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The validity for taxation of international accounting principles in determining business income, with particular attention to the implications of applying IAS/IFRS 39, dealing with financial instruments

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The insertion of IAS/IFRS international accounting principles into our system in recent years has triggered a process of revision of the methods used to prepare company financial statements, not only from the statutory-accounting perspective but also with regard to tax.

Indeed companies have rapidly adjusted to the new regulations that have impacted accounting and taxation matters in the past, and continue to do so.

It is indeed the tax framework deriving from the implementation of IAS/IFRS international accounting principles that is referred to in this paper, with specific attention paid to standard number 39 dealing with financial instruments.

In performing the analysis one cannot ignore the way the tax regulations have evolved due to the mandatory introduction of IAS/IFRS for preparing the financial statements of various specific categories of Italian companies starting from 2005, given the historical context.

With Legislative Decree 28 February 2005 number 38 (the so-called "IAS Decree") the legislator authorised the transposition of the new international principles for the purposes of preparing company financial statements.

The IAS Decree represents the link between EU and domestic law for the application of IAS/IFRS accounting principles in our country. It has been said that the extension of IAS/IFRS principles also to cover individual company financial statements marks a momentous turning point, particular for civil law system countries such as Italy. International standards favour the provision of useful information to investors and for this purpose aim to make the financial statements of companies operating in the market comparable, and in this way "*they overcome the self-evident limitations of historical cost in balance sheet valuations and lead to measurement of company performance –not just negative, but also positive– that disregards historic cost and is made on a valuation basis. The measurement of net assets at fair value is the new criterion that companies are invited to use optionally –or, in some cases, such as for the valuation of tradable securities, compulsorily– but that in future will in all probability permeate the financial statements in ever more mandatory fashion*".

It is useful to recall the definition of fair value contained in IAS 39, entitled "*Financial instruments: recognition and measurement*", according to which "*fair* *value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".*

The use of fair value within IAS/IFRS should not be interpreted as a total abandonment of historical cost, underpinning as it does the principles used to prepare statutory financial statements, as dictated in particular by article 2423-bis of the Civil Code and by Italian accounting principles. Indeed, the prudence principle exists under IAS even with reference to valuations at fair value. In particular fair value "*does not qualify as a valuation technique applicable to every case, but only for some assets and, above all, in many cases constitutes an alternative accounting method to historical cost. It is also worth adding that fair value does not represent a valuation method that necessarily impacts the profit and loss account: in some cases its effects are, by express provision of the accounting principles, felt only on the balance sheet, in the sense that the balancing entry is posted directly to equity, this item not being distributable to shareholders as it cannot be considered to have been realised".*

Indeed due to the fear that applying fair value might lead to the distribution of unrealised profits, from a statutory accounts point of view articles 6 and 7 of Legislative Decree number 38/2005 place specific limits on the distribution of amounts posted to equity and profits derived from revaluations that have been performed in application of the principle of fair value, inherent to international standards, both when transition is being made to said standards (henceforth "*First Time Adoption*" or "FTA") and after they have been implemented.

In the interests of completeness of this paper it is considered appropriate to mention the historical context. Indeed the impact of introducing IAS/IFRS to company financial statements over recent years, with a recession in progress, has necessarily led to much discussion about the fair value valuation criterion.

In substance the generalised fall in the market value of financial instruments brought about by the turbulence currently affecting the entire global financial system may be reflected, in a negative way, in company financial statements, particularly those of IAS adopters valuing their portfolio of financial instruments at fair value and that may therefore be forced to recognise enormous write-downs.

The fall in value of many financial assets as a consequence of the economic crisis has led to the re-emergence of fears, raised ever since the adoption of IAS/IFRS in Europe, that the use of current values would automatically give rise to increased market volatility.

The legislative decisions regarding tax that were outlined following the introduction of IAS/IFRS with Legislative Decree number 38/2005 were to maintain the principle that taxable profit should be derived from the financial statements and that tax neutrality between IAS-adopters and other companies should be guaranteed.

The tax system mentioned above was then transformed by the introduction of Finance Law number 244 dated 24 December 2007, which provided for a method of determining taxable profit that relied much more closely on the IAS/IFRS financial statements than had been the case with the preceding Legislative Decree number 38/2005, taking on board the criteria of qualification, balance sheet classification and accruals-based accounting, as provided for by IAS/IFRS.

Indeed direct tax derivation from the IAS/IFRS financial statements is one of the key points that the analysis of this paper focuses on, so as then to be able to understand the tax implications for IAS adopter entities of various particularly representative aspects of IAS 39 covering financial instruments.

Legislative Decree number 38 of 2005 (the so-called "IAS Decree") introduced changes to tax regulations for business income inspired by the aim of keeping the financial statements as the basis for taxation (*the derivation principle*), limiting itself to introducing tax measures required to address specific issues arising as a result of the introduction of IAS/IFRS.

In preparing the changes to the tax treatment of business income to harmonise it with the introduction of international principles, the legislator of Legislative Decree number 38 of 2005 was guided by those principles expressly indicated in the report that accompanied said decree. Indeed, as can be seen from the parliamentary documents, the IAS Decree implements the authority contained in article 25, sub-section 1, letter g) of EU Law 2003, on the basis of which the government is authorised to make "*any modification to tax regulations relating to* *business income in order to harmonise them with the innovations deriving from the application of international accounting principles*".

Legislative Decree number 38/2005 implements this authority in two ways: i) article 11 modifies various provisions of the Income Tax Consolidation Act for when the new rules are fully in use; ii) article 13 introduces various transitory provisions whose aim is to regulate the effects of the introduction of international accounting principles during the early period of application (the so-called "FTA").

Firstly, Legislative Decree number 38/2005 introduced various "organisational" regulations to take into account the fact that some operational events –for example the adoption of IAS– may *not* be credited/charged to the profit and loss account, but must be directly attributed to equity.

In order to allow the features of IAS/IFRS to be valid for tax purposes, the legislation that was passed:

i) added to article 83 of the Income Tax Consolidation Act, labelled "*Determination of overall income*", establishing that the starting point for determining taxable income, by means of the system of adding to and deducting from this amount, is the profit shown in the profit and loss account "*increased or decreased by those items that have been charged to equity under international accounting principles*" (article 11, sub-section 1, letter a) of Legislative Decree number 38/2005);

ii) modified article 109 of the Income Tax Consolidation Act, labelled "*General regulations for the components of business income*", specifically providing that "*those items directly attributed to equity under international accounting principles should be considered to be credited/charged to the profit and loss account*" (article 11, sub-section 1, letter d), number 1) of Legislative Decree number 38/2005). Thus the deductibility of negative income items that under IAS/IFRS criteria are attributed directly to equity rather than the profit and loss account is provided for.

The desire to leave unaltered the validity for tax of such items despite the fact that they are not credited/charged to the profit and loss account led to the express affirmation of this point, through the additions made to article 83 and 109 of the Income Tax Consolidation Act. It follows that when measuring business income it is appropriate to assume that the initial value of income also includes the positive and negative items that are attributed to equity, subject to the subsequent application of the regulations dealing with business income (Heading I, Item VI of the Income Tax Consolidation Act).

Given that direct attribution to equity will also take place during the initial phase of application of international accounting principles (FTA) when balance sheet values are being aligned with these principles, in order to constitute the starting point for applying the principles on an ongoing basis sub-section 1 of article 13 of the IAS Decree provides that the aforesaid modifications shall also be effective during the initial phase when said principles are applied. Finally, sub-section 2 of article 12 of the IAS Decree extends the principle of validity for tax of items directly attributed to equity also to the calculation of IRAP taxable income.

In particular, faced with the significant issues left unresolved by Legislative Decree number 38/2005, the upholding of the abovementioned principle of the "derivation" of taxable income from the financial statements constitutes an important point of reference when interpreting the gaps in the legislation that still exist, since financial statement accounting policies provided for under the new international accounting principles must also hold when determining taxable income in cases where tax regulations do not expressly prevent this treatment.

In concrete terms the implementation of these principles was achieved first of all through modification of article 83 of the Income Tax Consolidation Act, extending the principle of derivation to those operational events that are excluded from the profit and loss account by virtue of the application of IAS. The same modification naturally applies also when identifying IRAP taxable income.

Substantial tax neutrality, irrespective of the system used to prepare the financial statements, represents a key element in the tax reform provided for in Legislative Decree number 38/2005, even though this tax policy legislation would later be totally and further revolutionised by the legislator.

On the basis of these concise introductory statements, given the area of enquiry of this paper, it is stressed that international standards and in particular "*IAS 39 does not provide for the sub-division of financial instruments on the basis* *of their nature but on the basis of the purpose for which they are held in the management of the business. Financial assets are sub-divided into four categories (financial assets at fair value through profit or loss* [FVTPL], *assets held to maturity* [HTM], *loans and receivables* [L&R] *and assets available for sale* [AFS]*), liabilities into two categories (financial liabilities at fair value through profit or loss, other financial liabilities). Even though IAS 39 does not supply any guidance in this regard, it is held that financial liabilities that are not classified as liabilities at fair value through profit and loss fall into the category of other financial liabilities. Any financial liability can fall into this category, with the sole exception of financial and credit derivative contracts*".

To take account of the various categories of financial instruments provided for by international accounting principles from a tax point of view, the concept of financial fixed assets relevant for income tax purposes has been modified (article 11, sub-section 2, IAS Decree number 38/2005) with consequent effects.

The principle that substance should prevail over form lies at the root of this definition. The classification of a financial instrument must therefore be made on the basis of its content rather than how its legal form. The accounting treatment of financial instruments under IAS 39 is disconnected from the contractual form in which they are presented, but rather depends on the portfolio within which they are classified, using logic shaped by what the financial instruments are to be used for.

It is worth remembering here that IAS 39 has been modified on numerous occasions over time in pursuit of the prime objective of rendering it easier to read, and at the same time of adapting it to the financial market crisis that gave rise to a timely revision of its rules. As things currently stand the restyling process wished for by the IASB has not yet reached its end. To be extremely brief "*the new standard improves the ability of investors and other users of financial information to understand how financial assets are accounted for, reducing their complexity (an objective also endorsed by the G20)*".

To pursue this objective the IASB has simplified the classification system, reducing the four categories of IAS 39 to just two categories in the new standard:

financial assets valued at amortised cost and financial assets at fair value through profit or loss (FVTPL).

The introduction of the new IAS principles overcomes the traditional split between current assets and fixed assets, and brings with it a different and more structured differentiation in the financial statements of the categories to which financial instruments belong. This new classification reflects the purpose for which the financial instruments are held in the business and on its balance sheet, and the valuation criteria to be adopted. The result is a structured framework that does not lend itself to the traditional two way split on the simple basis of the name of the category to which the financial instruments belong.

Nevertheless, for the very purpose of taking account of the various different categories of financial instruments provided for by international principles the legislator intervened with the regulations contained in article 11, sub-section 2 of Legislative Decree number 38 and made clear that "*for companies that adopt international accounting principles, investments in subsidiaries and associates shall be considered to be financial fixed assets, as will those financial instruments that are held until maturity, and those that are available for sale*".

Despite this specific legislative intervention, aimed as it was at adapting tax regulations to take account of the new requirements for IAS adopter entities, some special questions of interpretation have arisen.

Finally, IAS adopter entities, in order to reconcile profit in the financial statements to overall income as per article 83 of Income Tax Consolidation Act, have also had to take account of those positive and negative items attributed directly to equity as per international accounting principles. Naturally, to record the tax adjustments the usual mechanisms must be adopted, and shown in the tax returns of IAS adopter entities. These must also show the positive and negative items attributed to the profit and loss account or directly to equity, the relevance to tax of which might not be recognised –in whole or in part– or that might be allocated between different periods using criteria that differ from those used in the statutory accounts.

Based on these assumptions it is inevitable that the problems connected with misalignment between the civil code and IAS will be accentuated. This is still more evident when it comes to tax, given the difficulties involved –both for the legislator and for professionals interpreting the legislation– in reconciling tax regulations with the various requirements of businesses following IAS compared to those that are sticking to the traditional type of accounting.

Now that a few years have passed since the adoption of IAS one can recall how IAS adopter entities were required to perform laborious exercises to reconstruct financial statement data, above all outside the accounting system, so as to comply properly both with statutory rules for preparing financial statements properly and with tax regulations used for the calculation of their tax charge.

Even now professional tax advisors are still waiting for an exhaustive circular from the Inland Revenue to clarify the numerous uncertainties regarding the interpretations of how these regulations should be applied. The relevant trade associations, led by Assonime and ABI, have on various occasions lobbied the authorities about the requirements of the IAS adopter entities, and have also issued their own illustrative circulars in support of their members.

Similarly, many taxpayers have queried the taxation authorities by means of tax clearance applications; in some cases the authorities have made public their clarification of correct practice, but in other cases this has not happened.

The most emblematic representation of the complexity of managing the differences produced during the transition period to IAS/IFRS (the so-called FTA) and then later when they are in regular use is perhaps contained in Ministerial Resolution number 100/E dated 16 May 2007. Very briefly, in this case a bank requested clarification from the Inland Revenue in the form of a tax clearance application, pursuant to article 11 of Law 27 July 2000 number 212 (the so-called Taxpayer Statute).

The focus of the case analysed was the tax implication of a transaction, legally classified as an assignment of receivables without recourse; as such the accounting treatment would have been to remove these assets from the balance sheet, but for other reasons connected with the particular nature of the transaction the international accounting principle IAS 39 –taking into account the substance of the transaction over its form– states that a financial asset may be removed from the balance sheet only when all the risks and rewards connected with it have been transferred (so-called *derecognition*).

For these reasons the receivables that had been legally assigned without recourse and removed from balance sheet assets had to be reinstated for IAS purposes, since this treatment represented the transaction in conformity with the financial reality as opposed to the legal form.

Law 23 December 2007 number 244 ("the Finance Act 2008") stated that "*Pending the reordering of the regulations covering business income, as a consequence of the complete transposition of the directives 2001/65/CE of the European Parliament and Council dated 27 September 2001 and 2003/51/CE of the European Parliament and Council dated 18 June 2003, in order to rationalise and simplify the process for determining income of entities obliged to adopt international accounting principles pursuant to EU regulation number 1606/2002 of the European Parliament and Council dated 19 July 2002, which takes account of the specific nature of businesses in the banking and finance sector and to the income tax consolidation act pursuant to the decree of the President of the Republic number 917 of 22 December 1986, and subsequent modifications*" it was modifying various articles of the Income Tax Consolidation Act, setting out regulations directed in particular towards entities preparing their financial statements using international accounting principles. In substance an out-and-out revolution in the system used to determine taxable income for IAS adopter entities was being witnessed.

Firstly it should be recalled that the Finance Act 2008 introduced various new innovations in how the IRES and IRAP taxable base is determined for entities preparing financial statements under IAS/IFRS international accounting principles.

To implement sub-section 60 of article 1 of Law number 244/207, Ministerial Decree 1 April 2009 number 48 (henceforth also "the IAS implementation decree") was issued, entitled "*Measures for the implementation and coordination of the regulations contained in sub-sections 58 and 59 of article 1 of Law 24 December 2007 number 244 dealing with the determination of income of entities obliged to adopt international accounting principles*". It should be stressed that, although its legislative journey was long and drawn-out, this decree is of fundamental importance since it represents the instrument linking the new legislation to its predecessor for determining income for IAS adopter entities and, in particular, during FTA.

Further co-ordination regulations are contained in article 15 of Legislative Decree number 185 of 29 November 2008, entitled "*Voluntary realignment and revaluation of accounting values*", which states, in sub-section 1, that:

- "*<u>The modifications</u> introduced by article 1, sub-sections 58, 59, 60 and 62 of Law 24 December 2007 number 244 <u>to the IRES tax system for entities preparing their financial statements using international accounting principles</u> pursuant to EU regulation number 1606/2002 of the European Parliament and Council dated 19 July 2002, <u>are effective</u>, save for the provisions of sub-section 61, second sentence, of said article 1, <u>with regard to income and balance sheet items recognised in the financial statements for accounting periods beginning after 31 December 2007</u>*";
- "*Nevertheless the income and balance sheet effects in the financial statements of this and subsequent accounting periods of previous transactions that are qualified, classified, valued or attributed between accounting periods differently to how they were qualified, classified, valued or attributed between accounting periods in the financial statements for the accounting period in progress at 31 December 2007 shall continue to be subject to the tax regulations that were previously in force. The prior period arrangements shall also be valid for the purposes of determining taxable income for IRAP, as modified by article 1, sub-section 50 of the cited Law 244 of 2007*".

Additionally, sub-section 8 of article 15 of Legislative Decree number 185/2008 introduces additional coordinatory regulations when the transition to international accounting principles takes place <u>subsequent</u> to the tax year in progress on 31 December 2007 (i.e. from 2008 onwards when the tax year is 31 December). Sub-section 8-bis of article 15 makes reference to an additional decree of a non-regulatory nature of the Economics and Finance Ministry for the related implementation.

This latter Decree was issued on 30 July 2009. It specified that for entities adopting IAS subsequent to the accounting period in progress on 31 December 2007 the principle of "reinforced" derivation, consequent to the modifications introduced by Law number 244/2007, should exclusively be applied to income and balance sheet items recognised in the financial statements from the accounting period when international accounting principles are first applied, with it remaining the case that the income and balance sheet effects in the financial statements of that period of previous transactions that are qualified, classified, valued or attributed between accounting periods differently for tax and accounting purposes are subject to the tax regulations that were previously in force. These regulations are also applicable for the determination of taxable income for IRAP purposes, as modified by article 1, sub-section 50 of the cited Law 244 of 2007.

This represents a complete U-turn regarding determination of taxable income for IAS/IFRS entities: "*under the new arrangements the so-called IAS/IFRS classifications of company transactions, where they diverge from the legal-contractual classifications to which the financial statements of companies following domestic accounting principles make reference, together with the related tax regulations, are essentially recognised as being valid also for tax purposes. It is thus clear that the validity of the principle of "neutrality" in determining the business income of IAS/IFRS adopter entities and other entities has been severely reduced; this principle, as noted, had strongly influenced Legislative Decree number 37 of 28 February 2005 that regulated the introduction in Italy of international accounting principles and that set out how the tax effects of financial statements drawn up using them would initially be governed*".

As has been illustrated, the legislative process underpinning the reform of the tax system for IAS adopter entities has been both complex and fragmented, whilst at the same time various transitory tax regimes have been specified, that have generated and continue to produce effects that must be handled outside the accounting system until the period of transition is over.

Indeed the modification made to article 83 of the Income Tax Consolidation Act, i.e. the reference of direct tax derivation to criteria of qualification, attribution between accounting periods and classification in the financial statements provided for by the IAS/IFRS principles, has consequences that are not particularly easy to evaluate, but the main criteria must be analysed separately in order to understand their true significance.

Regarding the "*qualifications*" provided for by IAS/IFRS, it should be remembered that the framework for the preparation and presentation of IAS/IFRS financial statements sets out that:

a) "*the financial statements show the financial effects of transactions and other events, grouping them together in broadly defined classes on the basis of their financial characteristics. These classes are designated as elements of the financial statements. The elements relating directly to the measurement of net asset-financial value are the assets, liabilities and net equity. The elements relating directly to the measurement of financial performance are the revenues and costs…*" and therefore that "*a process of sub-classification is required in order to present these elements in the balance sheet and the profit and loss account*";

b) the definitions of assets and liabilities, as well as of revenues and costs "*identify their essential aspects but do not seek to specify the conditions that must be satisfied before these are recognised*" respectively in the balance sheet and profit and loss account, and that recognition "*is the process by which an item that meets the definition of an element and satisfies the conditions for accounting recognition …is recorded in the balance sheet or the profit and loss account*".

Regarding the criterion that items must be "*attributed between accounting periods*" as provided for by international standards and recalled by article 83 of the Income Tax Consolidation Act, some remarks are needed to identify its characteristics, separating them out from those that are implicit in the *qualification* of the financial statements prepared using IAS/IFRS principles.

Generally speaking, on the basis of what has been explained above, it is logical to hold that the new principle of tax derivation of IAS/IFRS financial statements overrides the indications contained in article 109, sub-sections 1 and 2 of the Income Tax Consolidation Act that determine the criteria to be used for the attribution of costs, revenues and other positive and negative components of income. Indeed these rules are intimately linked to the legal-formal manifestations of the negotiations by which business is carried out: for these purposes the rules make reference to the transfer of title of the assets being exchanged, to the rendering of the service, when a service is involved, or to when pro-rata payments accrue if the services are rendered over a period of time in a technical-legal sense, and so on. Since IAS/IFRS represents transactions in a way that can diverge from their legal form, attributing different characteristics to transactions (and as a consequence changing the period which they relate to), then it is the new, different qualification that should be referred to going forward, including for tax purposes.

In the initial phase, i.e. the period between the coming into force of the new tax system based on direct derivation from IAS/IFRS financial statements – from 1 January 2008 for entities whose tax year ends 31 December– and the issuing of the IAS implementation Decree, which did not take place until 1 April 2009, many judgements and comments were made by the experts seeking to understand the true significance, from an operative perspective, of the new regulations. The question was asked whether the tax regulations dealing with *valuations* and *quantifications* still remained applicable to IAS adopter entities.

There were some who highlighted that here also one was dealing with accounting recognition issues that impacted the accounting treatment between periods, and that this should therefore be relevant for tax purposes, since the new version of article 83 of the Income Tax Consolidation Act makes express reference to the IAS/IFRS criteria of attributing items between accounting periods.

At this point it should be stated that this aspect was subsequently clarified by the IAS implementation decree. To sum up, not only the regulations that place limits on depreciation, valuations and accruals, but also those that depart, for strictly tax-related reasons, from financial statements drawn up using traditional criteria, shall continue to be applied also to IAS adopter entities, since they have no bearing on the notions of qualification, classification and attribution between accounting periods. These include the regulations that provide for the attribution of positive and negative income items on a cash basis rather than an accruals basis (late payment interest, directors' emoluments, dividends, etc.) and the regulations that do not permit or limit the deduction of costs on the grounds that they are not inherent business expenses, or that provide for a taxation of positive items spread over time for reasons of tax expediency.

Article 6 of the IAS implementation decree clarifies the provisions of article 1, sub-section 61, second sentence, of the Finance Act 2008, according to which for tax periods prior to 2008 –for entities with 31 December year ends– the impact on the tax calculation of the treatment adopted based on proper application of international accounting principles is safeguarded, provided it is consistent with that which would have been derived from the application of the regulations introduced by said Finance Act 2008 for calculating taxable income for IAS entities.

The purpose of this article is therefore to protect the actions of companies that, in the accounting periods before the new system came into force, made early use for tax purposes of financial statements prepared under IAS. This protection is operative for said treatment used for the 2005, 2006 and 2007 accounting periods, which have already been the subject of tax returns. It is nevertheless necessary for consistent treatment to have been adopted during the three periods, save for the specific case of differing treatment adopted as a result of "medium term" declaratory judgements made by the Inland Revenue that led taxpayers to alter their conduct compared to previously. In this case consistency between accounting treatments cannot be required.

With reference to the change of regulations for IAS adopter entities, it should be remembered that during FTA it was asserted by article 1, sub-section 59 of the Finance Act 2008 that "*the application of the provisions of article 13 of the aforesaid legislative decree remains valid*".

It has therefore been asserted that the abovementioned tax regulations for FTA continue to be valid also as part of the tax reform for IAS adopter entities.

This choice permits equality of treatment to be achieved between entities starting to use IAS from the 2008 accounting period and those that have already adopted it.

The regulations also state that the cited article 13 should be applied by adopting the provisions of the version currently in force of article 83 of the Income Tax Consolidation Act up until the tax period in progress at 31 December 2007, in other words that overall income is determined by taking the profit or loss shown in the profit and loss account for the accounting period ending during the tax period and, "*increasing or decreasing it by those items that under international accounting principles are attributed directly to equity, consequent on the application of the criteria set out in the following regulations of this section*".

On the basis of the remarks made thus far, it is now necessary to understand from a strictly tax point of view how the management of accounting differences arising during FTA are regulated.

Indeed, beginning from the 2008 accounting period, the new tax regulations for IAS entities illustrated above strengthened the principle of derivation of income from financial statements prepared under IAS/IFRS by permitting a reduction in the phenomenon that saw new divergences between statutory and tax values forming. Nevertheless, differences created when IAS were first applied continue to exist (for example contracts legally classified as hire arrangements that possess the requisites to be classified as leases under IAS 17).

On top of the differences arising during FTA, for entities that transitioned to IAS/IFRS prior to 2008 it is necessary to manage the additional differences that were created prior to the adoption of the new tax rules that featured strengthened derivation.

With the aim of not forcing companies to continue managing the differences present in their financial statements, article 15 of Legislative Decree 29 November 2008 was issued, converted with modifications into Law 10 February 2009 number 2 (henceforth also "the Anti-Crisis Decree"), introducing onerous and optional regulations to allow the realignment of differences between the statutory and tax values present in the financial statements of IAS adopter entities.

This paper focuses attention on the accounting and tax effects of financial instruments in a broad sense, since IAS 39 includes investments, securities, receivables, payables and derivatives in this category.

With reference to investments, the concept of financial fixed assets is analysed from a tax perspective that is connected with the various financial portfolios (FVTPL, HTM, L&R, AFS) provided for by the international standard, with consequent effects on the tax treatment both of the valuations of financial instruments and the related components of income (dividends, gains and losses).

Additionally, in relation to receivables and payables, the tax implications of the phenomena of derecognition and continuing involvement that characterise international accounting principles are taken into account. Indeed, valuing these assets and liabilities using the amortised cost method generates a different attribution of interest to the profit and loss account for IAS adopter entities compared to entities preparing their financial statements using domestic standards, with significant implications in terms of calculating the tax deductibility of interest charges as per article 96 of the Income Tax Consolidation Act.

Still on the subject of tax, it has been an objective to analyse the treatment of interest charges and derivative financial instruments. On this subject, a derivative is considered to be a financial instrument falling within the terms of the application of IAS 39 when it displays the following three characteristics:

"*a) its value changes in relation to changes in a specific interest rate, price of a financial instrument, price of a good, foreign currency exchange rate, index of prices or rates, credit rating, credit index or in other variables;*

b) it does not require a net initial investment, or it requires a net initial investment that is smaller than that which would be required by other types of contracts from which similar responses to variations in market factors would be expected;

c) it is settled on a date in the future".

Derivative financial instruments may be used to hedge against financial risks connected with a portfolio or instruments that are already held, or for the purposes of speculation.

IAS 39 provides for a distinction between derivatives used for hedging and derivatives used for speculation. The former is so designated when its fair value or predicted cash flow is expected to compensate for changes in the fair value or cash flow of the item being hedged. For these transactions it is necessary to evaluate the effectiveness of the hedge, representing the degree to which the use of the hedging instrument compensates for the changes in fair value or cash flows attributable to the risk being hedged. In this regard it is stressed that IAS 39 provides for three types of hedge: the first, called a fair value hedge, has the objective of hedging exposure to changes in the fair value of a balance sheet item attributable to a particular risk. With this hedging transaction the change in the fair value of the item being hedged is compensated for by an offsetting variation in the fair value of the hedging instrument. The second, called a cash flow hedge, has the objective of hedging exposure to fluctuations in future cash flows attributable to particular risks associated with balance sheet items. The third type of hedge seeks to hedge the risks of an investment in a foreign-currency denominated item.

Speculative derivative financial instruments, on the other hand, are contracts whose value is linked with (derived from) changes in the price of the underlying financial asset and its ability to be traded in the market, but that are not held by the company for the purpose of hedging a risk.

In academic research the derivative contract has been defined as "*a bilateral contract with deferred execution, strongly aleatory in nature, referring to a financial object, real or abstract, the subject of which is the change in value over time of said object*".

The adoption of international accounting principles represents a kind of a revolution, because derivative financial instruments shift from being "off balance sheet" transactions to being transactions that are customarily shown on the balance sheet, like any other financial instrument, and are treated as being of equal significance. For tax purposes financial derivatives are regulated by article 112 of the Income Tax Consolidation Act entitled "Off balance sheet transactions". With the various legislative developments over time the opportunity has not been grasped to coordinate better the application of article 112 of the Income Tax Consolidation Act with the definition of derivative financial instruments contained in IAS 39. In particular it should be noted that sub-section 3-bis of article 112 of the Income Tax Consolidation Act affirmed the full deductibility of items as valued, eliminating therefore the numerous doubts in interpretation that had arisen above all regarding the deductibility of the effect of discounting foreign currency forward contracts and the full tax relevance of off balance sheet transactions connected with the forward purchase or sale of securities as per sub-section 3, letter b) of said article 112. From this legislative framework it follows that the valuation (positive or negative) of speculative derivatives which, it should be recalled, are always valued at fair value and attributed to the profit and loss account, are fully recognised for tax purposes. With regard to the notion of hedging, entities preparing their financial statements under IAS must make reference to the notion of hedging contained therein. Legislative Decree number 38/2005 states that "*to avoid unjustified divergences between financial statement principles and tax regulations, reference to the concept of hedging provided for by international accounting principles has been introduced*".

Once the hedging relationship has been verified, sub-section 4 becomes applicable, establishing that if the derivatives "*are brought into being to hedge assets or liabilities, or are hedged by assets or liabilities, the related positive and negative elements deriving from their valuation or realisation form part of income according to the same regulations that govern the positive and negative elements deriving from the valuation or realisation of the assets that are respectively being hedged or that are doing the hedging.*"

The regulation clearly affirms the so-called principle of symmetry, according to which the effects of the valuation or realisation of hedging derivative contracts are treated the same way for tax as the corresponding positive or negative elements, relating to valuation or realisation, deriving from the assets or liabilities being hedged. As a consequence, the tax effect must tend to be neutral, as is the case in the profit and loss account in the financial statements. The principle described above is applied in particular with reference to fair value hedging derivatives.

Finally, it should be noted that on 9 December 2010 the IASB published a consultation paper, Exposure Draft ED/2010/13 "*Hedge Accounting*", which represents the final phase of the project to revise IAS 39. The objective of the proposals contained in the Exposure Draft is to mitigate the differences in the recognition and measurement of the hedging instrument (for example, derivatives) and the item being hedged (for example, planned sales) when certain requisites are satisfied, and includes many changes to the current requirements, the objective being for the financial statements to reflect comprehensively the risk management activities that are carried out by the entity.