shall be measured in accordance with the measurement of the expected outflow.

(d) In measuring the expected expense, indirect costs that occur independently of the facts or circumstances that gave rise to the obligation and thus do not arise from that obligation shall not be taken into account.

3. Provisions shall not be deducted for the following:

(a) contingent losses;

(b) future cost increases.

4. Notwithstanding paragraph 1, when an enterprise introduced a new product and holds a patent or similar right for this product and cannot determine the statistical probability that the sale of the product will lead to a legal obligation arising from activities or transactions carried out in that, or previous tax years or the amount arising from that obligation, it
can deduct 1% of the costs of the new products sold under this article in the year in which the products are sold in the three years after which the first products have been sold under the patent or similar right. At the end of the third year after which the first products have been sold under the patent or similar right the requirements of paragraph 1 must be met and any amount deducted that cannot be deducted under paragraph 1 will need to be added to the profit of that third year.

5. Insofar Article 41, paragraph 3 leads to the evaporation of a loss, while the criteria of Article 23 are met at the end of the reporting year and the amount has already been deducted, a deduction can take place to the extent that the expected future outflow has not effectively decreased the taxable base of any year.

Article 4

(34) An obligation is present when an outflow of resources either in monetary or non-monetary amounts is expected, at the moment when the expense is deducted, towards a third party and over which the enterprise no longer has the overriding control. This can be either a legal or a constructive obligation.

An obligation can be constituted by an expected future outflow contingent only by time and not linked to future activities or transactions, which includes the situation where the taxpayer is not entitled to any future performance to be received.

A constructive obligation is an obligation that derives from an entity’s actions where:

(f) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
(g) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Large homogenous groups of items can lead to an obligation when it is probable that a percentage of these items will lead to such an outflow, when all the other requirements are met.

An obligation is deemed to exist when:
- a claim is made against the taxpayer and it is probable that the court will rule against the taxpayer;
- a large group of homogenous products is sold and on the basis of statistic evidence it is probable that a percentage of these products will be returned.
(35) The words ‘probable’ and ‘expected’ mean that chances of occurring are more likely than not.

7.3 Final conclusion

This concludes my research on the treatment of provisions in the common corporate tax base of CCCTB. The European Commission has made the harmonised tax base difficult by making it a stand-alone tax base. As this research has shown for provisions, a stand-alone tax base leads to a big number of questions and problems, which will, in the end, make effective harmonised taxation in the European Union even harder to reach. Apart from that, things are not looking bright for CCCTB and the relaunch may have an even more difficult time than the original proposal. I leave this research with mixed feelings. When I started this research in 2011, increased internationalisation seemed to be only a matter of time and something that Member States just needed to warm up to, in giving up part of their tax sovereignty. Harmonisation of a tax base seemed a logical consequence. In the years that followed, on the one hand, with the social unrest following the tax evasion debate and the BEPS-project having taken serious shape, a tidal wave for the common corporate tax base of CCCTB to ride on seemed to come. But more recently, a form of de-internationalisation and new nationalism has taken shape, with the unrest between Russia and the European Union, Brexit and the US-presidential elections, which does not bode well for CCCTB.
Nederlandse samenvatting

De aanleiding van dit onderzoek is gelegen in de afwezigheid van internationale consensus van wat een voorziening is, terwijl voorzieningen doorgaans posten van materieel belang zijn op de jaarrekening. Het vormen van een voorziening roept daarbij veel vragen op en de criteria voor vorming van een voorziening verschillen per land, maar het gaat bij een voorziening wel steeds om een verwachte onzekere toekomstige uitstroom van middelen, waarvan de oorzaak in het verleden is gelegen. De vorming van een voorziening in de vennootschappelijke jaarrekening is daarbij niet als vanzelfsprekend maatgevend voor de fiscale winstbepaling. De vennootschappelijke jaarrekening en de fiscale winstbepaling dienen namelijk niet dezelfde doelen. Reeds meer dan een halve eeuw staat de harmonisatie van de vennootschapsbelasting in Europa op de agenda. In respectievelijk 2011 en 2016 zijn door de Europese Commissie concepten voor een richtlijn inzake een geharmoniseerde fiscale grondslag uitgebracht, na een zeer lange voorgeschiedenis. Ook in deze richtlijnen is de vorming van een voorziening erkend als van de fiscale winst aftrekbare post. Opvallend aan de richtlijnen is dat ze een op zichzelf staand systeem van winstbepaling kennen dat niet formeel gekoppeld is aan de winstbepalingsregels van een lidstaat of de International Financial Reporting Standards, hoewel ze wel op die laatste zijn gebaseerd. De voorschriften omtrent de vorming van een voorziening bevatten echter opvallend veel onduidelijkheden en leiden tot veel vragen. Het is echter van groot belang dat toepassing van een geharmoniseerde standaard ook zoveel mogelijk gelijk plaatsvindt in de verschillende lidstaten, omdat anders nog altijd een mate van willekeur zal blijven bestaan. De doelstellingen van het onderzoek zijn derhalve

a) Het bepalen hoe voorzieningen zijn gedefinieerd en worden toegepast in geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB, IFRS en een selectie van lidstaten;

b) Het vaststellen in hoeverre geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB daarbij afwijkt van de andere onderzochte systemen en in hoeverre deze afwijkingen noodzakelijk zijn;

c) Het bepalen welke problemen en inconsistenties bestaan met betrekking tot de toepassing van Artikel 23 CCTB 2016;

d) Het formuleren van specifieke voorstellen voor verbeteringen of toevoegingen voor Artikel 23 CCTB 2016.

Naast geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB zijn IFRS en het Duitse, Engelse en Nederlandse stelsel onderzocht. IFRS omdat dit een set standaarden voor financiële verslaggeving betreft die ook daadwerkelijk worden toegepast in de praktijk. Het Duitse stelsel omdat de verwevenheid tussen de vennootschappelijke jaarrekening en de fiscale winstbepaling hier van oudsher sterk is, het Engelse stelsel sterk gebaseerd is op IFRS en het Nederlandse stelsel omdat de verwevenheid tussen de vennootschappelijke jaarrekening en de fiscale winstbepaling hier juist beperkt
is en de fiscale winstbepaling plaatsvindt via een open norm in plaats van door een grote hoeveelheid regelgeving.

In Hoofdstuk 2 is een normatief kader samengesteld op basis van de doelstellingen van CCCTB zelf, mede in het licht van de historische ontwikkelingen die tot CCCTB hebben geleid, en de eisen die aan een modern belastingstelsel mogen worden gesteld uitgewerkt, waaraan de bevindingen zijn getoetst.

Allereerst zijn de historische achtergronden en de wijze van winstbepaling in geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB, IFRS en het Duitse, Engelse en Nederlandse stelsel nader onderzocht en vergeleken. Daarbij is naar voren gekomen dat alle stelsels een lange historie kennen, waarbij de inkomstenbelastingen in Duitsland, het Verenigd Koninkrijk en Nederland dateren uit de 19e eeuw, harmonisatie van financiële verslaggeving, waar IFRS een uitvloeisel van is, uit het begin van de 20e eeuw en Europese harmonisatie van directe belastingen uit de jaren ’60 van de 20e eeuw. Inkomstenbelastingen hebben doorgaans als uitgangspunt om het belastbaar inkomen zodanig te bepalen dat ze acceptabel zijn vanuit sociale en economische optiek, hoewel ook instrumentalisme regelmatig voorkomt. Het sociale aspect speelt ook heden ten dage nog altijd een belangrijke rol. De doelstellingen van IFRS zijn in dat kader anders. Hiermee beoogt de IASB met name standaarden voor algemene financiële verslaggeving te geven waardoor nuttige informatie wordt verstrekt aan gebruikers van deze informatie. De doelstellingen van CCCTB zijn specifieker. Enerzijds is het een fiscale grondslag, maar anderzijds wordt door de Europese Commissie ook getracht om een aantal specifieke problemen in de Europese Unie op te lossen.

Voorts geldt dat de diverse stelsels verschillende verhoudingen kennen tussen financiële verslaggeving en fiscale winstbepaling. IFRS is niet ontworpen als grondslag voor fiscale winstbepaling en heeft ook geen specifieke doelstelling hiertoe. Voor fiscale winstbepaling in Duitsland en het Verenigd Koninkrijk is wel sprake van een grote mate van afhankelijkheid van de financiële verslaggeving, hoewel er wel bepaalde opties en bepaalde specifieke fiscale afwijkingen bestaan. De benadering in Nederland wijkt daar sterk van af, aangezien er geen verplichting bestaat om de financiële verslaggeving te volgen en in het algemeen ook een grote mate van vrijheid in het bepalen van fiscale winst. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB kent daarentegen enerzijds weinig vrijheid bij het bepalen van de fiscale winst en anderzijds geen koppeling met een reeds bestaand stelsel van winstbepaling. Verder is het opvallend dat, in tegenstelling tot de andere onderzochte stelsels, er binnen de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB geen balans wordt opgesteld bij het bepalen van de fiscale winst. Gezien het feit dat in de praktijk de fiscale winstbepaling voor de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB
doorgaans zal worden afgeleid van een bestaande balans en winst- en
verliesrekening leidt dit tot nauwelijks enige lastenverlicht en bemoeiilt het
daarnaast de controleerbaarheid. Ook heeft het op zichzelf staande karakter van
de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB
gaandeweg steeds meer vorm gekregen, waarbij echter het denken over de
balans niet evenredig mee is gegroeid.

Ten aanzien van de vraag of de systemen gebaseerd zijn op beginselen of regels
geldt dat uitsluitend het Nederlandse systeem primair gebaseerd is op
beginselen, waarbij moet worden opgemerkt dat de wetgever slechts een open
norm heeft gegeven en dat de eigenlijke beginselen zijn ontwikkeld in de
rechtspraak. Vooral IFRS kent een zeer uitgebreide regelgeving en kent, net als
de regelgeving in het Verenigd Koninkrijk, de mogelijkheid om af te wijken in
extreem zeldzame situaties wanneer de uitkomsten niet in overeenstemming met
de doelstelling zijn. De geharmoniseerde vennootschappelijke fiscale
grondslag van CCCTB kent een vergelijkbaar principe niet, terwijl het gegeven
dat CCCTB zich nog in de praktijk moet bewijzen als gegeharmoniseerde
grondslag in een veelheid van jurisdicties met hun eigen achtergronden,
waardoor het eenvoudigweg niet mogelijk is om alle mogelijke situaties te
voorzien. Een clause waarbij, overigens in zeer zeldzame situaties, zou kunnen
worden afgeweken wanneer de uitkomst van de regels apert onjuist is lijkt
daarbij redelijk, Daarnaast is uniforme toepassing in het algemeen een
aandachtspunt en probleem, aangezien het nog lange tijd zal duren voordat het
Europese Hof van Justitie een ruime hoeveelheid uitspraken zal hebben gedaan.
Daarnaast is het niet primair de rol van een rechter om de harmonisatie te
bewerkstelligen, maar de rol van een regelgever.

Met betrekking tot winstbepaling in het algemeen geldt dat het Duitse en
Nederlandse stelsel traditioneel gebaseerd zijn op het voorzichtigheidsbeginsel,
wat leidt tot een ongelijkheid in de toerekening van winsten en verliezen, omdat
hierdoor verliezen worden toegerekend naar de periode waar ze aannemelijk
worden en winsten in de periode waarin ze gerealiseerd zijn.
IFRS en de regels inzake financiële verslaggeving in het Verenigd Koninkrijk
vertonen ook veel gelijkenissen waarbij de focus vooral op de balans ligt. De
geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB is in dat
kader minder goed te karakteriseren. Waarschijnlijk vanwege het proces dat
vooraf is gegaan aan de ontwikkeling van CCCTB zijn diverse invloeden te
ontwaren. Verder bevat de geharmoniseerde vennootschappelijke fiscale
grondslag van CCCTB in haar huidige vorm een duidelijk beperkte hoeveelheid
regels en is op het eerste gezicht ook eenvoudiger. Of dit echter op de lange
termijn kan worden gehandhaafd is de vraag, omdat eenvoudige regels vaak
geen adequaat antwoord geven op complexere vragen en op die manier met
verloop van de tijd complexer en uitgebreider worden. Alle onderzochte
systemen erkennen binnen het systeem van winstbepaling de situatie waarin een
toekomstige uitgaaf wordt verwacht doch waarbij een oorsprong van die uitgaaf
in het verleden ligt en daarom wordt toegerekend aan die eerdere periode.
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Vervolgens is de specifieke wet- en regelgeving omtrent voorzieningen in de genoemde stelsels onderzocht en vergeleken. Alle onderzochte stelsels behalve de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB erkennen een algemeen concept van verplichtingen. In IFRS en het Verenigd Koninkrijk wordt dit gedefinieerd als een bestaande verplichting van het lichaam, dat voortkomt uit gebeurtenissen in het verleden en waarvan de afwikkeling naar verwachting zal leiden tot een uitstroom van middelen. Dit illustreert dat de onderneming weinig tot geen controle meer heeft over de uitstroom: het is immers de gebeurtenis uit het verleden die tot de verplichting heeft geleid en welke naar verwachting tot een uitstroom zal leiden. Voor gebruikers van financiële verslaggeving is dit relevante informatie. In de Duitse wet- en regelgeving, die geen exacte definitie van verplichtingen kent is het aspect van het geen controle meer hebben aanwezig, maar niet zo dominant als in IFRS en de wet- en regelgeving van het Verenigd Koninkrijk. Daardoor is minder duidelijk wat de exacte afgrenzing van dergelijke posten is, wat afbreek doet aan de informatiewaarde van de opname ervan. Het belang lijkt dan veel meer gelegen in matching en de meting van de prestaties van de onderneming dan de weergave van verplichtingen. Nederlandse wet- en regelgeving kent een vergelijkbare benadering, waardoor aanvullende toerekeningscriteria nodig zijn voor opname in de winstbepaling. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB gaat niet uit van het bestaan van een balans en kent ook geen algemeen concept of begrip van verplichtingen, wat overigens betekent dat het vergelijken van de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB met bestaande stelsels niet eenvoudig is. Het feit dat de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB weliswaar op diverse plaatsen gebaseerd is op IFRS en daar ook een aantal sterke gelijkenissen met IFRS en de regelgeving van het Verenigd Koninkrijk. Daarbij speelt ook een rol dat bijvoorbeeld in de Nederlandse wet- en regelgeving er voor schulden andere waarderingsgronden zijn dan voor voorzieningen, wat betekent dat het belang bij een duidelijk onderscheid evident is. Het valt in dat kader op dat uitsluitend in het Nederlandse stelsel, dat met name ontwikkeld is in de rechtspraak, aanzienlijk meer details omtrent transitoria zijn gegeven dan in de andere stelsels, wat de indruk versterkt dat in de praktijk op andere aspecten de nadruk wordt gelegd dan in de theorie. Verder is alleen in de Nederlandse wetgeving het concept van de fiscaal aftrekbare reserve bekend. Aangezien van de drie categorieën één een zeer grote overlap heeft met voorzieningen (de kostenegalisieringsreserve) en derhalve overbodig is, één mogelijk zal worden afgeschaft (de fiscale oudedagsreserve) en één een faciliteit betreft die in de andere stelsels (behalve IFRS) ook bestaat, maar daar geen fiscaal aftrekbare reserve is (de herinvesteringsreserve), is het verwijderen van het concept van de fiscaal aftrekbare reserve uit de Nederlandse wetgeving aan te bevelen.
NEDERLANDSE SAMENVATTING

Voor wat betreft voorzieningen kennen alleen IFRS en het Verenigd Koninkrijk een specifieke definitie van voorzieningen (verplichtingen waarvan de omvang of het moment van afwikkeling onzeker is), waarvan overigens de onzekerheid niet terugkomt in de afzonderlijke vereisten. Ook dit maakt dat de afgrenzing ten opzichte van de andere posten niet eenvoudig is. De afzonderlijke vereisten in de onderzochte stelsels vertonen enerzijds een mate van gelijkheid, maar anderzijds ook een aantal opvallende verschillen. De Duitse wet- en regelgeving is het enige van de onderzochte stelsels dat expliciet onderscheid maakt tussen twee typen voorzieningen: de voorziening voor onzekere verplichtingen jegens derden en voorzieningen voor interne verplichtingen. In de Nederlandse wet- en regelgeving bestaat een dergelijke benadering overigens zonder dat dit zo expliciet wordt gemaakt.

Alle onderzochte stelsels stellen de eis dat er sprake moet zijn van een gebeurtenis in het verleden die tot de verwachte toekomstige uitstroom van middelen leidt. In de situatie waar een bestaande verplichting per balansdatum wordt vereist, zoals het geval is in IFRS en het Verenigd Koninkrijk, is dit relatief helder: dit is de gebeurtenis die leidt tot het bestaan van een juridische of feitelijke verplichting en het bestaan van deze verplichting is voorts onafhankelijk van toekomstige handelingen. In Duitsland is er een verschil van inzicht hieromtrent tussen de rechtspraak en de belastingauthoriteiten. In de Nederlandse fiscale wet- en regelgeving bestaat het vereiste van een verplichting niet voor de vorming van een voorziening, waardoor de gebeurtenis uit het verleden automatisch een minder scherp concept wordt en, in tegenstelling tot de andere onderzochte stelsels, een afzonderlijk criterium voor toerekening noodzakelijk is. Een vergelijkbaar probleem bestaat mogelijk in de gehearmoneerde vennootschappelijke fiscale grondslag van CCCTB, gezien de introductie van de waarschijnlijke toekomstige juridische verplichting. Dit laatste criterium roept diverse vragen en problemen op en voegt mogelijk niets toe ten opzichte van de bepaling in IFRS waarop het artikel inzake voorzieningen op is gebaseerd.

Alle onderzochte stelsels vereisen voorts een verwachte toekomstige uitstroom van middelen. In IFRS en de wet- en regelgeving in het Verenigd Koninkrijk moet de verwachting ‘more likely than not zijn’ wat in de andere onderzochte stelsels niet zo sterk naar voren komt. Zowel in Nederland als in Duitsland zijn er aanwijzingen dat de vereiste waarschijnlijkheid lager ligt dan dat, maar wel meer in de richting van IFRS beweegt. Het is waarschijnlijk dat de vereiste waarschijnlijkheid in de gehearmoneerde vennootschappelijke fiscale grondslag van CCCTB vergelijkbaar is met die van IFRS, omdat de gehearmoneerde vennootschappelijke fiscale grondslag van CCCTB op het gebied van voorzieningen sowieso sterk gebaseerd is op IFRS, maar hier bestaat nog wel een mate van onduidelijkheid. In de Nederlandse wet- en regelgeving bestaat daarnaast nog een bijzondere vorm van transitoria, waar bestaande instromen worden toegerekend aan toekomstige verwachte uitstromen en elkaar op die manier compenseren.
IFRS en de wet- en regelgeving van het Verenigd Koninkrijk vereisen dat sprake is van een verplichting. Dit kan zowel een juridische als een feitelijke verplichting zijn, waarbij voor het bestaan van een feitelijke verplichting specifieke criteria zijn ontwikkeld. De Duitse en Nederlandse wet- en regelgeving draaien minder sterk om de aanwezigheid van een verplichting, maar zowel wanneer sprake is van een bestaande juridische verplichting als wanneer sprake is van een bestaande feitelijke verplichting kan een voorziening worden gevormd. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB staat de vorming van een voorziening voor een feitelijke verplichting echter niet toe, waarvoor de gedachte dat dit leidt tot een te grote mate van subjectiviteit waarschijnlijk de reden is. IFRS heeft echter laten zien dat het goed mogelijk is om de criteria voor het bestaan van een feitelijke verplichting te objectiveren aan de hand van een aantal uiterlijke kenmerken. Het meest problematische aspect ten aanzien van verplichtingen in de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB is echter de ‘waarschijnlijke toekomstige juridische verplichting’, die leidt tot een onacceptabel aantal onduidelijkheden en problemen.

Voorzieningen die aangroeien in de loop van de tijd zijn een ander bijzonder aspect. In IFRS en de wet- en regelgeving van het Verenigd Koninkrijk volgt uit de benadering die uitgaat van het bestaan van een verplichting dat de verplichting hetgeen is dat moeten worden gewaardeerd op het moment van de balansdatum. Dat zal doorgaans betekenen dat ineens een grote last moet worden genomen in de voorliggende periode en dit staat niet altijd goed in verhouding tot het veroorzaken van deze last, wat vaak met meerdere jaren te maken heeft. De wet- en regelgeving in Duitsland en Nederland, die minder steunt op het bestaan van een verplichting laat meer ruimte voor het gespreid toerekenen van kosten, zowel aan periodes voordat een verplichting bestaat als erna. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB kent echter enerzijds een benadering die uitgaat van het bestaan van een verplichting die gewaardeerd moet worden en anderzijds wordt een gespreide toerekening van kosten voorgeschreven in bepaalde gevallen en dat is niet met elkaar in overeenstemming.

Verder geldt dat in alle onderzochte stelsels wordt vereist dat een betrouwbare schatting van de uitstroom moet kunnen worden gemaakt. Daarbij moet overigens worden opgemerkt dat dat vereiste in algemene financiële verslaggeving een andere rol speelt dan in fiscale winstbepaling. Voor algemene financiële verslaggeving zal dit niet snel een beperkende factor vormen: verslaggevende partijen zullen, wanneer sprake is van een tendens, over het algemeen liever geen dan wel een voorziening vormen en de afwezigheid van een redelijk te maken schatting zal daar doorgaans niet de meest voor de hand liggende reden zijn om de voorziening niet te vormen. Fiscaal is dit anders: het vormen van een voorziening leidt tot uitstel van belastingbetaling en dit zal doorgaans de tendens zijn als er een tendens te onderkennen valt. Oppallend is dat dit onderscheid in geen van de onderzochte stelsels erg duidelijk wordt onderkend: het criterium blijft vrijwel hetzelfde.
Ten aanzien van IFRS, de wet- en regelgeving en de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB geldt tevens dat het maken van een redelijke schatting van de uitstroom niet in overeenstemming is met het feit dat hetgeen dat, als uitgangspunt, gewaardeerd moet worden op de schikkingswaarde per einde van de periode. Dat betekent dat de daadwerkelijke verwachte uitstroom niet het uitgangspunt is bij de waardering. Verder is een waarschijnlijke toekomstige juridische verplichting op het einde van de periode nog geen verplichting, waardoor de verplichting nog niet kan worden gewaardeerd. Sowieso is het opvallend dat Article 23, Paragraaf 2 CCTB 2016, dat over waardering gaat, het uitsluitend heeft over de juridische verplichting en niet over de waarschijnlijke toekomstige juridische verplichting. Verder is het, wanneer de schikkingswaarde als uitgangspunt wordt genomen, zo dat de waarschijnlijkheid in aanmerking zou moeten worden genomen, aangezien onafhankelijke partijen die tot een schikking zouden willen komen dit ook in aanmerking zouden nemen. Bij een schikkingswaarde is overigens een bijkomend probleem dat deze uitgaat van een gelijkheid in de mate waarin de betrokken partijen kunnen beschikken over informatie. Een dergelijke gelijkheid zal in veel gevallen niet bestaan.

Het erkennen van verplichtingen en waardering gebaseerd op grote homogene populaties is iets dat in het Duitse recht expliciet wordt erkend, waarbij dit ook een aparte categorie binnen de voorzieningen vormt. IFRS en de wet- en regelgeving in het Verenigd Koninkrijk erkennen de achterliggende concepten. Het Nederlandse belastingrecht erkent dit impliciet. CCCTB geeft hier geen inzicht in.

Wanneer de vorming van een voorziening een verplichting is, is het niet vormen van een voorziening een fout en dit leidt tot verplichte inhaal. Dit geldt voor IFRS en de wet- en regelgeving in het Verenigd Koninkrijk en Duitsland. In Nederlands belastingrecht ligt dit genuanceerder. Er zijn indicaties dat het niet verplicht is om een voorziening te vormen (tenzij dit in strijd komt met de stelselmatigheid) en dan is inhaal niet vanzelfsprekend. Het is in Nederland wel toegestaan om in te halen. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB is in dat kader minder duidelijk. Op het eerste gezicht lijkt het vormen van een voorziening een vrijwillige aangelegenheid, maar bij nadere bestudering van de artikelen is het sterk aannemelijk dat vorming verplicht is, wat uit de optiek van het voorkomen van subjectiviteit begrijpelijk is, maar minder vanzelfsprekend is wanneer beperkingen zijn aangebracht in verliesverrekening, wat het geval is in de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB.

Met betrekking tot compensatie en ander inkomen dat verband houdt met de uitstroom waarvoor de voorziening wordt gevormd zijn ook verschillen te onderkennen. Opvallend is het feit dat IFRS en de wet- en regelgeving in het Verenigd Koninkrijk in dit kader voorzichtiger lijken te zijn dan de Duitse wet- en regelgeving, omdat onder die eerste twee een voorziening moet worden gevormd ongeacht of hier een vergoeding voor zal worden ontvangen. Als het
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vrijwel zeker is dat deze vergoeding zal worden ontvangen kan er hooguit een actiefpost worden gevormd. Naar Duits recht mag een voorziening niet worden gevormd wanneer hier een vergoeding tegenover staat. Onder Nederlands recht ligt dit waarschijnlijk genuanceerder, waarbij de benadering van IFRS niet fout zal zijn, omdat deze recht doet aan zowel het realisatiebeginsel als het voorzichtigheidsbeginsel. Onder de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB wordt het niet als eis gesteld dat er geen compensatie voor de uitgaf wordt ontvangen. Wel moeten toekomstige instromen die direct verbonden zijn met de gebeurtenis die aanleiding heeft gegeven voor het vormen van een voorziening in aanmerking worden genomen. Hoewel ‘in aanmerking nemen’ bepaald geen duidelijk begrip is, lijkt hier bedoeld dat de uitstroom en instroom met elkaar verrekend moeten worden, waardoor effectief alleen het saldo in aanmerking wordt genomen als voorziening.

Wanneer een aantal regelmatig voorkomende situaties met betrekking tot voorzieningen wordt vergeleken, kan het volgende worden afgeleid. Ten aanzien van garanties, die zowel gebaseerd kunnen zijn op juridische verplichtingen als op feitelijke verplichtingen, is het opvallend dat alleen de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB de vorming van een voorziening voor een garantie gebaseerd op feitelijke verplichtingen niet toestaat. De erkenning een verplichting uit grote groepen homogene producten is alleen in de Duitse wet- en regelgeving expliciet. De voorbeelden die in IFRS en het Verenigd Koninkrijk zijn gegeven impliceren echter dat dergelijke verplichtingen ook daar worden erkend als zodanig. Er zijn geen aanwijzingen dat dit naar Nederlands belastingrecht anders zal zijn. De geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB is echter niet expliciet in deze erkenning. Er zijn geen toelichtingen bij gebreke aan toelichting, voorbeelden en een formele aansluiting bij een bestaand stelsel, is dit dus niet geregeld.

Verlieslatende contracten en de voorzieningen die daarvoor moeten worden gevormd worden zowel onder IFRS als onder de wet- en regelgeving in het Verenigd Koninkrijk als zodanig erkend als reguliere voorziening in IAS 37 en geven relatief veel toelichting hierop. Beide stelsels geven overigens aan dat de contracten in uitvoering (‘executive contracts’), waarvan sprake is wanneer geen van beide contractpartijen nog uitvoering hebben gegeven aan het contract of tot op gelijke hoogte. Op dat moment worden geen balansposities opgenomen, omdat de beide posities verondersteld worden elkaar op te heffen. Dit kan echter uitsluitend vanuit de gedachte dat beide posities op marktwaarde worden gewaardeerd. Het Duitse civielrecht erkent de voorziening voor verlieslatende contracten wel en als afzonderlijke categorie, maar het Duitse belastingrecht verbiedt expliciet de vorming van een voorziening hiervoor. Het Nederlandse belastingrecht erkent de voorziening voor verlieslatende contracten, hoewel het aannemelijk is dat voor niet-verlieslatende contracten in uitvoering geen voorziening mag worden gevormd voor de in het contract besloten verplichting. In de geharmoniseerde vennootschappelijke fiscale
grondslag van CCCTB wordt geen aandacht besteed aan verlieslatende contracten en toepassing van Artikel 23 CCTB 2016 roept diverse vragen op, zoals het verplicht spreiden van kosten over de toekomstige jaren en het verplicht in aanmerking nemen van gelieerde verwachte toekomstige instromen. Het niet kunnen vormen van een voorziening voor niet-verlieslatende contracten in uitvoering zal op basis van de huidige tekst moeten worden gebaseerd op de waardering (namelijk het in aanmerking nemen van toekomstige instromen) en niet op het principeel niet kunnen vormen van een voorziening voor een contract in uitvoering.

Met betrekking tot onderhoud en reparaties is ook sprake van een verwachte toekomstige uitstroom van middelen met een oorzaak in het verleden. Het vroegtijdig opnemen hiervan in financiële verslaggeving geeft relevante informatie aan gebruikers ervan. Het probleem is echter dat bij onderhoud en reparaties slechts zelden sprake is van een verplichting. Onder Duits recht is dit opgelost doordat onderhoud en reparaties kunnen worden gezien als een interne verplichting: een verplichting die de onderneming aan zichzelf heeft. Dit is een wat gekunstelde en niet consistente oplossing. Omdat het Nederlandse belastingrecht geen verplichting vereist voor de vorming van een voorziening kan hieronder zonder kunstgrepen een voorziening worden gevormd voor onderhoud en reparaties, mits aan de vereisten wordt voldaan. Het Nederlands belastingrecht kent daarnaast ook nog de wettelijke mogelijkheid van de vorming van een kostenegalisatiereserve. Onder de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB is het op het eerste gezicht niet mogelijk om een dergelijke voorziening te vormen, omdat geen sprake is van een bestaande juridische verplichting. Echter, de waarschijnlijke toekomstige juridische verplichting levert hier onduidelijkheden op. Het is mogelijk om te beredeneren dat onderhoud en reparatie op enig moment in de toekomst een juridische verplichting zal opleveren en daarom toch een voorziening zou kunnen worden gevormd. Dit lijkt echter meer een gevolg van onhandige regelgeving dan dat dit een bedoeld en voorzien effect is.

Voorzieningen voor herstructureringen zijn doorgaans ook niet gebaseerd op juridische verplichtingen maar op feitelijke verplichtingen. Onder IFRS en de wet- en regelgeving van het Verenigd Koninkrijk wordt dit ook met zoveel woorden aangegeven. Wanneer de vorming wordt beperkt tot juridische verplichtingen, dan kan pas in een zeer laat stadium worden gevormd, wat het ‘spaareffect’ dat ontstaat bij de vorming van een fiscale voorziening, drastisch beperkt. Het is daarom merkwaardig dat uitsluitend onder een fiscale grondslag als de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB de vorming van een dergelijke voorziening niet mogelijk is, terwijl dit nu juist een moment is waarop een voorziening in fiscale winstbepaling het effect heeft dat het moet hebben: het creëren van ruimte voor de uitgaven die de onderneming zal moeten doen. Er is een bepaald gevaar in de subjectiviteit die gepaard kan gaan met de vorming van voorzieningen op basis van feitelijke verplichtingen, maar door middel van IFRS is aangetoond dat het goed mogelijk
is om criteria aan te leggen waarmee een grote mate van objectiviteit wordt aangebracht.

Het opruimen van milieuvervuiling die door de onderneming is veroorzaakt zal ofwel het gevolg zijn van een bestaande of vrijwel zeker komende wettelijke verplichting of van een bedrijfsbeleid. Nu zal dat laatste een feitelijke verplichting vormen, tenzij er daarnaast nog een juridische verplichting bestaat (dit kan voorkomen wanneer een onderneming conform haar bedrijfsbeleid de milieuvervuiling in zijn eigen onthouding opruimt of daar een wettelijke verplichting toe bestaat). Wanneer slechts een feitelijke verplichting bestaat zal onder de geharmoniseerde vennootschappelijke fiscale grondslag van CCCTB de vorming van een voorziening niet zijn toegestaan (hoewel ook hier twijfel bestaat vanwege de waarschijnlijke toekomstige juridische verplichting).

Onder alle onderzochte stelsels zal de waarschijnlijkheid van de uitgaaf een thema vormen. Overheden hebben onvoldoende capaciteit om het opruimen van milieuvervuiling in alle gevallen af te dwingen. Er zal dus door de onderneming steeds moeten worden aangetoond dat het ook daadwerkelijk waarschijnlijk is dat de uitgaaf zal plaatsvinden. Verder is het van groot belang hoe de vervuiling plaatsvindt om deze te kunnen toerekenen aan de jaren. Hoe beter het mogelijk is om een eenheid vervuiling te koppelen aan een eenheid productie, hoe waarschijnlijker het is dat deze evenredigheid over de jaren dient plaats te vinden.

Daarbij kan overigens worden opgemerkt dat het feit dat het Nederlandse goed koopmansgebruik juist door het bieden van een mate van vrijheid en het afwezig doen zijn van de eis van een verplichting vaak eerder complexiteit oplevert dan eenvoud. In die zin ben ik ook geen voorstander van het bieden van een dergelijke mate van vrijheid aan belastingplichtigen. Het is beter om de waarschijnlijke toekomstige verplichting ofwel te verwijderen ofwel te verduidelijken, dan de verplichting uit de vereisten voor het vormen van een voorziening te verwijderen. Het feit dat noch verduidelijking, noch verwijdering in de voorgestelde Richtlijn van 2016 heeft plaatsgevonden is opmerkelijk.

Daarbij is ook de praktische toepassing van een aantal gangbare casus, waarin specifieke problematiek ten aanzien van voorzieningen aan de orde komt, in de genoemde stelsels onderzocht.

In Hoofdstuk 6 worden, na diverse afwegingen, diverse tekstvoorstellen gedaan waarmee tegemoet wordt gekomen aan de geconstateerde tekortkomingen. Het onderzoek is met een algemene beschouwing in Hoofdstuk 7 afgesloten.

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<td>Article 51 CCCTB 2011 =&gt; Article 50 CCTB 2016</td>
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Curriculum vitae

Peter de Heer, born on 7 December 1979, studied tax law at Tilburg University (the Netherlands) and graduated in February 2003 (with merit). In September 2009 he graduated from the post-master Accountancy at Erasmus University Rotterdam (the Netherlands).

From 2002 onwards he has worked as a tax and accounting consultant in various fields. He was a member of the Dutch accounting standards board from 2012 to 2014.

Since August 2009, he has worked as a lecturer at Radboud University Nijmegen. He specialises in tax accounting and international tax law. In 2013 and 2014 he also worked as a free lance lecturer in the field of tax accounting at the University of Amsterdam.
This is an in-depth study of Article 23 “Provisions” in the tax base of the Proposal for a Council Directive on a Common Corporate Tax Base. It includes an analysis of and a comparison with IFRS and German, Dutch and United Kingdom tax law.

It deals with questions like whether the recognition of provisions is or should be mandatory, the role of obligations in the recognition of provisions, and the recognition and measurement of obligations and probable future legal obligations.

The systems and their approaches are discussed separately and compared with each other, including the history of each system, the main workings of their respective tax bases, the recognition and measurement of provisions and the practical application of the approaches towards provisions.

Both from a theoretical and a practical viewpoint, several shortcomings of Article 23 CCTB have been found. In this study, proposals for improvements have been made, taking into account the objectives of a modern tax base and the objectives of CCTB specifically.

This concept of provisions in Article 23 CCTB

A critical analysis and comparison with IFRS, Germany, the Netherlands and the United Kingdom