

eJournal of Tax Research

Volume 15, Number 3

December 2017

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

The purpose of tax law: A perspective on financial instruments' fair value adjustments in Portugal

António Martins¹ and Daniel Taborda²

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. The purpose of this paper is to discuss both perspectives, using case analysis to arrive at a consistent interpretation. We conclude that the rational or purposive element should be of paramount importance in the interpretation of relevant tax rules, and no loss restriction should apply.

Key words: fair market value, corporate tax, financial instruments, loss deduction

¹ School of Economics, University of Coimbra and CEBER Research Center; Av. Dias da Silva 165, Coimbra, Portugal; amartins@fe.uc.pt.

² School of Law, University of Coimbra and CEBER Research Center; Pátio das Escolas, Coimbra, Portugal; danielgeraldotaborda@gmail.com.

The authors are grateful to two anonymous reviewers for valuable comments. The usual disclaimer applies.

1. INTRODUCTION

Until 2014 the Portuguese corporate income tax code (CITC — enacted by Decree Law 442-B/1988, 30 November) established, in its article 45, §3, that losses on equity instruments were not fully tax deductible, but rather only up to 50% of their amount. In 2010, with the introduction of an IFRS based financial accounting system and the subsequent reform of the CITC, a question emerged: should recognised fair value losses in equity instruments held by firms be subjected to this tax limitation?³

Two argumentative lines have been offered in litigation cases decided in Portuguese tax arbitration courts. One has argued for full deduction, given the purpose of the 50% deduction, anchored in fighting tax avoidance.⁴ Potentially avoiding transactions were linked to the *manufacturing* of capital losses, by conveniently timing realisation. As this could not be possible in a fair value accounting paradigm, where market prices underline loss recognition by investors, the argument was that a full loss deduction should be the proper consequence. The alternative arbitration judicial perspective argued for the restriction of loss deduction derived from fair value adjustments, because a literal reading of the CITC does not allow discrimination between different types of losses in equity instruments.

The purpose of this paper, drawing on legal interpretation and case analysis, is to discuss the following research question: which interpretation is appropriate, when the literal and purposive elements related to the mentioned corporate tax rule are considered? Or, to put it in another way, should fair value losses in certain equity instruments be fully or partially deductible (symmetric or non-symmetric treatment of gains and losses) in the computation of investors' tax base?

Our conclusion is that, given the accounting principles underlining fair value, it does not make sense to apply the aforementioned tax restriction on accounting losses. In a fair value setting, financial instruments have market prices and the occurrence of losses is not dependent on the will of the taxpayer, being a consequence of price movements that investors cannot control. Given the purpose of the restrictive loss rule, extending it to fair value is, in our view, an unjustified interpretation of the law.

To explore the issue this paper is organised as follows: Section 2 presents a review of accounting and tax literature related to fair value; Section 3 explains the methodology; Section 4 details arguments used in divergent arbitration courts' decisions on fair value loss deduction related to financial instruments; Section 5 offers our view on the appropriate interpretation, Section 6 explores policy implications to tax legislators; and Section 7 offers some conclusions.

³ 'Fair value' is intended as 'fair market value', given that financial instruments analysed here are equity instruments with quoted market prices.

⁴ The term 'purpose' of the law means its 'teleology' or 'rationale'.

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. This static record is sometimes seen as more reliable, since historical information is easily documented. However, asset values can become impaired and written down, generating losses. Thus, even in an historical cost accounting paradigm unrealised losses can be the basis for adjusting asset values and influence net income. However, on the other hand, unrealised gains are typically not recognised, given the conservatism applied in the preparation of financial information.

The debate concerning fair value-accounting has increased due to the last financial crisis, reflecting an old accounting issue: the tradeoff between relevance and reliability (Laux & Leuz, 2009). This debate has had several consequences. For example, following the 2008 global financial crisis, the IASB decided to allow financial instruments' reclassification. This decision responded to the claims that losses derived from fair value accounting affected net income and increased the credit crisis, creating a self-fulfilling mechanism (Ballas et al., 2012).

Accepting that markets aggregate preferences and reduce informational asymmetries, market values (that are supposed to capture internally generated intangible assets, like goodwill) are seen as a better guide to managerial decisions. Supplying publicly, timely and comprehensive information to support economic decisions, giving special attention to investors, reducing the cost of capital and promoting foreign investment, as well as improving its global transparency and comparability, all led to the widespread acceptance of fair market value (Benston, 2008).

Furthermore, fair value improves comparability, which is a key characteristic of financial statements. Among other requirements, the measurement of the financial effects of similar transactions and other events must be carried out in a consistent way by different entities. Cairns et al. (2011) analysed the use of fair value measurement by 228 listed companies in the UK and Australia, under IFRS adoption in 2005. Their findings indicate that, when fair value was a mandatory requirement, within and between countries comparability was enhanced through the increasing use of fair value accounting for financial instruments and share-based payments.

As Barth (2007) states, there is basically no real alternative to a fair value based model. Laux and Leuz (2009) stress that even critics of fair value accounting do not defend a return to historical cost accounting. They note that it is difficult to support historical cost accounting as a viable alternative for liquid assets. An approach based on historical costs inappropriately reflects the current fundamental value of assets and liabilities.

Results from Siekkinen (2016) suggest that fair value in asset measurement is more relevant than historical values, while BarHava and Rozen (2015) found that fair value estimates provide relevant and representationally faithful information when compared to historical cost values. Empirical evidence obtained from Elbannan and Elbannan

(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

financial position. As such, accounting income and taxable income are influenced by different priorities and policy goals.

Given the complexities in the computation of fair value for several types of assets, liabilities and equity instruments (especially when market prices are not available) it is understandable that tax legislators have to give detailed consideration to the treatment of fair value gains and losses.

In general terms, three solutions are possible as far as fair value taxation is concerned. A first option is to relegate fair value to the accounting domain, while continuing to base taxation on the realisation principle. That is, to shield taxable income from fluctuations in the fair value of assets that, in accounting terms, are recognised under this measurement criterion. This would lead to an even greater gap between book and taxable income.

At the other extreme, full acceptance of the tax impact of fair value could be considered. In this scenario, fair value gains and losses recognised by the accounting system would be automatically included in the computation of the tax base, and greater convergence between the accounting and tax consequences of fair value is achieved.

Finally, an intermediate solution could be devised, in which only in certain limited, well defined, cases changes in fair value have tax consequences.

Solutions adopted in many countries show that the decision is not easy. As stated Cavana et al (2013, p. 52) for the Italian case:

...the wide use of fair value in the measurement of financial assets required by IAS 39 is one of the most controversial issues in the debate about the suitability of IFRS for tax purposes because, as a general tax principle, capital gains or losses should assume relevance only at realization. Nevertheless the Italian Tax Code accepts IFRS valuation for certain categories of financial assets. For example, fair value has fiscal relevance for all financial assets held for trading, for bonds and similar assets designated at 'fair value through profit or loss' ...

Using a sample of 31 companies that have been part of the Portuguese Stock Index-20 (PSI-20) between 2005 and 2012, Cardao-Pito and Barros (2016) found that fair value accounting had a negative impact on Portuguese tax revenues. In 2010, CITC was revised and established restrictions to the tax effects of fair value accounting. However, a number of accounting measurements remained acceptable for fiscal purposes with several implications in corporate taxation. That is the case — as we shall see later — of fair value adjustments on financial investments when the participation on equity is lower than 5%.

Shuldiner (1992) argues that taxation of financial instruments has been challenged by the absence of a uniform theory and the evolution and technical sophistication of these assets, degenerating into uncertain and inconsistent rules. Some of these problems could be eliminated, switching the current realisation system for a mark-to-market accounting system for some financial instruments. Innovation and complexity in financial instruments has prompted some criticism to tax systems based on realisation rules (Hasen, 2003).

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 justifies the maintenance of a hybrid approach, with the realisation principle for some instruments and fair value taxation for others.

In the light of these considerations, the Portuguese solution to tax fair value adjustments in financial instruments — allowing a restricted and well defined acceptance, see section 4 — is quite understandable. However, the tax authorities' interpretation of fair value loss restriction based on a rule that was historically linked to the realisation principle is, in our view, excessive and economically unjustified.

3. METHODOLOGY

This paper's approach is based on the observation of a legal phenomenon (judicial decisions) and uses cases (law interpretation) in order to derive conclusions (answer the question of the feasibility of fair value losses limitations).

Our objective is to explain, interpret and critically analyse an existing legal rule. The ambiguous interpretation of this rule is reflected on contradictory judicial decisions.

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). From the observation of a certain real-life situation a process of investigation that increases knowledge may arise, becoming useful to a wider group of agents, such as taxpayers, tax practitioners and policymakers. Therefore, case analysis is of paramount relevance in the methodology adopted in this paper.

4. FAIR VALUE CASES AND TAX ARBITRATION COURTS CONTRADICTORY RULINGS

Portugal has had tax arbitration courts since 2011 (Decree Law 10/2011, 20 January). These courts can rule on cases involving amounts up to 10 million euro. Arbitrators must apply established tax law, as any state tax judicial court, and rulings must be delivered in six months. Many companies value the expediency of arbitration courts, especially medium and large firms as well as Portuguese affiliates of foreign companies, in complex matters like transfer pricing, intercompany debt or anti-abuse clauses. The number of tax cases decided in such courts increased from 26 in 2011 to 850 in 2014.

Since 2013, arbitration courts have dealt with the limitation on loss deduction established in article 45, §3 of the CITC. Typically, a tax audit focused on recognised fair value losses — through profit and loss accounts — on equity instruments. The taxpayer assumed losses were fully deductible, based on article 18, §9, a) of CITC. However, the tax authorities have applied article 45, §3 and disallowed the deduction of 50% of the recorded loss. These cases are usually litigated mainly by holding companies, the main investors in financial equity instruments.

The relevant legal rules of the Portuguese CITC are article 18, §9, a) inserted in the CITC in 2009 stating:

The accounting adjustments resulting from fair value do not affect taxable income, being recognized as revenues or expenses in the tax period in which assets that originated them are sold or liquidated, except when: a) they are related to financial instruments recognized at fair value through profit or loss account, provided that, in the case of equity instruments, they have a price taken from a regulated market and the taxpayer does not hold an equity participation higher than 5%.

Article 45, §3, inserted in the CITC in 2003, states:

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. The objectiveness of fair value and its supposed immunity to manipulation should not be taken as decisive arguments against tax authorities' interpretation of article 45, §3.
3. The Constitutional Court has already decided that the real income taxation principle is not violated by the restriction of certain types of losses (Ruling 85/2010). Therefore, no particular problem is created by restricting fair value losses.
4. The semantics concerned with 'expenses' and 'losses' are irrelevant, because the accounting notion of expenses also includes losses.

Faced with two opposing interpretations, what is our perspective on this thorny issue?

5. A DISCUSSION OF ALTERNATIVE JUDICIAL VIEWS AND OUR PERSPECTIVE

Let us begin by discussing the purpose of article 45, §3 of the CITC, enacted by Budget Law 2003 (Law 32-B/2002, 30 December). Its stated goal was to fight tax avoidance

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 are often restricted to offset operating gains. (This was the rationale of article 45, §3, but in a realisation paradigm, not in a fair value setting). Thirdly, loss carry over can be restricted in its amount. If a firm has a tax loss of 1000 in year 1, and a tax profit of 1000 in year 2, and if a 50% restriction applies, then in year 2 the tax profit is 500, and not zero, as it would be if full deduction applied.

However, the issue here is quite distinct. Tax authorities were applying to fair market value losses a restriction that was created to avoid the manufacturing of losses in a realisation paradigm. The essential feature of fair market value losses discussed in the previously analysed cases is that they emerge from observable and quoted market prices, not from the hypothetical convenience and timing of realisation. Thus, to apply article 45, §3, to losses with such a nature is, in our view, inconsistent with the purpose of that tax limitation rule.

6. SOME POLICY IMPLICATIONS

In previous sections of this paper we highlighted the complexities of devising a tax solution to accommodate the increasing importance of fair value in financial accounting. In many circumstances, the preferred option of legislators is to restrict the tax relevance

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. Should there be a symmetric treatment of gains and losses?

In many countries, business law establishes a threshold for the so called 'qualified equity participations'. Thus, when a shareholder acquires a number of shares above a certain percentage, this is considered a relevant holding and must be disclosed to market participants. In the Portuguese case it is 2%, but this was not followed in the fair value tax threshold, which is 5%.

It can be argued that for participations under this threshold, an investor is considered not to have a strategic position, and is basically a price taker. However, in many cases, holdings around 5% are strategic and can exert important influence on corporate events such as mergers, spin offs and take overs.

In our view, establishing a threshold has good economic rationale, particularly given the attribution of tax relevance to fair value should be strongly related to a low probability of price manipulation by investors.

Another reason argues for a low threshold: an investor with a low participation has a higher degree of market liquidity, given the easier tradability of assets. A tax liability triggered by a fair value measurement has, therefore, a corresponding higher liquidity on the side of the taxpayer to pay the tax due.

However, this option is plagued with a problem that is mentioned above — how to deal with fair value gains and losses arising when the investor's position goes above/below the threshold? That is, supposing the limit is 5%, if for example, a gain is built when the investor has 6% (tax irrelevant) and for some reason the participation goes to 4.5% (when the fair value gain has tax relevance), how to deal with such cases?

The problem can become even more complex, because a change in the investor's percentage of participation can arise from several causes such as the sale of stock, or dilution by new share issuance that investors do not buy.

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 that a portfolio of shares, representing 6% of the investee's equity, is bought in year 1, by 1000. In year 4 the portfolio has a fair value of 1600. Then, if in year 4 the participation goes to 4%, it is presumed that the gain (600) is realised. The fair value gains and losses only become tax relevant after year 4. If, in year 5, the fair value is 1800, then a taxable gain of 200 is recognised. It seems an ingenious solution, but introduces an inevitable higher degree of complexity in fair value taxation of financial instruments.

Regarding the symmetric treatment of gain and losses, we venture that symmetry is the right option. In fact, the loss limitation related to some realised capital gains is understandable, given the taxpayer has a timing option to realise them and to manipulate taxable income. But, when moving to fair value on equity instruments, with market observable prices, the possibility of manipulation of taxable income is not dependent on the will of the taxpayers. Therefore, taxation of gains and full deduction of losses seems the proper way to legislate.

Additionally, a legislator introducing fair value clauses in a corporate tax code based on the realisation principle must carefully comb the code for rules with wording like 'any loss...' or 'any gain...'. In a fair value environment, the economic nature of gains and losses may be a decisive reason to insulate them from general rules that may have been set up with other policy goals in mind.

7. CONCLUSION

Fair value accounting is often criticised for introducing optimism and inflating equity or earnings with non-realised gains. However, non-realised losses are also recognised, bringing potential problems to light. These anticipated results prevent hiding or delaying the disclosure of serious financial difficulties.

Furthermore, from an accounting perspective, historical cost is losing its appeal as a measurement alternative. The real challenge is to make fair value accounting more reliable, in particular when market information is not always available, requiring assumptions and significantly relying on judgment.

Concerning financial instruments taxation, the literature shows there is a considerable acceptance of fair value profit and loss recognition in detriment to the realisation approach.

After Portugal adopted an IFRS accounting based system, the tax relevance of fair value in equity instruments was clearly limited in scope. Moreover, tax authorities, in auditing, argued that a 50% fair value loss restriction would apply to fair value, inducing an asymmetric treatment of gains and losses.

We deem this position economically unjustifiable and not supported by the teleology of this loss restriction rule. Being set up to counter the manipulation opportunities of the tax base in an environment where the realisation principle was the rule for taxing financial instruments' gains and losses, it has no place in a fair value setting such as the one defined in article 18, §9, a) of the Portuguese CITC.

Therefore, faced with two contradictory perspectives of tax arbitration courts, we strongly supported the full deduction of recognised fair value losses in equity instruments.

8. REFERENCES

- Ballas A, Chalevas, C and Tzovas, C 2012, 'Market reaction to valuation adjustments for financial instruments: Evidence from Greece', *Journal of International Accounting, Auditing and Taxation*, vol. 21, pp. 52–61.
- BarHava, K and Rozen, H 2015, 'Can manager-provided fair value estimates be both relevant and reliable? Evidence from the United States public venture capital industry', *Journal of Accounting and Finance*, vol. 15, no. 2, pp. 129–156.
- Barth, M E 2007, 'Standard-setting measurement issues and the relevance of research', *Accounting and Business Research*, vol. 37, special issue, pp. 7–15.
- Benston, G 2008, 'The shortcomings of fair value accounting described in SFAS 157', *Journal of Accounting and Public Policy*, vol. 27, pp. 101–114.
- Cairns, D, Massoudi, D, Taplin, R and Tarca, A 2011, 'IFRS fair value measurement and accounting policy choice in the United Kingdom and Australia', *The British Accounting Review*, vol. 43, pp. 1–21.
- Cardao-Pito, T and Barros, J 2016, 'The application of "fair value" accounting standards to the income statements of companies listed in the Portuguese Stock Index-20 (PSI-20)', *Review of Business Management*, vol. 18, no. 59, pp. 67–86.
- Cavana, G, Guggiola G and Marenzi, A 2013, 'Evolving connections between tax and financial reporting in Italy', *Accounting in Europe*, vol. 10, no. 1, pp. 50–75.
- Elbannan, M A and Elbannan, M A 2015, 'Information content of SFAS 157 fair value reporting', *Journal of International Accounting, Auditing and Taxation*, vol. 25, pp. 31–45.
- Flyvbjerg, B 2006, 'Five misunderstandings about case-study research', *Qualitative Inquiry*, vol. 12, no. 2, pp. 219–245.
- Gestel R and Micklitz, H-W 2014, 'Why methods matter in European legal scholarship', *European Law Journal*, vol. 20, no. 3, pp. 292–316.
- Griffin, J 2014, 'The effects of uncertainty and disclosure on auditors' fair value materiality decisions', *Journal of Accounting Research*, vol. 52, no. 5, pp. 1165–1193.
- Hasen, D M 2003, 'A realization-based approach to the taxation of financial instruments', *New York University Tax Law Review*, vol. 57, pp. 398–481.
- Jager, P, Parsons, S and Roeleveld, J 2012, 'A commentary on SARS' proposed fair value tax on financial instruments', *South African Journal of Accounting Research*, vol. 26, no. 1, pp. 165–184.
- Laux, C and Leuz, C 2009, 'The crisis of fair value accounting: Making sense of the recent debate', *Accounting, Organizations and Society*, vol. 34, pp. 826–834.

- Libby, R, Libby, P and Short, D 2009, *Financial Accounting*, MacGraw Hill, New York.
- Kwall, J 2011, 'When should asset appreciation be taxed?: The case for a disposition standard of realization', *Indiana Law Journal*, vol. 86, pp. 77–117.
- Machado J 1998, *Contabilidade Financeira*, Protocontas, Lisboa.
- Maroun, W 2015, 'Peculiarities of the fair value taxation regime for financial instruments', *South African Journal of Accounting Research*, vol. 29, no. 2, pp. 151–161.
- Miller, A and Oats, L 2014, *Principles of International Taxation*, Bloomsbury, London.
- Muller, M A, Riedl, E J and Sellhorn, T 2015, 'Recognition versus disclosure of fair values', *The Accounting Review*, vol. 90, no. 6, pp. 2411–2447.
- Shuldiner, R 1992, 'A general approach to the taxation of financial instruments', *Texas Law Review*, vol. 71, no. 2, pp. 243–350.
- Siekkinen, J 2016, 'Value relevance of fair values in different investor protection environments', *Accounting Forum*, vol. 40, pp. 1–15.
- Slemrod J and Bakija J 2008, *Taxing Ourselves*, MIT Press, Cambridge.
- Smith-Lacroix, J-H, Durocher, S and Gendronc, Y 2012, 'The erosion of jurisdiction: Auditing in a market value accounting regime', *Critical Perspectives on Accounting*, vol. 23, pp. 36–53.