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CONTENTS

387 The purpose of tax law: A perspective on financial instruments' fair value adjustments in Portugal
António Martins and Daniel Taborda

402 Encouraging superannuation income streams with tax-free earnings to be taken in a form that provides longevity insurance
Rami Hanegbi

424 Tax professionals' profiles concerning tax noncompliance and tax complexity: Empirical contributions from Portugal
Ana Clara Borrego, Cidália Maria Mota Lopes and Carlos Manuel Ferreira

457 GST compliance and challenges for SMEs in Malaysia
Yong Mun Ching, Jeyapalan Kasipillai and Ashutosh Sarker

490 A cross-cultural study of religiosity and tax compliance attitudes in Malaysia and Turkey
Raihana Mohdali, Serkan Benk, Tamer Budak, Khadijah MohdIsa and Salwa Hana Yussof

506 The role and dimensions of taxpayer commitment in tax compliance behavior
Marina Bornman and Jurie Wessels

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eJ perspective on
instruments' fair value adjustments in

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Abstract

In recent Portuguese tax arbitration cases two opposing lines have emerged concerning fair value loss deduction in equity instruments listed in financial markets, one arguing for loss restriction, another sustaining full loss deduction. Both are based on an interpretation of corporate tax rules.

1. I

2. LITERATURE REVIEW

2.1 Some accounting issues related to fair value

The International Accounting Standard Board (IASB) and the Financial Accounting Standard Board (FASB) have adopted a conceptual path where fair value accounting is increasingly used in the preparation of companies' financial statements.

Accounting measurement of assets based on historical costs is insulated from the volatility of market prices.

(2015) also shows a relationship between fair value reporting and incorporation of firm-specific information into stock prices.

Accounting standards prescribe a three-level hierarchy of fair value measurement inputs: Level 1 reflects quoted prices in active markets; Level 2 applies to cases for which there are observable inputs related to the existence of a market with similar (not identical) items used as a basis for comparison; and Level 3 inputs are unobservable and correspond to the absence of a comparable market, thus making use of a theoretical model to derive hypothetical market prices. At this last level, reliability is lower and managerial opportunism and potential abuse may occur.

Considering its significant influence on investors' decisions, increasing the value relevance of financial statements is a major purpose of fair value reporting. In the absence of an active market to measure assets and liabilities, the range of evaluation methods and information sources are difficult and complex. They involve subjectivity and uncertainty, offering managers judgment discretion and leading to potentially distorted financial statements. Auditors must evaluate if fair value measurements in financial statements are reasonable, and decide if adjustments are required. Smith-Lacroix et al. (2012) emphasise the change of auditor role due to fair value accounting, similar to an arbitrator who mediates discrepancies over subjective values, often estimated by valuations experts, whose authority is difficult to challenge. Griffin (2014) found that auditors are most likely to require adjustments in fair value estimates when subjectivity and imprecision are both high.

In some cases, fair values are not recognised, but rather disclosed. Concerning investment properties, firms either recognise fair values on the balance sheet, with positive and negative effects in net income or through equity changes (fair value model), or disclose fair values in the footnotes, recognising those assets on the balance sheet at depreciated cost subject to impairment (cost model). Muller et al. (2015) gathered evidence on the relative importance of recognitions and disclosure.

If, on the accounting side, fair value is at the center of an ongoing debate, the tax consequences of its adoption are also a major issue for legislators, firms and tax practitioners.

2.2 An overview of tax issues related to fair value taxation

The design and application of a tax system has several well-known policy goals. Firstly, it must raise revenue to support public expenditure. Secondly, it should strike a delicate balance between principles such as fairness, efficiency and simplicity (Slemrod & Bakija, 2008). In this process, tradeoffs are inevitable. For example, a fairer system based on a careful tuning of deductions in personal income tax can add some complexity.

Finally, in recent decades, policy makers have made international competition a significant goal of tax systems. Corporate income taxation is a favoured area, where variables like tax rates, tax benefits and special treatment for intangibles, to name a few, have been used to lure foreign investors (Miller & Oates, 2014).

A financial accounting system has an overriding goal — to adopt a set of principles and rules that, when applied, produce a true and fair view of an entity's economic and

Fair value accounting reflects market volatility on reported earnings. These variations may be called artificial, in the sense of being unrealised. However, in the particular case of financial instruments, fair value taxation seems to gather some supporters, given its significant effects on a company's income tax bill. In fact, in comparison to the realisation principle, the most obvious difference between the two approaches is the time at which tax is due.

If acquisition and disposal dates occur in different fiscal periods, fair value taxation anticipates tax effects, as price variations will be reported annually, irrespective of any real(ised) profit or loss. If the tax rate remains constant over the years, which is not common in Portugal, the only difference is the time of taxation. However, even if the total amount of tax paid is the same, time is valuable in financial decisions. Under the realisation principle, assets appreciations are not taxed when they occur. Taxation is deferred until realisation (sale or exchange). This requirement is based on the fact that receiving a benefit, which is usually associated with increasing liquidity, triggers a legitimate tax collection, as stated by Kwall (2011) and Shuldiner (1992).

In a mark-to-market system assets are valued and taxed on the change in value over the period. However, the adoption of this system faces political problems and administrative costs. Investors resist paying taxes without a cash inflow, and it may be expensive to perform asset valuation every year. A realisation system is more stable, and triggers less valuation issues (Jager et al., 2012).

Another question that may arise is the underlying rationale of an exception to the realisation principle. It highlights the importance of an old issue, the book-tax relationship, which is at the core of the divergence between taxable and accounting income. The tax system is not designed to provide forward-looking economic information, but aligning taxation and financial reporting of financial instruments seems rational (Jager et al., 2012; Maroun, 2015).

A mixed tax system seems inevitable. As argued by (Shuldiner, 1992; Jager et al., 2012), accepting the existence of different financial instruments j0.9 ( )-engtsnsent fi8-1.6

This paper aims to understand the precedents, meaning and scope of some CITC clauses, in order to capture its real nature and implications. Understanding the reason behind the existing law leads to suggestions for improvements, removing uncertainty and providing a coherent framework. In this sense, Gestel and Micklitz (2014, p. 314) argue that:

> academic legal research should primarily be engaged with trying to understand what is behind the law on a certain subject, why lawmakers operate as they do, why they look for legal answers to certain societal problems instead of pursuing alternatives to law and why the law says what it says instead of pondering about how the answer to a legal problem can be embedded in the legal system.

The problem that leads to the research question is identified through analysis of arbitration cases. Narratives contained in cases often capture real life complexities and contradictions (Flyvbjerg, 2006).

> The negative difference between capital gains and losses realized by the sale of equity instruments, and other losses related to equity components, contributes to taxable income only in the proportion of 50% of its value.

As far as article 18, §9, a) is concerned it is understandable that the tax relevance of fair value has been, as a rule, limited to certain types of assets by the Portuguese tax legislators. The widespread adoption of fair value as measurement criterion with full tax implications could lead to undesirable fluctuations in the tax base. Furthermore, after 2010 the Portuguese public finance situation implied the need for an external bail out and a strong emphasis in maximising tax receipts.

Thus, for financial assets that are legally defined in article 18, §9, a), regular trading in a regulated market, liquidity, a percentage of participation that, as a rule, does not imply price making capacity, and public disclosure of prices, all give fair value some economic and legal support, and also a degree of objectivity, which reduces legislative concerns related to the respective tax adoption.

As far as article 45, §3, is concerned, we must stress that it was set up in 2003, when fair value was not an accounting or tax issue. It was enacted to fight the manipulative use of the realisation principle in generating capital losses to offset operating income. As such, its teleology has nothing to do with fair value.

4.1 Arbitration rules and their fundamentals

The first arbitration case (Process 108/2013) ruled for the taxpayer, based on the following arguments:

1. Article 18, §9, a) of the CITC allows full deduction of fair value losses on equity instruments and the restrictive regime established under article 45, §3, does not apply. That is, tax implications of fair value in equity instruments are fully and completely stated in article 18, §9, a), and article 45 is therefore irrelevant.

2. The purpose of article 45, §3, is objectively connected with realised losses. It intends to discourage the convenient timing of losses by taxpayers to reduce taxable income in a certain year. By timing realisation in a profitable year firms could manage or manipulate taxable income. In a fair value paradigm, given that equity holdings must be below 5% to grant tax relevance to fair value gains or losses, the taxpayer is mostly a price taker, because accounting standards demand market quotation. Thus, taxpayers cannot use fair value to manage or manufacture losses. In the case of article 45, §3, the *ratio legis* (fighting avoidance) is quite distinct from the purpose of denying fair value full loss deduction.

3. The Portuguese Constitution states (article 104) that companies are taxed based on their real income. 'Real', or effective, meaning that the accounting income is the starting point to compute the tax base, and adjustments are added or subtracted (e.g., adding non-deductible provisions or subtracting non-taxed capital gains).

In this legal paradigm, taxes should not fall on a firm that has no ability to pay, revealed by an increase in net wealth (or equity) in certain year. To illustrate, suppose a holding company presenting as its sole asset a portfolio of equity instruments recorded at fair

value. Suppose, also, that the evolution of the market price of such a portfolio is observed in table 1. If the loss restriction established in article 45 is applied, we arrive at the following result:

Table 1 — Market value of a portfolio recorded at fair value

Year end	Market price	Fair value gain/loss	Taxable gain/deductible loss	Total net taxable income
1	1000			
2	500	–500	–250 (50%*500)	
3	800	300	300	
4	1000	200	200	300+200–250 =250

If the interpretation of tax authorities is followed, we arrive at an inconsistent outcome: a profitless firm with no increase in economic wealth between years 1 and 4, revealing no ability to pay, has to bear the corporate income tax on the amount of 250. The constitutional rule would be severely strained, and this is an additional argument to reject tax authorities' line of reasoning.

4. Moreover, the wording of article 45, §3, mentions 'losses'. For holdings, whose main or core activity is to manage portfolios, fair value reductions in assets are expenses (ordinary) not losses (extraordinary or peripheral to operations).

Contrarily, another arbitration case (Process 25/2014) ruled for the tax authorities, based on the following motives:

1. Article 45, §3, does not qualify restricted losses. By writing 'other losses related to equity components' the legislator did not spare fair value losses from the code limitation. Thus, the interpreter cannot do what the legal wording does not allow.

2. In financial markets, prices are quite often manipulated.

potentially arising from the timing of realised capital losses. Firms could book losses in profitable periods, thereby manipulating the corporate tax base.

The adoption of the fair value paradigm in Portugal happened in 2010. In 2003 it was still quite distant. Thus, specific concerns about fair value losses can hardly be seen as a factor in interpreting article 45, §3, in the sense it was also designed to restrict fair value losses.

Moreover, in financial participations under 5%, when fair market value losses have tax relevance, firms holding portfolios of financial assets are not usually price makers. Therefore, the potential for timing transactions in order to influence market prices and recognised fair value changes is an unconvincing motive for applying loss restriction.

Arguing that the wording of article 45, §3, by stating 'other losses' means 'all losses, including fair value', is forgetting that the law's interpretation must go beyond the literal sense, if, as is the case, the meaning is not straightforward given the birth and evolution of the legal rule.

Regarding constitutional issues, and the taxation of real income, we detect a crucial argument against the tax authorities' interpretation. The CITC has a core principle — taxable income is based on profit plus other (if taxable) net equity increases. As table 1 makes abundantly clear, a non-symmetrical taxation of fair value gains and losses can lead to a situation in which a company pays taxes even if its profit or net equity increase is nil. This goes against the very foundation of corporate tax base definition in the Portuguese law. It follows that, when recording fair value gains and losses in holding companies, under the 5% participation threshold, full taxation of gains and full deduction of losses must be the appropriate interpretation.

The fact the Constitutional Court has ruled that expense or loss restraining is admissible, is not, in our view, a decisive argument. In fact, the Court has ruled that in order to fight tax avoidance and evasion, and to achieve a fairer distribution of the tax burden, some booked expenses (e.g. recreational, capital losses with related entities, non-documented costs) can be restricted. In many countries, extensive lists of non-deductible costs in computing the corporate tax base can also be found.

Yet the fair market value issue discussed here is distinct. In this case there is no avoidance opportunity, and the expense or loss in a holding company has a clear business purpose. The admission of loss restriction would imply paying taxes even if no profit is booked or, worse, in certain cases even if a net accounting loss is booked. This would be an excessively wide interpretation of the constitutional precedent of admitting certain loss restrictions as a fairness enhancing device.

Regarding the accounting question (expenses versus losses) our analysis is based on accounting standards and the financial accounting literature. Elaborating on the distinction between expenses and losses, and drawing on the Statement of Financial Accounting Concepts 6, issued by the FASB, expenses are defined as outflows from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. On the other hand, losses are defined as decreases in equity from peripheral or incidental transactions.

Items that are revenues for one entity may be gains for another, and items that are expenses for a certain firm may be losses for another. To illustrate, investments in

securities that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies.

This important doctrinal source stresses the distinctive nature of losses by linking them to peripheral activities of an entity. The same economic phenomenon can be classified as an expense in some cases and as a loss in others, depending on the economic activity developed by business entities.

In the Portuguese doctrine, Machado (1998) points out that losses do not relate to the core or productive activities originating revenues. Revenue, as defined by the Conceptual Structure of the Portuguese Financial Accounting System (SNC), stems from regular activities of an entity.

In the international literature, Libby et al. (2009) define losses as decreases in assets (or increases in liabilities) from peripheral transactions.

Article 45, §3, states that what is restricted is deductibility of 'other losses', not 'other expenses'. Accepting the conceptual distinction between expenses and losses, and bearing in mind the concrete case of holdings, it can be argued that their normal activity is the acquisition, managing and sale of shares. Holding securities listed on a regulated market, whose accounting value is affected by price changes, is not a peripheral phenomenon or fortuitous activity. Fair value gains and losses in these equity instruments are regular economic consequences emerging from holdings' activity as defined by law (Decree law 495/88, 30 December).

We venture that the purpose of article 45, §3, the relation between accounting concepts and the wording of this tax rule, and the real income taxation principle established in the Portuguese Constitution, all argue for the full deduction of fair value losses, when requirements stated in article 18, §9, a) of the CITC are observed.

A final remark on this issue. We are aware that, in many countries, loss restriction rules do exist. Firstly, loss carry over (or carry back) can be limited in time. Secondly, capital losses derived from financial instruments

of fair value. A general acceptance of fair value for tax purposes raises an (in our view, understandable) concern with the possibility of taxable income manipulation. Valuation based on financial models could be a dangerous tool for reducing the tax base, if fair value was granted total acceptance in corporate income taxation.

A total disregard of fair value for tax purposes seems also an excessive solution. When reliable market prices do exist, accounting values are determined outside the influence of managers and the possibility of manipulation is reduced. As such, the convergence between accounting and tax values is an acceptable solution. Financial instruments, with market prices, are thus a good starting point to adapt the tax law when financial accounting systems move towards a fair value based paradigm.

However, even if fair value tax relevance is limited to this type of assets, any legislator must ponder several thorny issues:

1. Should fair value have tax relevance for financial (equity) instruments independently of the participation of the investor?

2. If a threshold is established, how to deal with changes in the financial participation above/below that threshold?

3.

The Portuguese solution to this issue was to fiction a realisation when the participation goes above/below the threshold (article 46 of the CITC). For example, let us suppose

Therefore, faced with two contradictory perspectives of tax arbitration courts, we strongly supported the full deduction of recogn

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