Chapter 2

Fundamental principles of taxation

This chapter discusses the overarching principles of tax policy that have traditionally guided the development of tax systems. It then provides an overview of the principles underlying corporate income tax, focusing primarily on the taxation of cross-border income both under domestic laws and in the context of tax treaties. Finally, it provides an overview of the design features of value-added tax (VAT) systems.
2.1 Overarching principles of tax policy

In a context where many governments have to cope with less revenue, increasing expenditures and resulting fiscal constraints, raising revenue remains the most important function of taxes, which serve as the primary means for financing public goods such as maintenance of law and order and public infrastructure. Assuming a certain level of revenue that needs to be raised, which depends on the broader economic and fiscal policies of the country concerned, there are a number of broad tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility. In the context of work leading up to the Report on the Taxation of Electronic Commerce (see Annex A for further detail), these overarching principles were the basis for the 1998 Ottawa Ministerial Conference, and are since then referred to as the Ottawa Taxation Framework Conditions. At the time, these principles were deemed appropriate for an evaluation of the taxation issues related to e-commerce. Although most of the new business models identified in Chapter 4 did not exist yet at the time, these principles, with modification, continue to be relevant in the digital economy, as discussed in Chapter 8. In addition to these well-recognised principles, equity is an important consideration for the design of tax policy.

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of business activities. A neutral tax will contribute to efficiency by ensuring that optimal allocation of the means of production is achieved. A distortion, and the corresponding deadweight loss, will occur when changes in price trigger different changes in supply and demand than would occur in the absence of tax. In this sense, neutrality also entails that the tax system raises revenue while minimising discrimination in favour of, or against, any particular economic choice. This implies that the same principles of taxation should apply to all forms of business, while addressing specific features that may otherwise undermine an equal and neutral application of those principles.

- **Efficiency:** Compliance costs to business and administration costs for governments should be minimised as far as possible.

- **Certainty and simplicity:** Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their obligations and entitlements. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices. Complexity also favours aggressive tax planning, which may trigger deadweight losses for the economy.
• **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right time, while avoiding both double taxation and unintentional non-taxation. In addition, the potential for evasion and avoidance should be minimised. Prior discussions in the Technical Advisory Groups (TAGs) considered that if there is a class of taxpayers that are technically subject to a tax, but are never required to pay the tax due to inability to enforce it, then the taxpaying public may view the tax as unfair and ineffective. As a result, the practical enforceability of tax rules is an important consideration for policy makers. In addition, because it influences the collectability and the administerability of taxes, enforceability is crucial to ensure efficiency of the tax system.

• **Flexibility:** Taxation systems should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments. It is important that a tax system is dynamic and flexible enough to meet the current revenue needs of governments while adapting to changing needs on an ongoing basis. This means that the structural features of the system should be durable in a changing policy context, yet flexible and dynamic enough to allow governments to respond as required to keep pace with technological and commercial developments, taking into account that future developments will often be difficult to predict.

Equity is also an important consideration within a tax policy framework. Equity has two main elements; horizontal equity and vertical equity. Horizontal equity suggests that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity is a normative concept, whose definition can differ from one user to another. According to some, it suggests that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. In practice, the interpretation of vertical equity depends on the extent to which countries want to diminish income variation and whether it should be applied to income earned in a specific period or to lifetime income. Equity is traditionally delivered through the design of the personal tax and transfer systems.

Equity may also refer to inter-nation equity. As a theory, inter-nation equity is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions (OECD, 2001). The tax policy principle of inter-nation equity has been an important consideration in the debate on the division of taxing rights between source and residence countries. At the time of the Ottawa work on the taxation of electronic commerce, this important concern was recognised by stating that “any adaptation of the existing international taxation principles should be
structured to maintain fiscal sovereignty of countries, [...] to achieve a fair sharing of the tax base from electronic commerce between countries…” (OECD, 2001: 228).

Tax policy choices often reflect decisions by policy makers on the relative importance of each of these principles and will also reflect wider economic and social policy considerations outside the field of tax.

2.2 Taxes on income and consumption

Most countries impose taxes on both income and consumption. While income taxes are levied on net income (i.e. from labour and capital) over an annual tax period, consumption taxes operate as a levy on expenditure relating to the consumption of goods and services, imposed at the time of the transaction.

There are a variety of forms of income and consumption taxes. Income tax is generally due on the net income realised by the taxpayer over an income period. In contrast, consumption taxes find their taxable event in a transaction, the exchange of goods and services for consideration either at the last point of sale to the final end user (retail sales tax and VAT), or on intermediate transactions between businesses (VAT) (OECD, 2011), or through levies on particular goods or services such as excise taxes, customs and import duties. Income taxes are levied at the place of source of income while consumption taxes are levied at the place of destination (i.e. the importing country).

It is also worth noting that the tax burden is not always borne by those who are legally required to pay the tax. Depending on the price elasticity of the factors of production (which in turn depends on the preferences of consumers, the mobility of factors of production, the degree of competition etc.), the tax burden may be shifted and thus both income and consumption taxes can have a similar tax incidence. In general, it is said that the tax incidence falls upon capital, labour and/or consumption. For example, if capital were more mobile than labour and the market is a highly competitive and well-functioning one, most of the tax burden would be borne by workers.

2.3 Corporate income tax

Although the tax base can be defined in a great variety of ways, corporate income tax (CIT) generally relies on a broad tax base, formulated to encompass all types of income derived by the corporation whatever their nature,¹ which encompasses the normal return on equity capital in addition to what can be described as “pure” or “economic rents” i.e. what the enterprise