

António Martins, Cristina Sá and Daniel Taborda*

Fair Value and Corporate Taxation: Out through the Door, Back through the Window?

<https://doi.org/10.1515/acl-2021-0046>

Published online June 23, 2022

Abstract: The progressive harmonization of corporate financial information, based on the International Financial Reporting Standards, has moved fair value accounting (FVA) to the forefront of a debate that straddles accounting and corporate tax. Given the subjectivism that FVA may exhibit, especially when mark to market is not available and mark to model is used as in level 3 FVA, tax legislators have strongly restricted its impact on the corporate tax base. This paper argues that while the Portuguese corporate tax legislators explicitly followed this worldwide trend of restricting the tax impact of fair value to certain circumstances when market prices are observable (level 1 FVA), the corporate tax code has, nonetheless, several important avenues through which FVA influences taxable income determination. The main purpose of this paper is to present and discuss some important ways through which FVA may influence taxable income determination in Portugal, such as goodwill, impairment charges, transfer pricing, capital gains and exit taxation. Thus, the question emerges: is FVA returning through the window to impact the corporate tax base? Considering the global trends in public finance, and the need for present and future tax revenues, we believe this is an important topic to be addressed.

Keywords: fair-value accounting, Portuguese corporate taxation, fair value hierarchy, subjectivism in financial information

JEL Classification: M4 - Accounting and Auditing, H2 - Taxation, Subsidies, Revenue

Table of Contents

- 1 Introduction
- 2 Literature Review

***Corresponding author: Daniel Taborda**, School of Economics, University of Coimbra, CEBER, Coimbra 3004-512, Portugal, E-mail: danieltaborda@fe.uc.pt

António Martins, School of Economics, University of Coimbra, CEBER, Coimbra 3004-512, Portugal, E-mail: amartins@fe.uc.pt

Cristina Sá, School of Technology and Management, Polytechnic Institute of Leiria, CARME, 2400-822, Leiria, Portugal, E-mail: cristina.sa@ipleiria.pt

- 2.1 Some Accounting Issues Related to Fair Value
 - 2.2 An Overview of Tax Issues Related to Fair Value Taxation
 - 3 Fair Value in the Portuguese Corporate Income Tax Code: Out Through the Door?
 - 4 Fair Value in the Portuguese Corporate Income Tax Code: Back Through the Window?
 - 4.1 Goodwill
 - 4.2 Impairments
 - 4.3 In-Kind Assets
 - 4.4 Transfer Pricing
 - 4.5 Exit Tax
 - 5 Conclusion
- References

Accounting, Corporations and Tax Avoidance

1. Corporate Control and Exceptions to Minimum Corporate Taxation: A Step Toward Fairness or Financialisation?, by Yuri Biondi, <https://doi.org/10.1515/ael-2022-0054>.
2. The Interplay Between Tax Havens, Geographic Disclosures and Corporate Tax Avoidance: Evidence from European Union, by Sameh Kobbi-Fakhfakh, <https://doi.org/10.1515/ael-2021-0008>.
3. Board Level Employee Representation and Tax Avoidance in Europe, by Sigurt Vitols, <https://doi.org/10.1515/ael-2019-0056>.
4. Fair Value and Corporate Taxation: Out through the Door, Back through the Window?, by António Martins, Cristina Sá and Daniel Taborda, <https://doi.org/10.1515/ael-2021-0046>.
5. The Autonomous Taxation of Corporate Expenses in Portugal, by Ana Dinis, António Martins and Cidália Lopes, <https://doi.org/10.1515/ael-2019-0023>.
6. The Accrual Accounting Principle and its Implications for Portuguese Tax Courts Decisions, by Daniel Taborda and João Sousa, <https://doi.org/10.1515/ael-2019-0030>.

1 Introduction

The overall purpose of financial accounting is to produce information that presents a true and fair view of a company's performance and financial position. Users of financial reports have informational needs; thus, they rely on financial reports to make decisions. According to the Conceptual Framework for Financial Reporting, issued by the International Accounting Standards Board (IASB), "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity" (IASB, 2018, § 1.2). In the last decades, the historical cost paradigm (where assets were recognized at the acquisition cost and were depreciated or amortized over time) has been somewhat displaced by the introduction of a fair value accounting model (Biondi, 2011).

Accounting systems provide collective fundamental information and price systems provide market-driven information over time (Biondi & Giannoccolo, 2015).

It was argued that managerial decision-making is forward-looking and historical cost was not attuned to this purpose (Brealey et al., 2014; Cairns, 2006). Accounting regulatory bodies, such as IASB and the US Financial Accounting Standard Board (FASB), gradually introduced fair value accounting (FVA) to evaluate assets, moving towards an accounting paradigm based on current values and not on historical cost.

There is a large body of research debating the usefulness of historical cost and fair value in financial reporting. This research focuses on the impact of using FVA for tax purposes. It discusses the acceptance and implications of FVA for the taxable income, as laid down in the Portuguese Corporate Income Tax Code (CITC).

According to IFRS 13 – Fair value measurement, FVA is not based on a homogeneous set of principles and techniques. IFRS 13, § 61, states the general principle for measuring fair value as follows:

“An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.”

The standard promotes the use of market-based (observable) prices. These are the preferred inputs to anchor FVA. However, standard setters are aware that, in many cases, market prices, determined by arm's length transactions between independent parties, are not available. That is why a hierarchy of methods (three levels) is established in IFRS 13 to apply FVA as shown below.

Paragraph 76 – “Level 1 inputs are quoted prices (unadjusted) in active markets (...)”

Paragraph 81 – “Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly”.

Paragraphs 86 and 87 – “Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. (...). Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk”.

When asset prices are based on observable market prices (level 1), FVA may be considered as relevant and faithful. However, when FVA is based either on prices of comparable transactions (level 2), or on discounted cash flow models (DCF) (level 3) the subjectivism that is embedded in accounting values may affect financial information quality and induce investors into flawed decisions (Mora et al., 2019). In particular, at level 3 the fair value of an asset is based on models which estimate the present value of future cash flows, so-called mark-to-model. The estimation of the present value of an asset involves a discount rate along with other assumptions on the future. This discount rate and the other assumptions may be orchestrated by managers to report fair value at a desired level, resulting in

misleading information (He et al., 2021). Accordingly, the inexistence of pre-determined values and monitoring mechanisms create incentives for managers to select discount rates opportunistically (He, 2020).

Concerning corporate taxation, FVA raises a critical issue: should it be accepted for tax purposes, or – given its potential for subjectivism and manipulation – should it be relegated to the fringes of taxation, moving towards a greater disconnection between accounting and corporate tax bases (Maroun, 2015; Schmiel & Weitz, 2019)?

In Portugal, as a general rule, FVA does not have corporate tax effects. However, in certain cases, such as transfer pricing and exit taxation, DCF models are used to apply arm's length pricing for some companies' transactions. DCF models (the third level) are seen by regulators as an explanation of market prices formation, since economic actors establish asset prices by modelling future economic benefits (Cardao-Pito & Ferreira, 2018a, 2018b). The application of level 3 FVA to the valuation of items like non-traded shares, real estate, or intangibles is used for tax purposes.

Both transfer pricing rules and exit tax regime are engaged in fighting companies' profit shifting activities. Copying with aggressive tax-planning by multinational corporations requires an internationally coordinated policy approach, leading to the Base Erosion and Profit Shifting project (OECD, 2013). In response, EU addressed this phenomenon by enacting the anti-tax avoidance Directive (ATAD),¹ which includes exit taxation as an anti-abuse clause applied to companies transferring assets or its tax residence to other jurisdictions. But at the EU level, other initiatives should be mentioned, such as the common consolidated corporate tax base (CCCTB). As seen later, FVA impacts taxation not only through anti-abuse rules, but also by influencing the calculation of tax deductions, as in the case of goodwill periodical expensing or impairment charges.

Member States internal legislations depend and draw upon international guidelines and European regulations. To take an example from the Spanish CITC, Article 17(1) establishes that assets and liabilities will be valued in accordance with criteria provided in the Commercial Code, adjusted according to rules established in the corporate tax code. Consequently, FVA is tax neutral unless a specific regime prescribes the inclusion of value remeasurements in the profit and loss account.²

¹ In fact, "ATAD" refers to Council Directive (EU) n.º 2016/1164, 12th July (ATAD I); n.º 2017/952, 29th May (ATAD II), and to a draft Directive published on 22nd December 2021 by the European Commission (ATAD III).

² The Spanish version is as follows: "Los elementos patrimoniales se valorarán de acuerdo con los criterios previstos en el Código de Comercio, corregidos por la aplicación de los preceptos establecidos en esta Ley. No obstante, las variaciones de valor originadas por aplicación del criterio del valor razonable no tendrán efectos fiscales mientras no deban imputarse a la cuenta de pérdidas y ganancias, sin perjuicio de lo señalado en la letra l) del artículo 15 de esta Ley, o mientras no deban imputarse a una cuenta de reservas si así lo establece una norma legal o reglamentaria (...)".

However, transfer pricing rules (Article 18) imply the use of DCF methods in order to apply the arm's length principle. Similarly, Article 19(1) contains the Spanish version of the exit tax. The fair market value of non-traded assets (level 3 FVA) is then applied to estimate the amount of unrealized capital gains.

Outside Europe, the same general disconnection from FVA in the corporate tax base can be found in the Cape Verde corporate tax code (Article 23(6)). However, the latter allows level 3 FVA in the tax determination of certain biological assets, impairments and in transfer pricing rules.

In the USA, there is an illustrative example of how the DCF method was used in tax litigation between Amazon and the Internal Revenue Service (IRS). The transfer pricing litigation (Amazon.com, Inc., 148 T.C., 8, 2017) was centered on DCF implementation by litigants, bringing into tax base determination a technique based on level 3 FVA.

In 2005 and 2006, Amazon restructured its European businesses, setting up Amazon Europe Holding Technologies (AEHT), a Luxembourg subsidiary, that centralized the management of units operating across Europe. Because the restructuring would allow the European entities to generate income using Amazon's pre-existing intangible assets, developed in the US, the US tax code and regulations required AEHT to compensate Amazon for the use of assets that met the regulatory definition of an intangible asset.

Under the arrangement, AEHT was responsible for initial buy-in payment for the pre-existing intangibles and for regular future cost-sharing payments of its share of future R&D activity pursued by Amazon. The buy-in payment was taxable income for Amazon, and under AEHT's related cost-sharing agreement (CSA) future payments would reduce Amazon's U.S. tax deductions for R&D costs. US tax regulations required the buy-in payment to reflect the fair market value of the pre-existing intangibles made available under the CSA. Amazon initially booked a buy-in payment of \$255 million. Consequently, under the CSA, AEHT also made payments to Amazon for its share of ongoing intangible development costs. Amazon reported revenue from AEHT of \$116 million in 2005 and \$77 million in 2006.

The IRS concluded that the buy-in payment had not been determined at arm's length and performed its own calculation, resulting in an amount which was about 14 times bigger than Amazon's own assessment. Amazon filed a petition in the United States Tax Court.

The IRS argued that a DCF methodology offered the best method for determining an arm's-length buy-in payment, and that the required payment should be \$3.468 billion (instead of 255 million estimated by the company). The first question the Tax Court had to answer was whether the IRS had misused its discretionary power in this calculation. The Court answered affirmatively. Although the Tax Court found several gaps in the IRS method, judges stated that the biggest mistake was to value short-lived intangibles as though they have a perpetual or infinite life.

It was unreasonable, the Court affirmed, for the IRS to determine the buy-in payment assuming that a third party, acting at arm's length, would pay royalties in

perpetuity for using these short-lived assets.³ The Court concluded that the website technology that Amazon US initially transferred to AEHT had a useful life of about seven years; and that after depreciating, over a seven-year period, Amazon's website technology, as it existed in January 2005, would have little value left by year-end 2011. In 2019, a Federal Court of Appeals upheld the view that the IRS did not apply the DCF method in a proper way.

Under Portuguese tax law and regulation, the main rule is that FVA is not relevant for tax purposes, unless level 1 data are available. However, business acquisitions and goodwill, the recognition of impairment losses, transfer pricing, exit taxation among others, imply the use of the techniques that are established as level 3 FVA by the "IFRS 13-Fair value" standard (paragraphs 61–66). It is our view that, while explicitly rejected by Portuguese legislators, fair value finds many disguised ways to re-enter the computation of the tax base.

The rest of the article is organized as follows. Section 2 introduces a brief literature review in accounting and taxation concerning to fair value, Section 3 deals with the general treatment of FVA by the Portuguese CITC, Section 4 describes examples where level 3 FVA has tax consequences and Section 5 concludes.

2 Literature Review

2.1 Some Accounting Issues Related to Fair Value

The IASB and the FASB have been promoting an international trend in accounting harmonization where FVA is increasingly used in the preparation of financial statements. The IASB has been extending FVA to financial instruments and issued IFRS 13 to clarify its use. The historical cost paradigm, traditionally dominant in financial accounting, especially in countries with a continental approach of accounting, is being relatively sidelined by the extended use of fair value (Cairns,

³ As emphasized in the Veritas case (*Veritas Software Corp. v. Commissioner*, 133 T.C., 297, 2009), the cost sharing regulations "unequivocally require a buy-in payment to be made with respect to transfers of 'pre-existing intangible property'. No buy-in payment is required for subsequently developed intangibles". Mentioning the similarity of the IRS valuation method used in Veritas and Amazon cases, the Court emphasized the "essential similarity between the DCF methodology the IRS employed in Veritas and the DCF methodology employed here. Both assumed that the pre-existing intangibles transferred under the CSA had a perpetual useful life; both determined the buy-in payment by valuing into perpetuity the cash flows supposedly attributable to these pre-existing intangibles; and both in effect treated the transfer of pre-existing intangibles as economically equivalent to the sale of an entire business".

2006; Cairns et al., 2011). Both supporters and critics of FVA can be found in the accounting literature (Adwan et al., 2020; Biondi, 2011; Yuan & Liu, 2011).

According to Biondi (2011) the debate between historical cost paradigm and FVA lays in understanding the fundamental principles of financial accounting, including their implications for relevance and reliability. Accounting standards provide the grounds for managerial decision-making, cost setting, profit determination and many other important matters for business. From this perspective, accounting numbers are not straightforward “natural” measurements, but “artificial” social-economic constructions, which are framed and shaped by standards and conventions underpinned by fundamental accounting principles of reference.

Even before the financial crisis of 2007–08, critics argued that FVA may be procyclical and may impair financial stability (Dietrich et al., 2000). Particularly after the financial crisis, the relationship between accounting and financial market stability has been an issue of interest in the academic community with fair value charged of being a risk for financial market stability (Biondi, 2015). Biondi and Giannoccolo (2015) developed a theoretical framework of analysis for comparatively assessing alternative accounting regimes in terms of systemic risk and financial stability. Their results show higher market volatility under FVA regime, making the financial system more unstable.

One alleged advantage of FVA is that it generates more up-to-date balance sheet figures that reflect market consensus on the financial market value of assets and liabilities (Hung & Subramanyam, 2007; Tsalavoutas et al., 2012). The supporters of fair value consider accounting as “*part of the information required by capital market participants to predict current values based on the future, which is supposed to be the proper basis for financial decision-making*” (Biondi, 2011:11). On the other hand, income volatility can increase, and the firm becomes less attractive for financial investment purpose (Hung & Subramanyam, 2007; Tsalavoutas et al., 2012). Some empirical research (Landsman, 2007; Siciliano, 2019) highlights the usefulness of fair value to investors and cast doubts about its negative impact on financial stability, while other studies stress its shortcomings concerning the contracting and stewardship role of accounting. Mirza et al. (2011) point out that the inconsistencies in the assessment of investment properties could influence the information available for investors and then their financial decisions.

FVA does not appear suitable for assessing assets traded in illiquid markets or valuing specific business assets. Additionally, historical cost-based accounting is seen as more reliable (Fukui & Saito, 2020; Ramanna, 2021), since past acquisition expenditures and realized revenues from customers are easily proven. Under historical cost accounting, unrealized gains are usually not recognized, given the conservatism applied to the preparation of financial information.

While, 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, companies, and tax practitioners. With the widespread acceptance of FVA, tax

legislators around the world have struggled to find how to accommodate FVA in corporate tax codes, since the determination of the corporate income tax basis depends and draws upon financial statements.

2.2 An Overview of Tax Issues Related to Fair Value Taxation

Financial accounting standards aim at establishing a set of rules which provide a true and fair view of a reporting entity's performance and financial position. Designing a tax system has also some overarching goals: It must raise revenue to support public spending; it should strike a balance between fairness, efficiency and simplicity (Slemrod & Bakija, 2017); it is expected that accounting and taxable income are impacted by different policy goals (Blaufus & Jacob, 2017).

In a significant number of countries, tax rules are based on lower-of-cost-or-market and historical cost systems instead of references to current market prices. In the last years the standardization of the taxable income and accounting income has been under discussion. The European Commission considered the IFRS framework as a starting point for the implementation of CCCTB⁴ (Becker & Steinhoff, 2014). According to Desai (2005:172) the existing differences between book and taxable income led to a deterioration of financial results and “*greater conformity in the measurement of book and tax profits could provide firms with some automatic incentives to reduce tax avoidance and to be less aggressive in reporting profits to capital markets*”. Sunder (2011) highlights the advantages of combining tax and financial reporting, such as the end of dual auditing (tax auditors and statutory auditors).

Different solutions are potentially available when fair value-based taxation is discussed. To relegate fair value to the accounting side, while basing taxation on

⁴ In 23/10/2001, the European Commission (EC) – COM (2001) 582 – *Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities* – identified CCCTB as a long-term solution to remove tax obstacles to the Internal Market. CCCTB allows companies operating in the internal market to offset profits in one Member State against losses in another. In this sense, it is also an instrument to reduce profit shifting opportunities between EU Member States, replacing the need of application of transfer pricing methods application to allocate profits to the jurisdiction where value is generated. In 16/3/2011, the EC published a Directive proposal on a CCCTB – COM (2011) 121 – *Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB)* – and, in 25/10/2016, EC relaunched the CCCTB project. Despite all this effort, CCCTB project did not meet the desired Member State agreement, criticizing the lack of respect for the principle of subsidiarity. Recapturing some of CCCTB advantages and focusing on a fair and effective taxation goal, EC proposed in 18/5/2021 BEFIT – Business in Europe: Framework for Income Taxation – COM (2021) 251 – *Business Taxation for the 21st Century*.

the realization principle, would imply a complete disconnection between book and taxable income. The realization principle protects taxable income from the assets' value oscillations. On the other hand, the full acceptance of the tax consequences of fair value could be adopted. That is, fair value gains and losses recognized by the accounting rules would be included in the determination of the tax base, achieving greater convergence.

An intermediate solution could be adopted, according to which limited and clearly stated changes in fair value would produce tax effects. Solutions adopted by many jurisdictions show that this is not an easy regulatory decision. As stated by Cavana et al. (2013:52) 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*".

After the introduction of the IFRS standards, countries tend to move toward a greater disconnection between corporate book and tax income (Gee et al., 2010; Wahaba & Holland, 2015). FVA is a key reason for this disconnection, given the lower reliability of accounting values, especially when levels 2 and 3 of FVA are used for assessment. At the same time, several countries provide exceptions from the general realization principle that usually underpins taxation (Blaufus & Jacob, 2017). Such exceptions typically concern financial assets and liabilities held for trading. These authors point out that in the Czech Republic, Denmark, Finland, France, Hungary, Italy, Portugal, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom financial assets and liabilities held for trading, measured at fair value, produce, in certain circumstances, unrealized (fair value) profits and losses subject to corporate tax. Thus, some tax base items for which fair value accounting is accepted are found in some jurisdictions around the world.

Given that traded financial instruments are accounted for at FVA level 1 basis, this subset of FVA values is considered for tax purposes. This is a usual area where accounting values have tax consequences.

Following the fair value hierarchy, when quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) are not available, several tax systems, including the Portuguese CITC, introduce several limitations on the use of FVA. Unobservable inputs (Level 3 inputs), usually described as mark to model valuation, bring undesirable subjectivism of economic and financial assumptions into the tax base definition. In particular, as mentioned above, Level 3 inputs often rely on DCF models, reflecting current market expectations on discount rate or cost of capital. Paragraph B13 of IFRS 13 establishes that present value determination includes several elements such as: (i) estimates of future cash flows for the asset or liability under measurement, (ii) expectations about variations in the amount and timing of the cash flows representing riskiness, (iii) the time value

of money, represented by the rate on risk-free monetary assets, (iv) the price, or compensation, for bearing the uncertainty inherent in the cash flows (i.e., a designated “risk premium”), and (v) other factors that market participants would consider.

At level 3 of FVA measurement hierarchy, the absence of a comparable market requires the use of a model to calculate hypothetical market prices. Tax legislators choose to keep FVA at the margin because of its volatility and lack of reliability when there are no organized markets to trade assets (Martins, 2015; Tavares, 2011). To prevent managerial opportunism and potential abuse, the role of FVA is explicitly restricted in corporate taxation in Portugal, as analysed in next Section 3.

However, the DCF method, which is prominent in Level 3 FVA, permeates the tax base through goodwill expensing, transfer pricing, impairment charges, exit tax issues and in the measurement of other assets and liabilities, bringing - through the window - precisely the volatility and subjectivism inherent to FVA that legislators explicitly tried to avoid. These issues are addressed in detail in Section 4.

3 Fair Value in the Portuguese Corporate Income Tax Code: *Out Through the Door?*

The solution adopted by Portugal regarding the link between accounting and corporate taxation is stated in the preamble of the Portuguese CITC. It proposes to start by applying positive or negative adjustments, set out in the law, to the accounting net income to determine a taxable income. This is defined as a partial dependency model, provided in Article 17 of the CITC. In addition, when the tax law does not provide for any specific treatment, the general rule is to accept the accounting treatment.

Following Decree-Law 159/2009, 13th July, the CITC incorporated the impact of changes in accounting standards. As mentioned by Rodrigues (2011), while adjusting the CITC to the new accounting regulations there was a clear option for maintaining the model of partial dependence on tax law, which prescribes that when its own rules are not established, the accounting treatment is followed. This is affirmed as a general principle but deviations exist. In particular, tax law may deviate from accounting rules in view to pursue specific economic policy objectives. Consider the following example. In the post-acquisition re-measurement of tangible assets, such as property, plant and equipment, Portuguese Accounting and Financial Reporting Standard n. 7 (based on International Accounting Standard n. 16 as adopted by the EU) authorizes an alternative model to historical cost. This revaluation model is based on the asset market price and its application depends on the feasibility of reliable measurement. Concerning the case of real estate valuation, an expert should be hired to deliver a qualified and independent

opinion (Accounting and Financial Reporting Standard 7, paragraph 32). This professional valuation may follow several methods, such as the sales comparison approach, the cost approach, or the income approach. The latter is based on the DFC method for calculating the anticipated monetary benefits for income-producing property.

In fact, assuming that the revaluation was not specifically established by tax law (legal revaluations), the depreciation increase derived from the revaluation model is not deductible (Article 15 of Regulatory Decree 25/2009, 16th September), as explained in the following example.

Suppose that a certain company has a net profit of 100, assuming accounting depreciations of 200 based on historical cost model. In the context of this example, let assume that under the revaluation model, based on an independent opinion, a positive change in tangible asset value is recognized on the balance sheet (credited to other comprehensive income), and a subsequent increase of the book depreciation begins, based upon the revaluated value of 300 yearly. In this scenario the accounting income would become null, if CITC accepted the deduction of this surplus expense (100).

The core question under analysis here is what level of acceptance of FVA is considered by the CITC. The first reference to FVA in the CITC appears in Article 18, which states the general rules related to periodization of taxable profit. Article 18(9) allows some income or expenses, even if not realized, to be factored into the calculation of taxable profit. It states that “*adjustments arising from the application of fair value are not factored into the calculation of the taxable basis, rather being entered as income or expenses in the tax period in which the elements or rights that gave rise to them are sold, extinguished or liquidated, except when:*

- (a) *They concern financial instruments recognized at fair value through profit and loss, provided that they have a price set by a regulated market and, in case of equity instruments, the taxable person does not, directly or indirectly, hold a share of the capital equal or greater than 5%; Or*
- (b) *Where expressly provided for in this Code.”*⁵

5 The Portuguese version is as follows: “Os ajustamentos decorrentes da aplicação do justo valor não concorrem para a formação do lucro tributável, sendo imputados como rendimentos ou gastos no período de tributação em que os elementos ou direitos que lhes deram origem sejam alienados, exercidos, extintos ou liquidados, exceto quando: a) Respeitem a instrumentos financeiros reconhecidos pelo justo valor através de resultados, desde que, quando se trate de instrumentos de capital próprio, tenham um preço formado num mercado regulamentado e o sujeito passivo não detenha, direta ou indiretamente, uma participação no capital igual ou superior a 5% do respetivo capital social; ou b) Tal se encontre expressamente previsto neste Código”.

Thus, the Portuguese CITC states a general disconnection from the FVA reported in financial accounting with regards to the determination of taxable basis. The tax standard maintains the historical cost rule (purchase or manufacturing acquisition price). This rule is an example of the principle of realization, establishing that profit and loss should be considered for tax purposes only when the assets are sold, transferred or written-off.

However, after having affirmed a general disconnection between FVA and the corporate tax base, the CITC allows the consideration of FVA for income tax purposes, concerning financial instruments and other situations expressly stated.

The same can be said of certain types of gains and losses booked in the context of a company's use of derivatives. Article 49 of the CITC gives tax relevance to such fair value profit and loss derived from derivative instruments in regulated markets. This occurs when fair value adjustments are recognized through profit and loss, and their reliability is, in principle, ensured because the current price is set by a regulated market. There is no interference by the taxable person with the occurrence of the negative or positive fair value adjustments. That is, the latter occur regardless of the intention of taxpayers.

In addition to the acceptance of fair value losses and profits emerging from instruments listed in financial markets and held for trading, the CITC also encompasses consumable biological assets, except for multi-year forestry explorations.

Accounting and Financial Reporting Standard n. 17 (based on International Accounting Standard n. 41 as adopted by the EU) categorizes biological assets (e.g., a living animal or a plant) as "consumable" and "bearer" biological assets, with the former containing assets that will be harvested as agricultural products or sold as biological assets, such as the animals raised for meat production and sale. Biological assets are measured at fair value (market prices) less their estimated sale costs at initial recognition and in future dates.

Portuguese tax law accepts the measurement of these assets as described in the accounting law, i.e., using the fair value less estimated transaction costs for sale. Given this mandatory use of market prices, it is understandable that the latter become relevant for tax purposes.

The legislator's intention when adopting FVA for tax purposes was restricted to situations where the reliability of the valuation of fair value is in principle ensured (Level 1 FVA). To sum up, a first look at the CITC leads to the conclusion that fair value factored into the calculation of the tax base is strictly circumscribed to situations where it can be determined in a reliable and objective way.

4 Fair Value in the Portuguese Corporate Income Tax Code: *Back Through the Window?*

Generally speaking, tax law prefers objective measurement criteria, such as the historical cost, which prevents the potential drift of taxable income implied by FVA, protecting public revenue security from income variations due to the references to ever-changing current values (Desai, 2003; Gee et al., 2010).

Nevertheless, even though not explicitly formulated in CITC, there are exceptions to this conservative approach. As shown below, a certain number of situations can be found in the Portuguese CITC where level 3 FVA can have a significant impact on the taxable income.

4.1 Goodwill

Goodwill is defined by the Accounting and Financial Reporting Standard n. 6 (based on International Accounting Standard n. 38 as adopted by the EU) as an intangible asset with an indefinite useful life. Considering that a business combination gives the acquirer control of other businesses, the identifiable and separate assets and liabilities transferred to the acquirer are revalued at fair value at the time of the acquisition. It must be noted that in a business combination, the net assets acquired (if an acquisition of net assets) or the entity over which control is obtained (if an acquisition of equity interests) must constitute a business (Accounting and Financial Reporting Standards n. 14). Goodwill, as a kind of residual asset, is also recognized at the date of the acquisition as the difference between the consideration paid to perform the operation and the revaluated value of acquired net assets.

The reliability of this measurement is based on an effective transaction that occurred between participants to the business combination transaction. However, it is, by nature, a forward-looking value that depends on several unobservable variables and forecasts (Neves, 2004). Baker et al. (2008) describe several problems arising from the measurement of that consideration paid to achieve a business combination.

In Portugal, since 2016, the Accounting and Financial Reporting Standard n. 14⁶ states that goodwill must be amortized according to its useful life, or if the latter is indefinite, for ten years. This diverges from international accounting standard as adopted by the EU, which excludes goodwill amortization. Moreover, following the recommendation of the Commission for the Reform of Corporate Income Tax in

⁶ Legal Act n.º 8256/2015, 29th July.

2013,⁷ the legislator granted a specific tax treatment to intangible assets without a defined useful life. For these “perpetual” assets, the CITC established (in article 45-A) the deduction of their acquisition cost, in equal parts, over twenty tax periods.

This tax treatment was not placed in the CITC’s section dealing with “Depreciation and amortization”. It was set up in “Other tax deductions”.⁸

When asset control is transferred, goodwill represents “the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized” (IFRS 3, Appendix A). The consideration paid to achieve the business combination is then split between goodwill and the acquired identifiable assets and liabilities on the basis of their revaluated values. The rest of the consideration after having deducted the revalued net assets is allocated to goodwill in the financial statements of the acquiring entity. Thus, not only the fair values of the assets transferred have tax effects, but also the amount corresponding to goodwill is deductible over a twenty-year period (Article 45-A of CITC).

Supposing that, for an amount of 100, Company A acquires assets and assumes liabilities from Company B. The latter set of accounting elements is supposed to constitute a business. The allocation of B’s identifiable net assets on the basis of their fair values amounts to 80. The excess (20) of the consideration paid to acquire those net assets over the amounts assigned to the identifiable accounting elements would be recognized as goodwill.

In this case, the identifiable assets will be depreciated over their useful lives, and, as a rule, these expenses are tax deductible. The amount related to goodwill will be amortized for ten years, assuming that its useful life is not indefinite. But, as said, the Portuguese CITC should not allow in principle the inclusion in the taxable base of goodwill amortization, since depreciation of assets with indefinite useful lifetimes is not deductible. Nevertheless, it accepts the deduction of goodwill over twenty years.

To sum up, and considering the example given above, the expensing of goodwill through an annual tax deduction of 5% (implying twenty years for completing amortization), is based on its initial recognized value ($20 = 100 - 80$). Not only the acquisition value, but the specific allocation and valuation of B’s identifiable assets are based on fair values. This accounting evaluation procedure may include FVA level 1 (e.g., listed financial instruments held by B), level 2 (e.g.,

⁷ Available: <https://www.portugal.gov.pt/media/1157091/20130726%20seaf%20rel%20final%20anteprojecto%20reforma%20irc.pdf>.

⁸ According to the Portuguese CITC, intangible assets with definite lives are amortized. On the other hand, intangible assets with indefinite lives generate a tax deduction over 20 years, as stipulated in a section of the tax code called “other tax deductions”. The latter section allows the tax expensing of goodwill, which typically is an intangible asset with an indefinite life.

investment properties valued on the basis of comparable transactions) and level 3 (e.g., a patent). Thus, FVA may have considerable impact in the amount of goodwill (20) that is expensed for tax purposes, as well as on the remaining assessed values (80).

4.2 Impairments

The second example refers to impairment loss for non-current assets, which can be deducted from the tax base. According to Accounting and Financial Reporting Standard n. 12, following a conservative approach, an impairment loss should be recognized if the recoverable amount of a tangible asset is lower than its book value. The recoverable amount is the highest between a fair value less costs (market value) and the value in use (DCF value). This complies with international accounting standard n. 36. When the value in use of the asset exceeds the former, it becomes the reference value in the impairment test. In other words, if the present value of estimated cash flows related to the asset is lower than its net book value, a write-off ensures that the asset is not overvalued on the balance sheet. This occurs after identifying factors underpinning the asset's impairment, such as accidents, natural disasters, significant technology changes or new regulatory enforcements influencing the ability to generate future cash flows (Elliott & Elliott, 2009; Martins et al., 2020a; Rodrigues, 2021).

When a company records an impairment loss, it should be recognized as a reduction of net income. However, this expense is not automatically accepted for tax purposes. An ex-ante authorization from the Portuguese Tax Administration prior to its deduction from the taxable income must be obtained. This authorization introduces a further restriction beyond the requirements of the accounting standard of reference. As stated in Article 31-B of the CITC, an impairment loss on non-current assets from proved abnormal causes, such as disasters, natural phenomena, exceptionally rapid technical innovations, or significant changes with adverse effect in the legal context, may be accepted as tax expenditure. In the request, the cash flow that the asset was expected to generate, either through its best use, or by selling it to a third party, should be determined. Once again, financial valuation techniques (Level 3 FVA) are based on hypotheses and assumptions. Clearly, if the non-current asset refers to goodwill, the degree of complexity increases, as previously explained. In the impairment domain, DCF is key for accounting valuation and may have tax relevance.

4.3 In-Kind Assets

Portuguese commercial law allows equity holders to contribute in kind in the form of assets (e.g., land, buildings, inventory) in view to achieve an increase of the company's share capital.

When establishing a company, or increasing its equity capital, shareholders may contribute in-kind assets and not in-cash. This option involves legal procedures, such as an independent report by an independent statutory auditor, ensuring a fair and proportional distribution of the capital to shareholders. Additionally, since share capital is expected to work as a protective buffer for company creditors, in-kind contributions should be carefully measured. The professional rules followed by statutory auditors require a market approach when determining the value of contributions made in kind. Consequently, those assets transferred by shareholders to the company's capital are measured at fair value. The initial recognition of a building as part of capital paid up in kind may imply the use of DCF, if no market prices for similar assets are available. Thus, an additional avenue for the tax relevance of FVA is observed.

Additionally, further deductible amortizations, depreciations, or impairments factored into the calculation of taxable income have their base on a valuation of these in-kind assets (Article 31(1)(c) of the CITC). When these assets are not actively traded in markets, level 3 FVA is the last (and tax relevant) resort for valuing capital contributions in kind.

It should be noted that these assets come from the shareholders' personal sphere, as an alternative to cash contributions. Therefore, they are often in second-hand condition, bringing complexity and subjectivity to fair-value evaluation. For instance, one of the challenges faced by the statutory auditor consists of appreciating the usefulness of the assets for the firm. Their usefulness results either from the specific use of the asset at a business level, or its market liquidity. The admissibility of this procedure under tax law contrasts with the frequent legal restrictions designed to protect tax income. For example, as mentioned above, the increase in depreciation expenses resulting from a revalued fixed asset is not tax deductible.

4.4 Transfer Pricing

As known, transfer pricing deals with intra-group transactions, using the arm's length principle to derive prices for these transactions deemed similar to transactions concluded between unrelated entities, in comparable circumstances (OECD, 2017; 2022). The implementation of this principle requires alternative

measures (Avi-Yonah, 2017), and it plays a central role in international tax avoidance. The right to minimize tax burden and the duty to pay a fair amount of tax often frame the debate on related issues (Biondi, 2017).

The legal framework of the transfer pricing regime in Portugal is provided by Article 63 of the CITC and Regulation 268/2021, 26th November. Two cases suffice to illustrate the role of Level 3 FVA in tax relevant transfer pricing computation. In the first case, it is assumed that a company and its shareholders exchange non-traded equity instruments. Provided that no level 2 FVA can be used, then a DCF valuation must be performed to estimate the market value of those financial instruments. Tax authorities may accept or challenge the assessment. If it is challenged, the DCF is generally calculated again based on alternative assumptions. Significant amounts of taxable income may be at stake, depending on fair value inputs which do not come from regulated exchanges (Martins et al., 2020b). In Case No. 205/2020-T, 24/4/2021, a Portuguese tax Court analyzed the suitability of the method applied by the tax authorities to assure comparability between operations. The final decision concluded, in line with the OECD guidelines and with financial literature, that companies' share valuation must be based on available information, including data (cash flows and discount rates) that can be known, or estimated, at the time of the valuation.

In a hypothetical second case, it is conceivable that real estate transactions may happen between firms and related parties. If an appraiser is appointed by both parties to produce a technical report, the capitalization of future income generated by the assets (Level 3 FVA) may produce material values relevant for tax purposes.⁹

In both examples, we highlight that the valuation of transacted assets is not based on historical cost, book value or any other non-fair-value measurement technique. On the contrary, an assessment method anchored in Level 3 FVA is used and, if tax authorities do not challenge it, it has immediate tax consequences. Even if challenged in a tax audit, the adjustments made are, at their root, dependent on FVA inputs.

4.5 Exit Tax

Exit tax is regulated in Article 83 of the CITC, transposing the rules prescribed in EU ATAD Directive. This directive establishes that assets transferred between

⁹ The same reasoning may be applied to the computation of capital gains (Article 46 of the CITC) in some types of assets, when the realization price is derived from a DCF model. For example, when selling a patent to a third party, a price is observed, but the inputs for the negotiated price of that unique asset usually depend on a previous DCF valuation.

jurisdictions must be assessed at market value. This valuation implies the computation of potential capital gains (Zernova, 2011). Benefiting from a country's environment during a period of residence supports the option to locally tax the gains which arise during this period.

We point out two issues emerging from the EU Directive's application. One of a general nature, the other related to the Portuguese version of the exit tax.

The first one stems from the fact that most assets are not traded in active markets, comparable transactions are rarely available, and the typical valuation done in such circumstances is based on a DCF model (level 3 FVA).

In such an assessment, both the forecasted cash flows and the applied discount rate (cost of capital) are of paramount importance. In the computation of a proper discount rate, when an asset is less tradable or non-tradable, financial theory and practice recommend increasing the discount rate (and the corresponding decrease in fair values) by the so-called discount for "lack of tradability or liquidity" (Brealey et al., 2014; Hitchner, 2011).

Applying DCF methods in the context of exit taxes to non-traded cash-flow-generating assets may become a complex topic, prone to litigation between companies and tax authorities, because small variations in discount rates (and other critical assumptions) may induce significant changes in computed valuations and the exit tax's quantitative base.

The second issue is related to the Portuguese version of the exit tax. Under this rule, the taxable income base of the period in which a Portuguese company transfers its residence to another jurisdiction, must contain the positive or negative differences of market values and the tax-relevant values of the assets "*even if not expressed in the accounts*" (Article 83(1) of the CITC). Here we enter into a very problematic issue: how to value some internally generated assets that cannot be recognized in financial statements? How to value, for instance, often non-recognized assets such as a customer list, the skills of the workforce, brand recognition, or R&D in progress?

In case of a business combination, the entire value of these assets can be recognized, as explained above. However, since an effective transaction does not occur in a business dislocation, their values must be estimated. This is usually based on DCF methods, aiming to assess current values to determine the taxable income. In this sense, the impact of level 3 FVA is also introduced in the corporate tax domain.

5 Conclusion

One of the most debated areas in financial accounting is the application of historical cost or FVA to evaluate assets. Especially when dealing with level 3 FVA, a significant degree of subjectivism is found in accounting variables. Forecasting

cash flows requires assessing the cost of capital and growth rates. This is a very subjective process prone to manipulation. In spite of the general use of FVA, the fair value used for tax purposes depends on the nature and substantial characteristics of assets held by companies. This legal solution highlights the concerns about possible negative effects of fair value application from a taxation perspective.

It is known that accounting and tax law have different purposes, the latter having to meet the specific needs of calculating the tax base, particularly in terms of objective and fair treatment of taxpayers. Following this view, the Portuguese CITC restricts the impact of FVA on the calculation of the corporate tax base. Article 18(9) of CITC represents a general principle for the irrelevance of FVA in corporate tax matters, particularly in level 2 and 3. Accordingly, fair value may be factored into the calculation of the tax base only when it uses observable market prices and when current value re-measurements are passed through profit and loss.

However, a significant number of rules can be found in the Portuguese CITC where level 3 FVA has tax consequences, by applying DCF methods in the valuation of some assets. Therefore, in Portugal, what is a general legislative purpose - restricting FVA to very specific topics - is undermined by the actual role of level 3 FVA in shaping the tax base. An international comparative analysis may extend our results to other jurisdictions in EU and elsewhere.

Acknowledgments: We are grateful to the editor and the anonymous reviewers for their valuable comments and suggestions.

References

- Adwan, S., Alhaj-Ismail, A., & Girardone, C. (2020). Fair value accounting and value relevance of equity book value and net income for European financial firms during the crisis. *Journal of International Accounting, Auditing and Taxation*, 39, 100320.
- Avi-Yonah, R. (2017). International tax avoidance – introduction. *Accounting, Economics, and Law: Convivium*, 7(1), 1–5.
- Baker, C., Biondi, Y., & Zhang, Q. (2008). Should merger accounting be reconsidered?: A discussion based on the Chinese approach to accounting for business combinations. Università degli Studi di Brescia Working Paper No. 91. <https://ssrn.com/abstract=1303636>.
- Becker, J., & Steinhoff, M. (2014). Tax accounting principles and corporate risk-taking. *Economics Letters*, 125(1), 79–81.
- Biondi, Y. (2011). The pure logic of accounting: A critique of the fair value revolution. *Accounting, Economics, and Law: Convivium*, 1(1), 1–49.
- Biondi, Y. (2015). Accounting and the formation of share market prices over time: A mathematical institutional economic analysis through simulation and experiment. *Applied Economics*, 47(34–35), 3651–3672.

- Biondi, Y. (2017). The firm as an enterprise entity and the tax avoidance conundrum: Perspectives from accounting theory and policy. *Accounting, Economics, and Law: Convivium*, 7(1), 20170001.
- Biondi, Y., & Giannoccolo, P. (2015). Share price formation, market exuberance and financial stability under alternative accounting regimes. *Journal of Economic Interaction and Coordination*, 10(2), 333–362.
- Blaufus, K., & Jacob, M. (2017). In G. Livne, & M. Garen (Eds.), *Tax related implications of fair value accounting in the routledge companion to fair value in accounting and reporting*. Routledge.
- Brealey, R., Myers, S., & Allen, F. (2014). *Principles of corporate finance*. MacGraw Hill.
- Cairns, D. (2006). The use of fair value in IFRS. *Accounting in Europe*, 3(1), 5–22.
- Cairns, D., Massoudi, D., Taplin, R., & Tarca, A. (2011). IFRS fair value measurement and accounting policy choice in the United Kingdom and Australia. *The British Accounting Review*, 43, 1–21.
- Cardao-Pito, T., & Ferreira, J. (2018a). Demystifying fair value accounting: Rejoinder to baker and markarian. *Accounting History Review*, 28(3), 199–202.
- Cardao-Pito, T., & Ferreira, J. (2018b). Fair value accounting as the normative Fisherian phase of accounting. *Accounting History Review*, 28(3), 149–179.
- Cavana, G., Guggiola, G., & Marenzi, A. (2013). Evolving connections between tax and financial reporting in Italy. *Accounting in Europe*, 10(1), 50–75.
- Desai, M. (2003). *The Divergence between book income and tax income*. MIT Press.
- Desai, M. (2005). The degradation of reported corporate profits. *The Journal of Economic Perspectives*, 19(4), 171–192.
- Dietrich, J., Harris, M., & Muller, K. (2000). The reliability of investment property fair value estimates. *Journal of Accounting and Economics*, 30(2), 125–158.
- Elliott, B., & Elliott, J. (2009). *Financial Accounting and reporting*. Prentice-Hall.
- Fukui, Y., & Saito, S. (2020). Exploring the relevance and reliability of fair value accounting. *Accounting, Economics, and Law: Convivium*, 20200086. <https://doi.org/10.1515/acl-2020-0086>.
- Gee, M., Haller, A., & Nobes, C. (2010). The influence of tax on IFRS consolidated statements: The convergence of Germany and the UK. *Accounting in Europe*, 7(1), 97–122.
- He, L. (2020). Discount rate behaviour in fair value reporting. *Journal of Behavioural and Experimental Finance*, 28, 100386.
- He L., Wright S. & Evans E. (2021). The impact of managerial discretion on fair value information in the Australian agricultural sector. *Accounting and Finance*, 61(S1), 1897–1930.
- Hitchner, J. (2011). *Financial valuation*. Wiley.
- Hung, M., & Subramanyam, K. (2007). Financial statement effects of adopting international accounting standards: The case of Germany. *Review of Accounting Studies*, 12(4), 623–657.
- IASB. (2018). *Conceptual framework for financial reporting*.
- Landsman, W. (2007). Is fair value accounting information relevant and reliable? Evidence from capital market research. *Accounting and Business Research*, 37(1), 19–30.
- Maroun, W. (2015). Peculiarities of the fair value taxation regime for financial instruments. *South African Journal of Antarctic Research*, 29(2), 151–161.
- Martins, A. (2015). The Portuguese corporate tax reform and international trends: An assessment. *International Journal of Law and Management*, 57(4), 281–299.
- Martins, A., Correia, S., & Taborda, D. (2020a). *A Dedutibilidade de gastos no IRC-uma análise económico-fiscal*. Almedina.
- Martins, A., Correia, S., & Taborda, D. (2020b). Group transactions, transfer pricing and litigation: Evidence from Portugal. *Intertax*, 48(11), 998–1011.

- Mirza, A., Holt, G., & Knorr, L. (2011). *Practical implementation guide and workbook for IFRS* (3rd ed.). Wiley.
- Mora, A., McGeachin, A., Barth, M., Barker, R., Wagenhofer, A., & Joos, P. (2019). Fair value accounting: The eternal debate – AInE EAA symposium. *Accounting in Europe*, 16(3), 237–255.
- Neves, J. (2004). *Avaliação de Empresas e Negócios*. McGraw-Hill.
- OECD. (2013). *Addressing base Erosion and profit shifting*. OECD.
- OECD. (2017). *Transfer pricing Guidelines for multinational Enterprises and tax administrations*. OECD.
- OECD. (2022). *Transfer pricing guidelines for multinational enterprises and tax administrations*. OECD.
- Ramanna, K. (2021). Unreliable accounts: How regulators fabricate conceptual Narratives to diffuse criticism. *Accounting, Economics, and Law: Convivium*. <https://doi.org/10.1515/ael-2020-0088>.
- Rodrigues, A. (2011). Justo Valor uma perspectiva crítica e multidisciplinar. *IDET – Instituto de Direito das Empresas e do Trabalho*, n.º 7 das *Miscelâneas*. Almedina.
- Rodrigues, J. (2021). *O SNC explicado* (8th ed.). Porto Editora.
- Schmiel, U., & Weitz, A. (2019). Is a one-book-system Adequate? A framework for tax law analysis under genuine uncertainty. *Accounting, Economics, and Law: Convivium*, 9(2), 20160062.
- Siciliano, G. (2019). Has IFRS enhanced accounting uniformity? *Accounting in Europe*, 16(3), 313–339.
- Slemrod, J., & Bakija, J. (2017). *Taxing ourselves*. MIT Press.
- Sunder, S. (2011). Imagined worlds of accounting. *Accounting, Economics, and Law*, 1(1). <https://doi.org/10.2202/2152-2820.1014>.
- Tavares, T. (2011). *IRC e contabilidade: Da realização ao justo valor*. Almedina.
- Tsalavoutas, I., André, P., & Evans, L. (2012). The transition to IFRS and the value relevance of financial statements in Greece. *The British Accounting Review*, 44(4), 262–277.
- Wahaba, N., & Holland, K. (2015). The persistence of book-tax differences. *The British Accounting Review*, 47(4), 339–350.
- Yuan, M., & Liu, H. (2011). The economic consequences of fair value accounting. *Accounting, Economics, and Law, A Convivium*, 1(2), 1–44.
- Zernova, D. (2011). Exit taxes on companies in the context of the EU internal market. *Intertax*, 39(10), 471–493.