DENTONS

Indexation of public contracts

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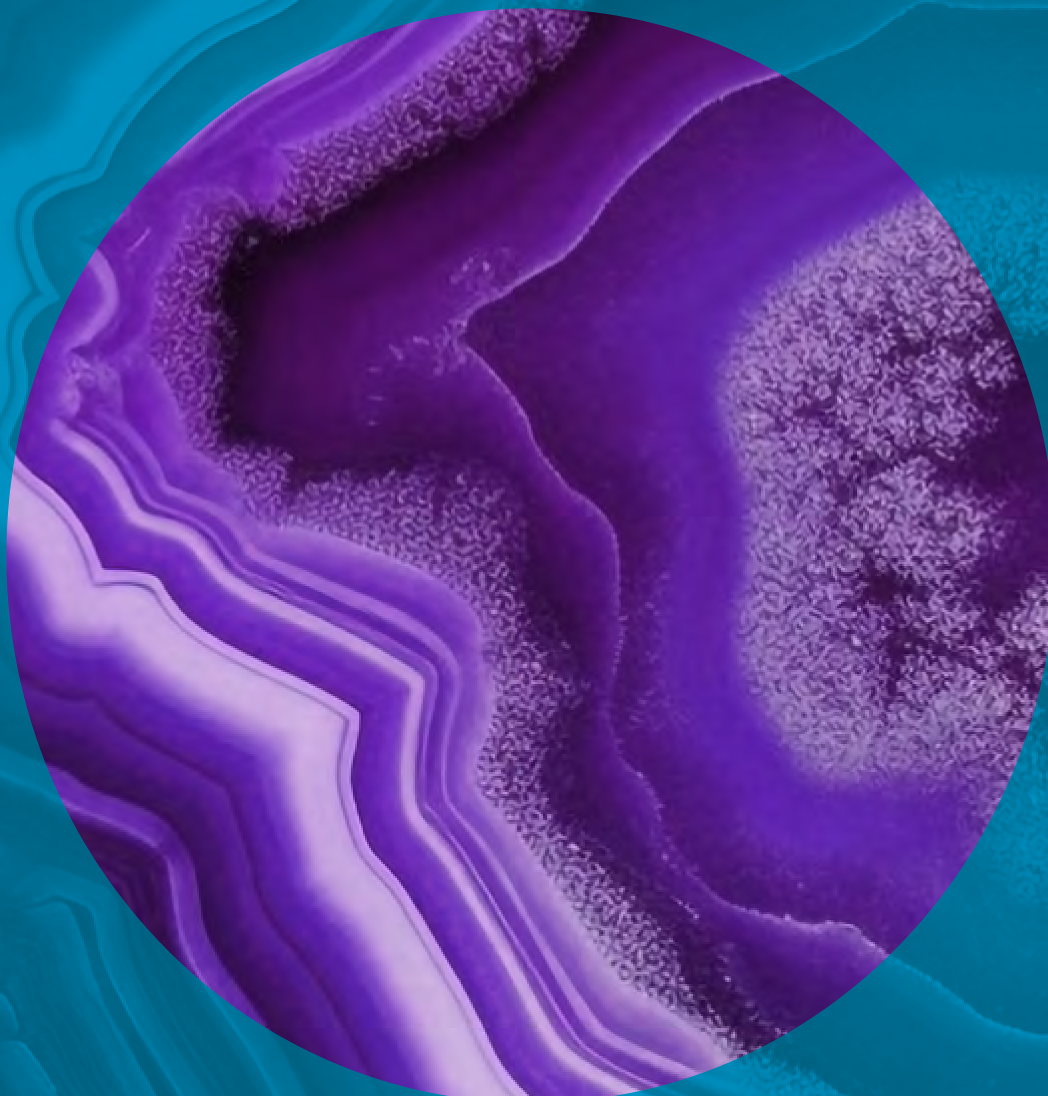

Introduction

In a dynamically changing world, parties to public contracts face new challenges and difficulties. Market disruptions, inflationary phenomena, increases in energy, materials and services prices are just some of those obstacles. Their impact on the obsolescence of assumptions and estimates adopted when submitting tender bids requires multidimensional analyses. A significant increase in the cost of implementing public contracts means that dialogue involving indexed pay and other contractual adaptations is increasingly necessary.

In this publication, we try to assist this dialogue by looking at the topic of indexation of public contracts from many perspectives - not only from the perspective of public procurement law, but also from the point of view of public aid, tax and restructuring. For the management staff of both contracting authorities and contractors, their responsibilities are also important. Only such a multi-faceted view can lead to the development of an optimal legal solution.

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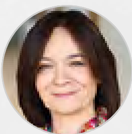

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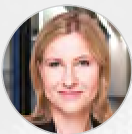

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Public procurement in Poland – Indexed prices benefit contracting authorities too

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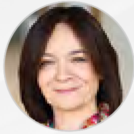

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Extraordinary circumstances, such as the Covid-19 pandemic or the war in Ukraine, and all that goes with them, including high inflation, which manifests itself in skyrocketing prices for raw materials, other supplies, energy, and labor, prevent contracts from being performed on schedule. Price indexation can effectively restore economic equilibrium for parties to public procurement contracts.

The need to reassess the concept of a public procurement contract, which is seen as an agreement unilaterally imposed by the contracting authority, in which the interests of the contracting authority alone should be secured, was already highlighted in 2018 when the new Public Procurement Law (PPL) was still in the consultation phase. The legislator saw the need for more partnership in the relationship between contracting authorities and economic operators (contractors). As a result, new legal measures were included in the PPL promulgated in 2019[1], such as a list of prohibited contractual clauses (Article 433), the obligation for the contracting authority and the economic operator to cooperate in the performance of their public contract (Article 431) and the legislator's clear encouragement of out-of-court settlements of disputes between contracting authorities and economic operators over the performance of public procurement contracts (Articles 591–595).

No turning back from the new trend

The legislator's move towards greater respect for the interests of both parties to a public procurement contract (including the economic operator), was evident even before the outbreak of Covid-19 and the war in Ukraine, and marks a broader trend from which there now seems to be no turning back. This trend became more pronounced as the legislator took further steps to mitigate the unprecedented impact on public procurement of the Covid-19 epidemic and then Russia's aggression against Ukraine, which caused so much disruption to supply chains and the availability of raw materials, in addition to triggering high inflation, manifested in soaring costs of raw materials and other supplies, energy, labor and transportation.

Timeline	Key events
11 September 2019	Enactment of a new Public Procurement Law Act (PPL)
March 2020	Covid-19 outbreak in Poland and enactment of the so-called Covid-19 Special Law[2]
February 2022	Russia's invasion of Ukraine
March 2022	Opinion of the Public Procurement Office titled, "Permissibility of public procurement contract amendments pursuant to Articles 455(1)(1), 455(1)(4) and 455(2) of the PPL"
July 2022	The General Counsel to the Republic of Poland opinion titled, "Contract amendment due to extraordinary price increase (remuneration indexation) – Recommendations"
October 2022	Enactment of the so-called Legal Shield

1. Public Procurement Law Act of 11 September 2019 (consolidated text in Journal of Laws of 2022, item 1710, as amended.
2. Act of 2 March 2020 on Special Measures to Prevent, Counteract and Combat COVID-19 and Other Infectious Diseases and the Crisis Situations Created by Them (consolidated text in Journal of Laws of 2021, item 2095, as amended)

Missing or insufficient contractual clauses

The magnitude of the problems faced by economic operators performing public contracts in the aftermath of the war in Ukraine usually pushes contractual risks above normal levels, leading to economic imbalance between the contracting parties and creating the threat of mass withdrawals by economic operators from ongoing public contracts. The legislator responded to this threat in October 2022 by introducing the so-called Legal Shield[3], which also applies to contracts concluded under the PPL (Articles 44 and 48 of the Legal Shield).

In addition to requiring indexation clauses in public procurement contracts (which are mandatory in all contracts concluded for a term of more than six months, including supply contracts), the Legal Shield introduces changes that express the legislator's approval of increases in the economic operator's remuneration. The existing wording of Article 455(1)(4) PPL, which allows the contract to be amended if circumstances arise which could not have been foreseen by the contracting authority, is supplemented by the clarification that such circumstances 'include, in particular, changes in prices.' This is a clear indication of the legislator's intention to remove any doubt in this regard. There can also be no doubt that the contractor's remuneration may also be changed pursuant to Article 455(1)(4) of the PPL, provided that certain legal requirements are met, i.e., if the provisions in the contract on contractual modifications – including those providing for changes in the contractor's remuneration – are insufficient or lacking.

Article 48 of the Legal Shield, which expressly permits the amendment of public procurement contracts due to significant changes in the prices of materials or costs that the contracting authority could not have foreseen, is also an indication of the legislator's strong will to respond to the market's need for mechanisms that allow contracts to be adjusted as efficiently as possible to the current circumstances of high inflation and unprecedented increases in the costs of performing public procurement contracts. This is in line with the above-mentioned trend towards a progressive approach to public procurement and is evidence of the recognition that treating economic operators (contractors) as equal partners in a public procurement contract, coupled with appropriate responses to any unforeseen events that may upset the economic balance between the parties, results in a win-win situation that is beneficial to both parties.

The new approach is also reflected in the opinion on permissible contract amendments published by the Public Procurement Office already in March 2022[4], in which the Office clearly states that contracts adversely affected by the conflict in Ukraine may be amended pursuant to Article 455(1)(4) of the PPL even if they do not contain indexation clauses or if the indexation clauses that do exist are not sufficient to restore the economic balance between the contracting parties. These issues are further elaborated in the opinion of the General Counsel to the Republic of Poland published in July 2022[5], which also indicates that a refusal to amend the remuneration due to the economic operator, despite the fact that the conditions justifying an amendment of the contract in this respect have been fulfilled in the given circumstances, may indeed be considered an act of economic imprudence on the part of the contracting authority.

3. Act of 7 October 2022 on Amending Certain Laws to Simplify Administrative Procedures for Citizens and Businesses (consolidated text in Journal of Laws of 2022, item 2185)
4. "Dopuszczalność zmiany umowy w sprawie zamówienia publicznego na podstawie art. 455 ust. 1 pkt 1 i 4 oraz art. 455 ust. 2 ustawy Pzp" [Admissibility of amendments to a public procurement contract pursuant to Articles 455(1)(1), 455(1)(4) and 455(2) of the PPL], https://www.gov.pl/web/uzp/dopuszczalnosc-zmiany-umowy-w-sprawie-zamowienia-publicznego-na-podstawie-art-455-ust-1-pkt-1-i-4-oraz-art-455-ust-2-ustawy-pzp.
5. „Zmiana umowy z uwagi na nadzwyczajny wzrost cen (waloryzacja wynagrodzenia) – podstawowe zagadnienia" [Contract amendment due to extraordinary price increase (remuneration indexation) – basic issues], Zmiana umowy z uwagi na nadzwyczajny wzrost cen (waloryzacja wynagrodzenia) - rekomendacje - Prokuratoria Generalna Rzeczypospolitej Polskiej - Portal Gov.pl (www.gov.pl)

From the contracting authority's viewpoint

Contracting authorities must not view indexation solely through the optic of 'climate' or statutory incentives but must ensure that indexation is consistent with the regulations governing the operations of each contracting authority concerned, paying particular attention to formal compliance with public procurement laws and to keeping indexation in line with the general principles underlying the public finance system.

As mentioned above, the grounds most often invoked when considering annexes to index prices or remuneration of a public contractor or when negotiating settlements include Article 455(1)(1) of the PPL and review clauses in the contract, as well as Article 455(1)(4) of the PPL, which refers to unforeseen circumstances necessitating contract amendments. The Legal Shield now provides more grounds for such amendments – or rather, confirmation of their permissibility.

Nevertheless, the contracting authorities are still concerned or plagued with doubts about the application of specific legal grounds to specific circumstances, pointing out that when they annex public procurement contracts, they will always fear that the authorities in charge of supervising their activities will take a different view of the amendments, especially with regard to the scope and amount of the permissible changes, and the proof and documentation of the circumstances that prompted the given changes.

However, it seems that if the contracting authority acts in good faith and can afford the changes, if it exercises the appropriate degree of care in determining and substantiating its costs of performing the contract, and if at the same time both contracting parties exercise a certain degree of common sense, there should be no problems in proving the reasons and justifications for the annex and reaching an agreement on its wording. In this connection, it is worth mentioning the above-mentioned opinion of the General Counsel to the Republic of Poland, in which it is emphasized, *inter alia*, that a settlement of a dispute concerning the claims of an economic operator may be considered not only permissible, but even desirable from the point of view of the principles of public funds management, in particular the principle of intention and efficiency of public spending.

Avoiding conflict through settlement agreements

However, if the contracting authority cannot rid itself of doubts as to the legality of the proposed annex and its wording, there are tools that can be used to mitigate the risks involved. First and foremost is the resolution of indexation disputes. If no agreement can be reached on the admissibility of indexation itself or on the wording of the indexation annex, in particular on the amount of the increase in remuneration, the economic operator can always request the increase, demonstrating the increase in the cost of performing the contract and the likely consequences of the refusal to grant the increase,

both for the contract in question and for its own operations (such as the inevitable withdrawal from the contract or the bankruptcy of the economic operator). If this is the case, the parties enter into a dispute which may well escalate into a lengthy and costly litigation, the outcome of which is uncertain and which, because of its duration, will effectively freeze the parties' operations and plans for the future.

Such an escalation can be avoided by entering into a settlement agreement pursuant to Article 917 of the Civil Code, in which the parties make mutual concessions in their relationship, thereby eliminating the element of uncertainty in their respective claims and extinguishing the dispute. It could be said that this is precisely the type of settlement of disputes concerning ongoing public contracts that is not only permitted, but even encouraged by the legislator. The new Public Procurement Law explicitly sets out the permissible ways of amicably resolving disputes over public procurement contracts, leading to a settlement, emphasizing, among other things, the possibility of mediation, and even designating the Court of Arbitration at the Office of the General Counsel to the Republic of Poland as one of the bodies competent to conduct mediation.

Settlements may also be entered into by public finance entities in accordance with the relevant – and unambiguous – provisions of the Public Finance Act, in force since 2017. Pursuant to Article 54a of this Act, public finance entities may enter into settlements in disputes over amounts due under civil law agreements if they conclude that the consequences that the settlement is likely to have for the entity, the State Treasury or the relevant local government authority, as the case may be, are preferable to the likely consequences of court or arbitration proceedings. This provision requires a prior written assessment of the likely consequences of settlement, taking into account the circumstances of the case, including, in particular, the merits of the claims at issue, the feasibility of satisfying those claims, and the likely duration and cost of any court or arbitration proceedings that may be instituted.

A reliable analysis setting out the benefits of settlement and the consequences of non-settlement (the latter being taken in a very broad sense, going well beyond the costs of litigation or other financial consequences to include social and other aspects of public interest) will be difficult to challenge, which means that the settlement reached in reliance on it will also be difficult to undermine.

It should also be noted that Articles 5(4), 11(2) and 15(2) of the Law on Liability for Violation of Public Financial Discipline now exempt from disciplinary liability entities that spend public funds under settlements that bind them.

Contracting authorities may also obtain additional protection by seeking court approval of the settlement under Article 184 of the Code of Civil Procedure, whereby the court confirms the legality of the settlement reached, including its compliance with the applicable public procurement regulations.

Local government sector

The local government sector seems to be particularly susceptible to the 'paralysis' caused by the multiplicity of audit institutions and is often affected by the internal and external political environment. Local government bodies are often unaware that they can increase the legal certainty of their operations by seeking the clarifications provided for in Article 13(11) of the Law on Regional Chambers of Accounts[6]. This provision designates the Regional Chambers of Accounts as the authorities competent to provide clarifications in response to requests from local government units concerning the application of public finance regulations, where 'application of public finance regulations' is interpreted in a broad sense, referring not only to the Public Finance Act, but also to all the other regulations that make up the public finance regime, which the Regional Chambers of Accounts are competent to audit.

Although the clarifications issued by the Regional Chambers of Accounts are not binding on the Chambers themselves or on other authorities, let alone a source of law, the cases of compliance with the opinions issued by a supervisory authority cannot be overestimated. Such authorities are unlikely to retreat from their positions once stated, and other audit bodies will not be eager to question their competence.

The authors' view

Dialog between contracting authorities and economic operators is essential, especially in these times of galloping inflation and runaway prices for raw materials, other supplies and labor. The growing number of annexes and settlement agreements providing for the adjustment of remuneration and other changes to public procurement contracts signals a change in the previously conservative attitude of contracting authorities and raises hopes that the effects of the emerging crisis will be mitigated for all market participants. It should not be forgotten that public procurement and the decisions made by contracting authorities in this regard have a significant impact on the functioning of the national economy.

Contracting authorities should be very reasonable and rational in their actions, even guided by breadth of vision, rather than limiting their attention to the immediate financial impact. They should always carefully consider the consequences that their refusal to increase contractual remuneration, often by a very small amount, will have on the local market or community, possibly leading to non-performance of the contract or even bankruptcy of the economic operator. In addition, given the current level of inflation and the general market situation, it is unlikely that contracting authorities will be able to negotiate a price as good as the indexed price in any re-tendering process, which would have to be carried out at a later date.

6. Act of 7 October 1992 on Regional Chambers of Account, Journal of Laws of 2022, item 1668.

Indexation and Review Clauses in Polish Public Tenders

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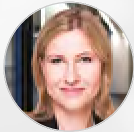

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As of 10 November 2022, the obligation to use indexation clauses in public contracts has been significantly expanded, and the legislator has also confirmed that the amount of remuneration and other contractual obligations established in existing contracts may be revised if the prices of materials or other costs affecting the performance of the contract increased significantly.

In today's market, the need for robust and effective indexation clauses in public contracts is greater than ever. It goes without saying that most of these contracts are of considerable value and have great social significance. As of 2021, there is a normative consensus that indexation clauses belong in contracts for works and services concluded for a period of more than 12 months. Another consequence of the Covid-19 pandemic and Russia's attack on Ukraine is that many contracts now require review clauses and a reassessment of the contractual relationship they create due to changes in circumstances that neither the contractors nor the contracting authorities could have anticipated in the normal course of business.

Changing regulations

In the wake of one economic turbulence after another, and with inflation running rampant (as both consumer and production statistics clearly show), it has become apparent in practice that the available legal remedies are not sufficient to effectively promote efforts to restore economic balance in the relationship between parties to public procurement contracts.

This issue was addressed by the Act of 7 October 2022 on amending certain acts to simplify administrative procedures for citizens and businesses (Journal of Laws, item 2185). As of 10 November 2022, the legal obligation to include indexation clauses in public procurement contracts has been significantly expanded, and as regards amendments to existing contracts, the legislator has expressly confirmed that the amount of remuneration and other contractual obligations stipulated therein may be revised if the prices of materials or other costs affecting the performance of the contract have increased significantly and unexpectedly.

It is worth recalling the important advantages of indexation clauses, in particular:

- restoring the economic equilibrium between the parties to the contract and the equivalence of their respective performances under the contract (to reflect the situation at the time the bid was submitted);
- adjustment of remuneration to realistic levels that reflect the rising cost of performing the contract, as well as changes in currency purchasing power and risk allocation, all of which are beyond the control of the parties;
- mitigating the adverse effects on contracting authorities;
- counteracting flaws in the prices offered by bidders (underestimation, overestimation) due to unstable external circumstances.

Drafting Guidelines

Currently, all contracts for works, supplies or services concluded for a period of more than six months should provide for a mechanism for adjusting the amount of remuneration due to the contractor in the event of changes in the prices of materials or the costs of performance of the contract. This does not apply to procurement procedures initiated before 10 November 2022 and still ongoing, which will remain subject to the previously applicable rules that are less stringent with regard to mandatory indexation.

Guidelines for the wording of the indexation clause are provided in the Public Procurement Law (PPL). These are, of course, of a framework nature, which means that the substantive content of each such clause will depend on the specific circumstances it is intended to reflect, including, but not limited to, the nature of the contract and the timeframe of its performance, the market situation specific to the industry concerned, the cost structure of the performance of the contract, and the resources available to the contracting authority. Irrespective of these circumstances, *lege artis*, all contracts for works, supplies or services concluded for a period of more than six months must provide for the adjustment of remuneration rules.

Not to be overlooked are the possible additional contractual obligations that may, in practice, extend the duration of the contract (such as various types of after-sales services, technical assistance, etc.). The rules apply only to changes in the price of materials or the cost of performing the contract, which may either increase or decrease.

The indexation clause in public procurement contracts should specify in particular

- the minimum degree of change in material prices or costs
- the first date of determination of the remuneration (e.g. the date of the opening of the bids or an earlier date, the date of the execution of the contract, etc.);
- the method of adjusting the remuneration:
  - on the basis of an index, such as the Consumer Price Index published by the Polish Statistical Office (GUS);
  - other indicators (e.g. a list of types of materials/costs);
- the frequency of adjustments;
- the method of determining the impact of changes in the prices of materials/costs on the cost of performing the contract;
- a cap on the remuneration adjustment.

Contractors are also required, where appropriate, to reflect indexation clauses in agreements with their subcontractors, as they are legally required to make reasonable adjustments to the remuneration they pay to their subcontractors where indexation is provided for in the prime contract.

Avoiding mistakes

Contracting authorities must exercise due diligence at the tender preparation stage and draft an appropriate indexation clause. For their part, contractors, who must act professionally, should review the draft contract with this clause in mind and, if they see anything that gives them cause for concern, they should respond by requesting that the relevant provisions of the proposed contract be amended. Another important tool for shaping future contracts and, more generally, appropriate standards and practical solutions, is appeals to the National Appeals Chamber (KIO). Contractors have the right to appeal to the KIO against provisions in the draft contract which they consider to be inconsistent with the PPL, including the draft indexation clause.

It should be noted that for an indexation clause to be reasonable, it must be

- **formally consistent with the PPL,** i.e. it must contain all the elements required by the PPL, and
- **substantively in accordance with the principles of the PPL,** including the principles of equal treatment of contractors, fair competition, transparency, proportionality and effectiveness, which means that the clause should be tailored to the given market situation and the subject matter of the contract and fairly allocate the identified contractual risks.

For example, the indexation clause may be found to be inconsistent with the principle of equal treatment if it unduly favors only one of several permissible methods of contract performance that suits a particular contractor. Other problems encountered in practice include apparent indexation, indexation that is inconsistent with the cost structure of contract performance, and inadequate indexation, i.e., indexation that is too low, applied too late, or subject to an excessively high threshold.

Contractors sometimes also object to the so-called indexation periods. Examples of clauses that may be considered unlawful include those that provide for the first adjustment of remuneration only three years into the term of a long-term contract, or those that limit indexation to a few percent of the contractor's remuneration. In all cases, it is important to keep in mind how the burden of proof is distributed among the parties to the appeal process, and that evidence must be provided to substantiate claims that the annual indexation caps are too low, that the indexes used are incorrect, that the thresholds for indexation are too high, or that indexation needs to occur more frequently than proposed, to name just a few objections.

Claims for contract amendment

Other issues that may arise in practice include the automaticity of the compensation adjustment versus the obligation to execute a confirmation annex, and the demonstration in the adjustment request of the circumstances justifying the change in remuneration. Regardless of the solution adopted (the choice of which may depend on a number of circumstances, such as the indexation method chosen), it must be borne in mind that, if the grounds for indexation set out in the contract arise, the beneficiary will be entitled to claim its remuneration adjustment. Thus, any provision that allows a contracting authority to adjust or not adjust remuneration at its discretion, despite the existence of the circumstances provided for in the adjustment clause, will be considered unfair.

Transitional provisions

The legal protection mechanism discussed here includes specific transitional provisions applicable to contracts already in force on 10 November 2022. These expressly allow certain modifications to be made to public contracts concluded prior to that date, provided – and this is an important point – that these modifications are caused by "significant" changes in the prices of materials or costs of performance of the contract that the contracting authority, acting with due diligence, could not have foreseen. The application of these provisions is not limited by law to contracts concluded under the PPL but extends to all public contracts.

Existing contracts may be amended, in particular, in order to:

- change the amount of remuneration;
- add an indexation clause to the contract;
- reword the indexation clause (e.g., to the extent that it sets the ceiling for the adjustment of the remuneration);
- change the subject matter of the contract, such as the scope of the services to be provided under the contract, the method of invoicing the services, the deadline for performing the contract, or temporary suspensions of performance.

When a contract is modified, the remuneration may not be adjusted by more than 50 percent of the value of the contract, whether the contract is adjusted directly or indirectly (under an indexation clause), and the adjustment should be agreed upon with the parties equitably sharing the increased cost of performing the contract. The method of adjustment may be chosen in a simplified procedure by reference to the relevant index reflecting changes in material prices or costs (e.g. published by GUS) and must be adequately reflected in existing agreements with subcontractors.

The author's view

The legal solutions discussed above, which allow certain contracts to be amended, are to be seen as a reiteration and more detailed restatement of the earlier regulations (which remain in force), which allow contracts to be amended whenever this is justified by circumstances that the contracting authority could not have foreseen by exercising due diligence, provided that the amendment does not change the general nature of the contract and that the value of the originally concluded contract does not change by more than 50 percent with each successive amendment. This means that contracts entered into after 10 November 2022, under procedures initiated before that date, shall also enjoy legal protection. Although the new rules on indexation clauses do not apply to this latter category of contracts, the general conditions for amending contractual provisions still apply to them, in particular the aforementioned general rule on unforeseen circumstances.

The use of indexation and revision clauses during the implementation phase of a public procurement contract requires due care on the part of both parties – the contractor and the contracting authority – who must, above all, work together to ensure the proper performance of their contract. Circumstances may also require appropriate monitoring, record keeping, countermeasures and reporting of situations that warrant the application of adjustment mechanisms.

In conclusion, while the legal tools to address new and unforeseen market challenges are already in place, their proper application is still evolving and taking shape. The times we live in require that departures from the principle of nominalism be allowed within reasonable limits. It is worth recalling that already in 2014, the Supreme Court ruled that an indexation clause does not in fact alter a contract, but only serves to promote the original intention of the parties at the time of the conclusion of the contract, by restoring the original economic balance of the parties' respective performances and thereby preventing damage to one of the parties to the contractual relationship (case no. II CSK 773/13).

To Index-link or Not to Index-link – That Is the Question for which Boards May Be Held Accountable

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When a contract is no longer economically viable, the company board must decide what action to take and what to do with the contract.

Contract indexing has been a much-discussed topic in recent years. The combined effects of the Covid pandemic, the war in Ukraine, disrupted supply chains and rising inflation, threw many contracts off balance and highlighted the need for remedies. A number of previously obscure and rarely used legal remedies (such as the *rebus sic stantibus* clause) suddenly gained currency. Needless to say, the vicissitudes of the market and the problems associated with them also affected public contracts. Directors of public companies who are parties to these contracts – whether as contracting authorities or as contractors – face exactly the same challenges as their private sector counterparts, are subject to exactly the same rules of liability, and face exactly the same accountability for their decisions.

When do directors become liable?

The amended Commercial Company Code (CCC), which came into force in October 2022, introduced new rules on the liability of members of corporate bodies, in addition to the implementation of the so-called "holding law". In particular, the legislators responsible for the amendments wanted to introduce the so-called "business judgment rule" into the Polish legal system. This rule is intended to serve as a security guarantee for members of corporate bodies, shielding them from liability to the company for any of their actions or omissions that ultimately prove to be detrimental to the company, but were decided upon in the exercise of due care.

Articles 209[1] § 1 and 377[1] § 1 CCC require directors to perform their duties with the diligence of a prudent businessman and, at the same time, to be loyal to their companies. In turn, Articles 293 § 1 and 483 § 1 CCC make directors liable to their companies for any damage caused by their acts or omissions that are contrary to the law or the provisions of their company's articles of association, unless the directors are not culpable.

However, it was not clear from the Commercial Company Code whether directors were liable only if their acts or omissions violated a specific provision of the law, or whether they could also be held liable to the company for acts or omissions that, while not violating the law, were reckless and the result of a failure to exercise due care. Ultimately, the Supreme Court held that a director's culpable action, while exceeding the limits of acceptable economic risk, is inconsistent with the company's interests and, as such, violates the law.

The new Articles 293 § 3 and 493 § 3 of the amended Commercial Company Code provide that the members of the board of directors do not violate the duty of care inherent in their profession if, while acting in good faith towards their company, they act within the limits of reasonable economic risk, including on the basis of information, analyses and opinions that should be taken into account in a prudent assessment under the given circumstances. This provides some guidance as to what directors should be able to rely on in order for their decisions to be considered properly made.

So what about the contract?

If a contract no longer makes economic sense for the company, its board of directors must decide what action to take and what to do with the contract. Situations in which one party is free to increase its own contractual compensation are virtually unheard of, and cooperation between all parties to the contract is required. It also goes without saying that the other party is usually not interested in changing the previously agreed terms.

If the other party is unwilling to play ball, the board should consider resorting to the indexation tools provided for in the Civil Code (e.g., Articles 357[1] and 632 § 2), although these require the intervention of the courts in the contract. While litigation cannot be avoided in these circumstances, the ultimate outcome may be favorable to the company, especially if the company succeeds in obtaining a court injunction early on, thereby securing its claim through a temporary regulation of the parties' respective rights and obligations for the duration of the court proceedings.

However, legal proceedings are usually lengthy and their outcome is always uncertain, so before going to court, the board should try to negotiate with the other party to modify the contract. This is where Articles 439 and 455 of the Public Procurement Law come to the rescue. The former of these Articles requires the inclusion of so-called "indexation clauses" in contracts, while the latter regulates contract modifications that do not require a repetition of the public procurement procedure. Thus, board members of companies that are contractors under public procurement contracts can invoke both contractual and legal grounds when requesting changes to a contract that has become unprofitable for reasons beyond the contractor's control.

The contracting authorities' dilemmas

But how should the board members of a capital company, which is the contracting authority in the contract, react when the contractor comes in with a request to modify the contract? Contracting authorities are naturally reluctant to change their contracts, particularly where the contractor's compensation is concerned. In addition, contracting officers often express concern that they are exposing themselves to liability by agreeing to modify their contracts. This concern is misplaced, however, as failure to modify a contract may also constitute an act by a director that exposes the director to liability for damages to the corporation.

In deciding whether or not to modify a contract, directors must always consider all of the factual and legal circumstances surrounding the contract in question.

If the compensation due to the general contractor under a construction contract has become inadequate (e.g., as a result of significant increases in the price of construction materials) and the general contractor threatens to walk off the job or sue for a modification of the contract, or even announces the risk of bankruptcy, a modification of the contract may be advisable in light of the tasks of contracting authority, whereas failure to modify the contract would ultimately harm the company (and expose the directors to liability).

Of course, it is never possible to draw a line between situations in which a contract amendment is "good" and those in which an amendment is "bad." Board members are expected to simulate the outcomes and costs of all possible scenarios and the likelihood of each scenario occurring. In most cases, the opinion of external experts will also be sought, as explicitly mentioned in the amended Commercial Company Code.

How to proceed

Further guidance on how to proceed can be found in Article 54a (1) of the Public Finance Law, although commercial companies, including those owned by municipalities, are not part of the public finance sector. Pursuant to this Article, public finance entities may enter into settlements in disputes over amounts due under civil law agreements if they determine that the consequences of the settlement for the entity, the State Treasury or the relevant local government authority, as the case may be, are preferable to the likely consequences of court or arbitration proceedings. In making this determination, consideration should be given to the relevant circumstances of the case, including, without limitation, the merits of the claims in dispute, the feasibility of satisfying those claims, and the likely duration and cost of any court or arbitration proceedings that may be instituted.

In other words, the members of the company's board of directors must determine whether or not an amendment to the contract with the contractor – even if it means having to pay the contractor more – is not, on balance, more advantageous than, for example, the contractor's bankruptcy, the inevitable prospect of claims being filed in bankruptcy proceedings, the need to find a new contractor and, of course, in such circumstances, the postponement of the completion of the investment in question.

The author's view

The decision whether or not to index-link a contract, and how to proceed with indexing (whether through litigation or amicable settlement), must be made on a case-by-case basis, taking into account the circumstances of each individual case. And it is by no means the rule that the contracting authority should always insist that the originally agreed terms of the contract remain in place and the contractor should always seek to change them, e.g. by initiating legal proceedings which are unlikely to succeed.

Amendments to a contract with a contracting authority may constitute state aid

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The regulations allow, and even mandate, a consequential amending of a public contract in certain cases. However, they do not prejudge whether such an amendment is state aid.

Pursuant to the classical definition adopted in EU law, state aid is understood as any support provided selectively to a specific undertaking or group of undertakings (premise of selectivity) by a Member State or from public resources (premise of public origin of funds), which may distort competition (premise of effect on competition) in trade between EU member states (premise of effect on intra-EU trade).

Procurement as a form of state aid

In this context, it is generally accepted that the acquisition of goods or services by the state, its authorities or institutions from an undertaking may also be a form of state aid. This is because such an acquisition is generally financed from public funds (so the premise of public origin of funds is satisfied), and moreover, these funds go to a specific undertaking providing certain goods or services (so the premise of selectivity is also satisfied). In addition, depending on the volume of the delivery and the size of the market affected by the contract in question, the premises of effect on competition and effect on intra-EU trade may also be satisfied; in the European Commission's practice, the latter two prerequisites are virtually always assumed to be fulfilled, except in the case of small value support (known as *de minimis* aid) or specific, strictly local markets or infrastructures.

Consequently, the acquisition of goods or services by the state from an undertaking may constitute state aid. In particular, the award of a contract to an undertaking for the delivery of certain goods, construction works, the design, construction or management of certain infrastructure, or the provision of public services may be considered state aid, which involves a number of important legal implications, including in particular the obligation of the relevant member state to notify the above state aid to the Commission in advance and the obligation to refrain from the awarding of the aid pending a positive decision issued by the Commission (standstill obligation).

A breach of the above obligation may have serious consequences for the supplier (contractor), such as the EU law-based obligation to repay state aid (if the Commission declares it incompatible with the internal market), the possible obligation arising directly from national law to repay state aid (regardless of its possible incompatibility with the internal market and the Commission's decision in this regard), the risk of annulment of the relevant public contract, etc.

Annex to the public contract

The fact that the above legal regime is not just theoretical or marginal was experienced, for example, by the contractor in the well-known dispute over the Wielkopolska Highway. In the above case, on the basis of a tender and a corresponding concession agreement, the Polish authorities entrusted a private Polish company, Autostrada Wielkopolska S.A., with the construction and operation of the highway in 1997. However, after Poland's accession to the European Union, Polish regulations were amended to implement certain EU regulations on toll highways. Since this amendment resulted in a loss of revenue for highway concessionaires, Polish law also provided for adequate compensation for them, paid from a dedicated national fund, the rules of which were to be detailed in an annex to the relevant concession agreement.

Therefore, Autostrada Wielkopolska and the Polish authorities negotiated and concluded an annex to the concession agreement providing for the method of calculating the said compensation, which, according to the Polish authorities, was intended to put Autostrada Wielkopolska S.A. back in the position it would have been in had the Polish regulations on toll freeways not been amended.

Breach of the notification obligation

Over time, however, the Polish authorities came to believe that the methodology for calculating compensation provided for in the annex to the concession agreement was flawed and led to the company being overcompensated. As a result, the Polish authorities demanded that Autostrada Wielkopolska S.A. return the compensation, and furthermore notified the Commission of the compensation as a form of state aid.

The company refused to return the compensation, and also went against the Polish authorities before an *ad hoc* arbitral tribunal (UNCITRAL), which ruled in 2013 that the annex to the concession agreement was valid and should be respected by the Polish authorities. The latter, however, filed a case in a Polish civil court in 2013 to set aside the arbitral award.

Meanwhile, on the basis of the aforementioned notification of state aid made by the Polish authorities in 2012, the Commission opened a formal investigation of the aid in 2014 and in 2017 concluded in its decision that the amount of overcompensation constituted illegal aid incompatible with the internal market and should be recovered by the Polish authorities from Autostrada Wielkopolska S.A with interest.

Courts affirm Commission's decision

The company appealed against the Commission's decision to the EU General Court, which, however, dismissed the company's complaint. The company's appeal against the General Court's judgment to the EU Court of Justice, which confirmed the Commission's decision in its judgment of 11 November 2021 in *Autostrada Wielkopolska v Commission and Poland* (C-933/19 P), also proved unsuccessful.In the meantime, proceedings pending before the Polish courts in relation to the arbitration award of 2013 led (after a trial court's ruling dismissing the Polish authorities' claim) to a ruling issued by the Court of Appeal in 2019 (case no. I ACa 457/18), in which the court upheld the Polish authorities' position and overturned the arbitral award. In this respect the Court of Appeal first of all noted that pursuant to the rules of Polish civil procedure, an arbitral award may be set aside by a court if it is contrary to the fundamental principles of the Polish legal order.

However, as the Court of Appeal noted, EU law has also become part of this national legal order. In particular, EU competition law (including state aid law) is also part of national public policy, which national courts should take into account when reviewing arbitral awards.

The Court of Appeal further emphasized, referring to the CJEU judgments of 26 October 2006 in the *Mostaza Claro* case (C-168/05) and of 1 June 1999 in the *Eco Swiss* case (C-126/97) - that if a member state's national rules of judicial procedure require setting aside an arbitral award that is inconsistent with national public policy principles, then, due to the principle of equivalence, if an arbitral award is inconsistent with the relevant EU law principles of the same kind, it should also be set aside.

In that regard, the Court of Appeal found that the arbitral award in question did not consider aspects of the case related to state aid regulations at all. In particular, the Court of Appeal noted that the said arbitral award could not be reconciled with the Commission's final decision of 2017, which classified the overcompensation - approved in the arbitral award - as unlawful state aid granted in breach of the suspension obligation (as the annex to the concession agreement was concluded prior to its notification to the Commission).

In addition, in the opinion of the Court of Appeal, the arbitration court failed to note that under Polish law, contracts that are inconsistent with a statutory law [Polish: *ustawa*] are considered invalid, and pursuant to the established case law of Polish courts, the concept of a statutory law in this sense also includes the rules of EU competition law, including, in particular, the third sentence of Article 108(3) of the TFEU providing for the suspension obligation. Thus, the court explicitly stated that "the contradiction with Article 108(3) sentence 3 of the TFEU causes the invalidity of an act in law that does not comply with this provision as contrary to the law."

It is worth noting that the judgment of the Court of Appeal was appealed to the Supreme Court, before which the case is still pending.

Arm's length transactions

However, it is also assumed in EU law that the acquisition of goods or services by the state from an undertaking does not constitute state aid if it is done in accordance with market conditions. At the same time it is worth noting that the Commission views compatibility of a public contract with market conditions quite restrictively, allowing only that the competitive tendering procedure *"leave(s) the successful bidder with a normal return, not more"*.

In this context, it is believed that awarding a public contract to an undertaking in full compliance with the rules and regulations of the public procurement law is one way to ensure compatibility of the transaction with market conditions .
Thus, an undertaking winning a contract under this procedure and in full compliance with its requirements need not, in principle, be concerned about the risks of obtaining illegal state aid. It is yet another issue, raised in the rich decision-making practice of the Commission and the case law of the EU courts, which of the range of procedures provided for in the public procurement law sufficiently ensure compatibility of the transaction with market conditions and whether the use of a full tendering procedure is always sufficient to avoid the granting of state aid to the supplier or contractor.

However, it is important that under the above rules, the source of state aid may not only be the contract originally awarded, but also an amendment to that contract, in particular an amendment in favour of the undertaking, for example, an increase in the remuneration due for the originally agreed scope of deliveries or works. Also in such a case allegations of state aid (related not to the original contract, but to a subsequent change in its terms) can be avoided if it is demonstrated that the amendment to the contract was in line with market conditions.

Since, as mentioned above, strict compliance of the contract with the public procurement law essentially warrants its arm's length nature (for the purposes of the analysis of the presence of state aid discussed above), if the contract is amended strictly in compliance with the requirements of the public procurement law, it should not be regarded as a source of state aid due to its market nature.

A change that is not a form of state aid

Thus, based on the above principles, it may be assumed that where explicit, universal and mandatory provisions of the public procurement law authorize or even prescribe a specific consequential amendment to a contract, making such an amendment in an individual case in full compliance with these provisions serves as grounds for arguing that such a change is not a form of state aid provided to a contractor or supplier.

It can be considered that a provision of this kind - providing the basis for considering an amendment to a contract to be at arm's length - is the currently binding revised Article 439(1) of the Public Procurement Law (PPL). This provision stipulates that a contract for construction works, supplies or services, concluded for a term exceeding 6 months, must include provisions governing amendments to the contract regarding changes in the remuneration due to the contractor in the event of a change in the price of materials or costs related to the performance of the contract.

Nonetheless, it is worth noting that the said provision only obligates certain contracts to specify rules of future contract modifications in the event of the circumstances specified in this provision. Thus, the above provision may be considered a delegating one - authorizing and at the same time obliging the parties to the contract to agree certain rules (indicating to what extent and how the terms of the contract may be amended), but it does not concern or shape the material content of these rules themselves, leaving this task to the parties.

Consequently, Article 439(1) of the PPL provides grounds for the claim that the establishment of rules for the modification of terms and conditions of a public contract, or the subsequent modification of terms and conditions in performance of the relevant contractual provisions, in cases covered by this provision, does not yet as such constitute a form of state aid. However, and this is particularly important, the fact that the parties are acting on the basis and within the limits of the above provision does not yet determine whether the rules they set in the contract for amending its terms, or a specific amendment of the terms of the contract is, indeed, on an arm's length basis and thus does not constitute state aid.

Author's view

The provisions of Article 439(1) of the PPL are undoubtedly relevant to the subject at hand, and create a starting point for the contracting parties to amend the contract so as to avoid allegations of state aid. However, it is still crucial for the parties to make and document a sound and in-depth economic analysis that allows them to demonstrate, on the basis of Article 439(1) of the PPL, that the amendment of the terms of the contract is on an arm's length basis and therefore does not constitute state aid. This principle will apply even more so in the case of contracts that, for various reasons (including subject matter or intertemporal issues) do not fall within the scope of the said Article 439(1) of the Public Procurement Law or similar earlier regulations of the Public Procurement Law. Such an in-depth analysis of the arm's length character of amendment to a public contract would also be recommended to the extent that the contract in question is financed by EU funds – since the amendment of such a contract made in full compliance with the standards set by the Public Procurement Law should also be free from the risk of the competent institutions recognizing the costs incurred by the beneficiary (as the contracting authority) under the amended contract as ineligible expenses.

Indexing Through Restructuring

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Entrepreneurs in difficulty, who are struggling with the performance of a contract, may benefit from a restructuring procedure. Any restructuring procedure guarantees the protection of executed contracts, with the most effective solution being the reorganization procedure.

Recent years have seen a number of extraordinary developments, such as pandemics and the war in Europe. To everyone's surprise, these events proved capable of affecting the economy as a whole and its various sectors in a relatively short period of time, with a subsequent negative impact on companies and the situation of consumers. The mounting prices of fuels, commodities, services and raw materials make the performance of contracts already concluded, including public contracts, less profitable than before, thereby negatively affecting the profitability of contractors.

Mandatory indexation clauses

Although legislators have provided for mandatory inflation indexation clauses in public procurement contracts, and contractors strive to ensure that appropriate 'adjustment clauses' and safeguards are put in place in the contract to allow for change and/or risk management, these solutions may prove insufficient. Market fluctuations in the economy as a whole, or in its constituent sectors, may be so significant in relation to the contract execution phase that the contractor may end up having to foot the bill for the excessive costs generated by the contract. An indexation clause may therefore not serve its intended purpose and may prove to be an overly conservative solution in the face of turbulent economic changes.

Of course, at such a time, it should be a natural solution to try to renegotiate the contract so as to bring it into line with the current market conditions. First and foremost, indexation of the contract performance price is the first viable option. However, renegotiation does not necessarily have to be successful for the contractor. This is because the contracting authority may either refuse indexation altogether or agree to it only to a very inadequate extent.

When negotiations fail

In such a situation, it seems that the only tool available is judicial indexation and the initiation of a typical civil action leading to a modification of the contract. This could be the optimal solution for a contractor who is not affected by liquidity problems and who, although he has signed a public contract, even an unprofitable one, in one of his business areas, are lucky in that this particular predicament, it does not affect the situation of the company as a whole. In such a situation, the contractor can afford to file a lawsuit that will eventually lead to a final settlement after a number of years.

However, for contractors whose portfolios include a significant proportion of no longer profitable public contracts, a typical court-ordered indexation may prove to be a risky measure that arrives too late. After all, litigation is a time-consuming exercise with uncertain outcomes, whereas companies need adequate response tools in the here and now. If too much money is spent on handling key contracts, the company runs the risk of becoming insolvent in the near future. This, in turn, will trigger the legal obligation to file for bankruptcy.

However, this does not mean that the contractor is in a no-win situation. After all, a distressed company may decide on a restructuring procedure and use it as an appropriate response tool to modify executed contracts.

Currently, the law recognizes four different types of restructuring proceedings, each of which aims to avoid bankruptcy and facilitate the execution of an arrangement, i.e. an agreement with creditors. Arrangement agreements are usually signed to reorganize the way in which the company will meet its defaulted liabilities and obligations. On the other hand, the nature of the restructuring process depends mainly on the extent of the company's business problems, the scope of the corrective measures required and the volume of disputed debts.

Contracts will be protected

Protection of executed contracts is the most important protection for entrepreneurs undergoing restructuring. Articles 225 and 247 of the Restructuring Law (the "RL") expressly provide that all contractual clauses providing for the modification or termination of a contract in the event of the filing of a petition for a court-approved arrangement, or in the event of the approval of an arrangement, the publication of a notice setting an arrangement date, or the filing of a petition for the opening of restructuring proceedings, or the opening of such proceedings, are null and void by operation of law. Consequently, the contracting authority will not be able to enforce any such clauses, even if they are expressly provided for in the contract. The above mechanism is intended to guarantee that the mere fact that a company is undergoing restructuring procedures will not have negative consequences for the existence of the contracts it has signed. In this way, the contractor will be able to continue with any outstanding contracts that it deems profitable.

Although it is true that any restructuring procedure guarantees the protection of existing contracts, in a situation where the contractor needs to change the way in which the contracts are performed or even rescind them, the reorganization procedure (*postępowanie sanacyjne*) seems to offer the greatest number of available options. In addition to being fully protected from enforcement, being able to sell redundant company assets without encumbrance, and being able to lay off some employees, this procedure also allows the company to rescind unprofitable contracts. This mechanism can be particularly useful if the contract in question does not allow for rescission and the company has not yet succeeded in having it indexed.

To rescind or not to rescind?

Article 298 RL, which governs the rescission procedure, authorizes the reorganization administrator to file a petition for rescission. Since the contracting authority's performance is quantifiable (it is expressed in monetary terms), it is possible to rescind the relevant part of the contract that remains to be performed after the procedure has been initiated. The provision does not contain any criteria as to the type of contract, the contracting party or the grounds for rescission. In practice, however, the vast majority of applications relate to contracts that are too costly to perform and adversely affect the company's ability to recover financial liquidity, where previous attempts to index the contract to inflation through negotiation have been unsuccessful.

A petition to terminate a contract is submitted to the bankruptcy judge in charge of the restructuring process. The administrator, as a court-appointed body empowered to act on behalf of the debtor, is therefore not entitled to take a decision to rescind a contract. This decision must be accepted by the judicial authority.

At first sight, it would seem that in a situation where the judge-commissioner has granted the administrator's petition to rescind a contract on the basis of a final and non-appealable decision, the only further scenario is for the administrator to terminate the contract by serving a notice of rescission. The other party is then bound by the notice.

However, the practice of reorganization proceedings shows that the approval of the judge-commissioner could actually create space for further negotiations with the contracting authority.

In fact, once the administrator has obtained a final and non-appealable decision from the judge-commissioner, he is not obliged to implement the terms of the decision. This is because the decision does not constitute an unconditional order for the administrator to terminate the contract, but rather a kind of "green light" for the administrator to proceed with the proposed rescission. Nevertheless, the administrator can use the decision as a strong argument in further negotiations to amend the contract so it becomes more favorable to the contractor.

This tool can be particularly useful for contractors performing a public contract that constitutes an investment project. Such projects, especially technological projects, rely very heavily on the knowledge, skills and *know-how* of the contractor. In performing a public contract, the contractor may contribute some of its own assets to the project, e.g. by reselling its licenses. In such a case, it may be unprofitable for the contracting authority to rescind the contract and to abandon it altogether, as this would mean hiring a new contractor, who may need a lot of time to understand and take over the project. For this reason, the mere possibility that the administrator may rescind the contract on behalf of a company in reorganization may encourage the contracting authority to negotiate a favorable amendment to the contract.

Restructuring by arrangement

The other tool available in reorganization proceedings, as in all other restructuring proceedings, is the possibility of restructuring the defaulted liabilities of the company on the terms set out in an arrangement which has been put to the vote of the creditors and then finally and non-appealably approved by the court. Although arrangements in restructuring proceedings mainly concern unperformed monetary obligations (for example: they provide for payment deferrals, payment in installments, repayment of 80% of the principal, redemption of interest, etc.), they may also concern unperformed non-monetary obligations arising from contracts not performed before the opening of the restructuring proceedings. This possibility is provided for in Article 150 (2) RL. In order for such non-monetary obligations to be included in the arrangement, the underlying contract must be unperformed in a situation where the contracting party has performed but has not received adequate consideration before the opening of the restructuring proceedings (or – in the case of proceedings for approval of the arrangement – before the date of the arrangement). In such a case, the contracting party's claim for the paid part of the contract to be performed becomes its non-monetary claim included in the arrangement.

The law does not prescribe how such claims are to be restructured, but leaves this matter entirely to negotiation between the debtor and the creditor, i.e., in the present case, between the contracting authority and the contractor. Accordingly, arrangement proposals may, for example, provide for the deferral of a certain part of a public contract, in the case of infrastructure projects – a change in the timetable and project performance rules, and in the case of technology projects – a change in the product functionality. As restructuring proceedings practitioners are familiar with cases where non-monetary claims have been restructured in return for an adequate additional payment made by the creditor, this form of contract modification cannot be ruled out either. This, a final and non-appealable arrangement may result in the modification of the performance of a certain part of a public contract in favor of the contractor.

Modification for the duration of the restructuring procedure

In addition to the above mentioned restructuring instruments, Article 248 RL may provide complementary solutions regarding the way the contract is performed. This article stipulates that any provision of an agreement (contract) to which the debtor is a party that prevents or hinders the achievement of the purpose of the restructuring proceedings shall be ineffective against the 'arrangement estate'. This means that a particular contractual provision may not be implemented during the restructuring process if it stands in the way of a successful restructuring. The provision is worded broadly enough to apply to a very wide range of factual situations. Thus, if the relevant contractual provisions do not include an optimization of the subject matter of the contract and the approach to its implementation, the contractor may use the aforementioned article to achieve this objective for the duration of the restructuring proceedings.

The authors' view

The options described in the article can be used as a method of public contract indexation, especially when the company is facing insolvency and previous attempts to modify the contract have proved unsuccessful. However, restructuring is by no means a smooth route without risks and difficulties. In reorganization proceedings, the company generally loses control of its assets in favor of a court-appointed administrator. Conversely, in other restructuring procedures, it must obtain the approval of the court supervisor for any action outside the day-to-day management. Each restructuring procedure is a time of intense effort for the company to take corrective action and restructure its liabilities and operations. It is also crucial to convince the creditors to support the arrangement proposals, otherwise the restructuring process will be terminated and bankruptcy will become a reality. The "second chance" offered to the entrepreneur by the restructuring procedure is therefore not unconditional, and should be accompanied by active efforts – not only during the restructuring procedure, but also in the period leading up to the restructuring. Only then will it be successful and help restore financial stability and full solvency.

Long-term contracts and indexation – practical advice in the context of CIT

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Long-term contracts are the mainstay solution in public procurement procedures for large-scale infrastructure projects. Given the strategic nature and extended terms of contracts offered in these procedures, careful consideration should be given to the tax consequences that go with long-term contracts, which may depend to some extent on specific contractual provisions.

In practice, long-term contracts are based on a variety of formats. In Poland, an increasing number of infrastructure investments are based on the FIDIC Conditions of Contract, the international standard for construction contracts. The specifics of the FIDIC standard may have bearing on the timing of recognition of revenue earned and expenses incurred in the performance of long-term contracts.

The FIDIC standard

The FIDIC Standard Conditions of Contract, developed by the International Federation of Consulting Engineers (Fédération Internationale Des Ingénieurs-Conseils) in the 1990s and published in Poland by the Association of Engineering Consultants and Experts (SIDiR), are widely used throughout the world as a contract template in the construction and engineering sectors. In Poland too FIDIC has been growing in popularity over the past years, especially for large-scale construction projects such as road investments – the General Director for National Roads and Motorways (GDDiK) for one has long preferred this standard.

FIDIC contracts set contractual standard for various elements of a construction contracts – which, needless to say, may be modified as the parties to a given contract see fit – such as those relating to investment project management and distribution of risks and costs. Thus, the FIDIC Conditions of Contract can go a long way in facilitating relationship building among parties to an investment project.

Tax settlements – Revenue

When determining the right moment to recognize income (revenue) earned under a long-term contract, it is always crucial to identify the settlement rules agreed therein. What needs to be determined, in particular, is whether the parties to the contract have defined any accounting periods binding upon them. Also important in any contract (from both the formal and tax viewpoints) is what event the parties agreed will signal the successful performance of a service. Examples of such – widely approved in practice - events, relevant on the grounds of law (and hence also taxation), include delivery of requests for works inspections or acceptance of handing-over records.

In CIT settlements, the date of income earning by businesses providing services against payment is, as a rule, seen to coincide with the date of full or partial performance of a given service, with such income not to be recognized later than on the date of invoicing or payment of the amount due for the service.

Accounting periods

The contractual aspect is also important in correct determinations of the income (revenue) earning date from the tax perspective. Where the parties to a contract agree that service performance is to be settled within specific accounting periods, the last day of each accounting period specified in the contract or in an invoice issued is deemed the revenue recognition point (which must fall at least once a year).

Although no definitions were provided in the Corporate Income Tax Act of "services settled within accounting periods" or "partial performance of services," it is assumed that the term "accounting period" means a contractually defined recurring time interval, the lapse of which triggers the obligation to settle mutual financial obligations (with this to be any, quarterly or annual period, for example).

What must be borne in mind, however, is that it may not be enough for contracting parties to just formally indicate in their contract that they want services to be settled within a specific accounting period, such as a month, say. The position of the

tax authorities here is that where some specific services are defined as services settled within a particular accounting period, it is key to have in the contract provisions regulating payment for services performed. In other words, the tax authorities may refuse to recognize a service as one settled within an accounting period, .e.g. if the contract explicitly provides for a single payment to be made for the service in advance.

Thus, where long-term contracts are concerned (including those based on the FIDIC standard), for a service to be classifiable as settled within accounting periods rather than as a partially rendered service, it always needs to be established whether or not the contract explicitly provides for settlements to be made within periods approved by the parties.

Services performed in stages

The situation is different for services performed in parts and settled in stages, based on the level of progress of work actually performed. The prevailing practice of the tax authorities confronted with long-term contracts – where no invoice has yet been issued or payment made – is to consider income from work performed to have been earned:

- on the date when the engineer issues the interim or final payment certificate in the case of FIDIC-based contracts; or
- on the date when the control inspector signs the partial or final works acceptance record (or an equivalent document provided for in the contract) in the case of other contracts.

That said, the tax authorities point out that if the final date of service performance completion cannot be established with certainty, they will rely on the date of invoicing the service (as when, for example, no date is put on the signed acceptance record).

It is important to keep in mind, however, that in the case of services settled within monthly accounting periods (e.g. by the last day of each month), the tax authorities also sometimes treat the date when the contracting authority executes the acceptance record as the date of income earning, as is the case with services settled in stages.

Advance payments

Not every payment received in a given accounting period must necessarily be recognized as the contractor's income (revenue). It is universal practice to require advances for contract work that will not be performed until later accounting periods.

What tax authorities emphasize, however, is that a given payment may be deemed an advance (prepayment) towards a specific service due to be performed in some subsequent reporting period only if this follows from the contract made between the parties and is reflected in the relevant documentation. If, say, a given payment for construction materials is not in the nature of an advance payment, this income must be recognized at the end of the given accounting period / upon settlement of the relevant stage of work.

Thus, it is always worthwhile to consider how best to formulate the contractual provisions relevant to the adopted settlement model which, once approved by the other party, would make for simpler or uniform settlements on the part of the taxpayer.

Tax settlements – Costs

Tax authorities and administrative courts alike take the position that deductible (revenue earning) costs incurred in connection with the performance of long-term contracts should be accounted for in proportion to the income received in consideration of the performance of these contracts.

What this means is that taxpayers should recognize expenses incurred at the time of reporting the corresponding revenue from each completed stage of work performed, adopting an appropriate method of costs allocation to allow commensurate cost accounting. In this regard, it should be noted that the National Tax Information Service (*Krajowa Informacja Skarbowa*) in principle rightly approves in its interpretations some of the cost accounting methodologies proposed by taxpayers, such as those based on accounting principles.

Where costs are directly tied to revenue and incurred in subsequent tax years, these must be recognized in the tax year in which the revenue corresponding to them was earned. If, however, a direct cost is incurred after the date of the current financial statements (the deadline for filing the current tax return), i.e., already after a tax year has ended, it is deductible in the tax year following the year to which it relates.

At the same time, until the completion of the contract (when work is still in progress), the costs accounted for may not exceed the amount of the costs actually incurred, so that the methodology adopted does not violate the principle of actual cost incurred. In its interpretations, the National Tax Information Service likewise sees it important that these costs are not artificially inflated or understated, thus distorting the taxpayer's bottom line and, therefore, the reported income or loss figures.

Also, the tax authorities generally allow the cost of services performed by the time income generated by them was recognized to be classified as deductible costs even though the taxpayer has not received an invoice documenting these costs in the period for which the revenue is recognized. If that is the case, the taxpayer may recognize the (direct) cost of services rendered, incurred (as entered in the books) by the taxpayer during the period, based on the taxpayer's internal accounting documents, such as account notes.

Increased remuneration

Pursuant to Article 439(1) of the Public Procurement Law Act of 11 September 2019, all contracts for works, supplies or services concluded for periods of more than six months should provide mechanisms for adjusting the amount of remuneration due to the contractors in the event of changes in the prices of materials or the costs of performing their contracts.

The FIDIC Conditions of Contract in principle provide for mechanisms of adjusting the amount of remuneration due to the contractor on an ongoing basis (indexation). If these mechanisms are applied, the increased income should also be recognized on an ongoing basis for taxation purposes, in line with the rules discussed in the first part of this article.

Starting from 1 January 2016, indexation of remuneration relating to past periods – if not necessitated by an accounting error or some other obvious mistake – is made on an ongoing basis, i.e., in the accounting period in which the correcting invoice was issued or, in the absence of an invoice, another document warranting the adjustment.

The above applies analogously to the recognition of income received when a court orders contractual remuneration to be increased.

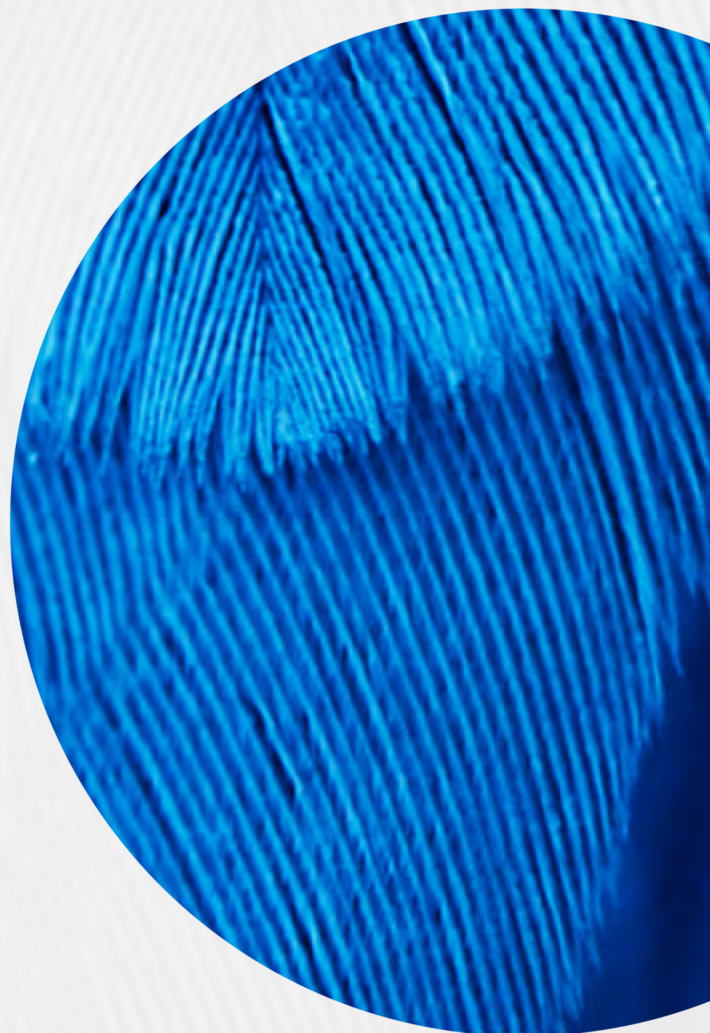
Some consequences of remuneration adjustments in the course of contracts that may not be immediately obvious are also worth keeping in mind. Depending on the circumstances, an increase in remuneration may sometimes also result in a change in profitability, the level of which will be relevant to identifying possible obligations relating to mandatory minimum corporate income tax payments (in practice, the regulations governing this minimum tax have been suspended until 1 January 2024).

This tax, constituting 10 percent of the tax base (calculated as the sum of a certain percentage of operating income and certain types of expenses) must be paid by companies and tax capital groups which in the given tax year have either incurred a loss from a source of income other than capital gains or have received income from such sources amounting to no more than two percent of their revenue. Thus, in some cases indexation serving as a mechanism for safeguarding the contractor' interest may help maintain an adequate level of profitability and thus avoid the minimum income tax.

In addition, indexation of remuneration (whether contractual or court-ordered) may significantly impact EBITDA, thereby also impacting the level of limitation of debt financing costs classifiable as deductible costs.

The author's view

Given the complex nature of long-term public procurement contracts, they must always be reviewed from the tax perspective, particularly with regard to corporate income tax. You can avoid negative consequences in the future if you review a contract thoroughly before executing it or look closely at a contract model (such as one based on the FIDIC standard) before adopting it in your company.



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