

**Small businesses, share buybacks, tax auditing and the use of valuation methods:
An analysis of the Portuguese case**
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Purpose – The purpose of this paper is to analyze how share buybacks can be, in Portuguese small privately held firms, a source of tax-based conflicts between shareholders and tax administrations. Two issues are of particular relevance: the favored tax treatment of capital gains relative to dividends, and the use of valuation formulae to compute prices used in such transactions. The paper intends to present some advice to firms and consultants regarding equity valuation in privately held firms, to avoid tax based litigation. An extended analysis of the issue and its relevance to other jurisdictions is also presented.

Design/methodology/approach – The paper is based on a conceptual discussion of the usual approach taken by the Portuguese tax authorities to challenge share buybacks in small, privately held, firms. The arm's length principle in transfer pricing rules is the cornerstone of the topic analysed. The paper compares the merits of alternative pricing basis, and shows the economic and legal problems that each alternative presents.

Findings – The paper finds that the lack of tax neutrality between dividends and capital gains in Portugal can induce tax motivated transactions in small firms. The tax administration try to challenge these transactions on transfer pricing grounds. The alternative valuation strategy used by tax authorities is flawed, and puts the taxpayers in a good litigation position. However, a sensible valuation put forward by the firm can avoid such legal battles, which consume time and other resources of small owners.

Practical implications – The owners of privately held firms and the tax authorities should use valuation methods in very sensible terms. Cash flow valuation rests on several assumptions. These assumptions should not be used to produce prices that are easily questioned and increase litigation between firms and taxpayers.

Originality/value – The paper can be a source of practical advice for small business owners and advisors, as far as share transactions and share valuation are concerned. It is useful not only for the Portuguese managers and tax authorities, but also for any country where taxation of dividends and capital gains induces tax motivated buybacks.