

## Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses



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**ABSTRACT:** The payment of taxes determined on the actual income generated by companies is one of the topics debated for a long time in all countries. Each country has its tax and civil law, so it is impossible to make apodictic statements on the subject as everything depends on the regulations mentioned above. However, the Italian example is exciting because, in the writer's opinion, the evolution of the two sets of rules has covered every possible solution to the relationship between civil and tax legislation. In the following pages, however, we will point out that not everything depends on this relationship. The personal will of the person drawing up the balance sheet has a considerable influence on the issues dealt with in this article. In the following pages, we will see how the personal will of the preparer of the balance sheet acts and how the inter-relationship between tax law and financial reporting law affects the possibility of paying taxes on the income actually produced by the company.

**KEYWORDS:** Taxes, tax evasion, taxes and financial reporting, incorrect balance sheet or profit and loss items incorrectly included in financial reporting, calculation of taxes on income not produced by companies or on a value lower than the latter.

### 1) TAXES ON CORPORATE PROFIT AN INTRODUCTION<sup>1</sup>.

Determining taxes calculated on the profit actually produced by companies is one of the most discussed issues at the theoretical, academic, scientific, and pragmatic levels.

In Italy, as in many other countries, there has always been a need to create tax procedures that would allow the determination of taxes on the company's profit, in real terms, in a given period. Although this is a goal that all scholars and managers would like to achieve, it has never been achieved. There are many reasons why taxes are levied on a notion of wealth that differs from the wealth actually produced by firms. Some of them can be traced back to the law and the interconnection between that law and the legislation governing the year's balance sheet. But these are not the only reasons why taxes are not levied on the wealth actually produced by companies. The reasons are many and, in very summary terms, we can say that these causes can be summarised as follows:

- Tax evasion is caused by failure to issue invoices or the use of false or inflated purchase invoices compared to reality
- Inclusion in financial reporting of incorrect values that lead to the determination of taxes not calculated on the profit actually produced by the company due to:
  - A) tax-saving motivations (potential tax evasion or, better to say, tax deferral)
  - B) other motivations (motivations related to administrative costs, motivations related to lack of knowledge of the law, motivations related to the inability to communicate correctly with the outside world of the company)

In this article, we will focus our attention on the reasons directly or indirectly related to the coexistence of tax rules and rules governing the preparation of the balance sheet of the year, which represents, in each country, the starting point for the calculation

<sup>1</sup> <sup>1</sup> To facilitate reading, I have decided not to include in the text, except in exceptional cases, the names of the scholars who have dealt with the subject under analysis since the bibliography is endless, I have opted not to indicate all the terms of the scholars in the text because this would have meant a continuous interruption of the reading of the complete sentence in which I express my thought.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

of taxes. Despite this, it is not possible to altogether avoid making some general considerations on the first cause of non-payment of taxes connected to the profit economically produced by companies, namely pure tax evasion carried out by failing to issue sales invoices and using false, non-existent or modified purchase invoices concerning what has actually been purchased from third parties.

We will only mention this last issue because the article aims to verify the possibility of paying fair taxes on the profit produced by companies according to the tax and civil law in force. However, it was impossible not to devote at least some fundamental considerations to this issue, which will summarise in the next paragraph.

### **2) Non-payment of taxes on the company's actual profit due to tax evasion carried out by not issuing sales invoices or using purchase invoices that do not exist are false or have been altered concerning reality.**

Indeed, 'pure' tax evasion, i.e. not issuing sales invoices or using false or inflated purchase invoices, is one of the main reasons why taxes are not calculated on the actual profit produced by companies. It is clear that if a company does not account for revenues or accounts for non-existent costs, it does not pay taxes in proportion to the actual wealth produced by the company. As we have pointed out in the previous pages, this problem is not part of the analysis of this article. Still, since it is one of the reasons why the taxes paid are not commensurate with the actual wealth produced by the company, we could not refrain from addressing this issue, albeit in a highly concise manner.

In Italy, tax evasion carried out according to the procedures indicated above is exceptionally high, but in recent years, there has been a slight reduction in such evasion.

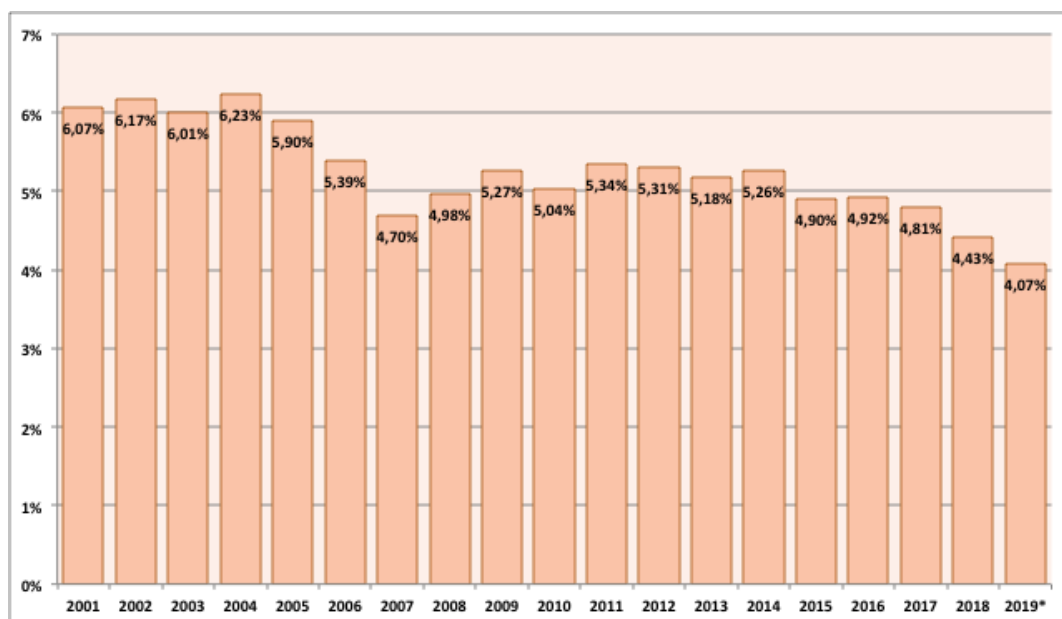
In the Economic and Financial Document, Report on the Unobserved Economy and Tax and Social Security Evasion of 2021, approved by the Council of Ministers on 29 September 2021 and annexed to the Economic and Financial Document, it is pointed out that "As anticipated, in the period between 2014 and 2018, the tax gap was reduced in absolute terms by approximately €6.7 billion. This reduction was mainly due to a strong reduction in the VAT (value-added tax) gap (almost €4 billion), IRES (corporate income tax) (about €2.7 billion) and IRAP (profit tax on productive activities, which affects a modified form of value-added) (about €2.6 billion). On the other hand, an increase in the IRPEF (tax on the profit of physical persons) gap is reported for both the self-employed and business component (by about 1.6 billion) and the irregular work component (by about 500 million)."

From the above data, it can be understood how from 2014 to 2018 (the last year of data available to the Ministry of Finance), there was a decline in tax evasion due to failure to issue sales invoices or the use of false or inflated purchase invoices compared to reality, of three taxes: value-added tax, corporate profit tax and profit tax on productive activities (which, as already mentioned, affects the added value produced by companies, even if, concerning this concept, the values relevant for tax purposes have been modified in order not to act, for example, the cost of labour). Against this reduction in tax evasion, however, there is an increase in the evasion of the profit of individuals connected to self-employment and irregular work.

Concerning the evasion of personal income tax, the Economic and Financial Document 2021 states that 'The estimate of the personal income tax evaded by irregular employees is complementary to the forecast made by the Italian Revenue Agency to calculate the IRPEF (personal income tax in Italy) tax gap attributable to other categories of individuals. Irregular employees represent a significant share of the irregular labour market, which, in a broad sense, can be defined as a set of work activities voluntarily evaded observation by the authorities to avoid payment of taxes, social security contributions, etc.

Taxation in the broad sense, compulsory social contributions, and not to comply with administrative regulations and labour market standards. From this point of view, the input of irregular employment can cover a heterogeneous set of work types: irregular positions, formally regular workers with other non-regular occupations, hours worked in the black economy or with wages, and further compensation received 'off the payroll', illegal immigrants".

## Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses



**Figure no. 1 Tax Gap as a percentage of Gross Domestic Product . Years 2001-2019**

**Source:** Report attached to the Economic and Financial Document approved by the Council of Ministers on 29 September 2021.

The report mentioned above sets out the guidelines for the three years 2021-2023 that the Government intends to implement to reduce tax evasion. This report states that: "Intending to reduce the tax gap, in the three years 2021-2023, the Government intends to continue the re-visioning of the functional structure of the tax administration initiated in recent years, to ensure an increasingly customer-oriented approach in providing services to taxpayers, encourage tax compliance and to rationalise the use of resources. All of this is in line with the objectives of the National Recovery and Resilience Plan (PNRR), which, to these ends, indicates as a priority the strengthening of compliance and the reinforcement of controls.

This strategic direction, aimed at reducing the tax gap, is functional to lowering the tax burden and to the reform project that the Government intends to implement to promote an increasingly fair tax system conducive to the economic recovery of the country, a need strongly felt also as a result of the negative effects of the Covid-19 pandemic.

In this context, improving the performance of the tax administration is also an essential element. In this perspective, it will implement the strategic indications contained in the Policy Act for the achievement of tax policy objectives for the years 2021-2023, the improvement of the services offered to favour the fulfilment of tax obligations and the spontaneous emergence of taxable bases and, on the other hand, to combat tax evasion through targeted ex-post control and assessment measures, as a result of specific risk analyses.

The programmatic indications contained in the aforementioned Act have been translated into the 2021-2023 Agreements, currently being signed between the Ministry of Economy and Finance and the Agencies. The process of updating these documents, on the one hand, reaffirms the autonomy and flexibility already granted to the Agencies in the exercise of their activities, in line with the consolidated Principal-Agent model<sup>44</sup>; and, on the other hand, confirms the priority objective of simplifying relations between taxpayers and tax authorities, ensuring greater certainty to economic operators and attracting new investment in the country, with a view to a structural reduction of the tax gap, without neglecting the need to ensure legality in the areas of competence of the tax authorities and the fight against crime.

For the drafting of the 2021 activity plans, the adoption of the methodology based on the model contemplating the dimensions of efficiency (input-output) and effectiveness (output-outcome) has been confirmed to measure the effects of short-term interventions in terms of the product immediately resulting from the activities carried out by the Agencies (output). The objective is to measure the impact of short-term interventions in terms of the product immediately resulting from the activities carried out by the Agencies (output), as well as to verify the effects on the socio-economic context (outcome), to assess, in a medium-long term perspective, the actual implementation of the political priorities in the tax field and, in particular, the reduction of the tax gap.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

In continuity with the previous year, the following activities will be carried out, among others:

- consolidation of the experience and solutions gained in managing the emergency in adopting innovations in a long-term perspective to continue and strengthen the process of simplifying and making the administrative activity more efficient. Ensuring effective management of the issues related to the continuing crisis and providing rapid responses to the needs of taxpayers could also have significant reputational effects for the entire tax administration, helping to consolidate the relationship of trust between taxpayers and the tax authorities;

- Strengthening coordination and complementarity between the components of the tax administration and operational synergies with other national, European and international public authorities by reinforcing the exchange of information and global cooperation tools, such as participation in the maintenance and updating of the EU list non-cooperative jurisdictions. The main objective of these activities will be a more effective fight against tax fraud, with increased efforts to combat national and international tax evasion. In addition, operational synergies between the central financial administration and the territorial authorities to stimulate processes of sharing in the recovery of state taxes and, at the same time, to make the processes of analysis, control and recovery of local and regional taxes more efficient;

- adopting measures to enable citizens, businesses, self-employed and employees to cope with the economic and social hardships related to the spread of the Covid-19 pandemic and the consequent risk containment measures, as well as targeted controls to prevent the undue use of the favourable treatments provided and fraudulent behaviour related to them;

- ensuring greater certainty and predictability for businesses and investors, as part of a more general orientation towards the growth of the economic system, by providing a coherent and unified approach by the tax authorities to those entities that decide to adhere to cooperation instruments with the tax authorities, such as the collaborative compliance institute, the appeal for new investments, prior agreements for companies with international activities and understandings relating to the optional concessional taxation of income from the use of intangible assets (patent box);

- improvement of relations between the tax authorities and taxpayers, including professional associations, through the strengthening and simplification of access to telematic services, the introduction of a new system of 'remote' relations with users, and through tools for making data available aimed at facilitating and rationalising compliance, as well as reducing the time taken to issue tax refunds, to inject liquidity back into the economic system, also to help counter the effects generated by the Covid 19 epidemic.

- In this perspective, the pre-filled tax return aims to become the ordinary form of tax return, not only for employees and pensioners, for whom it is already a consolidated reality but also for VAT holders;

- optimisation of the sending of notices to promote compliance, and activity resumed during 2021, after having been suspended mainly in 2020 to facilitate the gradual recovery of economic and social activities. In this regard, also in line with the objectives of the NRP, the number of compliance letters sent will be increased and, in particular, those aimed at encouraging the emergence of tax bases for direct taxation and VAT purposes. To this end, the number of staff dedicated to these activities will be increased, focusing in particular on the enhancement of technological infrastructures, the interoperability of databases, and the improvement of selection algorithms to reduce cases of 'false positives';

- definition of organisational forms capable of making available to taxpayers all the information contained in the Public Administration's databases that is useful for the fulfilment of tax obligations;

- monitoring and development of electronic invoicing through the Interchange System, together with the management, once fully operational, of the requirement to transmit receipts electronically, also to manage the 'receipt lottery';

- consolidation of the activities of analysis and study of tax non-compliance aimed at identifying the most significant risks of non-compliant behaviour in order to direct prevention and counteraction activities in an even more targeted manner;

- updating of the synthetic indexes of tax reliability (ISA), aimed at fostering greater declarative compliance by small and medium-sized enterprises and the self-employed;

- encouragement of electronic payments with a view to digitalising tax processes, rationalise VAT operators' obligations, also to obtain simplified tax breaks or incentives, such as the suspension, as of 2022, of quarterly reporting - the so-called 'esterometer'

- for entities involved in cross-border transactions;

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

- improving the quality of controls carried out by the tax authorities, optimising the use of data resulting from the automatic exchange of information, also in the context of international cooperation, by increasing the use of existing cooperation tools, such as country-by-country reporting. In this perspective, more targeted selections of taxpayers at higher risk of evasion will be made, made possible by the application of more advanced data analysis tools, such as the massive exploitation of big data, and by the interoperability of databases, facilitated by the pseudonymisation of information;

- monitoring the behaviour of taxpayers who have undergone a tax audit to verify their propensity to comply in subsequent years and, more generally, to assess their level of tax loyalty;

- strengthening the effectiveness of tax collection, to be also pursued by implementing the techniques for analysing the debts on the tax rolls, to prioritise the collection activity towards the most solvent debtors and the credits that have the greatest chance of being collected, through the improvement of the exchange of information between the tax collection agent and the tax collection bodies or beneficiaries, as well as the progressive alignment of the various databases, without prejudice to the need to safeguard all the credits entrusted for collection.

- The Policy Act for the three years 2021-2023 provides, moreover, that the Guardia di Finanza shall direct its activities to the prevention and counteraction of the most severe, dangerous and widespread illegal phenomena on the national territory, also through targeted intelligence and analysis activities, in line with:

- the programmatic fiscal policy scenario that will outline in the Programme for Recovery and Resilience (PNRR) envisaged by the European Council decision of July 2020;

- the investigative projection of an economic-financial police force with general competence performs competition functions in matters of public order and safety. It is an integral part of the national Civil Protection system.

In particular, the Corp:

\* will direct, as a priority, its action, also with ultra-national projection, towards the phenomena most damaging to the budget of the European Union, of the State, of the Regions and the local Administrations, such as tax fraud, the most pernicious forms of international tax evasion, tax avoidance, the submerged economy, the black and irregular work and the connected phenomena of illegality, systematically exploiting the data acquired through judicial police and economic-financial police investigations; intelligence activities; risk analysis through the databases in use (the interoperability of which will be intensified); the use of artificial intelligence systems (also from a predictive perspective); economic control of the territory and international cooperation channels;

\* will carry out joint risk analyses with the Revenue Agency, also based on the information received in the context of the automatic exchange in tax matters, both for mapping evasive phenomena and for the preparation of integrated action plans, ensuring its contribution to the spontaneous fulfilment of tax obligations through an appropriate exchange of information with the same Agency, functional, among other things, to avoid overlapping and duplication of intervention;

\* the action to combat smuggling, including foreign processed tobacco, and fraud in the customs and excise sectors, as well as gaming and betting offences, will continue, both by strengthening the synergies in place with the Customs and Monopolies Agency and by expanding and enhancing the wealth of information available with all the data in the customs and police area, in the function of the elaboration of risk analyses aimed at consolidating the levels of security and competitiveness of the Italian customs system, guaranteeing, at the same time, adequate protection against illegal trafficking;

\* it will guide operational plans to combat economic and financial crime by monitoring its evolutionary dynamics and using intervention methodologies based on the integration of tax, currency and judicial police functions. In particular, it will carry out prevention and repression actions against offences related to public, EU and national expenditure, as well as against corruption and illegality in the public administration, to counter the undue use and misallocation of public resources intended to cope with the consequences of the epidemiological emergency;

-\* It will also continue to participate in the initiatives promoted within the EU Policy Cycle - EMPACT, such as, for example, actions to combat VAT and excise fraud and money laundering. It will also continue to take part in the work of the CCWP (Customs Cooperation Working Party), about joint customs operations and other activities promoted by this forum and by other international organisations and to make use of the elements acquired through international cooperation and exchange of information, both within the Eurofisc network and the other initiatives of the European Union in the field of taxation;

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

\* it will continue to support the Department of Finance in the working tables of the Task Force on Tax and Other Crimes (TFTC) and the Peer Review Group of the OECD Global Forum, providing its contribution to any initiative related to the changed scenarios caused by the epidemic crisis

\* guarantee technical and training assistance to third countries, through appropriate initiatives of the International Academy for Tax Crime Investigation of the OECD and the Frontex Academy, operating at the Economic and Financial Police School".

-\* finally, it will enhance the network of experts and liaison officers deployed abroad, according to Legislative Decree no. 68/2001, and the remaining personnel operating outside the national territory, in multilateral and bilateral contexts, also function of the need to orient the international cooperation system to support the healthy economy of the country and its citizens".

It is clear from the above figures that the government's activity aims to reduce tax evasion as much as possible. From the statistics included in the Ministry of Finance report mentioned in the previous pages, it can be seen how this is happening. Despite the attempt to reduce this evasion, which does not allow for the calculation of taxes on the real wealth produced by companies and non-corporate structured enterprises, evasion is still extremely high. 80.6 billion euros are missing, which is a highly tall figure if one considers the connection between total taxes paid and the gross domestic product of our country.

Because of the objective of this article and the observations made above, it is sufficiently clear that one of the causes, or rather the leading cause, for which taxes are not calculated on the actual profit produced by businesses is pure and simple tax evasion. In the following pages, we will analyse other ways in which taxes are determined on economically incorrect values. Consequently, the amount of tax is not determined by the economic profit produced by the enterprises

### **3) Tax interferences in the financial statements: payment of taxes on income other than that actually produced by the company due to the inclusion in the financial reporting of economically incorrect values to obtain tax savings or postponement of tax payments or due to other reasons (reasons related to administrative costs, reasons of lack of knowledge of the law, reasons concerning the inability to communicate correctly with the outside world of the company).**

Taxes calculated on the real economic profit produced by companies assume that the costs and revenues considered at the tax level coincide with the economically correct costs and revenues. In Italy and in many other countries, the rules concerning the preparation of true and fair financial reporting and understandable are contained in the Civil Code. For the economically correct profit and the taxable profit to coincide, it would be necessary for the company to completely accept the values recorded in the year's financial reporting. Of course, we approach this issue having already "overcome" the tax evasion issue dealt with in the previous paragraph. Therefore, the topic analysed in this paragraph presupposes that no reference is made to the possibility of tax evasion through the non-issuance of invoices or the use of false purchase invoices or invoices that are not in line with the economic reality that is the subject of the invoice. Suppose such tax evasion is not carried out in a company. In that case, we can ask ourselves if, as a consequence, the profit shown in the financial reporting of the year coincides with the tax profit on which the tax is calculated and if the profit shown in the financial reporting of the year indeed identifies the profit actually produced by the company. We can already state that the answer will be negative to both questions. To go in order, one must first ask whether the tax values coincide with the economically correct values that, at least in theory, should characterise financial reporting. This would be the case only if the tax legislator accepted as tax-relevant values the financial reporting data without placing any limit on the taxpayer's freedom. This does not happen in Italy and it does not happen in any country in the world because it is clear that, if the taxpayer were left free and had no fiscal limits to deal with, he would certainly adopt a behaviour that would ensure that the taxable profit would be as limited as possible. Even if not perfectly correct, this behaviour would indeed be implemented by the majority of all taxpayers. To avoid this, the tax legislator sets limits on the deductibility of costs recognised in financial reporting to prevent a high degree of freedom from the taxpayer from inappropriately reducing the taxable profit.

Despite these considerations, for decades, there have been scientific and pragmatic discussions and legislative ones to try to bring closer together the economic profit actually produced by the company and the taxable profit on which to calculate taxes. A critical step has been taken in Italy by introducing the so-called "enhanced derivation".

The enhanced derivation aims to bring statutory profit and taxable profit closer together.

With the Legislative Decree No. 38, Article 4, paragraph 7 ter of February 28, 2005, the tax legislator amended Article 83 of the Presidential Decree by providing for the so-called enhanced derivation for IAS adopter companies. With the above mentioned amendment, Article 83 was modified in 2005 as follows:

Article 83 ( TUIR or Consolidated Income Tax Law)

"The overall profit shall determine by applying to the profit or loss shown in the profit and loss account for the financial year ending in the tax period [...] the increases or decreases resulting from the application of the criteria established in the subsequent



## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

provisions of this section. In the case of activities benefiting from partial or total profit tax relief schemes, the relevant tax losses are relevant to the same extent as positive results. For entities that prepare their financial reports following the international accounting standards set out in Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002, also in the formulation resulting from the procedure set out in Article 4, paragraph 7-ter, of Legislative Decree No. 38 of 28 February 2005, the criteria of qualification, temporal allocation and classification in financial reporting set out in said accounting standards apply, also by way of derogation from the provisions of the subsequent articles of this section".

The enhanced derivation envisaged for IAS adopting companies consists in the circumstance that, also as an exception to the tax rules in force, since 2005, the criteria of qualification, temporal imputation and classification in financial reporting envisaged by the international accounting standards apply. For these companies, substance prevails over form as the IAS/IFRS principles base the structure of every other international standard on this fundamental principle. There are restrictions to this standard which we will not go into here. The circumstance to be pointed out is that, in the period before 2017, for non-IAS adopting companies, the tax criteria established by the (TUIR) enjoyed a mandatory application that could also contrast with the principles set out in the Civil Code and the national accounting standards OIC. For IAS adopting companies, therefore, substance prevailed over form, not only in financial reporting but also in taxation. For companies that prepared their financial reporting according to the Italian Civil Code and the national accounting standards OIC, substance prevailed over form in financial reporting following a widespread interpretation of Article 2423 bis. This, however, had no fiscal impact. From a tax point of view, the tax rules dictated the principles, even conflicting with the code, which had to be applied when determining the IRES tax base.

Interesting, in this respect, to fully understand the meaning of such enhanced derivation is the observations contained in the Circular of the Inland Revenue No. 7E of 28 February 2011. The following is § 3.1 concerning the subject matter of this Circular because from reading this part of the Circular, one can perceive the scope of the enhanced derivation for IAS adopting companies:

*Circular of the Revenue Agency 7E of 28 February 2011 concerning: The rules for determining the profit of entities required to adopt IAS/IFRS - General part - Legislative Decree no. 38 of 28 February 2005, Law no. 244 of 24 December 2007 and Decree no. 48 of the Ministry of Economy and Finance of 1 April 2009.*

### **"3.1 The principle of enhanced derivation**

The general principle of "enhanced derivation", which informs the new tax regulations, is contained in the current Article 83 of the (TUIR), which, as a result of the amendments introduced by Article 1, paragraph 58, letter a), of Law No. 244 of 2007, provides that to determine the profit of the company "apply, even as an exception to the provisions of subsequent articles of this section, the criteria of qualification, temporal allocation and classification in financial reporting provided by those accounting standards". In particular, it should note that the provisions of the Law mentioned above, No. 244 of 2007, have eliminated, in the text of Article 83 of the (TUIR), the words "increased or decreased by the components that as a result of international accounting standards are charged directly to equity".

The IAS Regulation confirmed this approach, reaffirming how, according to Article 83, paragraph 1, third sentence, of the (TUIR) for IAS adopters, "to apply Chapter II, Section I, of the Consolidated Act, the income and balance sheet elements represented in financial reporting based on the criterion of substance over form provided by the IAS".

In particular, as pointed out in the explanatory report of the regulation mentioned above, the novelty of the reference to Article 83 of the (TUIR) consists in assuming the financial reporting representations inspired by the principle of substance over form, which strongly pervades the entire accounting discipline provided by the IAS, instead of the traditional reference to the contractual results.

Indeed, the principle of substance over form is a general principle that is not always perfectly defined: the Framework, in paragraph 35, merely states that transactions and other events must be "recognised and accounted for under their substance and economic reality and not merely following their legal form"; consequently, IAS/IFRS give priority to economic substance over legal form in cases where these two aspects conflict.

Therefore, the IAS/IFRS principle removes the representation of business events according to their legal-formal nature (to which the previous tax law referred) and gives way to a presentation that - favouring the reader-investor view of financial reporting - highlights the substantial effects of each transaction in the light of the actual transfer of the related risks and benefits.

In other words, for IAS adopters, instead of the legal-formal evidence of the balance sheet and income statement, the representation of transactions carried out according to their economic-financial substance is relevant for tax purposes.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

With the changes introduced by the 2008 Finance Act, the tax structure provided by the (TUIR) for IAS adopters - recognising the representation of business transactions according to the economic and financial substance of the same for tax purposes has been changed.

With the amendments introduced by the 2008 Finance Act, therefore, the taxation structure provided by the (TUIR) for IAS adopters - recognising for tax purposes the representation of business transactions according to the qualifications, temporal allocations and classifications IAS compliant and overcoming, therefore, the previous legal-formal approach - significantly reduces the discrepancies between the financial reporting profit and the business profit.

The new regulation thus abandons the tax structure outlined by Legislative Decree No. 38 of 2005 - which had maintained the management of values (financial reporting and tax) in "double track" and the relevance for tax purposes of the legal-formal representations of business operations - and strengthens the direct dependence of the tax profit on the qualifications, classifications and temporal imputations of IAS-compliant financial reporting.

Precisely because this dependence is limited to the recognition of the "qualifications", "classifications", and "temporal imputations", it represents an "enhanced derivation" (and not a "full" derivation): the valuation phenomena, not expressly mentioned in the letter of Article 83, are generally excluded from this context, as well as, as we will see, some specific cases for which the tax legislator, with exceptions and additions to the principle as mentioned earlier of enhanced derivation, wanted to provide different rules (sometimes maintaining the previous taxation scheme).

The provisions of Article 15 of Decree-Law No. 185 of 2008 (the subject of Circular No. 33 of July 10 2009), which introduced the possibility for IAS-compliant companies to realign, through a specific option in their tax return, the differences between the statutory and fiscal values of financial reporting items relating to transactions - carried out by the company itself or by its subsidiaries - with the fiscal values of the assets and liabilities of the company. The provisions of Article 15 of Decree-Law No. 185 of 2008 (the subject of Circular No. 33 of July 10, 2009), which introduced the possibility for IAS adopting companies to realign, by means of a specific option in the income tax return, the differences between the statutory values and the fiscal values of the financial reporting items relating to transactions - carried out before the entry into force of the enhanced derivation rules - which from a fiscal point of view have been differently qualified, classified and imputed in time (as well as, for the sole purposes of the aforementioned realignment, also differently valued) with respect to the qualifications, classifications and temporal imputations (as well as, for the sole purposes of the aforesaid realignment, to the valuations) resulting from the IAS-compliant financial reporting (for such transactions, in the absence of the exercise of the option for the realignment, the different representation of the financial reporting with respect to the qualifications, classifications, valuations and temporal imputations of a fiscal nature, generated a "transitional regime", with the consequent possible ultraticity of the pre-existing rules).

The same Article 2 of the IAS Regulation, after affirming the fiscal relevance of the principle of substance over form, provides, consequently, that "the provisions of Article 109, paragraphs 1 and 2, of the Consolidated Act shall not apply to such entities".

The provision in question introduces an exception to the provisions of Article 109, paragraphs 1 and 2, of the Consolidated Law on Income Tax (TUIR) which, concerning the fiscal relevance of costs and revenues, refer to:

- 1) the requirements of certainty and determinability of income components (para. 1)
- 1) the certainty and determinability of the income components (paragraph 1);
- 2) the results of the negotiations and, in particular,  
to the acquisition or transfer of ownership or other real  
or other rights in rem over the assets (paragraph 2).

The non application of the provisions of paragraphs 1 and 2 of Article 109 is necessary, as highlighted in the explanatory report, "to overcome the applicative uncertainties generated by the reference to the criteria of certainty and objective determinability identified differently compared to what is provided in the IAS/IFRS financial statements".

It was also necessary to associate with this non-application of the fiscal irrelevance of the recognition of management events based on the contractual/legal nature of the same since, in financial reporting, such events are ordinarily recognised based on the transfer of the relative risks and economic benefits and not based on the purchase or sale of ownership.

For example, the transfer of a receivable is not derecognised in financial reporting because the transfer of control (in terms of the related risks and rewards) does not occur. In this

In this case, the general criteria of fiscal competence as per Article 109, paragraphs 1 and 2, of the ( TUIR or fiscal law) do not apply.

Therefore, concerning cases arising after the entry into force of the enhanced derivation regime, the interpretative solutions adopted under the tax system based on Legislative Decree No. 38 of 2005, whereby the tax relevance of the IAS-



## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

compliant accounting treatment was disallowed and the (different) legal-formal representation was given tax relevance, can no longer be recognised.[...].

In other words, the principles of certainty and objective determinability, as well as the legal and formal recognition of phenomena - which, according to the provisions of paragraphs 1 and 2 of Article 109 of the TUIR, are the basis for the application of the criteria of temporal allocation of the TUIR - are not always compatible with the recognition criteria used for IAS-compliant financial reporting, based on the principle of substance over form. Therefore, insofar as the principles mentioned above of the Italian Civil Code diverge from the "substantial representation" of the company's events, the tax legislator has had to provide for their non-application for IAS adopting entities." ("revenue agency circular 7E del 28 febbraio 2011, § 3.1 Derivazione rafforzata.).

Regarding the possibility that such enhanced derivation, after the issuance of the decree as mentioned above, could also be applied to non-IAS Adopter companies, i.e., companies subject to preparation under the rules of the Civil Code, the Italian Revenue Agency replied as follows:

"The principle of "enhanced derivation", based on which the different qualifications, classifications and temporal imputations provided for by the accounting standards are recognised to determine the IRES taxable base concerning the rules of the (TUIR), laid down by Article 83 of the (TUIR), as amended by Article 1, paragraph 58, of Law no. 244/2007, is reserved, by express legislative provision, only for entities that prepare their financial reporting under IAS/IFRS. Therefore, it is to be considered that any extension of this principle to ITA Gaap entities that prepare financial reporting per the rules introduced by Legislative Decree No. 139 of 2015 can only take place through a regulatory amendment. It is clear that this will result in ITA Gaap companies having to manage a dual civil/taxation system. It will adopt different tax regimes for the same phenomenon that is accounted for similarly according to international and national standards".

From the position of the Revenue Agency, it is clear that, necessarily, to be able to operate the enhanced derivation recognised to the IAS adopter companies, to the companies that prepared the financial reporting according to the civil law and according to the national accounting standards OIC, a legislative intervention was needed.

Such an intervention was implemented by Law Decree No. 244 of 30.12.2016, converted, with amendments, by Law No. 19 of 27.2.2017.

The decree-law, known as the "Milleproroghe" decree, 30.12.2016 no. 244, converted, with amendments, by Law no. 19 of 27.2.2017, provided, concerning the relationship between financial reporting of the year and tax provisions, the introduction, starting from 2016, of the principle of "enhanced" derivation of taxable profit for companies that prepare their financial reporting according to the OIC, except micro-enterprises.

In other words, with Article 13-bis, the profit determination methods provided for IAS-adopters are also applicable to companies that prepare financial reports based on the Civil Code supplemented by the national accounting standards OIC. Only the micro-enterprises referred to in Article 2435-ter of the Italian Civil Code are excluded from the principle of enhanced derivation, as these companies are subject to particular simplifications and, therefore, the legislator did not consider it necessary to extend enhanced derivation to this type of company already enjoying advantages, benefits and, above all, simplifications.

With Article t. 13-bis, paragraph 2, letter a), no. 1, of Law Decree no. 244 of 30.12.2016, converted, with amendments, by Law no. 19 of 27.2.2017, such enhanced derivation was, therefore, extended to all companies that prepare their financial reporting according to the rules of the Italian Civil Code and accounting standards, with the sole exclusion of micro-companies.

Therefore, the principle that the substance of transactions recognised in financial reporting prevails over their legal form (except for leasing, for which the form continues to prevail over the substance) is now also applicable to such companies.

For the sake of clarity, Article 83 ("TUIR") as amended by Article 13-bis, paragraph 2, letter a), no. 1, of Law Decree no. 244 of 30.12.2016, converted, with amendments, by Law no. 19 of 27.2.2017 is reported below.

*Art. 83 (TUIR) after integration of art. 13-bis, paragraph 2, lett. a), n. 1, of DL 30.12.2016 n. 244, converted, with amendments, by L. 27.2.2017 n. 19.*

" It shall determine the overall profit by adding to the profit or loss shown in the profit and loss account for the financial year ending in the tax period [...], the increases or decreases resulting from applying the criteria set out in the following provisions of this section. In the case of activities benefiting from partial or total profit tax relief schemes, the relevant tax losses apply to the same extent as positive results. For entities that prepare their financial reports following the international accounting standards referred to in Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002, also in the formulation resulting from the procedure provided for in Article 4, paragraph 7-ter, of Legislative Decree No. 38 of 28 February 2005, and for entities, other than those that prepare their financial reports following the international accounting standards referred to in

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002, also in the formulation resulting from the procedure provided for in Article 4, paragraph 7-ter, of Legislative Decree No. 38 of 28 February 2005. 38 of 28 February 2005, and for entities other than micro-enterprises referred to in Article 2435-ter of the Italian Civil Code, which prepare their financial reports in accordance with the provisions of the Italian Civil Code, the criteria for qualification, temporal allocation and classification in financial reporting provided by the respective accounting standards shall apply, also by way of derogation from the provisions of the subsequent articles of this section.

1a. For paragraph 1, the provisions issued in implementation of paragraph 60 of Article 1 of Law No 244 of 24 December 2007 and paragraph 7-quater of Article 4 of Legislative Decree No 38 of 28 February 2005 shall apply, *mutatis mutandis*, to entities, other than micro-enterprises referred to in Article 2435-ter of the Civil Code, which draw up their financial reports following the provisions of the Civil Code. "

In operational terms, it introduced the amendment to art. 83 ( TUIR) by art. 13-bis, paragraph 2, letter a), no. 1, of DL 30.12.2016 no. 244, converted, with amendments, by L. 27.2.2017 no. 19 means that the formal and legal evidence of certain items, previously relevant in the tax area, can be replaced by the economic substance applied in the preparation of the financial reporting of the year.

The consequence of such a situation can be summarised as a desirable replacement of the representation of facts according to their formal legal nature with the correct practice of representing events according to their substantial effects and, therefore, in the light of the actual transfer of the related risks and benefits. In theory, this should bring statutory profit and taxable profit closer together and, therefore, one cannot but express a positive opinion on the amendment as mentioned above.

In the report accompanying the Ministerial Decree of 3 August 2017, concerning Article 2, it is noted that "Article 2, paragraph 1, letter a), lists the provisions of Ministerial Decree No. 48 of 1 April 2009, applicable "insofar as compatible" also for the determination of the IRES taxable base of the New OIC entities according to paragraph 1-bis of Article 83 of the (TUIR).

In particular, paragraph 1), referring to Article 2, paragraphs 1, 2 and 3, aims to extend also to New OIC entities the declination of the concept of enhanced derivation already provided for IAS/IFRS entities. To this end, the financial reporting qualifications inspired by the principle of substance over form, as outlined by the Italian Accounting Standards Board in the national accounting standards, are also recognised for tax purposes.

In this sense, the waiver of the provisions of Article 109, paragraphs 1 and 2, of the Consolidated Income Tax Law (TUIR) has been extended to the New OIC entities, which, in the assumption of costs and revenues, mainly refer to the conditions of certainty and determinability of the income components (paragraph 1), to the negotiated results and the acquisition/passage of ownership of the assets (paragraph 2), as well as to any other tax rule that refers to representation rules that do not comply with the principle as mentioned above of substance over form. Conversely, the tax provisions limiting the relevance of depreciation, valuations and provisions remain unaffected. These are, in particular, the provisions providing for the taxation/deduction of positive and negative components on a cash basis instead of on an accrual basis (interest on arrears, directors' fees, dividends, etc.) and those which do not allow or limit the deduction of costs because they are not inherent or which provide for the taxation of positive components spread over time for reasons of tax expediency (such as the pro-rata taxation of certain capital gains) or which provide for the exemption or exclusion of positive components".

The report concerning the Ministerial Decree of 8 June 2011 also points out that "number 5) (i.e. Article 5 of the Ministerial Decree of 8 June 2011, n.d.a.), finally, makes Article 9 applicable, concerning 'liabilities of uncertain maturity or amount that meet the requirements of OIC 31'. Accordingly, the rules set out in Article 107 of the Consolidated Income Tax Act (TUIR) concerning provisions apply to all components recognised as a balancing entry to liabilities of uncertain maturity or amount that meet the requirements of OIC 31, even if they are negative profit components classified based on the nature of the expenses generating the said liabilities (and not as provisions). It should note that OIC 12 (December 2016 version), in paragraph 79, provides that "provisions for risks and charges shall be recognised in priority in the cost items of the income statement of the relevant classes ....., the criterion of the classification 'by nature of the costs having to prevail."

The statutory principle of substance over form with enhanced derivation takes on a particular value.

Undoubtedly, with the introduction of enhanced derivation for many financial reporting items, there has been an approximation between the profit produced by companies and the taxable profit on which to calculate taxes. For this reason, enhanced derivation must be welcomed and considered a step forward towards an ever more excellent approximation between economically correct profit and profit affected by taxes. However, the major problem left open by enhanced derivation concerns depreciation and all provisions that are not covered by the enhanced derivation rules. For these values, the law in force since 2008, which completely prevents the application of enhanced derivation, continues to apply.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

The fact that enhanced derivation cannot be applied to depreciation and provisions implies that for these items, the amounts recognised in profit and loss may not be relevant for tax purposes in their total amount. The absence of enhanced derivation for such financial reporting items may result in a difference between the amount recognised in profit and loss and the amount that should use to calculate taxable profit. It is evident that if the two values were perfectly identical and, at the same time, if this value identified the economically correct amount of the event to be recognised in financial reporting, the sum of all costs and revenues calculated in this way would lead to the determination of the profit produced by the company and would imply the calculation of taxes on the wealth economically realised by the company.

The fact that there may be differences between the two values represents an obstacle to the taxation of the company's profit. As we will see later, the presence of a value recorded in the profit and loss that differs from the amount relevant for tax purposes certainly causes the calculation of a tax on a profit that is not the one produced by the company. In addition to this, it should be noted that the presence of a difference between the two items, the economically correct item and tax item, may lead, in reality, to the drafting of a profit and loss made up of financially incorrect values as polluted by tax values that have nothing to do with the profit produced by the company.

The impact of taxation on the values written in the profit and loss and the company's balance sheet depends on the content of the tax regulations. In Italy, regardless of the actual substance of the tax rules, the fact that there is a difference between the civil law regulations governing the preparation of financial reporting and the tax legislation governing the determination of taxable profit often leads to the preparation of financial reporting that is incorrect and untrue from an economic point of view. This happens regardless of the tax formula adopted by the legislator.

In Italy, the tax legislator has imposed three ways of calculating taxable profit and, consequently, the relationship with the statutory profit and loss values.

The three methods can summarised as follows:

### **1) period before 2003**

In 1991, the civil law legislator provided for two special items to be included in profit and loss:

- 24) Value adjustments made exclusively for tax purposes;
- 25) provisions made exclusively for tax purposes;

From a fiscal point of view, the tax legislator provided that:

As regards the content of articles 52 and 75 consolidated text on taxes on profit i.e. tax legislation governing the determination of taxable profit (henceforth TUIR), the paragraphs that are of interest in this context are the following:

Article 52 (TUIR)

Paragraph I: The company's profit [...] is determined by applying to the net result of the profit and loss account for the financial year closed in the tax period, the increases or decreases resulting from using the criteria established in the subsequent provisions of this chapter.

Article 75 (TUIR)

Paragraph IV: Expenses and other negative components are not allowed to be deducted if and to the extent that they are not charged to the profit and loss account relating to the financial year closing. However, expenses and other negative components are deductible even if they are not attributable to the profit and loss account but are deductible by law and those attributed to the profit and loss account of a previous year if the deduction has been deferred following the preceding rules of this chapter that provide for or allow the deferral. Expenses and charges explicitly relating to income and other revenues that, although not charged to the profit and loss account, contribute to the formation of profit shall be allowed as deductions if and to the extent that they result from certain elements precise.

Briefly, from a fiscal point of view, in 1986, recalling two provisions contained in the previous tax legislation of the decrees 597 and 598 of 1973, it established that the necessary condition for the fiscal deductibility of the negative components of profit was represented almost exclusively by their allocation to the profit and loss account, except in some borderline cases.

In this way, the legislator introduced 'legalised' tax interference into the civil financial reporting, albeit highlighted transparently by including two special financial reporting items. Tax rules granted them.

The provision of the so-called "tax appendix" represented the acceptance of a situation that was now evident: all financial statements, due to the tax rules provided for by the tax legislator (TUIR), tax valuations constantly pollute us without economic content and, therefore, it would have been impossible to ignore such a situation.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

Concerning items 24 and 25 of the profit and loss account, it must remember that Article 2427 of the Italian Civil Code, introduced following the implementation of the Fourth EEC Directive, also provided, in paragraph 14, for the illustration of the composition of items 24 and 25 together with the obligation to indicate the reasons for the choice made.

Therefore, tax interference in financial reporting was legalised, "softened" on the one hand, by the explicit highlighting of tax items without economic content and, on the other, by the obligation to explain in the notes to the financial statements. No. 14, the range of the items themselves accompanied by an illustration of the reasons for such financial reporting entries.

In 1994, faced with the problems of interpretation posed by the combination of Article 2425 of the Italian Civil Code, which included items 24 and 25, and Articles 52 and 75 of the Consolidated Income Tax Act, the legislator intervened with a mini-reform of the civil law provisions concerning the relationship between financial reporting and tax provisions.

In particular, with Article 2bis of Law Decree no. 416 of 29 June 1994, converted into Law no. 503 of 8 August 1994 and published in the Official Gazette no. 193 of 19 August 1994, items 24 and 25 of the profit and loss account were eliminated with the consequent elimination of item no. 23.

In addition, the Article mentioned above 2 bis attempted to solve the problems connected with the deductibility of costs subject to subjective evaluation for the part without economic content by adding a paragraph to Article 2426 of the Italian Civil Code. This provision established that it was "permitted to make value adjustments and provisions exclusively in applying tax regulations". It should point out that the legislator had assumed only a mere option to use the provision and not a legal obligation to apply it. In addition, Art. 2 bis amended the explanatory notes by introducing. No. 14, a legal obligation. In particular, the legislator, in Article 2427 no. 14 of the Civil Code, established that the notes to the accounts should indicate, in addition to what is established by other provisions: 'the reasons for value adjustments and requirements made exclusively in the application of tax regulations and the relative amounts, highlighted explicitly concerning the total amount of the adjustments and provisions resulting from the appropriate items in the profit and loss account.

From what was established by the legislator in 1994, it can understand that tax interferences, i.e. the recording in the profit and loss of economically non-existent values that are only relevant for tax purposes, had become legitimate. Therefore, tax contamination was not against the law in this period but was legitimised by the legislation itself.

The possibility of entering tax values in financial reporting meant that the profit for the year shown in the profit and loss and the balance sheet could not be correct from an economic point of view. If the items included in financial reporting had only fiscal and not economic content, the profit determined through financial reporting was certainly not the actual profit produced economically by the company.

### **1) Period 2003-2008**

In 2003, the legislator carried out a comprehensive reform that included financial reporting and tax legislation.

The company law reform was introduced by Legislative Decree No. 6 of 17 January 2003 and concerned the civil law regulation of joint-stock companies and cooperatives. It completed this decree by issuing Legislative Decree no. 5 of 17 January 2003 concerning the definition of proceedings in banking and credit matters, company law and financial intermediation. The tax reform, by which IRES, i.e. the corporate income tax, was established, was issued by Legislative Decree No 344 of 12 December 2003.

The delegated decree no. 6/2003, implemented the indications of the delegation by issuing limited but radical changes. In particular, it abolished the second paragraph of Article 2426, which provided the right to "make value adjustments and provisions exclusively in the application of tax regulations" and adapted for consistency. No. 14 of the notes to the financial statements. While in the period before the 2003 reform, in this point, the notes required the explanation of the reasons why the value adjustments and provisions were made and the quantification of their amounts with the Legislative Decree 6/2003. The point n. 14 was remodelled with the requirement to prepare a statement to explain and justify the recognition of deferred tax assets and liabilities resulting from temporary differences between financial reporting values and values relevant for tax purposes.

Concerning the fiscal pollution of the financial reporting, of particular interest is the part of the reform according to which the depreciation of tangible and intangible assets, other value adjustments and provisions were deductible if in a specific statement in the income tax return their total amount, the civil and fiscal values of the assets and those of the provisions were indicated.

In summary, 'the reform introduced numerous changes in financial reporting. First of all, the elimination of interferences produced by tax regulations, the correlated provision of the obligation to take into account deferred taxation and the integration of balance sheet and income statement items to highlight, among other things, tax credits and deferred tax assets, following the so-called double track between civil and tax financial reporting" (Ianniello, 2002).

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

The instrument through which the tax legislator established the deductibility of depreciation and other value adjustments, as well as of provisions, was, therefore, a prospectus linking financial reporting and income tax return, which was intended to accommodate the recognition of the components mentioned in off-balance-sheet deduction, without the need to go through financial reporting. This schedule became known as "Schedule EC" and could be found in the "Modello Unico" (i.e. the income tax return), of which it was an integral part. The deletion of the last paragraph of Article 2426, preventing the inclusion of tax items in financial reporting, obliged companies to draw up a financial report with items of an exclusively economic nature.

Based on these considerations, it can therefore be stated that, since the entry into force of the 2003 company reform, both the financial reporting of the year as a whole and the balance sheet and profit and loss account are individually considered - unlike in the pre-reform period - had to be characterised by clarity, correctness and truthfulness.

The prohibition to proceed, at the civil level, to purely fiscal evaluations should have allowed affirming that, on 1 January 2004, all the assessments at the end of the financial year present in the financial reporting had, necessarily, to be determined based on the civil law and, by implicit reference, of the correct national and, as far as compatible, international accounting principles, that is to say, of the principles that, at least in theory, represent the sum of the correct economic and business knowledge on the subject of financial reporting evaluations.

The reform of tax law was a prerequisite for eliminating tax interference, as envisaged in the company law reform, to be implemented in practice.

### **Period 2008 to date**

With Law No. 244 of 2007, the legislator implemented the last major reform concerning taxable profits. Through this reform, "As a result of the amendments made to the Consolidated Income Tax Law by letter o) of paragraph 1 of Article 3, starting from the tax period following the one in progress on 31 December 2007, non-accounting deductions for depreciation, other value adjustments and provisions will no longer be allowed, without prejudice to the deductibility of costs charged to the profit and loss account within the maximum limits allowed by the tax law" (Report attached to Law No. 244/2007).

Currently, the taxable profit is determined by applying the provisions of Articles 83 and 109 of the Consolidated Income Tax Act. In particular, Article 83 of the Consolidated Income Tax Law (TUIR) provides that '1. The overall profit is determined by adding to the profit or loss shown in the profit and loss account for the year ended in the tax period, the increases or decreases resulting from applying the criteria established in the subsequent provisions of this section.....'.

This article should be interpreted in the light of Article 109, which contains the general rules on the components of business profits, which, among other things, states that: "..... Expenses and other negative components are not allowed to be deducted if and to the extent that they are not charged to the profit and loss account for the relevant period.....".

From the above, it is clear that, following the reform implemented in 2008, it is no longer possible to deduct negative profit components through the mechanism of the EC panel, i.e. by highlighting, in a specific statement included in Unico, the difference between the economic value recognised in financial reporting and the maximum limit deductible for tax purposes.

This means that if the economically correct value, i.e. determined following the statutory provisions supplemented by the OIC accounting standards and charged to the income statement, is lower than the maximum limit deductible for tax purposes, the company preparing the financial reporting loses the possibility of deducting the difference that, potentially, the tax legislator considered as hypothetically deductible if it had passed through financial reporting.

With the 2008 reform, this is no longer possible. According to the legislation passed in 2008 and currently in force (with the amendments made to the tax law from year to year), financial reporting must be prepared by recording only and exclusively the economically correct values, while the tax return does not allow deductions higher than the amounts recorded in the income statement.

Such a situation puts companies in a position to make a difficult decision:

- (a) To prepare true and correct financial reporting and forgo potential tax deductions and, as a result, pay more tax than it could if it had recognised the maximum tax-deductible amount in the income statement;
- b) or prepare financial reporting contaminated by tax valuations and consequently illegitimate, which allows taking full advantage of the tax deductions of the negative profit components recognised in the income statement.

From a theoretical point of view, the researcher must affirm that the company must draw up a financial reporting true and correct in all its parts, even if this leads to a loss of tax-deductibility of some negative profit components.

From a pragmatic point of view, however, it is undoubtedly true that this situation inevitably leads to the preparation of financial statements tainted by tax interference, as there are certainly few companies that renounce tax deductions, paying more taxes to draw up perfect financial reporting: clear, true and correct under Article 2423 of the Italian Civil Code.



## Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses

As we have seen in the previous pages, the Italian legislator has repeatedly modified the tax legislation and the civil law so that, as far as possible, the financial reporting could indicate economically correct values or fiscal values accompanied by a series of information that would allow the reader to determine the economically correct part of the value and the part of the amount entered in the financial reporting having an eminently fiscal content.

From what has been illustrated above and based on what has been underlined in the previous pages, it is possible to stop that; according to the legislation, whoever prepared, especially before 2008, the Financial reporting had all the instruments to be able to deduct tax costs and, at the same time, enter in the Financial reporting values that were economically correct and true. After the 2008 reform, all this is more complex because the legislation provides that the Financial reporting must include the economically valid value independently from the amount fiscally deductible. As we have already pointed out, this may result in the non-deductibility of part of the value recorded in the financial reporting or the loss of deductibility of an expense if the financial reporting shows an amount that, although economically correct, is lower than the amount that the taxpayer could potentially deduct for tax purposes.

### 4)Tax interference in financial reporting: analysis of data from a survey of Italian financial reports from 2002 to 2019 <sup>2</sup>.

Because of the panorama we have described and which considers the period after the 1991 reform, we can ask ourselves whether, at least when the legislation allowed it, the values recorded in the financial reporting were free from tax influences. What we want to verify is therefore, whether the theoretical possibility of drawing up a correct and true financial reporting, as well as understandable, combined with the possibility of deducting the entire cost potentially deductible for tax purposes, has meant that in the past the financial reporting was characterised by the presence of economically correct items free from any tax contamination. We speak of the past because nowadays, the circumstance of not being able to deduct the fixed portion potentially deductible for tax purposes if not recorded in the profit and loss represents, without doubt, a severe obstacle to the elimination of any tax interference in financial reporting.

To verify the reality that could be and still can be detected in the inclusion of cost items in the profit and loss it is necessary to refer to the financial statements prepared by companies in the various periods in which the legislation, civil and tax, has evolved, changed and made changes in the tax-financial reporting relationship.

To do this, we will focus only on one item of financial reporting, namely depreciation and amortisation, as analysing all the financial reporting items would not be appropriate for the size of this article. In particular, to analyse this issue, we will refer to the results of a study that has been in progress since 2001 and will end in 2026. This research aims to verify, over time, how the relationship between financial reporting amounts and tax legislation has changed over time, obviously bearing in mind the legislation in force in the various periods analysed. In the following pages, we will therefore highlight the depreciation and amortisation item concerning years falling within the multiple periods in which reform was carried out only for tax purposes, only for statutory purposes or, at the same time, for statutory and tax purposes.

For clarity, it is preferable to report the data relating to different years and make a comment at the end of the list of values. Otherwise, the commentary would be continually interrupted and would not have the fluidity that this subject requires.

**Depreciation of tangible fixed assets, (plants in particular) recorded in the income statement, in account, are upper, lower or coincident with the values deductible for tax purposes?**

#### Results:

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<u>Total number of companies</u>	554	554	554	554
<u>Replies received</u>	96,57% of Replies received	96,57% of Replies received	96,57% of Replies received	96,57% of the sample
<u>Upper</u>	1,87% of Replies received	1,50% of Replies received	1,50% of Replies received	0,81% of Replies received

<sup>2</sup> I would like to thank, in order of the time in which the fieldwork was carried out, Dr. Giovanni Ghezzi, Dr. Katia Maschietto, Dr. Matteo Beggio, Dr. Jessica Filippi, Dr. Nicole Manfreda, Dr. Sara Vesco, Dr. Anna Berlese, Dr. Marco Antonello, Dr. Giorgia Striulli, Dr. Marco Antonello. Giorgia Striulli, Dr. Marco Antonello. The data collected by the above-mentioned collaborators was integrated by the values provided, by the companies, to the undersigned and to other collaborators who provided their work for a short time. I would like to thank everyone for their help in achieving this important research result.



**Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

<u>Lower</u>	<u>2,62% of Replies</u> <u>receveid</u>	<u>4,112% of Replies</u> <u>receveid</u>	<u>4,112% of Replies</u> <u>receveid le</u>	<u>0,81% of Replies</u> <u>receveid</u>
<u>Coincident</u>	<u>95,51% of Replies</u> <u>receveid</u>	<u>94,39% of Replies</u> <u>receveid</u>	<u>94,39% of Replies</u> <u>receveid e</u>	<u>98,38% of Replies</u> <u>receveid</u>

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>Total number of companies</u>	<u>917</u>	<u>917</u>	<u>917</u>	<u>917</u>
<u>Replies receveid</u>	<u>100%of Replies</u> <u>receveid</u>	<u>100% of Replies</u> <u>receveid</u>	<u>100% of Replies</u> <u>receveid</u>	<u>100% of the</u> <u>sample</u>
<u>Upper</u>	<u>13,01% of Replies</u> <u>receveid</u>	<u>14,30% of Replies</u> <u>receveid</u>	<u>14,28% of Replies</u> <u>receveid</u>	<u>14,32% of Replies</u> <u>receveid</u>
<u>Lower</u>	<u>8,86% of Replies</u> <u>receveid</u>	<u>7,69% of Replies</u> <u>receveid</u>	<u>7,82% of Replies</u> <u>receveid</u>	<u>8,78% of Replies</u> <u>receveid</u>
<u>Coincident</u>	<u>78,13% of Replies</u> <u>receveid</u>	<u>78,01% of Replies</u> <u>receveid</u>	<u>77,90% of Replies</u> <u>receveid</u>	<u>76,90% of Replies</u> <u>receveid</u>

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
<u>Total number of companies</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>
<u>Replies receveid</u>	<u>97,8%of sample</u>	<u>97,8% of sample</u>	<u>97,8% of sample</u>	<u>97,8% of the</u> <u>sample</u>
<u>Upper</u>	<u>3,50% of Replies</u> <u>receveid</u>	<u>8,33% of Replies</u> <u>receveid</u>	<u>6,95% of Replies</u> <u>receveid</u>	<u>7,84% of Replies</u> <u>receveid</u>
<u>Lower</u>	<u>0,00% of Replies</u> <u>receveid</u>	<u>0,00% of Replies</u> <u>receveid</u>	<u>0,27% of Replies</u> <u>receveid</u>	<u>0,17% of Replies</u> <u>receveid</u>
<u>Coincident</u>	<u>96,50% of Replies</u> <u>receveid</u>	<u>91,67% of</u> <u>Replies receveid</u>	<u>92,78% of Replies</u> <u>receveid</u>	<u>91,99% of Replies</u> <u>receveid</u>

	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
<u>Total number of companies</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>
<u>Replies receveid</u>	<u>98,67%of Replies</u> <u>receveid</u>	<u>98,67% of</u> <u>Replies receveid</u>	<u>98,67% of Replies</u> <u>receveid</u>	<u>98,67% of the</u> <u>sample</u>
<u>Upper</u>	<u>7.7501% of</u> <u>Replies receveid</u>	<u>7,75% of Replies</u> <u>receveid</u>	<u>7,75% of Replies</u> <u>receveid</u>	<u>7,75% of Replies</u> <u>receveid</u>
<u>Lower</u>	<u>8,861,85% of</u> <u>Replies receveid</u>	<u>1,86% of Replies</u> <u>receveid</u>	<u>1,86% of Replies</u> <u>receveid</u>	<u>1,86% of Replies</u> <u>receveid</u>
<u>Coincident</u>	<u>90,94% of Replies</u> <u>receveid</u>	<u>90,40% of</u> <u>Replies receveid</u>	<u>90,40% of Replies</u> <u>receveid</u>	<u>90,40% of Replies</u> <u>receveid</u>

**The amortisation of goodwill recorded in financial reporting is upper, lower or coincident with the values deductible for tax purposes?**

**Results:**

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<u>Total number of companies</u>	<u>554</u>	<u>554</u>	<u>554</u>	<u>554</u>
<u>Replies receveid</u>	<u>64,09%of</u> <u>sample</u>	<u>53,78% of sample</u>	<u>53,79% of</u> <u>sample</u>	<u>53,79% of the</u> <u>sample</u>
<u>Upper</u>	<u>35,00% of</u> <u>Replies</u> <u>receveid</u>	<u>36,24% of replies</u> <u>receveid</u>	<u>36,24% of</u> <u>replies</u> <u>receveid</u>	<u>39,13% of</u> <u>replies receveid</u>

**Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

<u>Lower</u>	0, 35% of <u>Replies</u> <u>receveid</u>	0,35% of replies receveid	0,34% of replies receveid	1,00% of replies receveid
<u>Coincident</u>	64,65% of <u>Replies</u> <u>receveid</u>	63, 42% of replies receveid	63, 42% of replies receveid	59,87%% of replies receveid

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>Total number of companies</u>	<u>917</u>	<u>917</u>	<u>917</u>	<u>917</u>
<u>Replies receveid</u>	<u>81,67%</u> of sample	<u>81,67%</u> of <u>sample</u>	<u>81,67%</u> of <u>sample</u>	<u>81,67%</u> of <u>the</u> <u>sample</u>
<u>Upper</u>	45,40% of replies receveid	38,01% of replies receveid	38,10% of replies receveid	37,51% of replies receveid
<u>Lower</u>	0,59% of replies receveid	5,19% of replies receveid	4,97% of replies receveid	4,46% of replies receveid
<u>Coincident</u>	54,01% of replies receveid	56,80% of replies receveid	56,93% of replies receveid	58,03% of replies receveid

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
<u>Total number of companies</u>	<u>568</u>	<u>568</u>	<u>568</u>	<u>568</u>
<u>Replies receveid</u>	<u>68,71%</u> of sample	<u>68,71%</u> of <u>sample</u>	<u>68,71%</u> of <u>sample</u>	<u>68,71%</u> of <u>the</u> <u>sample</u>
<u>Upper</u>	41,40% of replies receveid	35,29% of replies receveid	35,19% of replies receveid	35,19% of replies receveid
<u>Lower</u>	0,00% of replies receveid	0,51% of replies receveid	0,51% of replies receveid	0,51% of replies receveid
<u>Coincident</u>	58,60% of replies receveid	64,20% of replies receveid	64,30% of replies receveid	64,30% of replies receveid

	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
<u>Total number of companies</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>
<u>Replies receveid</u>	<u>98,67%</u> of sample	<u>98,67%</u> of <u>sample</u>	<u>98,67%</u> of <u>sample</u>	<u>98,67%</u> of <u>the</u> <u>sample</u>
<u>Upper</u>	16,40% of replies receveid	16,40% of replies receveid	16,40% of replies receveid	16,40% of replies receveid
<u>Lower</u>	11,45% of replies receveid	11,45% of replies receveid	11,45% of replies receveid	11,45% of replies receveid
<u>Coincident</u>	72,16% of replies receveid	72,16% of replies receveid	72,16% of replies receveid	72,16% of replies receveid

**Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

For amortisation relating to intangible assets (except goodwill) ( in particular patents), are the values in financial reporting upper, lower or coincident with the values deductible for tax purposes?

**Results:**

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<u>Total number of companies</u>	<u>554</u>	<u>554</u>	<u>554</u>	<u>554</u>
<u>Replies received</u>	<u>50,90% of sample</u>	<u>50,90% of sample</u>	<u>50,90% of sample</u>	<u>50,90% of sample</u>
<u>Upper</u>	<u>10,61% of replies received</u>	<u>10,64% of replies received</u>	<u>10,64% of replies received</u>	<u>10,68% of replies received</u>
<u>Lower</u>	<u>0,35% of replies received</u>	<u>0,35% of replies received</u>	<u>0,35% of replies received</u>	<u>0,35% of replies received</u>
<u>Coincident</u>	<u>89,04 of replies received</u>	<u>89,01% of replies received</u>	<u>89,01% of replies received</u>	<u>89,97% of replies received</u>

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>Total number of companies</u>	<u>917</u>	<u>917</u>	<u>917</u>	<u>917</u>
<u>Replies received</u>	<u>92,30% of sample</u>	<u>92,30% of sample</u>	<u>92,30% of sample</u>	<u>92,30% of the sample</u>
<u>Upper</u>	<u>0,59% of replies received</u>	<u>0,70% of replies received</u>	<u>1,30% of replies received</u>	<u>1,35% of replies received</u>
<u>Lower</u>	<u>1,40% of replies received</u>	<u>1,27% of replies received</u>	<u>0,71% of replies received</u>	<u>0,80% of replies received</u>
<u>Coincident</u>	<u>98,01% of replies received</u>	<u>98,03% of replies received</u>	<u>97,99% of replies received</u>	<u>97,85% of replies received</u>

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
<u>Total number of companies</u>	<u>522</u>	<u>522</u>	<u>522</u>	<u>522</u>
<u>Replies received</u>	<u>91,99% of sample</u>	<u>91,99% of sample</u>	<u>91,99% of sample</u>	<u>91,99% of the sample</u>
<u>Upper</u>	<u>0,75% of replies received</u>	<u>1,26% of replies received</u>	<u>1,02% of replies received</u>	<u>1,23% of replies received</u>
<u>Lower</u>	<u>0,38% of replies received</u>	<u>0,19% of replies received</u>	<u>0,19% of replies received</u>	<u>0,19% of replies received</u>
<u>Coincident</u>	<u>98,87% of replies received</u>	<u>98,55% of replies received</u>	<u>98,79% of replies received</u>	<u>98,58% of replies received</u>

	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
<u>Total number of companies</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>	<u>5421</u>
<u>Replies received</u>	<u>98,67% of sample</u>	<u>98,67% of sample</u>	<u>98,67% of sample</u>	<u>98,67% of the sample</u>
<u>Upper</u>	<u>8,86% of replies received</u>	<u>8,86% of replies received</u>	<u>8,86% of replies received</u>	<u>8,86% of replies received</u>

## Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses

<u>Lower</u>	9,97% of replies receveid	9,97% of replies receveid	9,97% of replies receveid	9,97% of replies receveid
<u>Coincident</u>	81,17% of replies receveid	81,17% of replies receveid	81,17% of replies receveid	81,17% of replies receveid

From the above data, the presence of fiscal values in the financial statements is evident since, if attention is focused on the percentages in which the coincidence between amortisation/depreciation deductible for tax purposes and amortisation/depreciation included in the Financial reporting, it is noted that the percentage is very high in all the years considered. The only noteworthy element is that from 2002 to 2006, the coinciding percentages of the two values is close to 98%, while in the years from 2016 to 2019, it is 82%. 82% is a very high figure because it means that 82 out of 100 companies "by chance" identified economic depreciation exactly coinciding with tax-deductible depreciation. There is no need to go into the matter in-depth to understand how this randomness is only apparent and derives, instead, from a policy studied and applied by the companies that provide for the inclusion of the fiscal value in the financial reporting of the year. Of course, it cannot be ruled out that the fiscal and economically correct values coincide. The abnormality is identified in the very high percentage of this "random" coincidence. In this respect, it is interesting to see, for example, how the values for 2003 and 2002 do not show any significant differences concerning the amortisation of goodwill in the face of a radical change in the tax law concerning such intangible deferred costs.

Concerning patents, it can be seen that from 2002 to 2005, the change in tax law did not cause any change in the financial reporting data in the sense that the tax-deductible value and the economically correct value, for more than 64% of the cases are the same. In the first two years, the tax law provided for the amortisation of goodwill in 1/10. With the reform, from 1 January 2004, the percentage passed to 1/18. Despite this, the financial reporting values continued to reflect the tax-deductible value in more than 64% of cases. One must ask how more than 64% of companies may have considered it economically correct to amortise goodwill to 1/10 for the first two years and precisely 1/18 for the other years. It is unnecessary to examine this issue further to understand how the tax assessment prevailed over the economically correct evaluation. The percentage of coincidence between fiscal values and economically valid values also in the years following 2007 appears exceptionally high; therefore, it can be understood how for all fixed assets, tangible and intangible, the amortisation/depreciation is strongly influenced by the tax deductibility limit. One cannot think that such high percentages of coincidence between fiscal and economically correct values represent the reality that financial reporting must highlight. It is obvious how the tax rule replaces in practice the determination of an economically correct value, so that obviously, the financial reporting is strongly polluted by the tax rules, and the values contained therein, in very high percentages, do not represent economically correct values but identify tax-relevant values devoid of any economic content.

This consideration, proven by the data listed above that we leave the reader to analyse in-depth to verify the evolution of the percentages over time, means that we can safely say that, since always, or at least since 2002 since the research started from this year, taxes are not paid on the profit produced by the company. It should note that the answers also prove the above statements if another question we asked the companies. In the research questionnaire concerning the years 2002 and 2006, we wondered if the company had used the possibility given by the legislator to deduct the accelerated depreciation not present in the financial reporting through the income tax return. Without going into the details of the legislation on accelerated depreciation, which is no longer in force, it should be noted that since 2004, for some years, it has been possible to deduct a portion of depreciation off the books through the income tax return without having the value of such depreciation recognised in financial reporting. When asked whether companies had taken advantage of this tax benefit, more than 70% of companies said they did not. Since it would be illogical to think that a company refuses to adopt an accounting procedure that allows it to deduct costs for tax purposes and, consequently, to pay less tax, it is reasonable to think that in 2004 and 2005, just as happened in 2003 when this tax rule did not exist, the taxpayer would have indicated as depreciation in financial reporting the entire amount fiscally deductible without resorting to a double entry in financial reporting and extra-accounting in the tax return.

After these considerations and in the light of the data highlighted by the research started in 2002 and now including the 2019 values, it is easy to understand how tax contamination characterises a very high percentage of Italian financial reporting. Therefore, the subjective values included in financial reporting often lack a real economic value and only identify values that the tax legislator has included as threshold limits for tax deductibility.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

In addition to what has been written in the preceding pages, it is evident that this is one of the reasons why, in most cases, taxes are not calculated on the profit produced by companies. It should be noted, however, that this is not due to cumbersome, inconsistent or impractical legislation, but on the contrary, is due to the behaviour of the individual financial reporting manager. An analysis of the evolution of tax and civil law over the last twenty years shows that, from 1991 until 2008, it was possible to draw up economically correct and truthful financial reporting by taking advantage of the tax benefits provided by the tax legislation. However, this involved a double calculation of the subjective values. The economically correct values had to be credited in the financial reporting, while the tax values had to be used only to calculate the taxable profit. Even when the legislation allowed the tax-deductibility of non-financial reporting values, it is clear that the preparer of the profit and loss and balance sheet preferred to enter tax rather than economically correct values in financial reporting. Under current legislation, this may make sense because if a company decides to recognise an economically valid value in financial reporting that is lower than the amount deductible for tax purposes, it loses a critical tax opportunity to defer the payment of taxes. Therefore, from 2008 onwards, it is possible to understand, although not justify, the behaviour of companies that implement tax contamination. But before this date, it must indeed admit that the values entered in financial reporting resulting from tax interferences were deliberately entered by the financial reporting editor even if the latter could draw up a true and correct financial reporting without losing any tax benefits.

The reasons that led and led in the past to the recognition of tax values in financial reporting are two:

- 1) the desire not to lose tax benefits. However, this happens only when the economically correct value is lower than the value deductible for tax purposes. In this case, the part not deductible in the year subject to entry in the Financial reporting is deducted in subsequent years. In this case, the tax issue has no relevance because the maximum limit set by the tax legislator does not change when a higher value is recorded.
- 2) A second reason why both in the past and recent years, the financial reporting editor often opts for the entry of a tax cost in the financial reporting instead of an economically correct amount is due to the desire not to make a double calculation of the values subject to the personal assessment of the financial reporting editor: the economically correct value and the amount deductible for tax purposes. The double accounting and double valuation require time and effort from the administrative department, which translates into increased business costs. Many companies do not consider this duplication of calculation to be appropriate because they consider it economically advantageous to use a single value, in particular the tax value, to avoid double estimates and to avoid the necessary double accounting that results from the coexistence of different statutory and tax values. Entering a value in the financial reporting and having a deductible cost of an additional amount in the tax return inevitably creates the need, in subsequent years, to make tax restatement calculations which are not necessary if the statutory value coincides precisely with the tax-deductible value.

The two reasons mentioned above coexist. In fact, in the writer's opinion, the coincidence between the tax value and the value included in the financial reporting derives from the inter-relation of the two reasons illustrated above.

Adopting such an accounting behaviour entails the determination of taxes that are not calculated on the profit produced by the company ... It should also be noted that tax interference entails internal and external consequences for companies that are harbingers of particularly delicate dangerous situations.

At the external level, preparing a financial report that contains economically incorrect items causes consequences in the communication to third parties and in the legal situation of the financial reporting itself. At the level of external communication, it is evident how the presence of tax contamination in the financial reporting constitutes a cause of incorrect communication of the company's situation. Third parties, which can only count on the data contained in the public financial reporting as an instrument of information on the company's economic and financial situation, can take wrong decisions if the data communicated are not economically correct. Therefore, communication with third parties becomes an element that can be counterproductive for those outside the company. Such a situation highlights a gap in the financial reporting culture, an issue that, for obvious reasons, we cannot go into here.

The second external effect of tax interference in financial reporting concerns the legal implications of drawing up a balance sheet or a profit and loss statement containing economically incorrect values. Financial reporting with untrue, inaccurate and non-understated values causes the financial reporting itself to be null and void. Anyone with interest can challenge such a document, even if not a shareholder. The danger of a challenge to financial reporting is a sword of Damocles over the company. A third party could become aware of discrepancies between values and, consequently, take the company to court for infringing its fundamental rights to financial reporting. Requests that are now unanimously recognised by all third parties outside the company.

## **Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses**

From these brief considerations, it can be understood how the tax contamination of financial reporting with tax data without economic content also has detrimental effects on the company itself that carries out the tax interference.

Even at an internal company level, there can be severe consequences of including economically incorrect data in financial reporting. The first and most dangerous consequence is that the decisions taken on the basis of that cost will obviously be taken from an incorrect view of the company's situation and, consequently, the decisions may be totally wrong. In fact, the subjective values included in financial reporting are derived from accounting as they are the result of accounting entries made at the end of the year. In almost all companies, the accounts are the source of the values, which are used to prepare the financial reporting and identify the data used to determine the information aggregates that are essential in the decision-making process. For example, if data from the accounts are used to determine the cost of a product or the cost of a business sector (e.g. a particular department). It is evident that if the global cost contains economically incorrect values because they represent only tax data that can, in theory, be used exclusively to determine the taxable profit, the cost identified will be untrue and incorrect..

### **CONCLUSIONS**

From these brief considerations in the preceding pages, it can be understood how the fiscal pollution of financial reporting with tax data without economic content causes detrimental effects even on the same company that carries out the tax interference. As we have been able to point out before, it is not a problem of civil and tax law, but it is connected to the financial reporting culture in the companies. It is to be hoped that, with time, the culture of financial reporting will increase in all companies, both large and small, and that tax interference will definitively disappear from the overview of financial reporting. It is only when companies understand that informing third parties and their managers with correct and truthful data is the only way forward so that there are no decisions made on incorrect data, financial reporting challenges and third party information rights.

As I always say in my articles, it is said that beauty and culture will save the world. I do not know if this is true. But surely, the diffusion of the culture of financial reporting will avoid, in the future, the tax pollution of statutory financial reporting. And for the same reason, it will help to bring the determination of taxes close to the value that should pay as it is calculated on the actual profit produced by the company. As pointed out in the previous pages, tax interferences are not the only reason why taxes are not calculated on the substantial profit made by the company. Indeed, the presence, for example, of a maximum limit of tax deductibility related to the costs subjectively assessed by the financial reporting editor prevents the determination of a tax base that, realistically, is close to the profit produced by the company. Every step towards this goal is welcome. However, it is essential to note that this objective must be pursued by all the parties involved: the tax authorities, the community and the company. Only when everyone focuses their attention on this shared objective will the goal be achieved. However, it must emphasise that achieving this goal is not easy as conflicting interests are at stake (e.g. tax and company). The full achievement of the above objects may be an unattainable goal. Still, every step towards this goal helps to bring the taxes paid by companies closer to those that should be paid and is calculated on the actual profit produced by the company during the year.

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## Because in Italy, as in Many Other Countries, There is Still a Long Way To Ensure That Taxes Burden The Income Actually Produced By Businesses

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