PRINCIPLES OF TAXATION

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PREFACE

Few things are as ubiquitous, yet as little understood (and often reviled) as taxes. Evidently, most major events in a person's life trigger tax consequences: when two persons marry, their filing status and income tax regime changes, the applicable gift and inheritance tax regime changes, and so forth; when a child is born, tax benefits may become available; purchasing a home may lead to property tax liability and an entitlement to mortgage interest deduction; and so on. However, tax rules also apply to many ordinary, everyday occurrences, such as earning wages, purchasing goods or services, investing in stocks or bonds or giving a charitable donation, among other things.

Often, those rules apply almost imperceptibly. When purchasing groceries or dining in a restaurant, when going to the barber or streaming a film, consumers pay taxes, perhaps without being aware of doing so. Similarly, when an employee earns wages or a pensioner draws a pension, an amount of tax is withheld at source, so that the tax is paid without the individual involved actively taking any steps to do so. In other cases, the application of tax rules is much more noticeable, for instance, when an individual files an income tax return or when a business is audited by the tax authorities.

While taxes may have a significant impact on individuals' financial situation, they are even more important for governments. In most countries, taxation is the main source of government revenue, and without taxes it would be impossible to fund public services and government functions, ranging from education and healthcare to defence and infrastructure development.

Despite their importance, tax rules are often found to be complex and bewildering. The intricate and multifaceted nature of tax systems, encompassing a diverse array of tax types (each of which has its own terminology, calculation rules, deductions, credits, filing procedures, etc.) sometimes makes it difficult to see the forest for the trees. As a result, tax rules often have a reputation for being ambiguous, confusing and (in some cases) unfair.

The purpose of this book is to provide a general overview of the basic principles that govern the design and application of tax rules. Because every country has its own tax system, the book does not address the technical details of any specific country's tax rules. Instead, it discusses characteristics that are common to most modern tax systems.

The book consists of four parts. The first part addresses the fundamental principles and questions of taxation. It sets out a working definition of the term 'tax', and discusses several theories that explain why the levying of taxes is justified, as well as principles that govern how taxes should be levied. The second part discusses individual income taxes, for example, taxes on the income earned by an individual. It contains an in-depth discussion of the definition of 'income', and explains how tax rates work and how personal and family circumstances affect an individual's income tax liability. The third part concerns international taxation. More specifically, it explains the rules of international law that determine where and how income can be taxed in cross-border situations. To a significant extent, this chapter is based on the provisions of the Organisation for Economic Co-operation and Development (OECD) Model Convention, the model that is generally used as a template when countries negotiate a bilateral tax treaty. The final part addresses Value Added Tax (VAT); a widely used consumption tax. It explains which persons qualify as taxable persons for VAT purposes, and which transactions are subject to VAT. Part 4 also touches upon VAT rates and a number of procedural issues related to the application of VAT.

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PART 1

THE FUNDAMENTAL PRINCIPLES AND QUESTIONS OF TAXATION

CHAPTER 1
WHAT IS A TAX?

1.1 GENERAL CHARACTERISTICS

1.1.1 DEFINITION OF TAXATION AND ITS IMPORTANCE

1 There is no generally accepted definition for a 'tax' and different terms are often used to describe taxes, such as levies, duties, impositions and contributions. In certain countries, the law contains a definition of what constitutes a tax, while in others it has been left to the courts to identify the characteristics that determine which contributions and payments qualify as taxes and which do not. While those definitions may be very different, there are generally a number of characteristics that are common to those different definitions. Those characteristics will form the basis of the concept of 'tax' as it is used throughout this book. In particular, irrespective of its formal name, a tax is a **compulsory payment that is usually made in cash to support the functioning and activities of the government**.[1]

2 While this definitional issue may appear to be trivial or merely academic, it has an important impact in practice. As will be discussed later in this chapter, there are a number of 'principles of taxation', such as the principle of legality. Those principles only apply to contributions that qualify as taxes. If a contribution is not a tax, but, for instance, a social security contribution or a fine, those principles do not apply. Of course, other (perhaps similar) principles may apply, but not the principles that govern taxation.

[1] See also the definition that is adopted by the Organisation for Economic Co-operation and Development (OECD): 'Taxes are compulsory, unrequited payments to general government. They are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments.' OECD, https://doi.org/10.1787/76e12892-en.

3 Taxes can come in many forms, including income taxes, sales taxes and property taxes, which each have their own specific objectives and characteristics. As noted, taxes are usually paid in cash, but can sometimes be paid in kind by transferring goods or services to the government.

A good historical example of taxes paid in kind are tithes, that is, mandatory contributions in the form of one-tenth of something (although not all tithes actually use a 10% proportion). In Mesopotamia, for instance, there is evidence of tithes from agricultural produce, cattle, wool, wood, and so on, but many (historical) church taxes also took the form of tithes, whereby members of the religious community were expected to pay a part of their production (e.g., crops or cattle) to support the clergy and maintain churches.

Figure 1: Pieter Brueghel the Younger, Payment of the Tithes, c. 1617–1622.

Another illuminating example is that of the corvée, a form of unpaid labour imposed by the government for the purposes of public works. In the Later Roman Empire, for instance, citizens could perform public works (such as working on roads or bridges) in lieu of paying taxes ('*opera publica*'). Similarly, serfs in medieval Europe were required to perform certain works (such as plowing and harvesting), but the feudal lord could also demand additional work, such as roadworks. As a current-day example, reference could be made to the system of Umuganda as it exists in Rwanda, a national holiday on which all citizens over the age of eighteen are legally required to take part in mandatory community work, for instance, by cleaning up public spaces.

Scan the QR code and read the article,
'Cleanest city in Africa? Kigali scrubs up' (Reuters).

Figure 2: An illustration from the Queen Mary Psalter (c. 1310), showing serfs in feudal England doing harvest work for their feudal lord.

4 It is often difficult to distinguish a tax from other types of payments to the government (see also *infra*, Section 2). Indeed, not all payments made to public authorities are considered taxes. First, payments that are made on the basis of a *contractual obligation*, even if they are paid to the government, are not considered taxes.

If a private individual rents a property from a public authority, the rent payments made by the individual are not considered taxes because they are made as part of a contractual agreement.

5 Additionally, payments made on the basis of a *non-contractual liability* of tort towards public authorities or even other private individuals are not considered taxes. Fines or penalties, for example, are financial sanctions imposed on individuals or businesses for committing crimes or misdemeanours. These payments are meant to serve as a punishment for the wrongdoing or as compensation for damages, rather than to support the functioning and activities of the government.

An offender is obliged to pay compensation for a personal injury caused by negligence or property damage caused by a car accident. The compensation, even though legally required, is not considered a tax.

6 A tax is a financial charge imposed by a government or other public authority on individuals, businesses and other entities. Therefore, *gifts, donations or voluntary payments* made to public authorities are not considered taxes. These types of payments are made out of generosity or for charitable causes, rather than as a consequence of a legal obligation and are therefore not seen as mandatory payments.

7 Taxes generally have the following characteristics:

- For a payment to be considered a tax, it must have a **legal basis**. This means that it must be imposed and collected in accordance with the rule of law. The levying of the tax must comply with the laws and regulations established by the government. This legal basis, which can generally be found in a country's constitution, tax laws or other rules, gives the government the authority to collect taxes (see *infra*, mno. 65 on the principle of legality).

- The government has a sovereign right to spend tax revenue for any **public purpose**. The public authority has the discretion to use the revenue as they see fit to support the functioning and activities of the government. This includes funding public services and infrastructure such as schools, hospitals, roads or national defence. The government is responsible for making decisions regarding the allocation of tax revenue and ensuring that the funds are used in the best interests of the citizens and the country.

- The taxpayer, however, neither has the right to claim some form of personal compensation for the amount of tax paid, nor any right to decide how the payment of the tax is spent by public authorities. Indeed, taxes are paid **without any form of consideration or compensation** in return. This means that the taxpayer does not have a right to receive any *direct* benefit or service from the government in exchange for the payment of taxes. They can, however, benefit indirectly from the government's decision to spend the funds by making use of public services. This does not mean that the government is entirely free to spend the tax revenue, as control is exercised by parliament which is elected by the citizens (see also *infra,* mno. 65).

In summary, a tax can best be described by the following working definition for the purposes of this book:
- a mandatory contribution (Section 1.1.2)
- in accordance with the rule of law (Section 1.1.3)
- imposed by the public authority on its subjects (Section 1.1.4)
- for the purpose of public spending (Section 1.1.5)
- without any personal compensation (Section 1.1.6)

In the following sections, each of these elements will be further elaborated upon.

1.1.2 A MANDATORY CONTRIBUTION

8 A first characteristic of taxes is that they are a mandatory financial charge imposed on individuals, businesses and other entities by the government or another public authority. This means that it is a legally required payment that the taxpayer must make to the public purse regardless of whether they agree with the government's spending decisions or their policy. Tax measures can be **enforced by the government** through a variety of means, including fines, penalties (such as late payment interest) and even legal action. The reason why taxes are mandatorily imposed is because they are considered an essential component of a functioning government as they help fund essential services such as healthcare, education, infrastructure and public safety.

9 The mandatory nature of taxes can also be explained by several **economic concepts**. First is the *risk of market failure* in the case of public products. Consider a simple society without a government in which each individual is responsible for safeguarding their own property from harm committed by another. This implies that each individual must devote resources to defence and security. These resources (time, labour and money) cannot be reallocated. From an economic standpoint, establishing a government tasked with defending the property of all its citizens will yield a more efficient result. The cost of the government's service (creating a secure environment) will be reduced for the individuals, allowing them to redirect their own scarce resources to another cause, which may be a more efficient outcome from an economic standpoint. The government's service is a public service, characterised by non-rivalrous consumption[2] and non-excludability,[3] which means that it is hard to exclude non-contributing citizens from a public service (such as national defence), which can lead to individuals being labelled 'free riders'.

10 Without mandatory contributions and enforcement, taxpayers would not be incentivised to contribute. Under normal circumstances, this will result in a market failure. Taxes on such public goods or services mitigate these issues.

[2] This term indicates that the consumption by one person does not come at the cost of consumption for another.

[3] This means that the cost of excluding beneficiaries who are not contributing is so high that no private firm would be willing to supply the good.

> If national defence were offered by a private organisation, it would be difficult for the organisation to guarantee the defence of a client who has purchased the defence while excluding that security from the neighbour who has elected not to acquire the service (i.e., a possible 'free rider'). In that sense, a compulsory taxation policy is a mechanism to ensure that all individuals who use the service, pay for it.

11 A second economic idea further supports centralising certain goods or services. From an economic point of view, in a rational world, so-called **economies of scale** can be realised by centralising certain government tasks. Economies of scale is a term used in microeconomics that indicates that certain cost advantages can be realised due to an enterprise's size or scale. The cost per unit of output decreases as the scale of output increases, mainly because fixed costs (i.e., costs that are due regardless of the amount of output) are spread over more units of output. Therefore, there is an economic incentive to centralise certain goods and services in the hands of the government, which in turn requires the payment of taxes for financing purposes.

12 Therefore, from the moment a taxpayer falls within the scope of the tax's application, the tax can be **imposed by force**. This means that the government has the authority and power to collect the tax from the taxpayer even if they are unwilling or unable to pay. This characteristic distinguishes taxes (as mandatory payments) from other types of voluntary payments or gifts which are made at the payer's discretion.

Figure 3: Detail from the tomb of Menna, Luxor, Egypt, illustrating the use of force in the collection of taxes.

13 The only way to **avoid paying the tax** is to put oneself in a factual or legal situation in which the tax is not due (i.e., outside the scope of application of the tax). This means that the taxpayer must take steps to ensure that they are no longer subject to the tax, such as meeting certain qualifications or changing their personal circumstances.

> A taxpayer who no longer wants to pay taxes on fuel for their car could consider no longer using the car.

1.1.3 IN ACCORDANCE WITH THE RULE OF LAW

14 A tax can only be levied in accordance with the rule of law, which means it must have a legitimate legal basis. This concept is known as the **legality principle**. This principle ensures that taxes are imposed and collected in a fair and transparent manner, in accordance with the government's laws and regulations. The legality principle ensures that the government has the authority to levy taxes and that the taxation process is clear and predictable for taxpayers. It also ensures that taxes are not imposed arbitrarily, and that the government cannot impose taxes without following due process and providing a clear rationale (see in detail on the principle of legality *infra*, mno. 65).

15 The principle of '**No taxation without representation**' is fundamental in most taxation systems. It expresses the notion that citizens have the right to participate in the taxation process and that they should not be required to pay taxes unless they have a say in how those taxes are collected and spent. This principle is rooted in historical documents such as the Magna Carta (1215), the UK Bill of Rights (1689) and the French Déclaration des Droits de l'Homme et du Citoyen (1789) and numerous national constitutions. Citizens have the right to have a say in how they are taxed and how their tax money is spent by holding their government accountable.

16 Indeed, national legislatures, which are normally elected by citizens, play an important role in implementing this principle by voting on, amending and repealing tax laws. They are in charge of enacting the laws and regulations that govern the imposition and collection of taxes, as well as ensuring that the government's budget is spent in the best interests of the citizens and the country. Members of Parliament are elected to debate and adopt laws that affect the taxation system.

'No taxation without representation'

The principle of 'no taxation without representation' became important in the eighteenth century during the American Revolution. It was a key slogan in the American colonies' fight for independence from British rule.
During the eighteenth century, the phrase 'no taxation without representation' was used in the thirteen American colonies, as colonists felt they were being unfairly taxed by the British government without representation in the British Parliament. To fight these taxes, the American colonies organised protests. They claimed that because they had no representation in the British Parliament, they should not be taxed by it.
The phrase became popular in the 1760s and 1770s, when the British government imposed a series of new taxes on the colonies, including the Sugar Act, the Tea Act and the Stamp Act, to help pay for the costs of the French and Indian Wars. The colonists fought back against these taxes, claiming that they were not being fairly represented in the British government and that their rights as British subjects were being violated. They had no representation in the British Parliament and thus no say over how they were taxed.
The phrase 'no taxation without representation' is still used today to express the belief that citizens have the right to have a say in how they are governed and should not be subject to laws or taxes imposed by a government without being duly represented and being able to exercise oversight.

Figure 4: The Destruction of Tea at Boston Harbor, an 1846 lithograph by Nathaniel Currier, depicts the 1773 protest against the Tea Act whereby a shipment of tea was thrown into the Boston Harbour (which later became known as the Boston Tea Party).

17 The history of taxation is therefore inextricably linked to the history of **democracy**, as the manner in which taxes are collected and spent has always been a reflection of a society's political and social values. In a democracy, the government is elected by the people and thus is accountable to them.[4] This accountability is reflected in how taxes are collected and spent. The scope of the tax, tax base, tax rate, administration and procedure of a tax must all be specified in the tax statute and voted on by parliament. This ensures that all citizens have a say in how their taxes are levied and how their money is spent. Taxation is about more than just collecting revenue for the government; it is also about ensuring that this revenue is used to meet society's needs in a democratic manner.

1.1.4 LEVY IMPOSED BY THE PUBLIC AUTHORITY ON ITS SUBJECTS

18 The authority to impose taxes is a fundamental aspect of a government's power and it is based on the government's authority over its subjects and territory. Like in other branches of law, the government can only exercise its competence within the boundaries of its own territory. For tax law, this means that the government can only tax subjects (or situations) that have a sufficiently close connection (or 'nexus') to its territory. Governments generally cannot impose taxes on taxpayers who have no link whatsoever with their territory. The concept of 'nexus' is further explained in Part 3 of this book, which deals with international tax law.

A government can generally only tax the worldwide income of persons who are residents or nationals of the state.
Transactions are only subject to sales taxes if they take place in the territory of the government imposing the sales tax.
A government cannot impose a tax on taxpayers who live abroad and have no link whatsoever with that state.

[4] As mentioned above, taxes need to be paid by both individuals and companies. It is interesting to note that while individuals have the right to vote and hence affect tax laws, legal persons, such as corporations, do not.

[19] Throughout this book, the term 'government' is used in a broad sense. Depending on a country's political structure, it is possible that regional or local authorities are involved in the tax process, either by levying taxes themselves, or by receiving a share of tax revenue from another government.

In recent times, due to the rise of the digital economy, questions have been raised as to the validity of the use of territory as a way to delineate the competence to impose taxes. In particular, a digital presence is often indicated as a new possibility to tax foreigners. An example of this is the *Wayfair* case.
The Wayfair v. South Dakota Supreme Court case dealt with the question of whether states can require out-of-state sellers to collect and remit sales taxes on transactions made with in-state residents. Prior to this decision, the physical presence rule established by a 1992 Supreme Court case, Quill Corp. v. North Dakota, allowed that states could only require retailers to collect sales taxes if they had a physical presence in the state.
The court's decision in Wayfair overturned Quill, ruling that states can require out-of-state sellers to collect and remit sales taxes, even if the seller does not have a physical presence in the state. This ruling allows states to collect sales taxes from online retailers that do not have a physical presence in their state, which many believe will provide much-needed revenue to states and level the playing field for brick-and-mortar retailers who were at a disadvantage due to their online competitors not having to collect sales tax.
The Supreme Court's decision in Wayfair has a particular impact on the e-commerce industry, as it allows states to collect sales taxes from online retailers that do not have a physical presence in their state. This ruling effectively means that online retailers will now be subject to the same sales tax obligations as traditional retailers.

Scan the QR code to read about the *Wayfair* case.

1.1.5 FOR THE PURPOSE OF PUBLIC SPENDING (IN THE PUBLIC INTEREST)

[20] The allocation of tax revenue is a complex process. The government must consider the evolving needs of society, its own priorities and the political and economic context when deciding to allocate tax revenue in the most efficient and effective way possible.

Climate change has recently led to an increased focus on the role that taxation can play in steering taxpayer behaviour (see also *infra*, mno. 94). A trend can be observed where governments have adapted their tax policies, not only by imposing taxes on harmful (polluting) activities, but also by providing tax incentives, for example, by way of providing tax credits for investments in renewable energy. These tax incentives are funded by tax revenue and are thus a result of a decision on the allocation of tax revenue.

[21] Even though the government is in principle free to decide on the allocation of the tax revenue, the government is still subject to certain legal constraints. For example, the government may be required by law to allocate a certain percentage of tax revenue to specific programmes or initiatives. Additionally, there may be constitutional limits on the government's ability to tax certain individuals or entities, or to use tax revenue for certain purposes.

A government cannot decide to subject the entirety of a taxpayer's income at a 100% income tax rate. This would run counter to the individual taxpayer's fundamental rights (i.e., the human right to property) which is included in international human rights treaties and constitutional rules (see *infra*, mno. 84).

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ISBN 9789464759402
NUR 820
D2024/11.089/1

© 2024, Borgerhoff & Lamberigts nv

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Design and cover: Robin J. August
Typesetting: Crius Group
Images: 14. Sockenpuppe123 via Wikimedia Commons; 15. Andreas Billman; 24. James Bourne via Wikimedia Commons.

Printed in Europe

First published in January 2024

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