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Tax Problems in the Hypothesis of Inventories not Found in The Company

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ABSTRACT: Inventories are one of the most important financial reporting items in the determination of income subject to income tax. In this article we analyse the various cases in which the inventories present in the company do not correspond to the inventories recorded in the books. In particular we focus on the hypothesis of inventories not found in the company. In the following pages, the potential causes of this hypothesis and the consequences of such a situation will be explained.

KEYWORDS: inventories, financial reporting, tax

1) GENERAL CONSIDERATIONS ON THE INTERRELATION BETWEEN INVENTORIES AND INCOME TAX CALCULATIONS.

Inventories are one of the main items in the income statement that the tax authorities consider when determining taxable income. As is well known, the tax authorities are not interested in the form of the profit and loss account but in the values entered in it. Therefore, in the various countries, the rules may vary, but the basic principles are undoubtedly similar throughout the world. In Italy, tax legislation refers to the profit and loss account reclassified according to the Civil Code or according to IAS/IFRS if the company is obliged to use the latter for its financial reporting (e.g. listed companies). However, the form and structure of the profit and loss account are of no importance to the tax authorities, since for the tax authorities, it is not essential how the values are indicated and how the financial reporting data are broken down, but rather the amount of each value entered in the profit and loss account.

We can explore the issue of inventories in the context of calculating taxable income in various ways. For example, one very relevant issue is the valuation attributed to inventories. It is possible that the valuation of inventories in financial reporting is not identical to the valuation imposed by the tax legislator. On the other hand, in some countries, the tax law follows the principles used to value inventories in the income statement and balance sheet. This issue requires an analysis of the costs included in the valuation of stocks from a balance sheet and tax perspective. This is not the subject we wish to explore in this article.

Another issue that falls under the topic of the inventory-taxable income relationship concerns the amount of inventories that are subject to valuation. From a theoretical point of view, it seems evident that the inventories subject to valuation should be those present in the company at the time of closing the accounts, i.e. the preparation of financial reporting.

The problem arises, in the year, if a tax assessment by the tax authorities occurs.

When the authorities responsible for carrying out tax assessments in companies enter the company to check whether or not tax evasion has occurred, one of the first items to be checked is the amount of inventories to check whether what is shown in the accounts represents exactly what physically exists in the company.

In many countries, including Italy, there is an obligation to keep special accounts of inventories and draw up a particular book. All entries and exits of goods from the company are indicated.

Suppose the check carried out by the tax authorities reveals differences between the quantity of inventories shown in the accounts and the quantity of stocks present in the company. In that case, the first thing they do is check for possible tax evasion. Suppose the inventory book shows, for example, 500 pieces of the finished product, and the company has only 300 elements of the finished product. In that case, the first thing that the tax authority will check is whether the 200 missing pieces have been sold without invoicing and, therefore, carrying out tax evasion.

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The object of our analysis is, therefore, the unrecovered stock. To carry out this study, it is evident that reference must be made to the legal regulations in force in each country. Each country may have different rules of conduct. Our analysis will also consider the Italian tax and civil legislation because the general principles imposed by such legislation are of general application. Therefore, it can assume that such regulations, perhaps expressed in another way, are present in the various legislations of countries other than Italy.

2) UNDISCOVERED INVENTORIES: ISSUES TO BE ADDRESSED.

The first case of differentiation between inventories that are physically present in the company and the amount of stock shown in the bookkeeping used to record stock entries. It can attribute exit to the physiological drops in the products present in the company. If, for example, we take a company that produces food products containing flour, the inventories will certainly include flour. This raw material has the characteristic of having a physiological decline due to the evaporation of the moisture present in the product. The fact that there is slightly less flour in the company than is indicated in the accounts used to monitor the inventories is a widespread occurrence in reality. There are many other categories of assets that decline physiologically over time. Therefore, if the control is carried out at the level of the quantity present in the company of inventories subject to a physiological drop in weight, the verification of a lack of a minimum amount of product is carried out bearing in mind the commodity characteristics the asset being controlled. In the presence of several missing inventories in the

In the presence of some inventories missing in the company and logically attributable to the physiological drop of the good, even the authority in charge of the fiscal control of the stocks will not raise any doubt about possible evasion implemented by the company. In this case, the physiological decline explains the amount of inventories not found in the store, and therefore, the problem is closed because it excludes a hypothetical tax evasion.

The second case in which the tax inspection authority may notice a discrepancy between the inventories present in the company and the inventories shown in the accounts can instead be attributed to genuine tax evasion. Let's assume that the control occurs and that the quantity of some goods present in the inventory shows a considerable difference with the amount of goods present, theoretically, in the inventory book. In this case, unless we fall into the hypothesis that we will analyse later, it is evident that the tax control authority raises the doubt of an evasion carried out by the company. The lack of physical inventories in the company, compared to what should exist based on what is indicated in the accounts, is, in fact, an almost unmistakable sign of a sale made without tax invoicing and therefore of a sale of products carried out fraudulently to evade tax on taxable income. When this specific case occurs, the tax inspection authority will identify factual evidence of tax evasion caused by unaccounted sales.

The third case in which it is possible to notice discrepancies between the number of inventories present in the company and the number of inventories shown in the accounting and financial reporting is the case in which the entry of inventories in the financial reporting is implemented incorrectly to make the balance sheet appear better than it is. As is well known, closing inventories are recognised as revenue in the income statement and the balance sheet assets. Reporting the value of closing inventories has a positive impact on the income and assets of the company. A high amount of closing inventories increases the operating income and, at the same time, increases the total assets of the company. Even if the most common cause is the recognition of low closing inventories to decrease taxable income, it is possible that in particular cases, the opposite requirement may arise. Consider the case where a company is going through a challenging period of crisis. In this case, the company is likely to be loss-making, and its assets will tend to decrease. If the company needs a bank loan, it is clear that such a situation would prevent it from obtaining financing. Therefore, if the company needs to show a better-than-actual concern in its accounts, it may record a high inventory in the absence of inventory. In this case, as opposed to the hypotheses previously considered, the accounting inventories are not real because they are not present in the warehouse, not because of physiological drops or tax evasion, but because the company wants, in a fraudulent way, to show in the financial reporting a non-existent income and a higher asset than the real one. If such a situation occurs, excluding any hypothesis of tax evasion, we are in the condition of invalid financial reporting.

In such a situation, the objective of the financial reporting writer is not to evade taxes but to provide untrue information to third parties outside the company. Financial reporting is the communication tool par excellence. The company has no other means of disclosing economic and financial information outside the company, or rather, financial reporting is the only means it uses to achieve this objective. Each company can voluntarily disclose any economic, financial, environmental and sustainability information when it sees fit. However, companies are unlikely to voluntarily disclose financial and economic information other than that required by law. Each country has different regulations on the rules to be followed when preparing financial reports. However, there is no doubt that each country has legislation that regulates the rules on financial reporting to a greater or lesser extent. In every country in the world, therefore, financial reporting is the external information tool par excellence.Qualora la situazione aziendale non fosse eccellente e gli amministratori si ponessero come obiettivo quello di dimostrare all'esterno una

situazione positiva che in realtà non esiste è possibile che, uno dei metodi utilizzati sia proprio quello di iscrivere inventories più elevate di quelle realmente esistenti in azienda punto in tal modo l'utile viene gonfiato e il patrimonio viene sovrastimato. Anche questa è un'ipotesi in cui si potrebbe riscontrare una differenza fra le inventories iscritte in contabilità e le inventories presenti in azienda.

The theft is a fourth hypothesis in which there may be, momentarily, a difference between the accounting inventories and the accurate inventories. In this hypothesis, it is clear that to avoid the danger of control by the tax authorities which would attribute the absence of a part of the inventory to tax evasion; it is necessary to make an immediate report to the competent authorities to have proof that a certain quantity of goods in the warehouse has been stolen. In the face of a complaint to the competent judicial authorities, the tax authorities in charge of fiscal controls can easily attribute the absence of a part of the stock to the theft previously reported by the company. Obviously, in this case, the stock records will also be corrected. It will eliminate the amount of the stolen stock to match the accounting inventories with the entire inventories existing in the company.

A fifth hypothesis in which it is possible to find, momentarily, the lack of a part of inventory compared to what is indicated in the accounts concerns the case which is the object of our analysis, that is the destruction by the company of a part of the inventories which can no longer be sold because they are obsolete or ruined.

It is easy to understand how it is to declare having destroyed part of the inventories when, in reality, the goods have been sold without invoicing, and tax evasion has taken place. Since this could occur widely due to the ease of implementation, the rule regulates how one should behave on this occasion in a very detailed way. We have already pointed out that different regulations characterise each country. In this article, reference will be made to the Italian legislation mainly because it contains unanimously shared general principles, which, presumably, are also taken up in the legislation of other countries. Below, we will illustrate the actions that must take in the event of voluntary destruction of products (obsolete or no longer saleable) to avoid any hypothesis of tax evasion by the tax authorities responsible for tax assessments.

First, it is necessary to understand what the law says when it speaks of the presumption of transfer of goods, an operation that falls within the scope of acts subject to taxation. In this case, too, the legislation varies from country to country. The reference to Italian legislation is particularly effective since the legislation refers to general rules and law.

Article 1 of Presidential Decree No 441 of 10 November 1997, which lays down rules for the reorganisation of the regulations on presumptions of supply and purchase, provides that:

1)Goods purchased, imported or produced which are not located in the places where the taxpayer carries out its operations, nor in those of its representatives, shall be presumed to have been supplied. Such areas include secondary establishments, subsidiaries, branches, establishments, shops, warehouses and means of transport at the enterprise's disposal.

2)The presumption referred to in paragraph 1 shall not apply if it is proved that the goods:

(a) have been used for production, lost or destroyed

a) have been used for production, lost or destroyed; b) have been delivered to third parties for processing, storage, gratuitous loan or under contracts of estimation, work, contract, transport, mandate, commission or another non-transferable title.

3)The availability of secondary offices, subsidiaries or branches, as well as of departments, establishments, shops, warehouses, other premises and means of transport, which is not apparent from the registration in the register of companies, the chamber of commerce or any other public record, may result from the declaration referred to in Article 35 of Presidential Decree no. 633 of 26 October 1972 (VAT Decree (i.e. the Decree regulating the value-added tax), that is to say, from the statement of the existence of the registered office, branch or subsidiary. 633 (Decree of the President of the Republic no. 633 of 26 October 1972, if made before the transfer of the goods, as well as from another document showing the destination of the goods at the places indicated above, recorded in one of the registers in use, kept following Article 39 of the Decree of the President of the Republic no. 633 of 1972.

4)The representation relationship is evidenced by a public deed, by a registered private deed, by a letter registered in a special register at the VAT office competent for the tax domicile of the representative or the represented person, or by a communication made to the VAT office following the procedures provided for by Article 35 of Presidential Decree No 633 of 1972, provided that it is dated before the transfer of the goods. The recording of the commercial letters in special registers at the VAT office is allowed only for the conferment of tasks involving the transfer of goods.

5)The handing over of goods to third parties by way of non-transfer of ownership shall be evidenced alternatively:

a) by the journal or other book kept by the Civil Code or by a special register kept following Article 39 of Presidential Decree No 633 of 1972 or by a deed registered with the registry office, showing the nature, quality and quantity of the goods and the reason for the transfer;

b) by the transport document provided for by Article 1, paragraph 3, of Presidential Decree no. 472 of 14 August 1996, supplemented with the relevant reason for the transfer, or by another valid transfer document;
c) by a specific annotation made, at the time of the transfer of the goods, in one of the registers provided for by Articles 23, 24 and 25 of Presidential Decree No 633 of 1972, containing, in addition to the nature, quality and quantity of the goods, the data necessary to identify the recipient of the goods and the reason for the transfer.

The paragraph concerning the object of our analysis is the second one. This paragraph states that the presumption of assignment is rebutted when the goods have been lost or destroyed. In Article 2 of Presidential Decree No. 441 of 10.11.1997, the legislature has laid down that :
The presumption referred to in Article 1 does not apply to the cases indicated in the following paragraphs if the obligations laid down therein are observed.

The loss of property due to fortuitous or accidental events or in any case circumstances beyond the control of the person concerned shall be proved by appropriate documentation provided by a public authority or, failing this, by a declaration instead of affidavit ..... made within thirty days from the occurrence of the event or from the date on which the person became aware of it, showing the total value of the property lost, without prejudice to the obligation to provide, at the request of the tax authorities, the criteria and elements based on which determined such value.
The company shall prove the destruction of the goods or their transformation into goods of another type and of lower economic value.
a) by written communication to be sent to the offices referred to in paragraph 2, letter a), within the terms and in the manner provided therein, indicating the place, date and time when the operations will be carried out, the manner of destruction or transformation, the nature, quality and quantity, as well as the total amount, based on the purchase price, of the goods to be destroyed or transformed and any residual value that will be obtained following the destruction or transformation of the goods themselves. This communication shall not be sent if the destruction is ordered by a public authority;
b) the report drawn up by public officials, officers of the Guardia di Finanza or notaries who were present at the destruction or transformation of the goods, or, if the amount of the cost of the goods destroyed or transformed does not exceed 10,000 euros, a declaration in lieu of a notarial act ..... The minutes and the declaration shall show the date, time and place of the operations, as well as the nature, quality, quantity and amount of the cost of the goods destroyed or transformed;
c) a document .....progressively numbered, relating to the transport of any goods resulting from the destruction or transformation.

As can be seen, the legislator sets out in detail the documents that must be completed and sent to the competent authorities in the event of the destruction of goods within the undertaking due to the obsolescence or unsaleability of the goods. It is essential that the rules set out above be followed exactly because if the steps set out in Articles 1 and 2 above are not followed, and the documents required by law are not provided, the lack of inventories is considered a verified supply for tax evasion. Since the issue is particularly delicate and essential for companies, we feel we have to report the thought of the Court of Cassation, the Court of Justice that represents the last level of judgement in Italy on the issue that is the subject of our analysis.

The Italian Supreme Court of Cassation, in its judgment no. 26223 of 28.9.2021 states that "in the matter of income tax assessment, in the event of "inventory differences", i.e. recordable differences between the quantities of goods in stock and those inferable from the loading and unloading records, the presumptions of sale and purchase of goods in evasion of tax, according to art. Forty-four of Presidential Decree no. 441 of 1997 operate. 441 of 1997, which can be counted among the so-called "mixed" legal presumptions, which allow, within the limits of object and means of proof established for anti-avoidance purposes, the contrary demonstration by the taxpayer, who will be required to prove, in the manner peremptorily indicated by Articles. 1 and 2 of Presidential Decree No. 441 of 1997, that the contraction recorded in the consistency of the stock is the result of the productive use of goods and not of sales or acquisitions not accounted for" (Court of Cassation, judgment 30.10.2018, No 27549).
The interest in the Court of Cassation's ruling of 2021 lies in the fact that this court addressed the hypothesis that destruction does not occur within the company but is delegated to a third company that assumes the disposal. Italian law provides that, in such cases, must fill in a unique form. Still, this rule is often underestimated and not taken into account when, in fact, it is essential to prevent a tax assessment claiming the existence of tax evasion.
The Court of Cassation, in its judgment no. 26223 of 28.9.2021 specifically addresses this issue. In particular, it states that indeed, proof of direct destruction of assets implies compliance with the administrative procedure governed by Presidential Decree no. 441 of 1997, Article 2, paragraph 4, whose completion is functional to allow an effective tax control;

in particular, in the hypothesis in which one chooses the voluntary destruction of the goods, also for reasons related to their obsolescence, the disposal postulates several steps, ranging from the need for prior notification to the office of the Revenue Agency (indicating the place, date and time of the operations, of the modalities of destruction, of the nature, quality and quantity of the goods themselves, of the total amount, based on the purchase price, of the goods to be destroyed or transformed, of the eventual residual value that will obtain following the destruction or transformation of the goods themselves) to the punctual recording of the destructive operations;

In conclusion, the failure to demonstrate the completion of the procedure provided for by law in case of destruction of inventories of stock authorises the tax authorities to tax the higher value of inventories determined under the process so-called "analytical-inductive", ... However, if the company does not directly destroy the goods but delivers them to the appropriate authorised entities according to the applicable laws on waste disposal, the proof of destruction of the goods does not have to be provided employing the procedure described above, but is given by the annotation on the identification form provided for by Article 15 of Legislative Decree no. 22/97 (the so-called "Ronchi" law on waste disposal and environmental protection);

This is also supported by Circular no. 193 of 23.7.1998, in which the Ministry of Finance, Department of Revenue, Service VI, clarified that "taxpayers who need to send their goods for destruction may proceed with the operation by handing over the goods to persons authorised, according to the laws in force on waste disposal, to carry out such operations on behalf of third parties, demonstrating, in this case, the destruction of the goods through the identification form referred to in Article 15 of Legislative Decree no. 22/97. Fifteen of the legislative decree of 5 February 1997, no. 22", with prescriptions that, integrated by the Ministerial Decree of 1 April 1998, no. 145, are peremptory (Court of Cassation sentences . no. 21260/2009; 34038/2019; 6707/2011).

The form referred to by the Court of Cassation is regulated by Legislative Decree no. 22 of 5.2.1997, Implementation of Directive 91/156/EEC (European Economic Comunity) on waste, Directive 91/689/EEC on hazardous waste and Directive 94/62/EC (European Comunity) on packaging and packaging waste. Article 15 of this Decree states that:

1. During the transport carried out by entities or companies, the waste shall be accompanied by an identification form from which shall indicate the following data :

(a) name and address of the producer and holder;

(b) the origin, type and quantity of the waste

(c) destination facility;

(d) date and route of transfer

(e) name and address of the consignee.

2. it must complete the identification form referred to in paragraph 1 m in four copies, filled in, dated and signed by the holder of the waste and countersigned by the carrier. One copy of the form must remain with the holder, and the other three copies, countersigned and dated on arrival by the consignee, are acquired by the consignee and two by the carrier, who sends one to the holder. It shall keep copies of the form for five years.

3. During collection and transport, hazardous waste shall be packaged and labelled following the applicable regulations.

4. The provisions outlined in paragraph 1 do not apply to the transportation of urban waste carried out by the entity that manages the public service nor to the transport of junk that does not exceed the quantity of thirty kilograms per day or thirty litres per day carried out by the producer of the waste itself.

5. The standard form of identification referred to in paragraph 1 is adopted within sixty days from when this decree comes into force.

5 bis. The identification forms referred to in paragraph 1 must be numbered and stamped by the registered office or by the chambers of commerce, industry, handicrafts and agriculture, and must be recorded in the VAT (Value Added Tax)-purchase register. The endorsement of these identification forms shall be free of charge and shall not be subject to any fee or tax.

Therefore, in the case of starting the destruction of one's goods by handing them over to parties authorised to carry out such operations on behalf of third parties (according to current waste disposal laws), destruction is demonstrated employing the waste identification form according to art. 15 of Legislative Decree no. 5.2. 1997 no. 22, the specifications of which are set out above, which must contain specific indications on the following data: a) name and address of the producer holder; b) origin, type and quantity of the waste; c) destination plant; d) date and route of transport; e) name and address of the consignee.

The Court of Cassation has therefore definitively established the following principle of law: "in terms of direct taxation, concerning the presumption of transfer under Articles 1 and 2 of Presidential Decree no. 441/97, taxpayers who are not subject to the presumption of transfer are obliged to pay the amount of tax due to the purchaser. 441/97, taxpayers, who need to send their goods for destruction, may proceed with the operation by delivering the goods to persons authorised to perform such operations on behalf of third parties, pursuant to current laws on waste disposal; in this case, the start of destruction is demonstrated by the

waste identification form pursuant to art. 15 of Legislative Decree no. 22 of 5.2.1997, containing the specific information required by the provisions which, supplemented by DM 1 April 1998, no. 145, are mandatory".

Therefore, the destruction of the goods by delivery to specialised waste disposal companies is sufficient evidence to eliminate any hypothesis of tax evasion even if, momentarily, the inventories existing in the company differ from the inventories recorded in the inventory book.

This principle is fundamental to avoid that operation being carried out in a perfectly correct manner to eliminate obsolete or no longer saleable inventories become the object of a tax assessment by the authorities responsible for carrying out tax audits in companies. The Supreme Court's 2021 judgement mentioned above, therefore, makes it possible to affirm that the correct filling in of the form provided for by article 15 of legislative decree no. 22 of 05/02/1997 is sufficient proof that the inventories not found in the warehouse were not sold without invoicing for tax evasion but, rather, were physically eliminated as they were no longer saleable not within the same company but by a company appointed to carry out the task of waste disposal.

CONCLUSIONS

As illustrated in the previous pages, the lack of inventories in the company compared to what is shown in the books can have various causes. Some of these have no fiscal significance, while others lead to a tax assessment with allegations of tax evasion. The tax auditor of a company must determine, in a particularly analytical manner, the causes of inventories not found in the company. This is the only way to avoid tax errors or errors in connection with the judicial review of financial reporting. A superficial analysis of the situation could lead to misinterpretation of the lack of inventories about the accounting records, resulting in penalties being imposed unfairly on the taxpayer or the financial reporting officer.

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