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The Strange Case of Inventories In Italy for the Tax Authorities, The Final Inventories of one Year are the Opening Inventories of the Following Year. Still, The Opening Inventories of One Year are not the Final Inventories of the Previous Year. Mystery.......

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Abstract: The principle of continuity in financial reporting is a fundamental element in the preparation of financial reporting. The final amounts of a financial report are, by definition, the opening amounts of the following year. Of course, the reverse is also true. The opening values of one year represent the closing values of the previous year.

In Italy, this principle is only half applied in taxation. It applies to the future (i.e. the following year) but does not apply to the past (i.e. the previous year).

Of particular interest is the position of the Italian Court of Cassation, i.e. the highest court of justice, which applies this principle of "lame continuity" in its judgments. Despite the astonishment of scholars, the Court of Cassation continues to consider that the final inventories of one year represent the initial inventories of the following year but does not accept as an obligation the opposite case. Only time will tell if it will resolve this dispute between the Supreme Court and the basic principles of business economics regarding financial reports.

1) Principle of going concern financial reporting: initial remarks

The going concern principle is one of the fundamental principles of financial reporting. What for one year identifies the final assets, by definition, also represents the initial capital for the following year. This is because the final financial reporting closes at h. 24.00 of 31/12/n, and the initial financial reporting opens at h. 0.00 of 1/1/n+1. The two instants coincide. Therefore, the final financial reporting of a year represents the initial financial reporting of the following year.

This concept has considerable accounting implications. Suppose the final assets of one year are equal to the initial assets of the following year. In that case, the values recorded in the two financial reports are identical. At the end of the year, what is owned is all the assets, rights, and obligations existing at 1/1 of the following year.

This principle is a cornerstone of accounting, financial reporting, the integrity of financial reporting, and this document's clarity.

It is unthinkable that, in a financial report, final inventories should be entered for a different amount than the initial inventories of the following year. It is possible that the initial value changes due to a change in valuation, but the first value entered in financial reporting before any transaction, can only be that of the previous year. And, of course, this principle applies to every account recognised in financial reporting.

In Italy, as in most European and non-European countries, the tax authorities follow different paths from those outlined for preparing economically truthful, correct and understandable financial reporting. Financial reporting interpreted as a tool for external information can provide truthful and transparent information to third parties outside the company. On the other hand, tax legislation and the bodies responsible for managing tax issues must limit the taxpayer's discretion. Tax legislation has other goals from the legislator who regulates financial reporting as a management and information tool intended for the outside world. He does not include in financial reporting values whose sole objective is to reduce taxable income through his behaviour.

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This is perfectly understandable, even if everyone wishes to bring operating income closer to taxable income. Each country intervenes in this matter in different ways. In Italy, recent years have seen the enactment of several tax laws which have attempted to bring the two types of income closer together so that the income produced by the company is taxed.

Despite these attempts to bring the true, clear and correct operating income closer to the taxable income, it is possible to identify some situations which are at least absurd and which leave those who deal with financial reporting from a theoretical or practical point of view astonished.

One of these hypotheses bordering on absurdity concerns inventories. From a tax point of view, the treatment of this item has evolved from an understandable situation into an unacceptable position. In fact, what has been affirmed by the recent case law of the Supreme Court of Cassation (i.e. the highest level of jurisprudence in Italy, which corresponds to the third level of judgement, in tax matters, which is dealt with after the decisions of the Tax Commission of the first instance and second instance) appears to be contrary to every accounting rule underlying the preparation of financial reporting.

To understand the current Italian situation regarding the tax authorities' assessment of the values indicated in financial reporting, one must bear in mind three tax rules that, in reality, reflect the cardinal principles of an economic-business nature. In summary, the three tax principles that we must bear in mind to address the subject matter of this article are the following:

1) The continuity of financial reporting values: according to this principle, the final inventories of one financial year constitute the initial inventories of the following financial year;

2) art. 92 paragraph 7 of the TUIR (the Tuir is the tax law under which also the rules concerning the determination of the taxable income and the principles to be applied in case of tax audits by the tax authorities are included) according to which the final inventories of a financial year in the amount indicated by the taxpayer constitute the initial inventories of the following financial year;

3) Article 110(8) of the same TUIR, according to which the adjustment by the office of the valuations made by the taxpayer in one fiscal year is also effective for the subsequent ones.

2) Inter-relationship between final inventories of one year and initial inventories of the following year

Based on the principles set out above, in the event of simultaneous controls by the tax authorities of several tax periods, if the competent tax office adjusts the inventories of one tax period, it is obliged to adapt, to the same extent, the corresponding inventories of the following period, since it is unthinkable to reduce the control and the variation of the tax values in one year and not in the following year. This would be unfavourable to the taxpayer and would therefore constitute a legal injustice. All this is due to the circumstance that the legislator has highlighted, in the TUIR mentioned above articles, the automatic logic of a seamless corporate life.

Based on the above, it is now unanimously accepted that the final inventories of one year must represent the initial inventories of the following year.

The Court of Cassation, i.e. the Court of Justice characterised by the highest degree of judgement, has explicitly established several times that in their assessments, tax auditors must take into account "Article 110, paragraph 8, Presidential Decree no. 917/1986, which provides that "the adjustment by the office of the valuations made by the taxpayer in one year shall also have effect for subsequent years". In such a case, 'the office shall directly take into account the adjustments made and shall adjust the valuations also in respect of subsequent years. Therefore, this rule enshrines the principle of continuity of financial reporting values, placing an obligation on the assessing office to consider the higher value attributed to inventories in subsequent years (Supreme Court, section no. 5, the judgment of 26.9.2018 no. 22932).

Therefore, if the Revenue Office ascertains the non-existence of part of the initial inventories of inventories, it may well affect them without any violation of the principle of continuity of financial reporting values.

In fact, [.....] in the event of adjusting the value of the final inventories for a financial year, the office must automatically adjust and re-assess the tax return for the year in question.

accordingly, the tax return for the following year, without the taxpayer having to take any action in that regard and regardless of any specific assessment relating to that tax period. (Supreme Court judgment 23/12/2020 no. 29347).

Therefore, the continuity of the financial reports identifies, also from a tax point of view, an inescapable principle which has been followed by many rulings of the bodies intervening in the event of an income assessment challenged by the taxpayer or by the control body (in Italy, tax agency, financial police, etc.). The Brescia section of the Regional Tax Commission of Milan, in its judgment no. 189/67/13 of 13 May 2013, ruled that "With the notice of assessment served on the appellant company, declared to refer to the 2007 tax year, the Office adjusted the taxpayer's review of financial reporting data relating to 2006, consisting of the final inventories as at 31 December 2006. The corresponding downward adjustment of the costs, represented by the initial inventories of the 2007 tax year, is an automatic consequence imposed by the principle of continuity of tax values and the prohibition of tax duplication established [by tax legislation], which obliges the Office (regardless of an express request by the taxpayer) to recognise the effects of its adjustments affecting more than one year.

In the case in question, the Office, to contest the higher income deriving from the reduction of the opening balances in 2007, constituting an automatic transposition of the adjustment of the 2006 final inventories, had necessarily and automatically to consider the effects favourable to the taxpayer deriving from the previous downward adjustment of the final inventories as at 31.12.2006 (constituting a positive income component indicated by the company in 2006), proceeding to determine any higher taxes due through a joint assessment of the effects of its adjustment in the two tax years concerned (2006 and 2007). Otherwise, there is a breach of the principle of continuity of tax values (the 2006 final inventories do not correspond to the 2007 initial inventories) and of the prohibition of double taxation (the same income component is taxed twice, first as a positive income component and in the following year in the form of a cost reduction)'.

The principle of continuity of financial reporting values applies in both senses. The initial inventories of one year must, of necessity, identify the final inventories of the previous year. If the final inventories of one year represent, by definition, the initial inventories of the following year, the same principle applies in reverse.

But on this last statement, one can note some judiciary positions, especially that of the Court of Cassation, which is controversial and in conflict with the above concept.

3) The final inventories of one year identify the initial inventories of the following year, but the opposite is not valid for the Court of Cassation

The Court of Cassation, therefore, upholds the principle of continuity of financial reporting only in the sense in which the final inventories of one year represent the initial inventories of the following year, but denies that the principle of continuity can be referred to in the opposite case, i.e. in the hypothesis in which it should be accepted that the initial inventories of a year must, necessarily, represent the final inventories of the previous year.

In simplified terms, it can be stated that the Court of Cassation affirms that, in the event of a simultaneous audit of several tax periods, if the tax audit office adjusts the inventories of one year, it cannot avoid also adjusting those of the continuing period, since it cannot imagine the principle according to which the audit body would limit itself to satisfying only the income component unfavourable to the taxpayer and not also the favourable one (i.e. that of the following year). All this occurs because, according to the Supreme Court, the legislator has made it clear, in the TUIR, that it accepts the automatic logic of a seamless tax control unfavourable to the taxpayer. It is for this reason that the Supreme Court, in the various judgments issued in recent years, emphasises that the adjustment by the office of the valuations made by the taxpayer in one year also affects for subsequent years; therefore, in such a case, the office must take into account the adjustments made and must proceed to amend accordingly the valuations relating to following years. Thus, the Court of Cassation accepts that Article 110 of the TUIR sanctions the principle of the continuity of financial reporting values, placing an obligation on the assessing office to consider the higher value attributed to inventories in subsequent years.

So far, the position of the Court of Cassation is perfectly acceptable and shareable. It reflects the tax legislation and the economic and business principles underlying financial reporting..

However, in the face of this position now unanimously accepted by all the rulings of the Court of Cassation, it is noted that the same Court applies a principle that cannot be shared when considering the opposite situation. That is when considering the ratio between initial inventories of a year subject to tax control and the remaining final inventories of the previous year.

Already in a judgment of 2012, the Court of Cassation stated, "nor is it of any benefit to the taxpayer to invoke the fact that the initial inventories were assessed on 1.1.04, to infer that at the end of 2003 the value of the inventories could only be of the same amount. Indeed, the principle of continuity of financial reporting values, enshrined in the [tax legislation], implies that the final values of the financial year are to be considered as the initial values of the following year, does not imply that the financial year's initial values are to be considered as the following year contrary is true.

In other words, once the taxpayer has ascertained the inventories at the beginning of 2004, it is not for this reason - given the principle of autonomy of tax periods, enshrined in [tax legislation] - that the inventories of the previous year must also be considered to be of the same value". (Court of Cassation judgment of 12.9.2012 no. 15250).

This unusual statement, which denies the principle of continuity of financial reports from one year onwards concerning the previous year, is affirmed by many Supreme Court rulings.

Thus, when upholding an appeal by the Revenue Agency or the taxpayer against the judgment of a Tax Commission of first or second instance, the Supreme Court recalls that the adjustment by the Office of the valuations made by the taxpayer in one year always affects also for subsequent years. This, as highlighted in the preceding pages, means that the Office carrying out the tax audit of the taxpayer's financial reports must necessarily take into account the adjustments made and must proceed to amend accordingly the valuations relating to subsequent years. Therefore, article 110 of the TUIR enshrines the principle of the continuity of financial reporting values, placing an obligation on the assessing Office to take into account the higher value attributed to inventories in subsequent years. However, from this principle, the Court has developed a contrary rule of conduct that does not appear acceptable as it is contrary to the regulation of continuity of financial reporting. In short, the Court has repeatedly stated that while it is true that, in the event of an adjustment of the value of the final inventories of a tax year, the Office must automatically adjust and re-assess the tax return for the following year, without the taxpayer having to take any action to do so and regardless of any specific assessment activity relating to that tax year, the opposite is not valid.

In other words, if the Office that controls the financial reporting data ascertains a specific value for the initial inventories of a year, this does not mean that - given the principle of autonomy of the tax periods, enshrined in Article 7 of the TUIR - the inventories of the previous year must also be considered of the same value. The Court of Cassation has also pointed out that, if the control of a year and the change of the final inventories of an administrative period implies the obligation to modify also the initial inventories of the following year, in the hypothesis of redefinition of the initial inventories of a tax period, the Inland Revenue maintains, however, the right/power (but not the obligation) to adjust the value of the final inventories of the previous year. Therefore, the Office that controls the taxable income values must control the following administrative period if it modifies the final inventories of the year but is not obliged to control the previous year and modify the final inventories if the control and modification concern the initial inventories of a year.

It is clear that such a principle undermines the concept of continuity of financial reports but, despite the criticism raised by many scholars, the Supreme Court continues to emphasise that the principle of continuity of financial reports is valid if considered for the future but does not have to be applied if it focuses on the past.

"The principle of continuity of the financial reports must be coordinated with the principle of autonomy of each tax period, which must be given continuity, and which does not require the tax authorities if they contest the non-existence of a debit item recorded in the financial reports, also to adjust the previous year's item, since it is the taxpayer's burden to prove the existence and the amount of the same, without any relevance of the possible inertia of the Office about the declaration made for the previous tax periods. Thus, as the appellant points out, while it is correct to state that the final values of one year are to be considered equal to the initial values of the following year, this "does not imply that the opposite is true" (Cass, V, 12 September 2012, no. 15250), as the tax authorities cannot be required - in the event of an assessment relating to the non-existence of liability items for a given financial year - to proceed, given the aforementioned principles, also to adjustments relating to previous years (Court of Cassation, judgment of 14.6.2021 no. 16691).

The Court of Cassation, therefore, continues to reiterate that "in fact, while it is true that, in the event of an adjustment of the value of the final inventories of a financial year, the Office must automatically adjust and re-assess the tax return for the following year, without any activation on the part of the taxpayer and regardless of a specific assessment activity concerning that tax period, the opposite is not true;

in other words, having ascertained by the Office the inventories at the beginning of 2009, it is not for this reason - given the principle of autonomy of tax periods, enshrined in Presidential Decree No. 917 of 1986, Article 7 - that the inventories of the previous year must also be considered to be of the same value;

moreover, as this Court has already had to clarify, in case of the definition of the value of the initial inventories of a tax period, the Inland Revenue maintains, however, the right/power to adjust the value of the final inventories of the previous year" (Court of Cassation judgment no. 17312 of 17.6.2021).

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In other words, if the Office that controls the financial The analysis of the position of the Italian Supreme Court of Justice is puzzling. Continuity of financial reporting is a half-accepted principle: it is valid for the years following the year subject to the tax audit but not, obligatorily, for the previous year.

The final inventories of one year are, according to the Court of Cassation, compulsorily the initial inventories of the following year (which the Office in charge of the tax audit of the taxpayer's declarations must obligatorily audit, accepting the value of the final inventories recalculated and adjusted by the Office itself), but this does not apply in reverse. The initial inventories of a year are not obliged to be considered the final inventories of the previous year. There is only the possibility, voluntarily, for the audit office to apply the principle of continuity also for the past and to audit the preceding year by changing the value of the final inventories to match this amount with the value of the initial inventories as adjusted by the Office. But there is no obligation to do so.

It is therefore understandable that, given the current situation, from a tax point of view, the continuity of the financial reports is only half-applied: this principle applies for the following year. Still, it does not necessarily apply for the previous year.

This leaves both the scholar and the taxpayer perplexed. The application of the continuity principle in the middle is not acceptable. Everything appears to be a mystery. Who knows, maybe the future will bring new tax rulings by the Supreme Court that will lead to the acceptance of the principle of continuity as a whole. It seems unacceptable to apply this principle only in one direction, i.e. towards the future and not in the opposite direction, i.e. towards the past.

Only time will tell whether we will overcome this bizarre situation to achieve the complete application of continuity of financial reporting towards the future and the past; a principle that should be stressed represents one of the main elements on which financial reporting itself is based.

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