

Tax Law

Marcel Schaper

- 1 What is Tax Law? – 253**
 - 1.1 Defining Taxes – 253
 - 1.2 The Taxing Power – 253
- 2 Goals of Taxation – 255**
 - 2.1 The Three R's of Taxation – 255
 - 2.2 Revenue – 256
 - 2.3 Redistribution – 257
 - 2.4 Regulation – 258
- 3 The Tax Mix – 258**
- 4 Taxes on Income – 259**
 - 4.1 What: The Definition of Income – 259
 - 4.2 Who: Subjective Tax Liability – 260
 - 4.3 When and What: Objective Tax Liability – 261
 - 4.4 How Much: Tax Rates and Credits – 263
 - 4.5 Income Taxation of Companies – 265
- 5 Taxes on Goods and Services – 266**
- 6 Taxes on Property – 267**
 - 6.1 Property Ownership Taxes – 268
 - 6.2 Property Transaction Taxes – 268
- 7 Tax Procedure – 269**
 - 7.1 Taxpayer Rights and Obligations – 269
 - 7.2 Assessment and Collection – 269
 - 7.3 Tax Management – 270

8 Globalization and Tax Law – 272

8.1 International Tax Law – 272

8.2 Tax Problems of Globalization – 273

Recommended Literature – 275

1 What is Tax Law?

1.1 Defining Taxes

Taxes are compulsory, unrequited payments to government. The law obliges a person to give money to the government without receiving anything specific directly in return. Taxpayers only enjoy a general benefit of their involuntary gifts; taxes pay for the institutions, infrastructure, and policies that the government provides to society.

User charges and service fees, such as highway tolls or passport fees, are considered nontax revenue. These charges and fees are normally only due when an individual requires a specific service or a good offered by the government as consideration. The amount of the charges and fees are roughly proportional to the cost to government of providing the services or goods.

It is sometimes difficult to distinguish taxes from nontax revenue. The best example is social insurance. Social insurance contributions may be qualified as nontax revenue because persons receive future benefits for their contributions in the form of social insurance payments. The level of the payment also often depends on the period during which an individual made contributions. Notwithstanding, participation in the social insurance system is usually compulsory, and persons perceive no real difference between paying contributions or income taxes.

1.2 The Taxing Power

Tax law is public law because it governs legal relations between private persons and the government as such. Tax law is often considered a field within administrative law. There are two areas of tax law: *substantive tax law* (which lays down the criteria of taxation, who is taxed, for what, for how much, where, and when) and *procedural tax law*, which regulates formalities on how the tax liability is assessed and collected, defines taxpayer rights and obligations, and states provisions concerning the powers of the judiciary for settling disputes between the taxpayer and the tax administration.

The tax system is a mix of different taxes (► Sect. 3). In many States, each tax is regulated by its own substantive law. A general tax law is most often used for definitions that apply throughout the tax system and for issues of procedural tax law.

Taxation as law

Limitations to the Taxing Power

The power to impose and collect taxes is normally granted to the government by the constitution. Tax laws may be enacted by the central government as well as by regional and local governments. The division of taxing powers between levels of government applies not only to unitary and federal States but also extends to supranational organizations like the EU.

The differences between the taxing powers of the United States and the European Union are particularly striking. The federal government in the highest level of government in the United States has enacted laws on income taxes but not on goods and services taxes. Whereas the States share the power to collect income taxes with the federal government, there is no universal federal goods and services tax in the United States. In contrast, goods and services taxes are harmonized throughout the European Union by EU legislation. There is no comprehensive legislation on income taxes at the EU level. Income taxes remain a reserved competence of the Member States. The European Union also cannot collect any taxes directly, except from its own civil servants. The Member States transfer a part of their national tax revenue to the EU budget.

The taxing power is not only created by the constitution, but it is also limited by the general principles of law and fundamental rights that the constitution protects. The principles of legality and equality are the major constitutional limitations to the taxing power. The taxing power is further balanced by assigning different tasks to the three branches of government. Legality, equality, and balance of powers should be upheld as guiding legal principles of a good tax system.

Legality

The legality principle prescribes that only the law may impose tax obligations. Taxation therefore requires a legislative act. This fundamental principle of representative democracy is also known as «no taxation without representation». Although one might view taxation as encroaching upon property rights, taxation is also necessary for the government to be able to maintain a justice system to protect property rights.

Equality

The principle of equality prohibits arbitrary taxation devoid of reasonable foundation. In the field of taxation, the legislature nonetheless enjoys a wide margin of appreciation in assessing whether and to what extent differences in otherwise similar situations justify a different tax treatment.

In *Burden v United Kingdom* [2008] ECHR 356, the European Court of Human Rights ruled that there was no violation of the prohibition of discrimination in the case of two sisters who had lived together all their lives in their parent's home. The sisters were afraid that they could not pay the substantial inheritance taxes on the house when either sister would die. The Grand Chamber held that the cohabiting sisters could not be compared to a married couple or civil partners who would pay much less inheritance taxes.

The legislative branch of government decides on the existence and the design of tax laws, but the executive branch carries out their enforcement. The tax administration as a part of the executive branch is responsible for the collection of taxes. The judiciary settles disputes between the tax administration and taxpayer. In many States, the legislature delegates competence to the executive to issue interpretative decrees and implement regulations for tax laws. This bypassing of parliament on substantive tax matters is thought to be necessary to allow the government to respond quickly to changes in economic situations and taxpayer behavior.

Balance of Powers

A domestic taxpayer of the Netherlands who earns foreign income may request a reduction of Dutch taxes on that foreign income to avoid double taxation. Article 38 of the General Tax Act leaves it to the Minister of Finance, without a requirement to involve parliament, to set the rules and conditions under which such relief is granted by an administrative decree.

2 Goals of Taxation

2.1 The Three R's of Taxation

To understand tax law, one first needs to define its objectives. Taxation serves three goals. We call these the three R's of taxation:

- Revenue
- Redistribution
- Regulation

Unsurprisingly, the main goal of taxation is to raise revenue to finance government expenditures. Redistribution of wealth and regulation of behavior are generally considered secondary goals but may even be the primary goals for some specific taxes. The extent to which a tax pursues these goals may differ, and the government must always make a trade-off between the three R's. Any political discussion about the size and the tasks of government has consequences for the design of the tax system in terms of these three goals. A political position that favors «small government» (e.g., a libertarian view) would advocate low tax revenue and little regulation through the tax system. A political position that favors egalitarian outcomes and solidarity (e.g., a social democratic view) would support using the tax system for redistribution of wealth.

2.2 Revenue

Raising revenue through taxation invariably means that persons need to transfer some of their income or wealth to the State. Taxation thus inherently reduces welfare. It is generally accepted that high taxes have a negative impact on economic growth. Nonetheless, taxpayers are willing to accept significant taxes in return for good government. Higher taxes, however, increase the likelihood that taxpayers put additional effort into tax management strategies to on their tax expenditures (► Sect. 7.3). Therefore, higher taxes do not necessarily result in more tax revenue. Beyond a certain level of taxes, any further increase in taxes leads to a greater loss in revenue due to taxpayers deciding to stop earning income or increased tax management strategies in the forms of tax avoidance and tax evasion.

Behavioral Responses

Taxes influence economic decisions and so trigger behavioral responses. Taxation has effects on the basic economic choices between work and leisure and between consumption and saving. In this way, distortions in economic choices lead to social costs. For instance, a tax on labor income increases wage costs for employers and so impacts employment. Further, value added taxes increase the cost of goods and services and so determine the quantities bought and sold by consumers and producers.

Deadweight Loss

Social costs of taxes arise because of behavioral responses. These negative impacts on welfare in addition to the cost of the tax are called the «deadweight loss» or «excess burden» of taxation. An efficient tax system raises revenue while minimizing the deadweight loss. Consequently, neutrality is a desirable design characteristic of a good tax system. A neutral tax system ensures that persons make decisions based on their economic merits and not because of their tax consequences. However, the goals of redistribution and regulation demand taxation to be non-neutral regarding some persons and choices of behavior. That means that some decisions become more economically favorable due to their tax benefits, whereas other decisions become less favorable in comparison after discounting their tax consequences.

Specific taxes (excise duties) are levied on cigarettes and alcohol. Smoking and drinking damage your health, increase the costs of health care to society, and are therefore considered socially undesirable behavior. Excises moderate the likelihood that people start and maintain these bad habits. The excise raises the price of smoking and drinking (it «internalizes» the cost to society—the costs to everyone else—into the private costs of the consumer) and so reduces demand for cigarettes and alcohol.

These activities may also be directly regulated, e.g., by a prohibition on the sale of alcoholic beverages to underage children and by smoking prohibitions in public places.

2.3 Redistribution

The extent to which the tax system should redistribute income and wealth between the rich and poor—its progressivity or regressivity—is a question that divides politics. Although it is best to assess the progressivity of a tax system as a whole, it may nevertheless be helpful to understand how individual taxes contribute to the distribution of income and wealth within society.

Progressivity

Thomas Piketty (1971) is a French economist who published the book *Capital in the Twenty-First Century* in 2013. The central thesis of his work is that when private wealth grows faster over the long term than the general economy (this has become known as the formula $r > g$), wealth will concentrate («the rich get richer»). Very unequal distribution of wealth may cause social and economic instability. Piketty therefore advocates a progressive tax system that takes more from wealthier persons. This view has received both acclaim and criticism from other economists.

Differential taxation, according to which not everybody pays an equal amount of taxes, redistributes income and wealth between taxpayers. The ordinary approach is to impose higher taxes on more advantaged persons and no or lower taxes on less advantaged persons. Differential taxation of this kind is called «progressive taxation», and it results in income and wealth positions becoming more equal after taxes as compared to before tax positions. In contrast, regressive taxation—the average tax rate decreases with higher income or more wealth—increases inequality between taxpayers. Taxation is proportional if the tax liability as a percentage of total income or wealth is equal regardless of the size of income or wealth.

Progressive, Regressive,
and Proportional
Taxation

Assessing the progressivity of a tax should be done in real terms. A tax that is equal in law may be unequal in effect. Take taxes on alcohol and cigarettes, for example. These are equal in amount for everyone who drinks and smokes, but they tend to hit less advantaged persons harder because their consumption of alcohol and cigarettes makes up a larger portion of their income or wealth. They are therefore regressive taxes.

When assessing the redistributive impact of a tax, the government must always carefully consider on whom the tax burden ultimately falls: the incidence of the tax. The statutory

Incidence

bearer of the tax is the person who is legally responsible to pay the tax (legal incidence). That need not be the same person whose welfare is, intentionally or unintentionally, ultimately affected by the tax (economic incidence).

Direct vs. Indirect Taxes

When legal and economic incidences normally coincide for the same person, the tax is a direct tax. This is the case for personal income taxes. Indirect taxes are those which legal and economic incidence likely falls on different persons: the statutory bearer of the tax generally tends to shift the burden of the tax to another person.

Entrepreneurs are legally responsible to pay VAT to the government. However, since the VAT is included as a part of the price of goods and services sold, the economic burden of the tax mainly falls on the consumers of the goods and services. Consequently, the VAT is an indirect tax.

2.4 Regulation

Taxation triggers behavioral responses, because persons consider the financial consequences of the choices that they make. Mindful of these economic effects of taxation, the government may steer peoples' behavior to choices that stabilize the general economy and foster growth. The government can also regulate specific choices and activities by stimulating socially desirable behavior (through decreased taxation) and discouraging undesirable behavior (through increased taxation). While some view these value judgments as tax paternalism, there is significant regulation through taxation in many States.

Examples of fiscal stimulation are the mortgage interest deduction for residences, a child credit, and lower tax rates on income from environmentally friendly investments.

3 The Tax Mix

The Tax Base Distinction

The tax base is what is taxed. While nearly everyone and everything will be subject to one or more taxes, we can make a broad distinction between different taxes in the tax mix according to their tax base. The three main kinds of taxes are:

1. Taxes on income (► Sect. 4)
2. Taxes on goods and services (► Sect. 5)
3. Taxes on property (► Sect. 6)

Taxes on income consider the personal and family circumstances of the taxpayer, in addition to the total amount of income earned. Income tax laws therefore require answers to nonfinancial questions like: is the taxpayer married; does the taxpayer have children; and, did the taxpayer make special expenditures for illness? Because they take account of the individual characteristics of the taxpayer, income taxes are also called personal taxes or *ad personam* taxes (Latin for taxes «directed to the person»).

Personal and
Transaction Taxes

Taxes on goods and services ordinarily do not consider the personal situation of the taxpayer and impose a charge to tax with exclusive regard to the nature and the value of each individual taxable transaction. Goods and services taxes are therefore often labeled as transaction taxes or *in rem* taxes (Latin for taxes «on things»).

4 Taxes on Income

Taxes on income were introduced in the United States and Europe during the last half of the nineteenth century. The first modern income tax was introduced in the United Kingdom to fund the Napoleonic war. Similarly, in the United States, the direct cause was the need to pay for the Civil War. In Europe, income taxes have been raised significantly to pay for the costs of the two World Wars.

4.1 What: The Definition of Income

In defining the tax base for income taxes, one fundamental question arises first: «What constitutes income?»

Historically, income is theoretically defined according to the accretion and source concepts of income.

Accretion Concept

The first approach to defining income is the accretion concept or Schanz-Haig-Simons concept of income. Under this very broad concept, income is the net accumulation of the taxpayer's wealth over the year. A taxpayer's wealth changes because the taxpayer consumes or saves his or her income. Consequently, income under the accretion concept is defined as the sum of the market value of all consumption (everything bought) and the change in the value of property rights over the year (the value of property at the end of the year subtracted with the value of property at the start of the year, i.e., everything saved).

The source concept of income defines income more restrictively as the market value of all gains from specific

Source Concept

and stable sources of income. A source of income generally exists if a taxpayer actively participates with some product of labor and capital in an economic market with a reasonable expectation to derive an economic gain. This includes participation in the economy as an employee, as an entrepreneur, or as an active investor. It typically excludes hobby activities and transactions between family and friends as taxable activities.

It is easy to understand the distinction between the two concepts of income with the classic apple and tree analogy. The accretion concept considers all economic gains: all apples that fall from the tree are considered income but also the change in value of the tree itself. Under a source concept of income, only the apples are tax relevant and are considered income. The existence of the tree is merely the precondition for earning income. This is the reason why many States that follow a source concept of income have not taxed capital gains on private investment property for a long time and have only done so after express changes to their income tax laws. The capital gain on disposition (the increase in market value compared to the historical cost price) was not considered income because the source of income itself, namely, the investment property, was alienated. Further, gains that do not have a source, such as lottery winnings or personal injury awards, are traditionally not regarded income under the source concept.

4.2 Who: Subjective Tax Liability

Taxes on income are levied from persons. Any income tax law therefore needs to define the taxpayer by answering the question about the subjective liability to tax: «Who is liable to pay income taxes?»

The unit subjectively liable to pay tax may be one or more persons. There are two theoretical extremes and a hybrid definition of the tax unit. The first extreme is that income taxes are assessed individually without regard to the family circumstances of the taxpayer. Under this system, a taxpayer is taxed on his or her personal income, and the tax position is not affected by the presence and income of family members. The second extreme is the exact opposite, namely, that income taxes are assessed with regard to the total sum of income of the family (however defined). Such a system would, for example, impose taxes on the total joint income of a married couple, and it would make the partners jointly liable to pay tax. Under a hybrid system, the tax is assessed individually and returns of married couples are filed separately, but the family circumstances and the income of other family members are considered in some way.

The aggregation of the income of married partners and their joint liability for income tax purposes has been found by courts to violate the equality clause of the constitutions in, among other States, Germany, Ireland, Italy, and Spain.

4.3 When and What: Objective Tax Liability

After we have established whose income is subject to taxation, we need to ask a question about the objective liability to tax: «What amount of income will be taxed at what moment in time?»

Three elements determine the objective liability to tax:

1. Timing
2. Taxability
3. Reductions

The most important principle of timing for income taxes is the realization principle. The norm is that income becomes taxable only when it is realized. Realization events traditionally include the moments when consideration has been received, when funds have been made available or settled, when a legal claim to income becomes recoverable and collectible, when property has been sold or disposed of, or at any moment when the law deems that income has been realized by way of fiction. However, the timing of taxation of realized income may be deferred into the future. We then say that the law grants a «deferral».

Timing

Realized and taxable income may be exempted from tax. Exemptions apply to income that is principally taxable according to the concept of income. The law requires an explicit provision to that effect. If taxable income is not specifically exempted, it is subjected to tax.

Taxability

Exemptions are prevalent in occupational pension plans taxation. When an employer contributes to a pension plan on behalf of an employee, that contribution normally constitutes income from employment for the employee. However, many States exempt these contributions and only tax the employee when he or she receives pension payments from the plan. Also, the return on investment by the pension plan is normally exempted from tax. The most prevalent system is therefore EET, meaning that contributions are exempt, returns on investments are exempt, and pension payments are subjected to tax. TEE systems tax contributions but exempt returns on investment and pension payments. The third system, ETE, only taxes the returns on investment.

Allowances and deductions reduce the amount of taxable income. Allowances are fixed or varying statutory amounts that reduce taxable income. Most States provide for at least a

Reductions

«basic» or «personal» allowance that keeps a minimum subsistence amount of income free of tax. Such an allowance thus functions as a threshold above which income becomes subjected to tax. Married couples' allowances and child allowances are also often granted. The regulatory goals that a legislator aims at achieving with providing allowances differ between countries.

Business and Professional Deductions

Some deductions are business and professional expenses that a taxpayer has incurred while carrying out income-earning activities. These expenses are thus directly linked to taxable revenues. Accordingly, they reduce taxable income and are thus recognized as such by the law as deductions. Business and professional expenses are not deductible when they are made for a capital purpose, e.g., when an enterprise buys a machine to use for production. However, the enterprise or professional may deduct depreciation expenses in each year to take account of the reduction in value of a capital asset.

Suppose that a shop receives a total revenue of €300,000 from sales of goods. To sell those goods, the enterprise has bought them from a manufacturer at a cost of €150,000. The shop is established in a rented space in a shopping mall. An annual rent of €15,000 is due to the owner of the shopping mall. The enterprise also employs a sales assistant for an annual wage of €20,000. The property and equipment owned by the shop has depreciated €5,000 in value over the year. To finance the activities of the shop, a loan was received from a bank at a principal amount of €10,000 over which the bank charges interest at 5% per year. Total revenues are €300,000. Business deductions amount to a total of €190,500 (€150,000 cost of goods sold + €15,000 rent expenses + €20,000 wages + €5,000 depreciation expenses + €500 interest expenses). The taxable income of the enterprise is therefore €109,500.

11

Personal Deductions

Deductions for personal expenses, like buying groceries, are not allowed. Personal expenses are rather considered to be a consumption of income. Some deductions for personal expenses are however recognized, including charitable gifts, expenses related to chronic medical conditions, and alimony payments. The reason for their deductibility is regulatory or is in consideration of the negative effect of these personal expenses on the taxpayer's ability to pay.

Suppose that the entrepreneur of the previous example has given €500 to charity. This personal expense will further reduce his or her taxable income to €109,000.

Some expenses are explicitly made nondeductible or are limited in deductibility. Bribes, penalties, and fines cannot normally be deducted, even though income from illegal activities may be subject to tax. So-called mixed expenses that are made in the course of a business, but which also relate to the personal situation of (or might carry an advantage for) the taxpayer, are limited in deductibility. This applies, for example, to commuting expenses or to expenses for business-related entertainment.

Limitations to
Deductibility

One way to pragmatically deal with the deductibility of expenses occasioned by the exercise of employment is to deny their deductibility altogether. Alternatively, a legislator could choose to allow the employer to reimburse the employee free of tax for any expense that the employee has incurred while exercising his or her employment and of which the employer believes such expense was necessary and reasonable for business or professional purposes.

4.4 How Much: Tax Rates and Credits

Once the law has given answers to the questions who is taxed, when, and for what amount of income, we can ask the final substantive question: «How much taxes are due?»

Tax rates are applied to the taxable income. Many States apply a progressive schedule of rates with lower rates on low-income brackets and higher rates for higher-income brackets.

Tax Rates

A simple example of a schedule with three rate brackets may look like this. The first bracket taxes income up to €25,000 at a low rate of 20%. Suppose that the next €50,000 of taxable income is taxed at a general rate of 30%. This means that the middle class pay at least €5,000 of income taxes in the first bracket and any income exceeding €25,000, but still below €75,000, will be taxed at this 30% rate. The third bracket could be a 40% rate on any income exceeding €75,000. So, a taxpayer with an income of €50,000 falls in the second bracket. He will pay the full €5,000 of taxes of the first bracket and an additional amount of 30% of €25,000 ($€50,000 - €25,000$) = €7,500 in the second bracket. The total tax on overall taxable income will be €12,500 for this taxpayer.

The distinction between average and marginal rates is essential. The average rate is the total taxes divided by total taxable income. The marginal rate is the tax rate that applies to an additional euro of taxable income. Marginal rates are important since they influence behavioral responses: people think

Average vs. Marginal
Rates

«at the margin». Higher marginal tax rates decrease the incentive to earn additional income.

The average rate for the taxpayer in the previous example is 25% ($€12,500 / €50,000 \times 100\%$). If the taxpayer would earn €1 more, that additional amount would be taxed in the second bracket at 30%. Therefore, the marginal rate for this taxpayer is also 30%.

Global vs. Schedular Systems

Irrespective of how the general concept of income is defined, any income tax law should address the question of whether all types of income should be taxed in the same manner when setting tax rates. A global system does exactly that: it applies the tax rates to the sum of all items of income, whether they are wages, business profits, private investment income, or of another nature. A schedular system of income taxation makes a distinction between the applicable rates for different items of income.

The Nordic countries (Denmark, Finland, Norway, and Sweden) apply a specific type of schedular system: the dual income system. The dual income system taxes wages, pensions, and other labor income at (higher) progressive rates, but taxes income from capital (such as business profits, dividends, interest income, and rents) at (lower) flat rates.

11

Flat Tax Systems

In political calls for income tax reform, reference is often made to «flat taxes». Several Eastern European States have indeed introduced such systems. What is usually meant by this term is an income tax system with:

1. A single proportional tax rate
2. No or only a very limited number of deductions
3. A generous basic allowance

In a flat tax system, the average tax rate on pretax income increases as taxable income increases, due to the basic allowance. This means that higher-income earners pay a larger proportion of total taxable income in taxes. Thus, even this «flat» tax system is progressive in effect. The only thing that stays the same is the marginal tax rate on income exceeding the basic allowance. Therefore, proponents argue that flat tax systems are less distortive to the economy.

Tax Credits

Tax credits directly reduce euro for euro the amount of taxes due. Some credits are refundable, which means that the taxpayer may claim a refund for the amount of credit that reduces tax liability beyond zero. The same applies to credits as to reductions: the policy reasons for which States give these tax advantages are multiple and varied.

While income reductions (allowances and deductions) also reduce taxes, the progressivity analysis of income reductions and tax credits is different. A tax credit of €1,000 reduces taxes for everyone with €1,000. It has the same tax value for everyone. However, a €1,000 tax credit takes a relatively larger chunk out of the low taxes of low-income taxpayers, compared to the limited significance it carries to the high taxes of high-income taxpayers. An income reduction of €1,000 through an allowance or a deduction has a tax value that corresponds to the marginal tax rate of the taxpayer. If the last €1,000 of a person is taxed at 25%, an income reduction of €1,000 has a tax value of €250 for that taxpayer. A taxpayer whose last €1,000 of income is subject to a higher rate of 40% enjoys an advantage with a tax value of €400.

4.5 Income Taxation of Companies

Taxes on income are not only imposed on individuals, they are also levied from legal entities, i.e., companies. These income taxes on companies are usually called «corporation taxes».

Companies are creatures of the law: a company can assume legal rights and legal obligations just like individuals. Unlike people of flesh and blood, companies exist only on paper. For this reason, some argue that companies cannot ultimately bear a tax burden. Why then impose income taxes on companies too?

All corporation taxes will be paid by individuals eventually. Corporation taxes, as any taxes, carry deadweight losses, and their burden also manifests as social costs. Corporation taxes will either be shifted to consumers (through price increases of goods and services), to shareholders and other capital providers (by lower rates of return, meaning lower dividends and interest), to employees (by decreased wages), or to management (by decreased compensation). Due to the uncertain economic incidence of the corporation tax, it is generally accepted to be a significantly distortive tax.

The main argument in favor of corporation taxes is pragmatic. It is simply more convenient to collect taxes from one legal entity than to assess all individual owners of the company with a personal income tax on their proportionate share in the company's profits. At the same time, the corporation tax assures that a tax on income is effectively levied, irrespective of the personal tax treatment of the companies' owners, i.e., the shareholders. There is also an element of fairness and neutrality: it does not matter how you run your business—as a

sole entrepreneur, in partnership with a business friend, or together with many other investors through a company—the sum of all business profits will be subject to income taxation.

5 Taxes on Goods and Services

Taxes on goods and services may come in three basic forms:

- General transaction taxes (e.g., VAT and sales taxes)
- Taxes on specific goods and services (e.g., excises on alcohol, cigarettes, gambling, and energy)
- Taxes on the use of goods (e.g., motor vehicle registration taxes)

Value Added Tax

The value added tax (VAT) is the most important general transaction tax. Almost everyone sees VAT charged on the invoices for goods and services bought. It was introduced in the 1960s and replaced many of the then existing general transaction taxes. Taxes on specific goods and services were actually reduced because of its introduction. The common VAT system in the EU is a result of harmonized laws, but its basic features are not unlike those of other VATs in force internationally.

In Australia, Canada, and New Zealand the VAT is called a Goods and Services Tax.

Basic Features of VAT

Taxable transactions for VAT are the supply of goods and services. Taxpayers are all persons who carry out taxable transactions. VAT does not apply to transactions between persons acting in a private capacity. VAT is charged fractionally as an exact proportion of the price of each taxable transaction in all stages of the production and distribution process up to and including the retail stage. This means that total VAT is collected in portions that correspond to the tax due on the economic value added of each stage in the production and distribution process of goods and services.

The general transaction tax (sales tax) imposed by the States in the United States only applies at the retail stage when goods and services are sold to the final consumer.

Exemptions and Rates

Some transactions are exempted from VAT. These exemptions are due to difficulties in assessing the tax in respect of some sectors (e.g., financial services) or may be a result of regula-

tory aims. About the latter, the exemption of medical and dental services, for example, aims to guarantee basic access to health care. Many systems provide for more than one rate and thus apply lower rates (sometimes even 0%) on some transactions. Low taxation of foodstuffs and books are well-known examples.

The minimum statutory standard VAT rate in EU is 15% (Article 97 of Directive 2006/112/EC), but almost all Member States apply statutory standard rates of 20% or higher.

Taxpayers are obliged to charge VAT on each taxable transaction, and they should record the VAT on the invoice that they render to customers. Each taxpayer may credit the VAT that is recorded on invoices received (input VAT) against the VAT charged on invoices rendered (output VAT). This invoice-credit method preempts that VAT burdens cumulate over several stages of production and distribution. It effectively makes only the value added in each stage subject to tax. There is usually no credit for input VAT that is attributable to exempted taxable transactions. However, input VAT attributable to transactions that are zero rated is deductible. If a taxpayer paid more input VAT than the output VAT charged in a taxable period, he or she is entitled to a refund from the tax authority.

Invoice-Credit Method

John produces and sells retail goods. In 1 month, John has produced and sold goods for a value of €100,000 to private consumers. Given a standard VAT rate of 20% of the price of goods supplied, John is obliged to record €20,000 in VAT on the invoices he renders to customers. In the same month, John has paid €48,000 inclusive VAT to suppliers for raw materials. On the invoices that John received from these suppliers, VAT was stated for an amount of €8,000. The value added of John's business over the month is €60,000, because the value of input materials was €40,000 and the value of John's output goods was €100,000. Accordingly, VAT for an amount of €12,000 (20% of €60,000) should be due. This corresponds exactly to the balance of €20,000 in output VAT charged and €8,000 in input VAT credited.

6 Taxes on Property

Taxes on property may be broadly divided into taxes on property ownership and taxes on property transactions.

6.1 Property Ownership Taxes

Taxes on property ownership are a product of a tax rate and the value of the property held by the taxpayer. If the tax includes all assets and debts of a taxpayer, we qualify this tax as a net wealth tax. Many States impose taxes on specific property, for example, a tax on immovable property.

A special system of property ownership taxation applies in the Netherlands. Until 2017, this system presumed that a taxpayer earns 4% of income from his net savings and investments above a basic allowance of nontaxed wealth. This fixed proportion was used as the tax base, even if the real income was higher or lower. The presumptive income is then taxed with an income tax of 30%. The Dutch system is economically equivalent to a net wealth tax with a 1.2% rate on the value of the taxable property. Legally speaking though, the Dutch tax is a tax on income.

6.2 Property Transaction Taxes

Taxes on property transactions include all estate, inheritance, and gift taxes that become due when property ownership changes from one person to another without consideration, for instance, by cause of death or by gratuitous promise. These taxes are sometimes referred to generally as succession duties.

Estate, inheritance, and gift taxes prevent the accumulation and concentration of wealth in the hands of a small proportion of taxpayers over generations, due to shared background and family relations. The tax takes away a part of the wealth when property ownership changes, usually down the line of the family tree.

An estate tax is levied on the value of the property of the deceased («the estate»). An inheritance tax is levied on the part of the property that an heir receives from the estate («the legacy»). Since it is easy to avoid estate and inheritance taxes by transferring ownership before death, many States also tax gratuitous transfers *inter vivos* (Latin for «between the living») with a gift tax. Many inheritance and gift taxes impose very low taxes on transfers of property ownership between first-degree relatives, but the rates are higher for more distant family relations.

A special type of property transaction taxes is financial transaction taxes. The financial crisis has increased the demand from society that the financial sector contributes to economic recovery by paying a fair share of taxes. The European Union has therefore proposed to levy a financial transaction tax that should raise substantial revenue and that should also discourage harmful speculation on financial markets. The latter objective is, of course, a regulatory goal to stabilize the economy.

7 Tax Procedure

7.1 Taxpayer Rights and Obligations

Most developed States recognize the following basic taxpayer rights and obligations in laws or regulations.

Taxpayer rights	Taxpayer obligations
Right to be informed, assisted, and heard Right of appeal Right to certainty Right to privacy Right to confidentiality	Obligation to be honest Obligation to be cooperative Obligation to provide information Obligation to keep records Obligation to pay taxes on time

In defining the proper rules of conduct between the tax authority and taxpayers, the principles of administrative law are important. In summary, this means that the tax authority should always duly observe that its actions toward the taxpayer are impartial and proportionate.

7.2 Assessment and Collection

The requirement for the taxpayer to file a tax return is the basis of most assessment procedures. This tax return includes all necessary information to establish the tax liability. A tax return is assumed to be correct unless the tax inspector determines otherwise. There are two basic types of assessment procedures:

1. Assessment by the tax authority
2. Self-assessment by the taxpayer

Assessment Procedures

Under the first method, the tax returns filed by the taxpayer are more or less treated as statements of information to the tax authority. The tax authority then uses the information in the tax return, combined with information received from employers, property registries, and banks and other financial institutions, to determine the tax liability of the taxpayer. The tax authority may also request additional information from the taxpayer. The determination of how much tax the taxpayer owes is thus carried out by the tax authority. The taxpayer receives a tax assessment from the tax authority that formalizes the liability. The taxpayer should then remit the taxes

owed to the tax authority. This system is used in many States for taxes on income.

Under the second method, the taxpayer himself determines the tax liability when filing the return. Since there is no need for the tax authority to issue a tax assessment, the taxpayer normally also immediately remits the taxes owed upon filing the return. This system is used in many States for taxes on goods and services, but some also apply it to income taxes.

Withholding Tax

A withholding tax is a tax that a third party withholds on behalf of the taxpayer (who is thus the statutory bearer of the tax) from payments that this third party makes to the taxpayer. Any taxes that have already been paid by a withholding procedure may be credited against the tax liability for the same income of the taxpayer. Withholding taxes often apply to payments of wages, dividends, interest, and royalties.

When an employer pays wages to an employee, the employer deducts any wage taxes due on the payment and remits those wage taxes to the tax authority. Although the employee is liable to pay income taxes on the wages, there is no need for the employee to make an actual payment since the tax liability has been fulfilled by reason of the wage taxes previously withheld by the employer.

11

Penalties

To ensure effective assessment and recovery in compliance with the law, the tax authority can impose penalties if a taxpayer does not comply with taxpayer obligations. These have both a deterrent and punitive function. In many States, the tax authority imposes penalties for the following categories of acts:

- Omission or late filing of returns and forms
- Inaccurate or frivolous filing of returns and forms
- Refusal to disclose information and similar obstructionist behavior
- Omission or late payment of taxes

Criminal Sanctions

Some acts of taxpayers are so wrongful that they are dealt with under criminal tax law. The main example of a tax crime is tax evasion or tax fraud.

7.3 Tax Management

A popular saying goes that nothing is certain but death and taxes. One might add that it is a lot easier to escape taxation than death. Bending the tax law to one's advantage is called

tax management. A general principle of tax management is that it is legitimate and lawful to arrange one's affairs as to keep taxes as low as possible. However, there are certain lines in the sand which any taxpayer should observe when engaging in tax management strategies.

If the legislator intentionally creates two sets of rules for similar activities or transactions, the taxpayer may lawfully construct his activities and legal transactions such that the more favorable set of rules applies to his or her situation. Often, the legislator intentionally creates tax-advantaged arrangements, recall the regulatory goal of taxation. The lawful use of options provided by the law is called tax planning.

Tax Planning

Due to the complexity of tax laws, it is not always clear whether the taxpayer stays within the distinct collection of legal possibilities afforded by the legislator. The imagination of one legislator is no match to the creativity of many taxpayers and tax intermediaries. That creativity becomes problematic and a legal issue when a legal arrangement is set up with the overriding view to obtain a tax advantage, but any changes in the economic position of the taxpayer are marginal and subordinate to that tax advantage. Such simulations, shams, and wholly artificial arrangements that are void of commercial justification run contrary to the legislator's general intention to reserve tax consequences for real economic transactions and activities.

Tax Avoidance

Michael J. Graetz, a renowned US tax professor, informally defined tax avoidance strategies as deals «done by very smart people that, absent tax considerations, would be very stupid.»

Tax avoidance may be viewed as unethical, but it is not unlawful. However, most States draw the line here and generally respond by closing the legal loophole for the future with additional regulation and specific anti-avoidance rules (SAAR). Many States also apply a general anti-avoidance rule (GAAR) that disallows tax advantages that taxpayers intend to obtain by constructing wholly artificial arrangements.

A GAAR may be expressly laid down in written legislation or construed by courts as a general principle of legal interpretation. The legal effect of a GAAR is usually that the wholly artificial arrangement is ignored for tax purposes, or the construct is reclassified to correspond to a legal arrangement that falls within the aim and purpose of the tax law, but that does not carry the intended tax advantage.

In contrast to tax planning and tax avoidance that take place within the black letter boundaries of the law, tax evasion or tax fraud involves illegal conduct. The evasion of taxes is pros-

Tax Evasion

ecuted as a criminal offense or crime depending on the type of illegal conduct involved. A simple example of tax evasion is intentional non-reporting of income: taxpayers who earn illegal income often hide it from the tax authorities. Or taxpayers disguise the true, illegal source by reporting it under another legitimate title, thereby effectively engaging in money laundering. Fraudulent fabrication of invoices leads to tax evasion by unlawfully claiming or overstating deductions of expenses that have not been made in fact.

The notorious Al Capone was convicted of tax evasion and was locked up in Alcatraz, whereas he could not be successfully prosecuted for bootlegging and smuggling liquor.

8 Globalization and Tax Law

8.1 International Tax Law

International tax law is the body of law dealing with the taxation of persons and events that have a cross-border element. International tax law concerns specifically rules that prescribe the allocation of taxing powers between States.

The taxing jurisdiction that a State asserts on domestic persons is universal: it covers all income and wealth, whether derived from domestic or foreign activities and property. The taxing jurisdiction that a State asserts on foreign persons is almost always limited to only those activities and property of the person which are within the national borders of that State. We then say that the income or property should be sourced in that State. Given these basic rules, it is very likely that one State asserts universal jurisdiction on a person, but another State asserts source jurisdiction on the same person.

Person X lives in State R. State R considers X therefore a domestic person and asserts universal jurisdiction on all income of X, wherever earned. Person X works in State R and also in State S. Because person X derives income from activities exercised on the national territory of State S, State S will assert source jurisdiction. Person X will be taxed twice on the income earned in State S: once in R and again in S.

Universal vs. Source
Jurisdiction

11

Single Tax Principle

Overlap between the taxing jurisdictions of two or more States on the same person arises easily in any cross-border situation. Consequently, more than one State will create a tax liability on the same person for the same income or property.

This potential overlap is called the problem of double taxation. Double taxation is a major obstacle to international trade and investment. The most important guiding principle of international tax law is therefore that a taxpayer should only once be subjected to taxation on income and property. Single taxation, not more and not less, is the norm.

International rules are necessary to resolve potential double taxation of persons and their income and property. To ensure single taxation, rules on international taxation give answers to the following legal questions:

- When is a person a domestic or a foreign person?
- What is the source of income and property?
- Which methods should States use to relieve double taxation?
- Which procedures govern how tax administrations exchange information and cooperate?
- To what extent should domestic and foreign persons be treated equally?

International Tax Rules

The detailed rules of international tax law are laid down in national law but also in tax treaties. Tax treaties are international agreements between two or more States that provide international tax rules to resolve potential concurrences of taxing jurisdiction between the contracting States.

Tax Treaties

There are over 3,000 tax treaties in force worldwide. Most treaties are modeled after the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD). The United Nations has drafted a specific model tax treaty based on the OECD Model Tax Convention to govern international tax relations between developing and developed States.

Whereas national tax law creates tax liabilities, tax treaties may only limit these existing tax claims. By limiting the taxing jurisdiction that each contracting State asserts on a person, the total sum of jurisdiction exercised by the contracting States under a tax treaty amounts to single taxation over the person in a best-case scenario. The rules of application and interpretation to give legal effect to tax treaties follow the general rules of international law.

Limiting Function of
Tax Treaties

8.2 Tax Problems of Globalization

Historically, taxation addressed domestic economic and social concerns. The process of globalization has reduced institutional barriers to trade and investment in other States.

Outdated International
Tax Rules

The mobility of persons has increased too. The current international tax regime was, however, developed when there were significant restrictions on trade, investment, and mobility. These international tax rules are predicated on a permanent physical foreign presence to enable the foreign State to exercise effective taxing powers. However, technological developments and the digitization of the economy have reduced the need for businesses to maintain a permanent physical presence in other States to participate in their economic markets. Globalization and digitization have therefore resulted in the current international tax rules becoming outdated. They are not fit to address the global economic and social concerns of now.

Tax Competition

As States became economically connected through globalization, domestic tax policies increasingly affected international trade and investment flows. States started applying specific tax policies to direct international trade and investment flows to their benefit. States commenced competing by lowering tax burdens to increase the competitiveness of domestic businesses and to attract international businesses. The problem of tax competition thus arose.

Tax competition can be good, because with lower taxes, the negative effects of taxes on the economy also decrease, which is beneficial to global welfare. Tax competition can also be harmful if the tax policies of one State unfairly erode the tax base at the expense of other States' economies.

11

International Tax Reform

Multinational enterprises are global players. As we have seen, States engage in tax competition with attractive domestic tax rules for international economic activity. Globalization and digitization have made the rise of multinational enterprises possible, but the outdated international tax rules are inadequate to effectively tax the mobile multinational tax base of these enterprises. Because of the combination of these two factors, society has questioned whether multinational enterprises pay their fair share of taxes. Citizens, governments, and nongovernmental organizations all agree on the basic premise that the time has come for fundamental international tax reform.

The G20 and the Organization for Economic Cooperation and Development have engaged in a project, called BEPS (Base Erosion and Profit Shifting) that should lead to fundamental international tax reform. The aim of the project is to enable States to effectively levy a fair share of tax from multinational enterprises, by significantly updating the international tax rules and by better coordinating domestic tax policies.

Recommended Literature

- Arnold B, Ault H (2010) *Comparative income taxation: a structural analysis*. Kluwer Law International, Alphen aan den Rijn
- Avi-Yonah RS, Sartori N, Marian O (2011) *Global perspectives on income taxation law*. Oxford University Press, Oxford
- Mirrlees J et al (2011) *Tax by design*. Oxford University Press, Oxford
- Schenk A, Thuronyi V, Cui W (2015) *Value added tax: a comparative approach*. Cambridge University Press, Cambridge
- Smith S (2015) *Taxation: a very short introduction*. Oxford University Press, Oxford
- Thuronyi V, Brooks K, Kolozs B (2016) *Comparative tax law*. Kluwer Law International, The Hague