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

António Martins, 2003

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.