The Notion of Income from Capital

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CHAPTER I

THE INFLUENCE OF TAX PRINCIPLES ON THE TAXATION OF INCOME FROM CAPITAL

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1. Introduction

There may be a worldwide consensus of opinion that income is the best indicator for the ability to pay and that a global income tax with its equal treatment of all kinds of income is the fairest tax. In contrast to this there is a worldwide tendency towards schedular income taxes.[1] This tendency has been increased by the tax competition.[2] In a globalized world income from capital seems to be taxed lower than labour-income.

The Scandinavian dual income tax[3] and the Dutch model of three clearly separated boxes[4] make the shift from the concept of a global notion of income to schedular concepts particularly evident. Box I of the Dutch income tax burdens income derived from labour and dwelling with a progressive rate of 32%-52%. Box II taxes dividends and capital gains of substantial shareholders at a rate of 25% and Box III taxes income from capital at a rate of 30% on the fictitious base of 4% earning. Box III has the effect of a wealth tax at a rate of 1.2% (30% of 4%).

1. See *A. Bavila*, Moving Away from Global Taxation: Dual Income Tax and Other Forms of Taxation, European Taxation 2001, p. 211. 24 years ago a completely different approach was decribed by *O. Oldman/R. Bird*, The Transition to a Global Income Tax: A Comparative Analysis, Bulletin for International Fiscal Documentation 1977, p. 439: "This worldwide move towards a "global" income tax has both an economic and an equity rationale..." Furthermore *S. R. F. Laschaert*, The Definition of Gross Taxable Income in Schedular or Global Income Taxes, Bulletin for International Fiscal Documentation 1977, pp. 535-546.
2. See the reports of the 2002 EATLP Congress in Lausanne: *W. Schön* (ed.), Tax Competition in Europe, IBFD Publication, Amsterdam, 2003.
3. See *L. Mutén, P. B. Sørensen, K. P. Hagen, B. Genser*, Towards a Dual Income Tax, Scandinavian and Austrian Experiences, Kluwer 1996; *P. B. Sørensen*, From the Global Income Tax to the Dual Income Tax: recent tax reforms in the Nordic countries, International Tax and Public Finance, 1994, pp. 57-79; *P. B. Sørensen* (ed.), Tax Policy in the Nordic Countries, New York 1998; *S. Cnossen*, Taxing Capital Income in the Nordic Countries: A Model for the European Union?, Finanzarchiv 1999, pp. 18-50.
4. Wet inkomstenbelasting 2001. See the report by *H. van Arendonk*, Part A, Chapter IV.

Nevertheless, in the history of income taxation the concept of a global income tax has never been fully realized anywhere. In all countries the mix of theories and accounting methods, lobby influenced loopholes, exemptions and reliefs results in *strong schedular effects* of unequal tax burdens. Especially the mixture of accounting methods creates a *hybrid* income tax: on the one hand the accrual method based on the net accretion theory and on the other hand the cash flow method as a consumption-type notion of income.

2. The framework of tax principles in the constitutional and the European law

2.1. Tax equity and equality

First of all tax equity means equal treatment of the taxpayer. Other aspects of tax equity are based on fundamental values in the legal systems of the nations and the European Community: social equity of the welfare state, but also right to property, the four freedoms of the EC Treaty and the protection of the family by the state.[5] The *notion of income* refers to the *horizontal equity* while the vertical equity addresses equity towards different income classes.[6] For example it justifies progressive tax rates.

2.2. Certainty

Certainty of law is very closely linked to legality, both principles of formal adherence to the rule of law. In most European countries the statutory tax law occupies a strong position. The provisions of tax law have to be enacted by the parliament. The ruling of tax courts has to be based on statutory law. But politicians abuse the power to enact the tax law. The tax legislation permanently modifies the statutory law and by doing so it produces a large uncertainty of law. Thus, the certainty of law nowadays is a very weak principle. Uncertainty is a main reason for the general discontent of the taxpayer with the current tax law.

5. See *G.T.K. Meussen* (ed.), The Principle of Equality in European Taxation, Kluwer, 1999 (with reports of Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, United Kingdom).
6. See *K. Holmes*, The Concept of Income, A multidisciplinary analysis, IBFD Publication, Amsterdam, 2001, pp. 19-21.

It is a task of the tax sciences to strengthen the certainty of law by finding a concept of income which is generally accepted. The taxpayer ought to rely on the fact that there are neither loopholes nor hidden privileges for his neighbour. Politicians may determine tax rates but the definition of income as the best measure for the ability to pay taxes should not be a playing field for politicians. The non-political character of the income tax base gives stability to the tax law. Institutions of civil law have grown in long traditions of jurisprudence and therefore are immunized against political abuse. The legal definition of income should obtain the same immunity. This gives the taxpayer the feeling that taxation is part of the civilized society.

2.3. Right to property

Taxation disturbs the right to use and enjoy one's property. The influence of the constitutional right to property is very unclear. In most countries only a ban of confiscatory taxation is established. For example Art. 31 of the Spanish constitution forbids confiscatory taxation[7] and the supreme courts of Switzerland (*schweizerisches Bundesgericht*)[8] and Germany (*Bundesverfassungsgericht*)[9] derive a ban of confiscatory taxation from the right to property. But usually, the supreme courts hesitate to apply the ban of confiscatory taxation in concrete cases.[10]

7. See *C. Palao Taboada*, La protección constitucional de la propriedad privada como límite al poder tributario, Hacienda y Constitución 1979, p. 277.
8. See *K. A. Vallender* in: *Ehrenzeller/Mastronardi/Schweizer/Vallender*, Die schweizerische Bundesverfassung, Zürich/Basel/Genf, 2002, Art. 26, par. 30-34.
9. See *K. Tipke*, Die Steuerrechtsordnung, vol. I, 2nd edition, Köln, 2000, pp. 439, 446-449 (references to Austria, Switzerland, Spain, France, Belgium and Luxembourg); *J. Lang* in: *Tipke/Lang*, Steuerrecht, 17th edition, Köln, 2002, § 4 par. 213. Spanish-German comparison: *P. M. Herrera Molina*, Capacidad económica y sistema fiscal, Análisis del ordenamiento español a la luz del Derecho alemán, Madrid/Barcelona, 1998, pp. 67-68, 98, 111-112, 129, 382-386,389-390 (principio de prohibición de confiscatoriedad).
10. *K.A. Vallender* (footnote 8), par. 31, states that the Federal Court of Switzerland on the one hand recognizes the ban of confiscatory taxation but on the other hand defines the ban in a way that deprives it of its effectiveness. The rulings of the German courts (Bundesverfassungsgericht and Bundesverwaltungsgericht) did not consider the ban of confiscatory taxation in a single case so far, in particular not the rulings on green taxes which are scholarly discussed as confiscatory taxes. See *J. Lang* (footnote 9), § 3 par. 11.

The German Federal Constitutional Court[11] established a limitation on the levy of a wealth tax which is unique worldwide. The Court derived from the right to property (Art. 14 *Grundgesetz*) a ban to tax *more than half of the earnings*. This so-called *Halbteilungsgrundsatz* could be a sharp weapon against the fiscal leviathan. But most of the German scholars fear that the *Halbteilungsgrundsatz* will suffer the same destiny of ineffectiveness as the ban of confiscatory taxation.[12]

Besides the issue of constitutionality the idea of tax fairness also calls for a *tax principle to spare the substance of capital*[13]. *First of all, taxation should be based on income defined as real accretion of capital. In relation to the real income tax, wealth taxes and other taxes with confiscatory effects should not be scholarly accepted. A wealth tax cannot be justified if the real accretion of capital is fully taxed.*[14] *The Spare-capital-principle* demands the consideration of inflation if the nominal notion of income has confiscatory effects.[15] Moreover, all kinds of income fiction can have confiscatory effects if there is no income derived from capital. Box III of the Dutch income tax fakes capital earnings.[16] Particularly this kind of wealth tax cannot be justified as part of an income tax system with the general purpose to tax the real accretion of capital.[17]

11. Ruling of the Second Division from 22 June 1995, collection vol. 99, p. 121. Reporter of the case was judge *Paul Kirchhof*, who presented the basic idea of the *Halbteilungsgrundsatz* already in 1980 on the Congress of the Association of German Public Law Professors (Vereinigung der Deutschen Staatsrechtslehrer). See *P. Kirchhof*, Besteuerung und Eigentum, VVDStRL 39 (1981), pp. 213, 271 et seq.
12. See with further references *J. Lang* (footnote 9), § 3, pp. 214-226, and *K. Tipke* (footnote 9), pp. 449-459. The German Federal Tax Court (Bundesfinanzhof) denies the constitutional binding force of the *Halbteilungsgrundsatz* (BFH 11 August 1999, Bundessteuerblatt II 1999, p. 771).
13. We call it "Prinzip eigentumsschonender Besteuerung" (see *J. Lang*, footnote 12).
14. In accordance with thesis 2 of *P. Essers* and *A. Rijkers* in their preliminary general report: A wealth tax cannot be justified if the personal income tax has been based on a comprehensive notion of income from capital.
15. In accordance with thesis 8 of *P. Essers* and *A. Rijkers in* their preliminary general report: In a civilized income tax regime inflation neutrality is indispensable. The method of compensation for inflation should be structural and equal for all types of income. Scientists should produce a method that is theoretically acceptable and feasible at the same time. This method could be optional for taxpayers.
16. See above 1 (Introduction).
17. *P. Essers* and *A. Rijkers* stated in their preliminary general report: "Nevertheless, many scholars in the Netherlands are of the opinion that the Dutch system cannot be justified and lacks legitimacy."

2.4. Rights of the family

In most European countries the family is entitled to a particular protection by the state.[18] On the one hand this means a ban of family discrimination and on the other hand a duty to promote the family.[19]

First of all, tax law has to respect the ban of discrimination. In relation to the real ability to pay the family is discriminated and has to bear a higher tax burden than the single taxpayer, if the tax law does not consider the alimony obligations of the taxpayer and the distribution of income within the family.[20] Tax rules of income splitting avoid the unconstitutional discrimination of the family. But this ruling of the German Federal Constitutional Court[21] cannot be generalized. Marital and family splitting rules are not generally accepted in the European Community. The opinions are very different.

2.5. The four freedoms of the EC Treaty

The four freedoms of the EC Treaty (free movement of goods, persons, services and capital) have a deep impact on the national tax law. The four freedoms provide by the rulings of the European Court of Justice (ECJ)[22] a very strict system of non-discrimination and non-restriction rules which also determine the notion of income.

Important examples are the application of splitting rules for non-residents demanded by the ECJ in the *Schumacker* case.[23] In 2001, the EATLP discussed the taxation of cross-border-pensions in Lisbon.[24] One of the main

18. See *M. T. Soler Roch* (ed.), Family Taxation in Europe, Kluwer Law International, 1999.
19. This states the German Federal Constitutional Court. See the report of *J. Lang* in: *M. T. Soler Roch* (footnote 18), p. 59/60, and the report of *K. Vogel* and *C. Waldhoff* in: *G.T.K. Meussen* (footnote 5), pp. 91-92, 96.
20. See *J. Lang* (footnote 19), p. 62 et seq.
21. Two verdicts affirmed the marital income splitting: BVerfG 17 January 1957, collection vol. 6, p. 5 and BVerfG 3 November 1982, collection vol. 61, p. 319, p. 355 (reference to a family splitting).
22. See pars pro toto *M. Lang* (ed.), Direct Taxation: Recent ECJ Developments, Wien 2003, with contributions by *L. de Broe* (cases filed by Belgian courts), *A. Cordewener* (German courts), *M. Helminen* (Finnish courts), *P. Martin* (French courts), *P. J. Wattel* (Dutch courts), *D. Weber* (Dutch courts), *B. Wiman* (Swedish courts).
23. ECJ 14 February 1995, C-279/93 *Schumacker*, ECR I-225.
24. The contributions are published in: European Taxation, vol. 41, suppl. No. 1 (2001).

issues is the cohesion of such a tax system which allows the deduction of contributions to life assurances, pension funds etc. under the condition that the assurance or funds payment can be taxed. This *cohesion principle*[25] *was developed by the ECJ in the Bachmann* case[26] and justifies differential tax treatment. But in the *Wielockx* case[27] the ECJ decided an important restriction of the justification by the fiscal cohesion principle if a *double taxation treaty* gives up the cohesion of contribution deduction and payment taxation and the *Danner* judgement[28] rules that the limitation to deduct premiums is not justified by the necessity to maintain the domestic tax base integrally. Such considerations make the *cohesion principle* unclear and inefficient.

3. Specific tax principles to determine the income

3.1. Ability to pay

a) *Historical background:* The ability-to-pay principle is the generally accepted legal rule to achieve equal treatment of the taxpayer.[29] The historical background of the ability-to-pay principle refers to the *equality* of taxation. The French declaration of 1791 demands the equal distri-

25. See the comprehensive analysis of more than thousand pages by *A. Cordewener*, Europäische Grundfreiheiten und nationales Steuerrecht, "Konvergenz" des Gemeinschaftsrechts und "Kohärenz" der direkten Steuern in der Rechtsprechung des EuGH, Köln, 2002.
26. ECJ 28 January 1992, C-204/90 *Bachmann*, ECR I-249.
27. ECJ 11 August 1995, C-80/94 *Wielockx*, ECR I-2493.
28. ECJ 3 October 2002, C-136/00 *Danner*, ECR I-8147.
29. *F. Moschetti*, Il principio della capacità contributiva, Padua, 1973; *C. Palao Taboada*, Apogeo y crisis del principio de capacidad contributiva, Estudios Jurídicos en homenaje al profesor Federico de Castro, vol. II, Madrid, 1976, p. 388; *L. G. M. Stevens*, Belasting naar draagkracht, Kluwer, 1979; *D. Birk*, Das Leistungsfähigkeitsprinzip als Maßstab der Steuernormen, Köln, 1983; *M. Reich*, Das Leistungsfähigkeitsprinzip im Einkommensteuerrecht, Archiv für Schweizerisches Abgaberecht, vol. 53 (1984/85), p. 5; Festschrift für *F. Cagianut*, Bern, 1990: *M. Reich*, Von der normativen Leistungsfähigkeit der verfassungsrechtlichen Steuererhebungsprinzipien, p. 97, pp. 104-106, and *R. Oberson*, Le principe de la capacité contributive dans la jurisprudence fédérale, pp. 125-135; Festschrift für *K. Tipke*, Köln, 1995: *H. Schaumburg*, Das Leistungsfähigkeitsprinzip im internationalen Steuerrecht, pp. 125-151; *C. Palao Taboada*, Leistungsfähigkeitsprinzip und Gleichheitssatz im Steuerrecht in der Rechtsprechung des spanischen Verfassungsgerichts, pp. 583-598; *K. Klett*, Progressive Einkommensteuer und Leistungsfähigkeitsgrundsatz in der Schweiz - 100 Jahre nach Georg Schanz, pp. 599-615; *P. M. Herrera Molina* (footnote 9); *K. Tipke* (footnote 9), pp. 469-534; *J. Lang*, Konkretisierungen und Restriktionen des Leistungsfähigkeitsprinzips, Festschrift für *H. W. Kruse*, Köln, 2001, pp. 313-338, and *J. Lang* (footnote 9), § 3 par. 81-122.

bution of the public financial requirements among the citizens in proportion to their ability to pay.[30] Ability to pay calls for taxpayers with *equal* capacity to pay the *same*. This is one historical origin of the ability-to-pay principle. First of all the ability-to-pay principle refers to the *horizontal* equity: taxpayers with equal income have to pay the same amount of income tax.

But there is another historical origin: the connection with a *progressive* tax rate. Some European constitutions consider this historical approach, for example art. 53 of the Italian constitution. This connection produces the political misunderstanding that the ability-to-pay principle serves the vertical equity by calling for a progressive tax rate. For this reason, in the past and nowadays, powerful groups of economists always have been fighting against the ability-to-pay principle in order to restrict Leviathan's fiscal appetite.[31]

b) *The ability-to-pay principle only justifies a proportional rate and claims for a correct notion of income*:[32] The progression is based on the vertical equity, meaning that taxpayers with greater ability should pay more. But this statement of ability to pay does not necessarily demand the progression. It supports also a *flat proportional* tax rate. Under a flat tax a taxpayer with a higher income pays more than a taxpayer with a lower income. Therefore, a flat tax is fully justified by the ability-to-pay principle.

As a rule of equality the ability-to-pay principle justifies the distribution of the tax burden in *proportion to the income*. Therefore, a flat proportional tax rate corresponds with the equal treatment of the taxpayer related to the

30. Déclaration des droits de l'homme et du citoyen, Art. XIII: Pour l'entretien de la force publique et pour les dépenses d'administration une contribution commune est indispensable; elle doit être également répartie entre tous les citoyens en raison de leurs facultés.
31. Essentially influenced by *F. A. Hayek*, The Constitution of Liberty, University of Chicago Press, 1960, and *G. Brennan* and *J. M. Buchanan*, The Power to Tax, Cambridge University Press, 1980.
32. In accordance with thesis 1 of *P. Essers* and *A. Rijkers* in their preliminary general report: In order to optimize equity and equality in the application of income taxes in the 21st century the ability-to-pay principle still is the most adequate guide.

amount of his income, which is the best indicator of ability to pay.[33] In this function the ability-to-pay principle *only justifies a proportional rate and claims for a correct notion of income*. The ability-to-pay principle does not support the fiscality of the state. It is not a principle aiming at getting as much revenues as possible. In contrast to this it *protects the taxpayer against a tax burden which is too high because of a wrong notion of income*. I discussed this aspect in relation to the subject of family taxation on the first annual EATLP-meeting 1998 in Alicante: The tax base is calculated wrongly and family members are discriminated against single taxpayers, if the tax law does not consider legal alimony obligations and the distribution of income within the family[34]. The main legal issues of the ability-to-pay principle concern the wrong or right notion of income, concern the *essential issues of the Cologne congress*.

c) Ability-to-pay principle and *welfare state principle*: The ability-to-pay principle does *not* serve goals of *social policy*. The political error results from claiming responsibility of the ability-to-pay principle for the progression. The ability-to-pay principle as a legal rule of equal taxation is not suitable to justify a certain progressive rate-structure. Such a rate-structure cannot be determined by legal arguments. The ability-to-pay principle may serve the vertical equity of a progression *only* in connection with the *welfare state principle*. The progressive rate structure is a matter of social policy based on the *welfare state principle*.

In fact the welfare state principle creates a policy of progression which sometimes even *impedes equal taxation* because the well informed taxpayer may better avoid progression by finding the loopholes of the tax legislation in a world of a high progression. Further, the globalization and the tax competition we discussed last year in Lausanne[35] require a reduction of the tax rates. That does *not violate* the ability-to-pay principle. It is violated by the different taxation of labour-income on the one hand and income from

33. See *K. Holmes* (footnote 6), p. 21; *R. Good*, The Individual Income Tax, The Brookings Institution, Washington D.C., 1976, p. 11; *R. A. Musgrave*, In Defense of an Income Concept, Harvard Law Review, vol. 81 (1967), p. 44, p. 50; *R. A. Musgrave/P. B. Musgrave*, Public Finance in Theory and Practice, 3d edition, McGraw-Hill New York, 1980, pp. 242-250; *J. Lang*, Die Bemessungsgrundlage der Einkommensteuer, Rechtssystematische Grundlagen steuerlicher Leistungsfähigkeit im deutschen Einkommensteuerrecht, Köln, 1981/88, and *J. Lang*, Prinzipien und Systeme der Besteuerung von Einkommen, in: *I. Ebling* (ed.), Besteuerung von Einkommen, Köln, 2001, p. 49, pp. 55-61.

34. See *J. Lang*, footnote 19.

35. See *W. Schön*, footnote 2.

capital on the other hand. It is violated by the shift from the concept of global income to schedular concepts like the dual income tax.

d) Ability-to-pay principle and *efficiency of taxation*: Another strong misunderstanding concerns the opinion, that the ability-to-pay principle disturbs the *efficiency of taxation*. In contrast to this, the ability-to-pay principle as a legal rule of equal taxation claims for an economically correct notion of income and therefore supports the fiscal neutrality.[36]

One of the main topics of fiscal neutrality refers to the issue periodical versus intertemporal notion of income. In our opinion the ability-to-pay principle claims for a *lifetime* notion of income.[37] This main feature of the ability-to-pay principle results in *intertemporal neutrality* and hopefully helps to reconcile former opponents of the ability-to-pay principle like *Professor Manfred Rose*, who criticized the ability-to-pay principle as a fiscal rule of progression.[38]

e) *Legal characterization*: As I already pointed out the ability-to-pay principle is a *legal* rule to achieve equal treatment of the taxpayer in proportion to his income. Three years ago, during the annual meeting of the Austrian Lawyer's Association the respondent to my contribution in Cologne, *Wolfgang Gassner*, and his colleague *Michael Lang* rejected the ability-to-pay principle with the statement: equality instead of the ability-to-pay principle.[39] In my opinion, this is a fundamental dogmatic misunderstanding: The ability-to-pay principle is not the alternative to the equality rule. It is a rule to materialize tax equality. It is the basic measure of comparison which is needed in order to determine equal treatment of the taxpayer.

aa) *Ability to pay versus public benefits as a basic measure of taxation*: The equal distribution of the public financial requirements among the citizens without relation to the ability to pay justifies the poll

36. See *R. Elschen*, Entscheidungsneutralität, Allokationseffizienz und Besteuerung nach der Leistungsfähigkeit, Steuer und Wirtschaft 1991, p. 99; *J. Lang*, Einfachheit und Gerechtigkeit der Besteuerung von investierten Einkommen, in: *M. Rose* (ed.), Integriertes Steuer- und Sozialsystem, Heidelberg, 2003, p. 86-87.

37. See below 3.7. (periodicity).

38. See *M. Rose*, Die Verführungskraft des Leistungsfähigkeitsprinzips, Mit einer Lebenseinkommenssteuer wider die Benachteiligung der Ersparnis, Neue Zürcher Zeitung, 28 September 2002, p. 14.

39. *W. Gassner/M. Lang*, Das Leistungsfähigkeitsprinzip im Einkommen- und Körperschaftsteuerrecht, Dogmatische Grundfragen - Rechtspolitischer Stellenwert, Wien, 2000.

tax of *Margaret Thatcher*. Millionaires and students pay the same. Nowadays, many economists and also tax lawyers plead for the *benefit principle* which demands that taxes should be levied in accordance to the benefits arising from the government services. It is indeed a fundamental decision to design tax systems on the base of the ability to pay or on the base of public benefits. The latter alternative would allow us to stop our discussion at this point because the notion of income is not an issue of tax systems based on the benefit principle.

bb) *Legal materialization*: Of course, I agree with my colleagues *Gassner* and *Lang*, that the ability-to-pay principle works on a very abstract level. Therefore, the fundamental decision to design the tax system on the ability to pay has to be shaped in specific terms, rules and provisions. Not all the provisions of tax law are based on the ability to pay. Tax incentives and norms with the purpose to simplify the application of tax law frequently violate the ability-to-pay principle. The Cologne conference had to consider such issues, for example the difficulties to exclude inflationary gains from taxation.

I agree with my colleagues *Gassner* and *Lang*, when they criticize the application of the ability-to-pay principle with the approach to create a certain accounting provision. The abstract level of the ability-to-pay principle does not allow the freehand creation of provisions without support of special considerations, for example generally accepted accounting rules. The fundamental decision to design tax systems on the base of the ability to pay leaves a lot of space to develop a system of equal taxation and to shape the specific principles and provisions to determine the taxable income.

On the way to the specific provision many aspects have to be considered. The ability-to-pay principle is embedded in a framework of other principles: constitutional principles like the right to property, the rights of the family, principles of the European Law like the Four Freedoms of the EC Treaty, principles of the International Tax Law like the principle of source taxation with an evident restriction of the ability to pay. In Alicante we have discussed the different ways to consider the family in tax provisions.[40] Probably, the globalization we discussed in Lausanne forces us to get a new

40. See *M. T. Soler Roch*, footnote 18.

understanding of ability to pay.[41] But this fact *does not make us guideless*. It rather brings us to the questions where the ability-to-pay principle can be saved and where this principle has to be restricted.[42]

It is a common experience of law that every basic principle is limited by other basic principles, limited by the task of the law to consider a great variety of interests and limited by the real circumstances to enforce the law. But all these limitations of basic principles give no reason to deny the ability-to-pay principle as a fundamental guideline to equal taxation, just like the limitations of private autonomy give no reason to deny the *private autonomy principle* as a fundamental decision of the civil law.

In my opinion, the ability-to-pay principle is the *most adequate guide to optimize the tax equity and equality*[43] because each branch of law needs basic principles and because the alternative of the benefit principle results in forms of taxation which find no legal acceptance like the poll tax of *Margaret Thatcher*.

3.2. Individual taxation

The ability-to-pay principle as a basic rule of tax equity refers to the individual taxpayer and not to a unit of people like the family unit. Therefore, the ability-to-pay principle forms the *individual taxation rule*.

This rule prohibits the taxation of family units with the effect of discriminating the family because of a higher progressive tax burden.[44] Thus, rules of income splitting are necessary in a progressive tax system. In case of a flat rate the lack of splitting rules has no discriminating effect. The splitting rules are derived from the basic rule of individual taxation. In accordance with the rights of the family[45] they consider the distribution of income among spouses and other family members as provided by alimony obligations. The splitting rules are also based on the ability-to-pay principle be-

41. See *W. Schön*, footnote 2.
42. See *J. Lang*, Festschrift für *H. W. Kruse* (footnote 29): materialization and restrictions of the ability-to-pay principle.
43. See thesis 1 of *P. Essers* and *A. Rijkers* in their preliminary general report (footnote 32).
44. Rulings of the supreme courts in Germany and Spain: see *J. Lang*, *K. Vogel* and *C. Waldhoff* (footnote 19) and *P. M. Herrera Molina*, footnote 9.
45. See above 2.4.

cause the obligation decreases the ability of the alimony payer and increases the ability of the payee.

3.3. Real income versus inflationary gains and fictitious income

As mentioned above, the ability-to-pay principle claims for a correct notion of income and therefore demands a measure of *real, not fictitious income*. Thus the foundation concept of income ought to include only *real economic benefits*. Gains without improving the taxpayer's economic position in reality are "illusory gains"[46] and unsuitable to measure the ability to pay. The taxation of "illusory gains" does not only conflict with the ability-to-pay principle, with tax equity and equality, but also violates the right to property.[47]

In a period of *inflation* the nominal accounting of income delivers taxpayers who have liabilities an untaxed *real* gain and taxpayers who are selling assets a taxed "*illusory* gain". The longer that the assets are held in a period of inflation, the greater the inflation component of the gain is likely to be. Thus, the *nominal accounting principle* is working against the ability-to-pay principle.

In Germany, the Federal Constitutional Court[48] interprets the nominal accounting principle as a principle supposed to protect the currency. This opinion refers to the experience especially in the countries of South America where the general use of index methods increased the inflationary situation of an economy. In Germany, index methods for accounting or for clauses to save the money value are generally not permitted. Only the Federal Bank (*Bundesbank*) is authorized to allow such clauses which disturb the value of a currency.

But index methods are not necessary to get a taxation which is neutral to inflation. It depends on the choice between accrual method and cash flow method. Only the accrual method needs index methods while the cash flow method guarantees the intertemporal neutrality of taxation including the inflation neutrality.[49]

46. See *K. Holmes* (footnote 6), pp. 341-378.
47. See above 2.3. (at the end).
48. BVerfG 9 December 1978, collection vol. 50, p. 57. See *J. Lang*, Die Bemessungsgrundlage der Einkommensteuer (footnote 33), pp. 176-183; *K. Tipke* (footnote 9), pp. 459-460.
49. See below 4.2.

The *fiction of income* as for example in Box III of the Dutch income tax[50] results in a tax benefit if the real amount of income is higher. In the case of a lower real income the fiction of income has a confiscatory effect which violates the right to property.[51] Furthermore, the unequal treatment is evident.

3.4. Net income

The income as a measure of the ability to pay taxes consists of the positive factor of proceeds and the negative factor of costs related to the earning of the proceeds. The result of both factors is the net income as the right measure of the ability to pay and therefore the *net income principle* (*net principle*) puts the ability-to-pay principle in concrete terms. The ability-to-pay principle demands the full deduction of costs and losses as well as the full consideration of the proceeds.

Furthermore, the deductible costs and losses have to be defined as costs and losses caused by an earning activity with the intention to make profit. Hobby losses as the result of a consumption activity cannot be part of the net income.

In accordance with the ability-to-pay principle the tax base of a global income tax includes all profits and losses from capital just as from labour. In contrast to this a schedular income tax with different tax rates merely allows the summation of profits and losses on the same schedule. This is not in accordance with the ability-to-pay principle but there may be reasons to justify a separate tax regime:

- One of those reasons is the need to consider the inflation especially if capital gains and losses are taxed. This may justify a *special tax regime* to apply lower tax rates or to let a growing part of long-term capital gains untaxed. The special tax regime prevents the global summation of profits and losses.

- Another reason is the need to *simplify* the tax law. Simplifying rules infringe the net principle. The limited deduction for a certain kind of income can hardly be justified, for example the limited deduction of employee expenses in the Spanish tax law. In the Netherlands, the de-

50. See above 1 and the report by *H. van Arendonk*, Part A, Chapter IV.
51. See above 2.3. (at the end).

duction of real employee expenses was completely abolished by the Income Tax Act 2001.

In Germany, the *net income principle* is a highly esteemed principle of income taxation.[52] Thus, the limitation or even the abolition of employee expenses could politically not be realized. No government would dare to introduce a bill with this evident discrimination of the employees compared to the deduction of business expenses.

3.5. Non-disposal income

The ability-to-pay principle demands not to tax the minimum subsistence. This is not a matter of a zero rate (zero-bracket amount) but a matter of tax base. In this context the part of income which is needed for the subsistence level is not at the disposal for taxation and therefore the non-disposable part of the income must stay untaxed either as an amount of regular subsistence or as deductible extraordinary expenses, for example in case of illness.

In the German tax law the *non-disposable principle* gets constitutional validity as a basic rule of the ability-to-pay principle by the ruling of the Federal Constitutional Court[53]. Similar developments of jurisprudence can be observed in Austria, Spain and Italy. In Germany, the social security system fully protects the minimum subsistence. In this regard the Federal Constitutional Court[54] decided that the amount of social help has to be the measure for the tax-free amount because it is not bearable that a taxpayer who earns his minimum subsistence himself has to pay taxes while the recipient of social help gets the minimum subsistence tax-free. An important opinion in Germany, the *Deutscher Juristentag*[55] (conference of German lawyers), demands a tax-free amount even higher than the minimum subsistence. Due to social obligations the working people need a higher minimum standard of living than lodgers of the welfare state.

52. See the references of *J. Lang* (footnote 9), § 9, pp. 54-55.
53. BVerfG 29 May 1990, collection vol. 82, p. 60 (ruling no. 2: "Income taxation has to release a minimum subsistence amount to the family; only the income above this amount may be taxed"), and in general the landmark decision BVerfG 25 September 1992, collection vol. 87, p. 153.
54. BVerfG 25 September 1992, footnote 53.
55. Deutscher Juristentag 28./29. September 1988, part N (subject: basic reform of the income tax), resolution No. VII.1. The reports of the Deutscher Juristentag are published by C.H.Beck, Munich. See report N, p. 215, Munich, 1988.

3.6. Efficiency of taxation: fiscal neutrality and simplicity

There are different points of view to understand efficiency: *Economists* use the term "efficiency" to describe the effectiveness of using resources. From that point of view taxation should not disturb economic decisions to allocate resources. It ought to be neutral to the allocation of resources (so-called *fiscal neutrality*). A growing group of economists[56] plead for a consumption-type or cash-flow-income tax because the traditional net-accretion income tax distorts the intertemporal allocation of consumption decisions.

From the *legal* point of view efficiency is identified with *simplicity*, mostly in contrast to tax fairness. The legal opinions are very different. Simplifying rules often break equity principles like the ability-to-pay principle. This has to be justified.

The reason to tax *deemed* or *fictitious* income may be *simplicity*. The violation of the right to property[57] and of the ability-to-pay principle may be justified if the efforts to account the income are unreasonable in relation to the result. But this does not allow a general income fiction that practically concerns all private property as Box III of the Dutch income tax.[58]

3.7. Periodicity

The periodical notion of income violates the ability-to-pay principle if the measure of ability to pay is the *lifetime income*. In our opinion the periodical accounting and taxing are based on technical and fiscal reasons.[59] Practically it is not possible to account a lifetime income and it is not acceptable for the budget if the whole income tax is not paid before the death of the taxpayer. But these reasons do not speak against a concept which considers lifetime aspects in the periodical accounting of income.

In our opinion the correct measure of ability to pay taxes is the complete income, thus the *lifetime income* of the taxpayer which is not restricted by an arbitrary period of time like one year.[60] Therefore, the notion of income

56. Topic reporter *M. Rose* (see below Part A, Chapter II) is member of this group.
57. See above 2.3. (at the end).
58. See above 1 and the report by *H. van Arendonk*, Part A, Chapter IV.
59. See *J. Lang* (footnote 48), pp. 186-190; *K. Tipke*, Die Steuerrechtsordnung, vol. II, 1st edition, Köln, 1993, pp. 668-671.
60. See below *M. Rose*, Part A, Chapter II, Paragraph 3; *J. Lang*, Prinzipien und Systeme der Besteuerung von Einkommen (footnote 33), pp. 63-67 (with further references).

has to consider *interperiodical* or *intertemporal* matters of income. For example the *carry over of losses* (carry-back and carry-forward) is no tax benefit. The carry-over-rules are justified by the ability-to-pay principle.

4. Theories and methods to determine the income

4.1. The historical debate: net accretion theory versus source theory

In the nineteenth century the development of income tax law was essentially influenced by two categories of income theories: firstly the *source theories* with their origin in the Roman law (income as fruits of capital assets) and secondly the *net accretion theories* which shape the *traditional concept of a global income tax* based on the *Schanz-Haig-Simons* concept of income.[61] This global concept aims to seize "the net accretion of one's economic power between two points of time".[62]

In contrast to this, source theories only cover the income from the source, not the source itself, that is to exclude capital gains and losses as the result of the source sale: the income derived from selling the fruit is taxable; the capital gain derived from selling the fruit garden is not taxable.

In the current income tax law of many countries the tax base is a mixture of net accretion and source theories, in the best case completed by a separate tax regime for capital gains and losses.[63] The net accretion theory includes three kinds of income:

a) *Market income*: In most countries the legal concept of taxable income embraces income derived from *market transactions*. In this way the taxpayer makes use of his skills and earns income derived from labour or he invests capital or he combines labour and capital to achieve income. Capital gains and losses belong to market income. Windfall gains are some sort of an accidental market success.

61. See *K. Holmes* (footnote 6), pp. 55 et seq.
62. *R. M. Haig*, The Concept of Income: Economic and Legal Aspects, in *R. M. Haig* (ed.), The Federal Income Tax, Columbia University Press, 1921, p. 7.
63. See below 5.3.2.

The main legal issue is to *exclude the consumption*: the nucleus of the market income theory[64] is to determine the taxpayer's *action with the intention to make profit*. If this intention is missing the action may be consumption. For example the losses are not deductible if the taxpayer enjoys a sailing boat but needs some receipts to finance the boat and therefore runs a part-time charter business. The whole sailing activity ought to be treated as consumption. Of course, the criteria of a profit action have to be judged as *objectively* as the findings of the German Tax court (*Bundesfinanzhof*) do.[65] Especially the criterion of intention does not depend on the subjective opinion of the taxpayer but the objective chance to make profit.

In German tax law *game* profits and losses are part of consumption because the chance to make profit is objectively too small. In most cases the total result of gambling is negative even though the gambler subjectively intends to make profit. In contrast to this the taxable speculation gains and other gains out of gambling are based on an investment with an objective commercial chance to make profit.

While the rule that losses from hobby are not deductible is practised worldwide the treatment of game losses is very different. If the taxpayer visits a gambling casino he definitely wants to make profit. In the United States casino profits are taxable and casino losses are merely deductible from casino profits. In Germany all kinds of games (lotteries, bets, wagers, gambling casinos) are part of consumption because the chance to win is too uncertain.

The net accretion theory is very unclear: are game losses part of the net accretion? If game gains have to be included in the net accretion, game losses must also be taken into account to determine the net accretion. The above mentioned *net income principle*[66] demands this. The casino loss has to be deductible not only within the schedule of casino profits.

b) *Imputed income*[67]: In contrast to the market income the imputed income is only rarely part of a taxable income. The term "imputed income" comprises "the value of the benefits derived from non-market

64. See the references of *J. Lang* (footnote 9), § 9, p. 52.
65. See the references of *J. Lang* (footnote 9), § 9, pp. 124-129.
66. See 3.4.
67. See *J. Lang* (footnote 36), pp. 99-100; *K. Holmes* (footnote 6), pp. 79-80, 521-562, and below *I. Roxan*, Part B, Chapter V.

transactions".[68] Thus, taxpayers receive the economic benefits from the use of their own assets and the self performed services.

In the legal concepts of taxable income only the use of own real estate is taxed (for example in Switzerland), not the use and enjoyment of houseboats and other assets in the consumption sphere. The taxation of the income from an owner-occupied home may be justified in comparison with the situation of a tenant.[69] But the unequal treatment of the taxpayer results from the arbitrariness to tax only the use of homes. There is not a single concept which consequently taxes imputed income. The Swiss tax lawyer *Peter Böckli*[70] discussed the services of a housewife (so-called "*Schatteneinkommen*"). What kind of services should be taxed? It seems to end in delicate issues.

In my opinion the economic concept of imputed income is legally not executable and so an equal treatment of the different kinds of imputed income is impossible in tax law. Therefore, equality demands to abolish the taxation of only a few cases of imputed income, especially the use of own real estate.

c) *Transfer income*: *Gifts* and *inheritances* are income if you look at the enrichment of the recipient. But if you look at the transfer, the donor becomes poorer. In reality, the transfer of property creates no new economic power. It leads to a decrease in the ability of the donor and to an increase in the ability of the recipient.

In most countries the taxation of gifts and inheritances is excluded from the tax base of the individual income tax and subject to the *gift and inheritance tax*.[71] Both taxes cause *double taxation*: the same economic power is taxed twice. Of course, a double taxation is not recognized if only the ability to pay of the recipient is regarded. But the economic effect is double taxation, if the same income is taxed twice in a row of two taxpayers. A similar case is the double taxation in a classical corporate income tax system.

68. *K. Holmes* (footnote 6), p. 521. *K. Holmes*, p. 79, refers to statements of *G. Schanz* (income from "the enjoyment of one's leisure, the use of one's house or one's garden") and of *R. M. Haig* ("the money-worth of...goods and services as are received directly without a monetary transaction").
69. See below *I. Roxan*, Part B, Chapter V, Paragraph 2.
70. Von Schatteneinkommen und Einkommensbindung, Gedanken zur Ehegattenbesteuerung, Steuer-Revue 1978, p. 98.
71. See below *C. Sacchetto* and *L. Castaldi*, Part A, Chapter III, Paragraph 1.3.

Double taxation may violate the right to property. Whether the taxation has confiscatory effects or not depends on the tax rates and the particular time of the double taxation. In any case the double taxation discriminates the saved income and especially the *income from capital*. This is the reason why no other tax produces such a strong resistance as the gift and inheritance tax. Therefore, the revenue from this tax is relatively low everywhere. In the tax competition some nations like Austria try to abolish or at least minimize the gift and inheritance tax.

Alimony payments and *maintenance grants* are part of the net accretion. In many cases the tax law leaves this kind of transfer untaxed if the payment has already been subject to the income taxation or if the grant is given by a public institution. The splitting rules mentioned above[72] consider the transfer of economic power and therefore realize a fair family taxation.

d) *Conclusion*: After all the net accretion theory is only partially realized in the legal concepts of income. First of all, the market income is subject to the individual income tax. The taxation of imputed income or of transfer income may come in conflict with the constitutional framework of tax principles (equality, ban of confiscatory taxation) if other kinds of income are exceptionally taxed.

4.2. The present debate: accrual method versus cash flow method

The present debate about income concepts is focused on the issue whether the notion of income has to be *periodical* or *intertemporal*. The traditional concept of income is based on the *net accretion theory* with its periodical approach of "one's economic power between two points of time".[73] For this periodical theory the *accrual method* is appropriate.

In contrast to this those economists who follow the optimal taxation theory plead for an intertemporally neutral concept of income which is realized by the *cash flow* method. For many decades economists and American tax law professors have been discussing the issue of a consumption-type income

72. See 2.4.
73. See *R. M. Haig* (footnote 62).

tax versus the traditional concept of income.[74] This dispute suffers from a deep misunderstanding because the traditional concept of income is more or less consumption based, too. The conceptual debate has to consider the following facts:

- Firstly, the net accretion theory refers to all kinds of economic benefits and therefore to the power to consume. Like all economical theories the net accretion theory as well as the cash-flow-income theories reflect the efficiency of consumption in a world of limited resources.

- Secondly, the traditional income tax is only partially based on the net accretion theory. It is a mixture of net accretion, accrual methods, and cash flow methods (especially the taxation of employees and their pensions), and cash flow realization but not periodical evaluation of the assets. Therefore, the current income tax systems have worldwide a *hybrid* character with a strong tendency to escape from the old ideas of net accretion and of a global income tax.

The main issue of the controversy is the accordance of the concepts with the *ability-to-pay principle*. If the measure of ability is decided upon as the *lifetime income* the arguments of *intertemporal neutrality* have to be respected. Theoretically, the lifetime incomes of taxpayers have to be compared. From this point of view the carry-over-rules are justified and the discrimination of the future consumption becomes relevant.

74. *W. D. Andrews*, A Consumption-Type or Cash Flow Personal Income Tax, Harvard Law Review, vol. 87, 1974, p. 1113; *M. J. Graetz*, Implementing a Progressive Consumption Tax, Harvard Law Review, vol. 92, 1979, p. 1575; *A. Gunn*, The Case for an Income Tax, The University of Chicago Law Review, vol. 46, 1979, p. 370; *A. Shachar*, From Income to Consumption Tax: Criteria for Rules of Transition, Harvard Law Review, vol. 97, 1984, p. 1581 (Reply by *H. E. Abrams*, Harvard Law Review, vol. 98, 1985, p. 1809; *V. Thuronyi*, The Concept of Income, Tax Law Review, vol. 46, 1990, p. 45; *Bankman/Griffith*, Is the Debate Between an Income Tax and a Consumption Tax A Debate About Risk? Does it Matter?, Tax Law Review, vol. 47, 1992, p. 377; *B. H. Fried*, Fairness and the Consumption Tax, Stanford Law Review, vol. 44, 1992, p. 961; *G. K. Yin*, Accomodating the "Low-Income" in a Cash-Flow or Consumed Income Tax World, Florida Tax Review, vol. 2, 1995, p. 445; *N. B. Cunningham*, The Taxation of Capital Income and the Choice of Tax Base, Tax Law Review, vol. 52, 1996, p. 17; *A. C. Warren*, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, Harvard Law Review, vol. 88, 1975, p. 931; *A. C. Warren*, Would a Consumption Tax Be Fairer Than an Income Tax?, The Yale Law Journal, vol. 89, 1980, p. 1081; *A. C. Warren*, How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?, Tax Law Review, vol. 52, 1996, p. 1; *Bankman/Fried*, Winners and Losers in the Shift to a Consumption Tax, The Georgetown Law Journal, vol. 86, 1998, v. 539; *J. K. McNulty*, Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform, California Law Review, Vol. 88, 2000, S. 2095; *G. R. Zodrow*, Prospects for Consumption-Based Tax Reform in the United States, FinanzArchiv, vol. 59, 2002/2003, p. 264.

There is no methodical difference if the taxpayer consumes his labour income in the same period. The difference of methods gains importance if a part of the labour income is saved. In this case the saved *income from capital* has to bear an increasing tax burden, well-known since the statement of *John Stuart Mill* that interests are double taxed.[75] Actually, *Manfred Rose*[76] (Heidelberg) pointed out the increasing tax burden of the periodical and accrual method in contrast to the constant tax burden of the cash flow method (see the chart on the following page).

From the legal point of view the economic arguments of double taxation (*John Stuart Mill*) and of the increasing tax burden (*Manfred Rose*) cannot be understood easily. The saved income creates new income - like interest. Nevertheless, the interdisciplinary discussion has to consider the different economic effects which are shown by the following chart with a money investment of € 10,000, an interest rate of 6% and a proportional tax rate of 30%. The chart on the following page represents three basic cases:

- The *first* column represents the fortune increase in a world without taxation. The final fortune amount of € 102,857 is the measure for the final tax burden.

- The *second* column shows the increase of the tax burden if the money is given to a bankbook. The interest is periodically taxed (*accrual method*) with the effect that the final tax burden increases within 40 years to an amount of 64.72%, which is more than twice the tax rate (see the statement of *John Stuart Mill*). Progressive tax rates of 50% and more produce a final tax burden of 90% and more. This is why taxpayers risk tax fraud and invest their capital abroad.

- The *last* column shows the taxation of pension schemes.[77] Contributions to the fund are deductible or not taxed if the employer pays into the fund. The interest is not disposable until it is paid out as a part of the pension. Finally the pension is taxed as the total result of the invest-

75. *J. St. Mill*, Principles of Political Economy with Some of Their Application to Social Philosophy, book V, Chapter 2, § 4, 1st edition 1848.
76. See also below *M. Rose*, Part A, Chapter II, Paragraph 3.
77. See below 5.3.1.

ment. Here the *cash flow method* works. Therefore, the final tax burden exactly amounts to a tax rate of 30%.

Accrual and Cash Flow Taxation of Interests

interest rate: 6% *tax rate: 30%*

age of taxpayer	fortune increase without taxation (€)	accrual taxation (€)	tax burden (%)	cash flow taxation (€)
25	10,000	7,000	30.00	10,000
26	10,600	7,294	31.19	10,600
27	11,236	7,600	32.36	11,236
28	11,910	7,920	33.51	11,910
29	12,625	8,252	34.63	12,625
30	13,382	8,599	35.74	13,382
.	.	.	.	.
.	.	.	.	.
60	76,861	29,544	61.56	76,861
61	81,473	30,785	62.21	81,473
62	86,361	32,078	62.86	86,361
63	91,543	33,425	63.49	91,543
64	97,035	34,829	64.11	97,035
65	102,857	36,292	64.72	102,857
				–30,857
consumable income		*36,292*		*72,000*
final tax burden			*64.72*	*30*

5. Notion of income towards a cash flow income tax?

5.1. The phenomenon of a hybrid income taxation

a) *Basic qualities of computation methods*: The chart above shows the intertemporal constancy of the tax burden in case of the cash flow method while the accrual method causes an increase of the tax burden.

aa) The *cash flow method* has optimal qualities of *fiscal neutrality*: neutrality of the tax payer's *decision* (saving, investment or consumption), neutrality of *inflation*, *intertemporal* neutrality of tax burden. The main *disadvantage* of the cash flow method is the *present lack of tax revenue* because of the payment's deductibility.

But in the future the tax revenue is increasing. The cash flow method ensures a better comprehension of income in the tax base than the accrual method. Taxpayers strongly oppose the accrual method. For example they risk tax fraud to avoid the accrual taxation of interests. In contrast to this, deductible contributions to pension funds stimulate the taxpayer to save his income under the control of the tax authorities which can have the full information about the fortune increase in the fund.

bb) The main advantage of the *accrual method* is the *efficiency of the present tax revenue* which is attractive for politicians who want to be voted into parliament only for a relatively short period of years. Therefore, the legislator prefers *net accretion theories* and accrual taxation. On the other hand the taxpayer has to suffer the disadvantageous effects of accrual taxation, the taxation of inflationary gains, the increase of the tax burden, the cuts and restrictions to carry-over losses, and the uncertainty of asset evaluation.

cc) The academic controversy focuses on the *quality of tax equity*: A powerful group of scholars argues that the cash flow method results in a *consumption-type* income tax and in a rich man's prerogative.[78] This may be doubted. On the one hand, rich people have too many possibilities to use the tax competition and to allocate their income to the places where taxation is lowest. On the other hand, the cash flow method helps taxpayers with labour-income to get a better tax position in relation to the capital investors if the taxation of pension schemes is based on the cash flow method. Eventually, the legal approach of equity only depends on the period of time or on the lifetime. If the *window is opened on the lifetime of the taxpayer*, you can see all the defects of the accrual method.

b) The struggle between efficiency of tax revenue and acceptance of tax burdens results in the phenomenon of a *hybrid notion of income* which is shaping up the income taxation worldwide and has the following features:

78. See the references in footnote 74, particularly the articles of *B.H. Fried, A.C. Warren, Bankman/Fried* and *J. K. McNulty*.

- The computation of *entity profits* generally uses the *accrual method* but the realization requirement and rules of book reserves refer to the cash flow method;[79]

- Income from *private capital* and *labour-income* is mostly computed with the *cash flow method* but the chart above shows that interests are taxed on an accrual basis;

- *Pension schemes* are *purely cash flow taxed*: the contributions to the pension funds are deductible or untaxed if the employer pays into the fund. The paying of the fund is fully taxed. But mostly this kind of taxation is restricted to a certain amount;

- *Capital gains* on the one hand are cash flow taxed because of the realization requirement and on the other hand taxed on an accrual basis because of the taxation of inflationary gains;

- The *increase of some capital* is not taxed due to the source theory. This is neither in accordance with the accrual method nor with the cash flow method;

- *Low corporate tax* rates partially realize cash flow taxation. A pure business cash flow tax allows the full deduction of the investment and finally burdens only the distribution of dividends. That implicates a corporation tax rate of zero.

5.2. Schedular or global income taxation?

Tax competition gives the acceptance of a tax burden more importance. Therefore, most European governments have lowered the tax burden on income from *mobile capital* either by *decreasing* the *tax rates* or by *modifying* the *tax base*.

The accrual tax accounting may be modified by cash flow rules like generous book reserves, especially risk and inflation reserves, provisions for bad debts and specific accounting rules for the shipping industry, for coordination centres of foreign investments. In some countries like in Germany the soft character of the tax accounting is based on the connection with the

79. See below the topic "Accrual versus realization", reported by *P. Kavelaars*, Part B, Chapter I.

commercial accounting with its caution rules. Sometimes it is difficult to decide whether an accounting rule is part of the general system or a harmful investment incentive. But anyway, low tax rates are the alternative which is more transparent for foreigners. The *tendency towards schedular income taxes* shows the following characteristics:

- *Flat rate taxation* of income from *capital* and *progressive taxation* of *labour*-income (*dual income tax*) not only applied in Scandinavian countries but also characterizing the Dutch income tax with its "boxen" system;[80]

- *Specific accounting rules* for particular sources of income, for example the low evaluated fiction of income from the shipping industry or from the private property in Box III of the Dutch income tax;

- *Low corporate tax rates*[81], *but return from imputation systems to the classical systems of double taxation or to systems with a small shareholder relief*;[82]

- *Tightening* of the *tax accounting* for the benefit of *low tax rates*, especially reduction of intertemporal cash flow rules (book reserves, deduction of losses).

Of course, the transition from the global income tax to schedular income taxation violates the principles of tax equity and equality. But the academic discussion of tax policy has to find solutions and justifications for a concept of income which on the one hand considers the conditions of administrative practice and tax competition, and on the other hand conserves the approach to equity and equality. Thus in Cologne, the discussion we had at the EATLP congress in Lausanne will be continued.

Schedular effects can be accepted as far as different kinds of income *concern every taxpayer*. Equality means the equal treatment of the taxpayer and not the equal treatment of all kinds of income. If the taxpayer consumes his whole income in the same period, the right tax base is easy to define: the whole consumed income ought to be included in the tax base. But if the taxpayer saves income or invests money or loses invested money, the *time*

80. See above 1. and the report by *H. van Arendonk*, Part A, Chapter IV.
81. Particularly Ireland: 12.5%.
82. For example Germany. See *J. Lang* (footnote 60), pp. 90-100.

value of money ought to be respected and the *issues of intertemporal fiscal neutrality* ought to be discussed.

The basic idea is to find a *general rule to treat saved or invested income*. The *cash flow method* with its above mentioned *qualities of intertemporal neutrality* includes such a rule. The problem of this rule is its *limitation* because the cash flow method lowers the *present* tax revenue. But in the long run the cash flow method supports the comprehension of the tax base and the lack of tax revenue is compensated.

5.3. Two essentials of the income from capital

5.3.1. Taxation of pension schemes

The taxation of *pension schemes* purely follows the cash flow method.[83] It shifts the income from the economically active period to the retirement period and therefore represents the first-best tax form to indicate a *lifetime ability to pay*. Furthermore, it redresses the discrimination of labour-income in the tax competition as far as labour-income is contributed to a pension fund. In this case the labour-income is taxed lower than dividend income because the taxation of pensions is equivalent to a corporation rate of zero.

a) The participation in pension funds ought to be *open to all taxpayers*, not only to employees but also to freelancers and any kind of businessmen. In many countries the cash flow taxation of pensions is increasing, for example in the UK and in the USA.

b) Nowadays, the *rules of limitation* are too complicated. The legislator presents the cash flow taxation of pensions as a tax incentive. But in fact this form of taxation is based on the ability-to-pay principle with its purpose to fairly tax the lifetime ability to pay. Only the background of a periodical understanding of the ability to pay pretends a tax incentive.

c) A severe problem of *revenue inefficiency* derives from the *International and European law*. If the retired taxpayer moves from a cold, rainy and cloudy northern country to a Mediterranean country, the pensions

83. See above 5.1., b, mark 3.

may be only taxable in the state of residence of the recipient. Therefore the deduction of contributions in the northern country will not be compensated for the taxation of the pensions. The *residence rule* is to apply in case of *private employment*.[84] *Only governmental* pensions can be taxed by the paying state.[85] Under the European law the *cohesion principle* justifies the connection between the deduction of contributions and the taxation of pensions.[86] But the *Wielockx*-decision denies this justification if the cohesion principle is given up in a double taxation treaty.[87] The adaptation of the treaty law is a difficult task which ought to be prepared by the academic discussion. The concept of adaptation has to consider that the contributions to a pension scheme do not represent income. That is why the contributions are deductible or not taxable if the employer pays into the fund. The former home states are the *source* countries of the pension payments and therefore they must have the right to tax the pensions.

5.3.2. Treatment of capital gains and losses

The taxation of capital gains[88] exceptionally suffers from the problem to tax inflationary gains. Therefore in many countries (for example in the UK) the taxation of capital gains is separated into a special schedular tax regime. This regime considers the inflation effects either with *low tax rates* or with *taper reliefs*. The latter act of reducing the tax base in relation to the length of the holding period refers to the inflation effects more exactly than low tax rates but only covers one side of the coin. The inflation also reduces the debt burden and so creates a real gain which is not taxed. Therefore, separate tax regimes for capital gains and losses do not completely neutralize the impact of inflation on tax bases.

The *first-best solution* would be the *cash flow* taxation of capital gains and losses. But this may be too disadvantageous for the present tax revenue. Therefore, separate tax regimes may be accepted which roughly consider inflation. Of course, capital losses are only to be taken into account on the schedule of capital gains. A full deduction of the losses is only justified from the full capital gain. That raises the question whether the amount of

84. See Art. 18 OECD Model Convention.
85. See Art. 19 OECD Model Convention.
86. See above 2.5.
87. See above 2.5. (footnote 27).
88. See below the topic "Treatment of capital gains and losses", reported by *J. Freedman*, Part B, Chapter III.

losses ought to be reduced in relation to the holding period, too. The complexity of such a rule may justify the full loss relief as a simplification rule.

6. Conclusions

In our academic discussion tax principles may have a deep impact on the notion of income. Nevertheless, the real tax policy often denies tax principles even of the constitutional and European law. A lot of Supreme Court and ECJ verdicts show the permanent violation of principles by the legislator. In spite of that, the discussion about principles and basic rules supports the development of a common European understanding of better tax structures. In this paper I would like to emphasize the following conclusions:

- The income tax base ought to be reduced to the *market income*[89]. *Imputed income* should be excluded because the equal treatment of the different kinds of imputed income is impossible;

- If the right measure of ability to pay is the *lifetime* income, the tax base should only include the *realized* income. The *accrual method* causes the *uncertainty* of asset *valuation*, the *increase* of the *tax burden* and denies inflationary effects;[90]

- Basically *fictitious* or *deemed* income should not be part of the income tax base. The taxation of fictitious income gets into conflict with the ability-to-pay principle and the right to property[91]. In some cases the fiction or deeming of income may be justified as a rule of *practicability*. A large fiction of income derived from private property cannot be justified. The income tax gets the character of a wealth tax;

- The *net income principle*[92] *demands the full deduction* of costs and losses. The fiction of costs may be an appropriate rule of practicability. But the full substitution of the real costs (for example: employee expenses in Spain) cannot be justified. In separate tax regimes the relief of losses can be limited to the schedule of the tax regime;[93]

89. See above 4.1., a.
90. See above 4.2.
91. See above 2.3. (at the end).
92. See above 3.4.
93. See above 5.3.2.

- The concept of the lifetime ability to pay demands a *cash flow notion of income*. This is already largely realized by the taxation of pensions. A second step towards a cash flow income tax could be the cash flow taxation of capital gains and losses. But that first-best solution decreases the present revenue too much. Therefore, a separate tax regime, which considers inflation effects in a rough way can be accepted;

- In the long run the notion of income should move towards a cash flow income tax. That will give us the best chance to keep the concept of a *global income tax*. The accrual taxation stimulates the resistance of the taxpayer and eventually ends in *schedular income taxes*. Of course, the income tax will not lose its *hybrid* character. But this does not disturb the equal treatment of the taxpayer if the basic rules concern the saved or invested income of each taxpayer. Pension schemes, capital gains and also dividends are income essentials of most taxpayers. Therefore, special tax regimes including the double taxation of dividend income are acceptable. Nevertheless a *fictitious income schedule for real estate property* violates equality as real estate is normally not part of each fortune and affects only a certain group of taxpayers;

- *Splitting rules* consider the distribution of income among spouses and other family members in accordance with the *individual taxation rule*;[94]

- Finally, the *non-disposal income* ought to be excluded from the tax base.[95]

94. See above 2.4. and 3.2.
95. See above 3.5.