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Complexity in the tax law and reported earnings: cost deduction in the Portuguese fiscal system

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Abstract

Purpose – The purpose of this paper is the analysis of some important clauses inserted in the Portuguese corporate income tax (CIT) code and how they can be a source of divergence between reported earnings and taxable income. Additionally, the paper also discusses if these clauses are a source of management flexibility in reporting earnings, even if it means paying higher taxes.

Design/methodology/approach – The approach taken in this paper is based on a branch of legal research methodology. The paper uses applied legal research, exploring two avenues. One is based on the recognition that it is usually not possible to arrive at the correct interpretation of the law only by pure deductive reasoning, because hard cases' outcomes tend to form a body of jurisprudence that affects the application of legal rules. Verbal interpretation and manipulation of law usually give rise to contradictory outcomes from apparently identical situations. The approach is also based on macro tax data, in order to present some empirical evidence of hypothesized management behavior.

Findings – The paper finds that ambiguity in CIT laws induces a type of management behaviour characterised by minimizing tax liabilities estimates. Portuguese corporate tax returns show an improbable low level of adjustments related to clauses where flexibility in the timing of cost deduction is an option.

Originality/value – The paper adds to the body of literature that analyses the relation between the level of ambiguity and uncertainty in tax laws and its impact on managers' decisions, particularly about reported income, and presents some supportive evidence of the hypothesized behaviour. It is useful for managers, tax authorities and tax courts, by discussing the relation between the nature of tax clauses and management behaviour.

Keywords Financial reporting, Cost deduction, Corporate tax, Tax havens, Portugal

Paper type Conceptual paper

1. Introduction

Taxes are a well-known factor influencing financial reporting (Scholes *et al.*, 2008; Stocken and Verrecchia, 2004). The purpose of this paper is to analyse if some important clauses inserted in the Portuguese corporate income tax (CIT) code can be a source of divergence between reported earnings and taxable income. Additionally, we also discuss if such clauses are a source of management flexibility in reporting earnings, even if it means paying higher taxes.

The Portuguese CIT code establishes, in its article 23, a general principle concerning conditions for cost deductivity: deductible costs have to be "indispensable" for generating revenue or to maintain a firm as a going concern. Thus, every cost has to pass the indispensability test in order to be tax deductible. The thorny legal and economic point is how to define "indispensability".

An ambiguous interpretation and application of this general principle can be a source of uncertainty in computing corporate taxable income. On the other hand, given legitimate doubts about the tax status of certain costs, the flexibility of managers in reporting earnings increases because, when in doubt, it can be alleged that costs are

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deemed to be indispensable and, consequently, tax deductible. Only hypothetical future audits can challenge this choice. And, as we shall see, court rulings are not clear about the meaning of indispensability (Sanches, 2006; Portugal, 2004).

It could be supposed that lack of clarity was confined to the mentioned general clause of the CIT. Unfortunately, this is not the case. Specific clauses related to particular costs do not escape this conundrum. Payments to residents in tax havens fall into this category.

Payments to residents in tax havens can be based on true economic reasons. Or they can be used with the sole purpose of minimising taxes (Dharmapala, 2008). Suppose that a company, resident in a non-tax haven, has a tax loss that expires in year t. If such company agrees with another firm, resident in a tax haven, to sell an intangible (e.g. trade mark, licence) to the latter at an inflated price a gain is booked, and it can offset the tax loss. Thus, the loss was used and, additionally, in future years, when the former company has positive income, it pays royalties to the tax haven resident company related to the previously sold intangible, and thereby reducing its tax burden.

If both firms are related parties, transfer pricing rules can be used by tax authorities to fight the whole arrangement. But, if they are not related, it can be easily conceived that companies can reach an agreement on how to share the proceeds of a tax motivated transaction.

It is not surprising that many governments react by inserting in tax codes a so-called anti-abuse clause, dealing with payments to residents in tax paradises. In the Portuguese CIT, article 65 disqualifies, as a rule, these payments. However, in the application of this clause, there is an established rule, followed by an exception. For example, if payments are not deemed "exaggerated" they can be tax deductible. In many cases it is quite difficult to decide if what is relevant for a certain case is the rule (exaggerated payment and non-deductible) or the exception (non-exaggerated and deductible). Again, the fuzzy nature of the law's application gives managers some flexibility in computing taxable income.

The paper adds to the body of literature that analyses the relation between the level of ambiguity and uncertainty in tax law and its impact on managers' decisions, particularly about reported income, and presents some supportive evidence of the hypothesized behaviour.

The paper deals with complexities in applying the two mentioned clauses in the Portuguese CIT – the general and the specific – and its financial consequences, and is organized as follows. Section 2 presents a review of literature, Section 3 deals with methodology, Section 4 discusses the conceptual and applied complexities in applying the aforementioned legal clauses, Section 5 offers a brief empirical analysis of management behaviour regarding taxable income computation and its relation to accounting income, Section 6 concludes.

2. Background: taxes and financial reporting

The relation between taxes and financial reporting has been the focus of research in several areas. Its impact on book-tax differences across tax jurisdictions (Scholes *et al.*, 2008; Nobes and Parker, 2002), the influence of corporate taxation in managers' discretionary decisions regarding revenue or cost recognition (Arachi and Bucci, 2010) its effect on investment decisions (Shackelford *et al.*, 2011) or compensation policies (Shackelford and Shevlin, 2001) are topics that have been analyzed.

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A major reason for the relevance of book-tax differences in financial reporting lies in the flexibility provided by such differences in the timing of recognition of revenues and costs. If managers value flexibility, they will opt for decisions that are more likely to provide it. This possibility has been empirically verified by Arachi and Bucci (2010).

Firms usually report accounting income that differs from taxable income (Scholes *et al.*, 2008; Slemrod and Bakija, 2008). Reasons for such divergence can be summarized in three broad factors. First, the purpose of financial reporting – to reduce information asymmetries between interested parties enabling them to make the best decisions – is significantly different form the objectives of tax statements – to provide a measure of the tax base, given the equity, efficiency and simplicity tenets of a fiscal system (Shackelford *et al.*, 2011).

A second reason rests on fact that financial reporting systems are designed to show the underlying economic nature of transactions, while the tax system has other objectives, such as inducing tax favored corporate behavior (Stocken and Verrecchia, 2004). For example, rules about depreciation and the reinvestment of funds from assets' sales are examples of operations that have a high degree of divergence between accounting and tax rules (depreciation), or tend to favor a certain kind of decision (reinvestment of asset sale's cash flows and the tax treatment of capital gains).

A third reason is linked to the tax law's purpose of closing some loopholes that could lead to tax evasion and fraud. Some recognized accounting costs may be disqualified, because the government does not want to bear the impact of transactions that are designed to manipulate net income (e.g. transfer pricing, thin capitalization).

There is a growing body of literature documenting the increasing rift between book and tax income (Gee *et al.*, 2010), and also arguing that such widening of the book-tax gap is costly and consumes corporate resources (Graham *et al.*, 2011).

In several countries, rules regarding financial statements are different from the ones governing tax returns. Nobes *et al.* (2004) show that, for Spain, important items such as depreciation and provisions have a tax treatment that significantly differs from the accounting conventions governing their recognition. Given that depreciation and provisions are dependent on estimates, it is not surprising that tax authorities tend to impose precise rules on the deduction of these costs.

Arachi and Bucci (2010) present empirical evidence confirming that the tax treatment of write-offs in Italy affects the timing of recognition of such losses. Based on observed changes in the write off tax regime, these authors tested if such changes influenced the discretionary timing of write off recognition and found supportive evidence.

Dyreng (2009) found that as American firms move closer to violate debt covenants, they tend to report higher accounting profits, even if at the cost of paying higher taxes. Fear of financial distress and debt downgrading overrides concerns about higher taxes. Also, for the USA, and given the regime of taxing profits from foreign subsidiaries not on booking them but on repatriation, there is an incentive to locate foreign operations on low tax jurisdictions (Altshuler and Grubert, 2003). This procedure allows firms to present higher income for financial reporting purposes and postpone taxes to the time of dividend repatriation.

Transfer pricing is also a growing area of divergence between financial and tax reporting (Shackelford *et al.*, 2011; Scholes *et al.*, 2008). Given the increasingly complex problems that transfer prices pose to firms and tax authorities (e.g. transactions related to intangibles, international cash pooling activities) an inevitable degree of tax

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ambiguity is inherent to these operations. In the meantime, uncertainty about tax due resulting from potential transfer pricing audits allows management some flexibility in estimating tax liabilities and managing reported earnings (Blouin and Tuna, 2006).

In the Portuguese case, many authors (Morais, 2006; Sanches, 2006; Portugal, 2004) have argued that the general rule of cost deduction established in article 23 of the CIT creates a high degree of uncertainty. This happens because, up to now, no definitive and uniform interpretation of "indispensability" has been established by tax courts. As such, financial reporting can be heavily influenced by managers' own interpretation of this concept.

3. Methodology

The approach taken in this paper is based on legal research methodology and is indebted to the works of Arthurs (1983) and Chynoweth (2008). The process of applying pure doctrinal research methodology, usually understood as an exercise in deductive reasoning, can be characterized by the following steps (Chynoweth, 2008):

(1) Identification of a general rule that applies to particular facts or situations.

(2) Description of real (or hypothetical) situations that are under the scope of the law.

(3) Discussion if the general rule applies to the particular situations, and also speculating about the expected legal outcome.

Such pure legal reasoning is often influenced by another avenue of legal research: applied legal research, that rests on two developments. The first one, based on the recognition that it is usually not possible to arrive at the most correct or adequate interpretation of the law only by pure deductive reasoning, because hard cases' outcomes tend to form a body of jurisprudence that affects the application of legal principles. Second, because verbal interpretation and manipulation of the law usually gives rise to contradictory outcomes in identical situations, depending on the weight that interpreters give to legal concepts (Smith, 2004). Thus, the logical framework proposed by Chynoweth must be adapted, when addressing the topic this paper deals with.

As we focus on two tax clauses that have an ambiguous wording and need interpretation, it means that our method will, first, be based on the logical interpretative approach; but we will also try discuss the role of courts in dealing with hard cases, and what follows from related rulings, mainly from the Supreme Tax Court (STC).

The accounting treatment of costs, their tax deduction and its impact on the flexibility of financial reporting is a multidisciplinary issue. Although we focus on the interpretation of tax rules, some extensions will be made, dealing with complementary topics.

As already mentioned, logical interpretation and court rulings will be of particular importance in discussing the meaning of some legal concepts. But the conclusions that emerge from this interpretative effort will support some behavioral hypotheses, concerning management's decisions about reported earnings and taxable income. In order to present some empirical evidence of the postulated management behavior, data from the corporate tax returns collected by the Portuguese tax authorities will be used.

The legal doctrine side will highlight the interpretation of deduction rules and its complexities, court rulings will help us to draw on the concrete aspects of specific outcomes and, finally, tax data will be called to address some behavioral hypothesis. Regarding this last point, we will try to confirm if the room for maneuver arising from

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indeterminacy built in the tax law favors the observed lack of adjustments on the tax returns. As said in the previous section, when managers feel that tax disputes can bring a wide range of outcomes, there is a tendency for not adjusting accounting costs and assume them as tax deductible. This will minimize recorded tax liabilities and maximize reported net income.

4. A legal and a specific rule concerning cost deduction

4.1 The general rule

The Portuguese CIT code establishes, in its article 23, the following principle concerning the general conditions for cost deductivity: expenses have to be "indispensable" for generating revenue or to maintain a corporation as a going concern.

This general principle has equivalents in many CIT around the world. In the USA, for example, the well-known principle that deductible costs have to "ordinary and necessary" to generate income is also applied (Caron, 2003).

How, then, is the concept to be interpreted, when costs have to pass the test of indispensability in order to be counted against taxable revenues? Just a as simple illustration, if, say, a company ALFA Inc has accounting revenues of 1,000 and accounting expenses of 900, if there is coincidence between recognized and deductible costs, then reported income before tax (100) is identical to taxable income. However, if some item valued at 60 (e.g. an inventory loss) is non-deductible because it is deemed not indispensable, them the reported income is 100, but the taxable income is 160, as the non-deductible cost is added back. Deductivity has thus a significant impact in corporate tax burden and, consequently, in return on invested capital, in cash available to pay dividends and other corporate financial policy matters.

A first approach to the meaning of indispensability is the logical-deductive interpretation. In Portugal, many authors have dealt with this thorny issue of the CIT (Sanches, 2006; Portugal, 2004; Tavares, 1999).

These authors explore two avenues concerning the right interpretation of the indispensability concept. First, by linking it to a causality nexus between costs and revenues, and, second, interpreting the concept as if any cost that is incurred with a business purpose, even it does not generate revenues, passes the indispensability test.

According to the first interpretation, a correspondence between costs and revenues is to be observed. The general principle of deductivity would impose a clear link between recorded costs and generated revenues. The main criticism that such an interpretation arises is that the tax authorities would pass judgement on the running of a business, limiting (by disallowing expenses considered not indispensable) the freedom of contracting inherent in business law.

Suppose that an investment fails to achieve profitability. Or even that an acquired asset, bought with a normal business purpose, remains idle because of sudden changes in market conditions. Is any cost related to such investment to be excluded from deduction, based on the a posteriori observed lack of correspondence between costs and revenues? Does the government have a right of passing judgment on the effectiveness of management decisions? If this was the right interpretation, the economic and financial risks of a business would induce the additional penalty of generating non-deductible tax costs. Such a strict and narrow interpretation is not held by the Portuguese legal doctrine dealing with cost deduction and, to be fair, tax inspectors do not generally use such a rigorous approach in auditing process (Nabais, 2011; Sanches, 2006).

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The doctrinal analysis clearly favours an alternative interpretation: "indispensable" means that costs are incurred with a "legitimate business purpose" (Nabais, 2011; Portugal, 2004; Tavares, 1999). That is, if a firm has a sound claim that a particular cost was borne in relation with the activity or the business pursued by a company, then it passes the indispensability test. Given the preferred doctrinaire interpretation, how have the Portuguese courts been applying it? This is another component of the method applied in this paper.

In a ruling published in February 2008[1], the STC had to decide the following case. A company recorded, in a given year, personnel costs paid to employees of one of its affiliates, and deducted these personal expenses in the computation of the parent's taxable income. The parent company had no payroll, and used services of human resources from the subsidiary. The tax authorities argued that costs were not indispensable, because, among other reasons, in that year the company did not record any transaction related to its business and its operating turnover was nil.

The parent was confronted with an interpretation of the tax administration under which the expenditure would be deductible only if it had a clear relationship with the business operations, reflected in a certain turnover. In the litigation that followed, the trial court ruled in favor of the company. The Court of Appeal upheld the tax authorities' adjustment, thereby ruling the cost was nondeductible, overruling the trial's court decision. Given the divergent rulings the case had originated in lower courts, the STC ruled that the correction made by the tax administration should not be maintained, and sustained that even if the parent's reported income resulted only from financial investments, this was not a definitive obstacle to the "indispensability" of personnel expenses. To pursue its activity, or purpose, personal expenses had to be incurred, and the fact that the parent company had no formal payroll did not preclude such a deduction.

In a ruling of October 2009[2], a Court of Appeal delves on the concept of indispensability in the following terms:

> But how should the concept of indispensability be assessed? It is a vague concept, in need of interpretation. Following Tavares (1999) we consider that the legal notion of deductible cost provided by article 23 of the CITC does not imply that the tax administration may question the principle of freedom of running a business, by scrutinizing the goals of managers' decisions and considering as indispensable only costs that are directly related to revenues. The indispensability mentioned in article 23 [...] requires only a causal economic link, in the sense that the cost has to be borne in the interests of the company.

In another ruling, dated from March 2006[3] the STC decided that the concept of indispensability, being ambiguous, has to be clarified by relevant case law. According to the court, the proper interpretation of indispensability means that expenses are properly recorded as tax costs if they fall within the scope of the business, and were not incurred for pursuing third party interests.

Thus, a link between recorded expenses and the scope of the business – that is, costs would not be tax deductible if no relation was discernible with business activity – seems to have the blessing of the STC. However, such apparent clarity was blurred in other cases. In a famous ruling[4], the same STC decided that if a company[5] borrows money from a bank and lends it to a subsidiary in order to support the latter's solvency, then interest paid by the former is not deductible. The meaning of activity was, in the wording of the ruling, "productive activity". According to this ruling, the purpose of the firm did not include actions needed to manage financial participations.

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More specifically, in this last case, the STC ruled that for a certain amount of interest to be deemed a deductible cost it is necessary that the "activity" is developed by the participating company itself, not by affiliates. The disputed interest on bank loans was incurred by the parent and used in the financing of an associated entity. A crucial question becomes what is to be considered the "activity", or the business purpose, of a company. This is of utmost relevance, since the notion of indispensability has been linked to it. Given the mentioned court rulings, a grey area of indeterminacy regarding the meaning of indispensability still remains, and is mainly related to the complexity in defining what is considered to be within the "business purpose" of a firm.

Based on the doctrinaire and jurisprudential analysis of indispensability, what can be inferred about its impact on management incentives concerning the nexus between taxes and reported income? As previously shown, the more ambiguous a tax rule, the higher the incentive for a manager to err on the side of interpreting the law with a certain degree of convenience. Thus, by using the default option of considering a cost deductible, by admitting its link with the firm's business purpose, the estimated tax liability is lower and the reported income is higher. Relations with creditors are improved with better financial ratios, dividends can be higher and, if a manager compensation is linked to reported income, everybody gains by a convenient interpretation of the law regarding cost deduction.

How can this hypothesis be confirmed? Several empirical ways – surveys, natural experiments involving law changes, and case studies – are all imaginable. Latter on we will use tax data to a preliminary discussion of this important issue.

It would seem that a general principle governing cost deduction, given its ambiguity, would be the sole contentious point regarding cost acceptance for CIT computation in Portugal. As we shall see in the next section, even specific clauses can be quite complex and generate a significant amount of indeterminacy.

4.2 A specific clause: tax havens and their impact on corporate income

The tax literature presents three main views of tax havens. The first (Woods, 2011) defends them as useful checks on the ability to impose ever increasing burdens in high tax countries. This view points that, if uncontrolled, governments in high tax jurisdictions – usually developed countries – tend to extract increasing tax receipts from citizens and firms. In short, it is a perspective on tax havens espoused by some opponents of "big government".

The second (Dharmapala, 2008) refrains from arguing that tax havens are a positive factor in the "world tax order". But their defenders point out that such territories or countries are usually democratic, well governed, with good infrastructure and where the rights of citizens and companies are protected from state abuse.

Finally, a third view sees tax havens as a crucial piece of the tax and financial fraud across the world (Hampton and Christensen, 2002). To this view, tax havens were at the centre of recent financial catastrophes. All the shenanigans imagined by highly paid tax consultants, bankers, accountants and other professionals, have generally involved entities or operations based in tax havens as a specific mark.

Tax legislators and governments tend to side with the last view. Lost tax receipts due to tax havens' existence must be compensated with higher taxes or increased deficits, none of them cherished by any government.

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Moreover, tax administrations, in their auditing activities, gather lots of examples to illustrate the last view. Political and technical justifications are usually ready at hand to impose tax restrictions on the operations with entities based in tax havens. What do tax auditors typically find as common strategies to avoid or to evade taxes using tax havens? As it is well known, the variety of such strategies has grown over time, as firms, banks, consultants and other participants got more imaginative.

Just for illustration, two of those strategies are: overbilling and triangulation.

Overbilling happens when an entity located in a tax heaven invoices a firm resident in a non-tax heaven a certain (deliberately inflated) amount. The paying company can use the payment in excess to send money to off-shore bank accounts. These funds can then be used to activities that would be more scrutinized in the non-tax haven.

Triangulation happens when a firm A sells a product or a service to another firm B. Suppose both firms are residents in non-tax havens and the product costs for company A are 10. Then the product is sold to B at the price of 15.

A third entity, C, controlled by A, located in a tax haven, is used, as shown in Figure 1, to shift profits to the lower tax country.

In this case, the practical consequence of this scheme is the imputation of all profits ($15 - 10 = 5$) to company (C) located in the tax heaven. The country where A is located, which, normally, in a transaction between A and B, would tax the profit gets no taxable income. Given such – and much more – strategies used by firms, how do governments, especially tax legislators, react?

In order to fight some of the mentioned strategies, the Portuguese CITC (article 65, § 1) states that:

> Amounts paid or due to residents in tax favoured regimes are not deductible in the computation of the corporate taxable income; unless the taxpayer can prove that such amounts result from effectively executed operations; have a normal business purpose and are not exaggerated.

We can devise a rationale behind the tax treatment of payments to tax havens: a rule (non deductivity) and an exception (deductivity), but the burden of proof rests with the taxpayer. The exception can be seen as a safe harbour, allowing deduction to economically meaningful transactions.

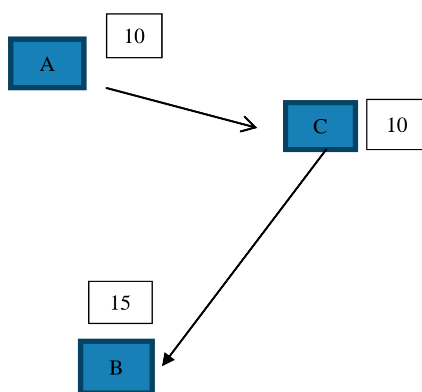

Figure 1.
An example of triangulation

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Our analysis of article 65, § 1, will be presented with the help of an example. Suppose a shoe making Portuguese firm asks a consulting company, resident in a tax haven, to do a report on the environmental impact of the chemical effluents produced by its operational activity. Suppose, also, this environmental report is an important technical element of support to fight a local government initiative, aimed at imposing on the company a new system of environmental protection. Such a new system would imply a heavy financial outlay to buy new fixed assets, such as equipment for a modern treatment of polluting chemicals. The consulting company did the report and charged €200,000, paid by the Portuguese firm.

In another context, the same shoemaking firms asked an individual financial consultant, also resident in a tax haven, for an expert opinion on how to implement an effective strategy of hedging against some risks (e.g. an increase in the price of raw materials or a fluctuation in euro-dollar exchange rate, given that the company exports to the USA and is paid in dollars). The financial consultant produced a report and charged €75,000.

Are those two operations under the rule established in article 65 (non-deductible) or do they fall under the exception (deductible, subjected to the verification that both operations were effectively executed, had a business purpose and amounts paid were not exaggerated)?

Regarding the first test – checking if the operation was effectively executed – if both reports are observable in the offices of the Portuguese company, no doubts arise about execution. Physical evidence does exist to confirm business operations.

On the second (business purpose test) it can be said that a shoemaking company can produce environmental damaging substances from the chemical treatment of raw materials, such as leather. Additionally, if such a company has a significant economic dimension and is internationally oriented, hedging policy can be a real concern for management. Thus, asking an expert to devise a strategy for covering risks is a sensible business decision.

The biggest question concerns the third test: would a tax auditor find the mentioned consulting fees "exaggerated"? The answer would depend, in our view, on a wide range of factors. First, on what kind of budgetary evidence could the firm present to tax inspectors in terms of billable hours by consulting entities and the reputational considerations about consultants involved.

Second, if the budgetary premises in terms of seniority of assigned consultants could justify such fees. Additionally, if the usual market price for comparable reports would be in the range of the charged prices by the hired consulting entities.

These, and probably other, questions would allow tax authorities to consider if both expenses were under the exception (and therefore deductible) or under the rule of article 65 (and, consequently, non-deductible).

Supposing that tax authorities did not accept deduction of these expenses, litigation could follow. In this case, a judge could call an expert witness to present an informed opinion about the reasonableness of prices charged, given the content of both reports and the professional curricula of assigned consultants.

To sum up, the degree of subjectivism of the exception stated in § 1 of article 65 can be a source of significant tax uncertainty and complexity. Once again, in court cases the interpretation of "exaggerated" is conditional on the case specifics. No uniform rule can be available to managers, when they have to decide if a payment to a resident

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in a tax haven is to be considered deductible or not. Thus, some degree of flexibility is, again, inherent to such decisions.

5. The impact of cost deduction in reported income: a brief discussion

Ambiguity in cost deduction rules favours management behaviour that tends to consider recognized expenses, not limited by clear and specific clauses, as being tax deductible. Given that the tax code does not explicitly define what, in article 23, is deemed "indispensable", and article 65 does not define what is "exaggerated", then a managerial practice should follow.

First, and concerning article 23, when managers have doubts related to the indispensable nature of a cost, they will have an incentive for not adding it back to taxable income. That is, they will probably wait until a tax audit checks the reasonableness of this managerial option. Thus, in corporate tax returns, very few deliberate adjustments made by companies – adding back costs that managers assume as non-deductible because they fail the indispensability test – should appear in the computation of taxable income.

In other words, if an objective rule about depreciation or impairment charges explicitly states the conditions for deductivity, tax adjustments to be made are clear, and tax returns would show a substantial amount of them. On the other hand, when it comes to costs that have no clear and unambiguous tax rule, then adjustments will tend to be rare.

As far as the specific anti abuse clause – payments to residents in tax havens – is concerned, the issue is similar. The probable option of a manager will be to consider that payments have a link to the business purpose and are not exaggerated. Once again, ambiguity in the formulation of the tax law has an impact in reported tax liability and net income. Table I presents some, albeit preliminary, evidence for Portugal.

As data from Table I confirm, the number of tax returns where adjustments – adding back recorded costs to taxable income – do happen is quite high in areas such depreciation and impairments, provisions, or fines and other penalties. In these areas, the tax code states unambiguously rules for cost deduction, and no doubts or flexibility arise when computing taxable income.

	2008	2009	2010
Number of tax returns			
Depreciation, amortization and impairment charges nor tax deductible	38,291	36,632	32,153
Non deductible provisions	3,826	3,669	3,128
Fines and other penalties	139,288	137,790	121,463
Transfer price adjustments	228	191	43
Payments to residents in tax havens	5	3	2
Amount (million €)			
Depreciation, amortization and impairment charges nor tax deductible	1,162	1,172	1,060
Non deductible provisions	5,317	4,828	5,978
Fines and other penalties	251	224	198
Transfer price adjustments	2	3	8
Payments to residents in tax havens	0	0	0

Source: Portuguese tax authority: www.portaldas financas.gov.pt (accessed 12 September 2012)

Table I. Adjustments in the Portuguese corporate tax returns

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Given that, in 2010, the number of corporate tax returns in Portugal was 393.891, we can conclude that 8.16 percent of total tax returns exhibit adjustments in depreciation and impairment, and 30.83 percent in fines and other penalties. Looking into the number of adjustments related to payments to tax havens, a stark contrast is observable.

It seems that our postulated management behaviour of not adding back such costs based on the consideration they are not exaggerated and related to the business activity originates some leeway in computing taxable income.

Although the paper does not focus on transfer pricing issues, it also clear that companies have some degree for flexibility. Transfer price adjustments have to be made if managers consider that prices of recorded transactions were not on an arm's length basis. The number of transfer price adjustments in Table I is an indication of flexibility in interpreting this rule. It is very doubtful that, in 2010, only 43 cases had a reasonable basis for transfer price tax adjustments, etc.

In the case of article 23 of the CITC, and the indispensability test, Portuguese corporate tax return files does not even present a line to fill with adjustments when managers presume that the indispensability test fails. It is true that blank lines do exist in the files, and that the they could be used for hypothetical adjustments, but these are quite rare.

If the top part of Table I shows the meagre number of adjustments, the bottom part – related to the amount of tax adjustments – is even more glaring. In the case of payments to tax havens, the amount lower than €0.5 million, and thus recorded as nil by rounding the figure.

It is obvious that one last question must be addressed. Is the negligible number of tax adjustments related to "indispensability", tax havens, or even transfer prices, the consequence of managers' assumed flexibility in reporting tax liabilities or is it the result of the absence of objective reasons for adjustments?

We have no empirical base to validate a definitive answer, but given the number of litigation cases concerning the proper interpretation of indispensability, transfer prices, and payments to tax havens, we have a solid foundation to venture that the level of litigation is based on a quite flexible interpretation of such legal rules by companies. Therefore, a visible link between tax law interpretation, the value of flexibility and reported income is present in Portugal.

6. Conclusion

In the Portuguese CIT code important clauses are based on principles. In particular, the general condition for cost deduction, by establishing the indispensability test, originates a highly complex application of such principle. Doctrine and courts have, up to now, not agreed on a clear cut definition of "indispensable".

As such, managers have an incentive to use this ambiguity to maximize the deductible costs, minimizing tax liability estimates and reported income.

The Portuguese tax returns confirm negligible numbers of tax adjustments is this area.

Should the law be changed? Would it be better if article 23 stated a list of costs that are deductible and, thus, denying deduction to non-listed costs? It is, in our view, very doubtful that this would represent a positive development.

First, because the dynamics of economic activity would mean that such a list would have to undergone constant revising. Second, because principles can be used to arrive

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at more balanced judgements, by taking into consideration the specific elements of any case. A precise rule can be easier to apply, but can generate outcomes with lower levels of fairness.

Regarding payment to tax havens, the principle seems a right one. Transactions with residents in tax havens, have, quite often, tax avoidance purposes. But often does not mean always. Thus, the burden of proof rests on the taxpayer to show that the operation is economically justified.

On the other hand, some alternatives that can be ventured would not be bullet proof. Let us suppose that an explicit amount would be inserted in article 65, § 1. Admitting that such an amount would be €50,000, it is immediately foreseeable that a payment of 60,000 would be easily split in two disbursements of 30,000 each. And, for different operations, the reasonable limits would be different. Surely, inserting in the CITC an explicit amount would run into trouble with firms and tax auditors, etc.

Finally, the fact that the law is based on a principle ("exaggerated") and not a rule (an explicit amount) gives a judge more room for deciding with fairness in litigation processes. Rules can be simpler to apply; but principles make the application of the law to specific situations fairer, by giving judges room for discretion in appreciating each case on its merits, and not being bonded by an explicit rule. A bit of fairness is worth some degree of complexity.

Notes

1. Process 0798/07.
2. Process 03022/09.
3. Process 1236/05.
4. Published in February 2007, Process 1046/05.
5. The case centres on a non-holding company that held financial participations, besides its operational business. In the Portuguese tax law, holding companies – SGPS – cannot deduct interest paid, and the capital gains derived from financial investments disposal are not taxed. However, Process 1046/05 did not revolve around a holding company.

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