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by Alessandro Adlechi Rossi

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Although taxpayers and their advisers originally considered the time value of money to be of little importance, over the years they have learned that a deferral in the recognition of income, or an acceleration in the deduction of an expense, can produce significant financial advantages. Of course, the tax authorities also discovered the importance of the time value of money and have begun focusing on the timing issues.

The first major Italian legislation to address issues of tax accounting was the tax reform of 1971, which was based on the adoption of a book conformity and financial statements conformity requirement.

After the 1971 reform, the accrual method became the required system of accounting for all corporations, whether or not they engaged in the purchase and sale of inventory. Article 109(1) of the Italian income tax code (Testo Unico delle Imposte sui Redditi, or TUIR) sets forth that requirement. However, despite the general accrual basis rules for recognizing items of income and expense, there are some instances in which taxpayers engaged in a trade or business must recognize income or expense for the year of receipt or payment. Examples include, but are not limited to, expenses for directors' fees, certain taxes, and certain interest and dividend income.

Under the accrual method of TUIR article 109(1), income and expenses are generally recognized in the year in which the taxpayer's right to receive the income or the fact of liability become certain and the amounts thereof can be determined with reasonable accuracy. In addition, under TUIR articles 109(2)(a) and (b), economic performance also must have occurred regarding the income or the liability.

As these general rules indicate, the requirements for recognizing income and expense are symmetrical. Both are subject to a three-pronged test, and income is recognized and expense deducted in the year in which the three events occur.

The three-pronged test may be favorable to taxpayers because income does not need to be recognized until the performance that gives rise to the income has occurred. However, the application of the economic performance test to liabilities can produce anomalous results. This article generally analyzes the three-pronged test for the reporting of items of expense and proposes a possible solution to the perceived anomaly.

As indicated above, the first prong requires that the facts of liability must be certain for an expense to be deductible. For example, if the liability's existence is subject to any conditions precedent, contingencies, or other circumstances that prevent the taxpayer from having a liability within the definition of TUIR article 109(1), the deduction is premature and likely to be denied. Should the tax authorities find that a deduction is improper in the year claimed, courts have recognized that the deduction can be taken in the year originally available by filing a claim for refund. (See Corte di Cassazione, sezione I civile, Decision 7479 of April 1, 1998.) The statute is silent as to when the certainty of the fact of liability should be determined; in the absence of guidance, the best course of action seems to make that determination on the basis of the facts actually known or reasonably knowable as of the close of the tax year.

TUIR article 109(1) also requires that the amount be determined with reasonable accuracy, not that it be certain. This is an objective test. For example, if a service provider charges €100,000 for services rendered to a corporation but the corporation admits liability for only €70,000 and disputes the difference, the corporation may take into account only the €70,000. The balance may not be deducted, because it fails to meet the objective test; the amount is contingent and cannot be ascertained with reasonable accuracy. If the issue is litigated, the amount of deduction is generally determined with certainty when the case is settled. (See Risoluzione 9/174 of April 27, 1991.)

The third prong, contained in TUIR articles 109(2)(a) and (b), provides that a taxpayer may not obtain a tax deduction before the time of performance. As a general rule, when a taxpayer's obligation consists of promising to pay for services or property provided to him, economic performance occurs only as these services are provided or that property is delivered.

The economic performance requirement has the effect of resolving some issues that may arise regarding the identification of the relevant liability and the determination of its certainty. For example, if the directors of a corporation resolve to incur a specific expense that will generate a tax deduction, the fact of the liability may or may not be certain depending on whether the directors' resolution actually establishes a liability of a certain amount or merely authorizes the corporation's management to incur a liability. If the resolution is found to establish a liability of a certain amount, the corporation in this example — without an economic performance requirement — would be able to obtain a tax deduction before the time of performance and possibly use the tax savings arising from the deductions to fund payment of the liability itself.

Payment is not economic performance. The tax section of the Italian Supreme Court of Appeal recently rendered a decision (Corte di Cassazione, sezione tributaria, Decision 24474 of October 3, 2006-November 17, 2006) confirming that for economic performance to be deemed to occur, it is unnecessary that payment is made to the person to which the liability is owed.

As a result, the provisions of TUIR article 109(2)(a) and (b) may deny deduction even when payment has been made, possibly giving rise to an anomaly of the economic performance requirement. As indicated in the preceding paragraphs, without that requirement, taxpayers would be able to obtain deductions before the time of performance. Nevertheless, because payment is not economic performance, the economic performance requirement — consistently with the principles of the accrual method of accounting — may deny a deduction even when payment has been made.

In recognition of this supposed anomaly, in particular circumstances — for example, when the services are rendered immediately after the payment — the legislator might perhaps consider moderating these provisions by introducing special rules similar to those adopted by other countries.

For example, in the U.S., Treas. reg. section 1.461-4(d)(6)(ii) permits a taxpayer to treat property or services provided to it as satisfying economic performance at the time the payment is made, if the taxpayer can reasonably expect the person that is to provide the property or services to provide them within 3-1/2 months after the date of payment. Under this rule, a failure to provide the property or services within the specified time frame should not prevent the occurrence of economic performance at the time of payment, if the failure was not reasonably expected.

A special rule similar to that provided under U.S. laws would not undermine the well-established Italian requirement to use the accrual method. In these limited circumstances, the taxpayer would effectively be placed on the cash method; arguably, however, the taxpayer would not actually be on the cash method because satisfaction of the "revised" economic performance test would not, in and of itself, permit a deduction. As discussed above, the fact of liability to which the payment relates should be certain, too. Also, the amount of the liability must have been determined with reasonable accuracy. Thus, if payment precedes existence of a liability the amount of which has been reasonably determined, a deduction would not be allowed merely because of the payment.

Accrual tax accounting is often susceptible to abuse and manipulation. Items of income and expense are recognized under the accrual method on the basis of, for example, contractual terms and business practices, which can be relatively easily rearranged to accelerate deductions or to defer the recognition of income. The proposed special rule would — when applicable — allow taxpayers conducting a trade or business in Italy an opportunity to accelerate deductions merely by making payments without engaging in any abuse or manipulation of their tax accounting. ◆