

**A THEORETICAL EXPLORATION OF NEUTRAL UNDERSTANDABLE
LEGISLATION AS A FUNDAMENTAL PRINCIPLE OF TAXATION, AND OF
FACTORS THAT CONTRIBUTE TO SUCH LEGISLATION**

by

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ABSTRACT

A THEORETICAL EXPLORATION OF NEUTRAL UNDERSTANDABLE LEGISLATION AS A FUNDAMENTAL PRINCIPLE OF TAXATION, AND OF FACTORS THAT CONTRIBUTE TO SUCH LEGISLATION

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Throughout history, Taxation appears to have been universally unpopular in every kind of society. Therefore, to avoid taxpayer revolts, taxes should be levied in a manner that is acceptable to those on whom they are levied. Governments should attempt, as far as possible, to achieve equilibrium between fiscal expenditure and attaining the goals of the state, and the taxes imposed upon its subjects. In order to achieve this, legislation applicable to Taxation should adhere to certain fundamental principles.

This study aims to explore the history and characteristics of, and the reasoning behind the Fundamental Principles of Taxation, and proceed to focus on the proposed Fundamental Principle: Neutral, Understandable Legislation and the factors that contribute to making it neutral and understandable, namely Simplicity, Neutrality, Optimal design, Certainty and Tax Law.

The Fundamental Principle: Neutral, Understandable Legislation is dissected by examining the definition of, and rationale for each contributing factor, its origin and historical development, and its current application and general trends.

Research results indicate that the contributing factors have guided fiscal policies for centuries and that their importance in balancing the taxes imposed against the needs and goals of the state cannot be overstated. This study concludes by affirming that merit

definitely exists for Neutral, Understandable Legislation to be deemed a Fundamental Principle of Taxation.

KEY TERMS:

Fundamental Principle

Neutral Understandable Legislation

Simplicity

Neutrality

Optimal Design

Certainty

Tax Law

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LIST OF ABBREVIATIONS AND ACRONYMS

Table 1 - Abbreviations and acronyms used in this document

Abbreviation	Meaning
AICPA	American Institute of Certified Public Accountants
CIPFA	The Chartered Institute of Public Finance and Accountancy
ICAEW	Institute of Chartered Accountants in England and Wales
OECD	Organisation for Economic Co-operation and Development
SAAR	Specific anti-avoidance rule
SATC	South African Tax Court
UK	United Kingdom of Great Britain and Northern Ireland
USA	United States of America
VAT	Value-added Tax

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

“The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.” Jean-Baptiste Colbert (1619–83), Finance Minister to King Louis XIV of France (Frecknall-Hughes, 2015:10).

The fundamental unpopularity of Taxation seems to be the one underlying theme that emerges from a study of tax history (Frecknall-Hughes, 2015:10). According to Frecknall-Hughes (2015:20), any system that is adopted must be acceptable to those affected by it if civil dissension is to be avoided. Since the state must balance fiscal constraints and the need to finance public expenditure with the nature and extent of revenue collection, any system of taxation should adhere to certain fundamental principles.

Although taxes have several functions, for example to discourage undesirable social behaviour (Du Preez, 2016:167), the most significant reason for collecting taxes, according to the OECD (2014:30), is to collect revenue to finance state expenditure. This idea is supported by Adams (2001:1), who states that tax is “the fuel that makes civilisation run”. The OECD (2014:30) warned that given the current global economic climate, governments will have to deal with the reality of less revenue and increasing expenditure, in other words, having to do more with less. The importance of adhering to the fundamental principles of taxation therefore becomes even more crucial.

Du Preez (2016) proposes six Fundamental Principles of Taxation. A single question that was posed in writing to international taxation experts required them to indicate the proposed Fundamental Principle of Taxation that they regarded as the most important (Du Preez, 2016). The Principle mentioned most often by the experts, and therefore emphasised the most during the discussion, was Neutral, Understandable Legislation. This indicates that, in the opinion of the participating international experts, Neutral, Understandable Legislation is the highest-ranking of the proposed Fundamental Principles, which suggests that it deserves to be further researched. The aim of this study is therefore to focus on the Fundamental Principle: Neutral, Understandable Legislation, and on exploring the five factors that

contribute to this Fundamental Principle, namely Simplicity, Neutrality, Optimal design, Certainty and Tax Law. The development of, adherence to and application of this Fundamental Principle and its contributing factors will be examined from ancient times to the present day, before concluding on the relevancy and applicability of the Fundamental Principle: Neutral Understandable Legislation to the field of Taxation.

1.2 RATIONALE FOR THE STUDY

Historical records suggest that guiding principles for Taxation were first formulated by Confucius in circa 500 BC (Du Preez, 2016:3). Adam Smith famously attempted to codify the most important Fundamental Principles of Taxation, which he referred to as maxims, in *An inquiry into the nature and causes of the wealth of nations* ([1776] 2005), which included the following:

- “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”
- “The tax which each individual is bound to pay, ought to be certain and not arbitrary.”
- “Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.”
- “Every tax ought to be so contrived, as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state” (Smith, [1776] 2005:676-678).

According to the OECD (2014:29) the “overarching principles” that are deemed to “have traditionally guided the development of tax systems” include Neutrality, Efficiency, Certainty and Simplicity, Effectiveness and Fairness, and Flexibility, which broadly correspond with Smith’s maxims (OECD, 2014:30-31).

However, as noted by Du Preez (2016:5), the Principles formulated by different organisations, committees and governments do not seem to be based on scientific evidence, but rather, in some form or another, on Smith’s maxims. The practical application of some of the previously defined Principles of Taxation has been examined to some extent by

scholars in the field of Taxation (Du Preez, 2016:6), who compiled various sets of proposed Fundamental Principles, one of which is Neutral, Understandable Legislation (Du Preez, 2016:73-79). Additional analysis of this principle is deemed necessary to further substantiate the validity of the contributing factors and their influence on this Fundamental Principle.

1.3 PURPOSE STATEMENT

The main purpose of this study is to explore the development, meaning, application and importance of one of the proposed Fundamental Principles of Taxation, namely Neutral Understandable Legislation. From ancient to modern times, several factors have contributed to the development of this Principle, and its role and application in tax policy design for the 21st century will be analysed in the global context.

1.4 RESEARCH OBJECTIVES

The research objectives of this study are:

- To explore and analyse the meaning, development, historical application and importance of the Fundamental Principle: Neutral, Understandable Legislation, and the factors that contributed to its development from ancient to modern times.
- To evaluate the current application of the Fundamental Principle: Neutral, Understandable Legislation on a global scale, with specific emphasis on South Africa, by examining current legislation, tax systems and reviews of tax systems, for example, reviews by the Davis Tax Committee.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

According to Frecknall-Hughes (2015:20), it would seem that taxes are generally unpopular, even though the need for systems of taxation has become evident. Ample evidence exists that unfair systems of taxation have caused much unrest in the past (Frecknall-Hughes, 2015:10-14). Since any taxation system adopted should be acceptable to those affected by it if civil dissension is to be avoided, it is becoming increasingly important to identify, formulate and critically assess the Fundamental Principles of Taxation (Du Preez, 2016:3).

The current study explores and scrutinises the development and application (both historical and contemporary) of the factors contributing to the Fundamental Principle: Neutral, Understandable Legislation. The five contributing factors, as identified by Du Preez (2016:153-156), are Simplicity, Neutrality, Optimal design, Certainty and Tax Law.

In order to further validate each factor in support of the Fundamental Principle, i.e. Neutral, Understandable Legislation, it is imperative to obtain additional evidence in support of the underlying factors. Each of the five contributing factors will be thoroughly studied to ensure that they are well understood. The development and application of these contributing factors will also be documented, and examples of the role played by the Fundamental Principle: Neutral, Understandable Legislation in tax jurisdictions around the world will be highlighted.

1.6 LIMITATIONS AND ASSUMPTIONS

1.6.1 Limitations of the study

This study has the following limitations:

- The study focuses only on the Fundamental Principle: Neutral, Understandable Legislation and its contributing factors, and does not cover any other Fundamental Principles of Taxation that are evident in this text, or that might become apparent during the course of the study.
- The evaluation of the application of the Fundamental Principle: Neutral, Understandable Legislation on a global scale is not exhaustive and does not include every sovereign state in the world. The study will include examples that are applicable specifically to South Africa.

1.6.2 Assumptions

An assumption is “a condition that is taken for granted, without which the research project would be pointless” (Leedy & Ormrod, 2012:5). This study is underpinned by the following basic assumptions:

- Historical records provide an accurate account of past events and can be relied upon.
- Taxes are imposed by sovereign states to a greater or lesser extent – and the Fundamental Principles of Taxation are therefore applicable.

1.7 RESEARCH METHODOLOGY

Since this study is, to a large extent, based upon historical facts, a non-empirical research method of a qualitative nature would be most appropriate. Philosophical analysis, conceptual analysis, theory-building studies and literature reviews are examples of non-empirical research methods (Mouton, 2001:175-179). This study can be described as solely an extended systematic literature review. According to Saunders, Lewis and Thornhill (2009:61), the purpose of a literature review “is not to provide a summary of everything that has been written on [the] research topic, but to review the most relevant and significant research on [the] topic”. Furthermore, research possibilities that were overlooked can be identified by way of a literature review, which can lead to possible recommendations for further research (Saunders *et al.*, 2009:61).

1.8 STRUCTURE OF THE MINI-DISSERTATION

The main outcomes of this study are presented in the format of a mini-dissertation. The structure of the mini-dissertation is explained and summarised below.

1.8.1 Chapter 1: Introduction

Chapter 1 provides an introduction and background to the current research and also sets out the research objective. The rationale for the current research is discussed, its delimitations are explained and the research design and methodology are briefly summarised.

1.8.2 Chapter 2: Introduction to Fundamental Principles

Chapter 2 introduces and defines the Fundamental Principles that are relevant to the main and secondary objectives of the study. This extended literature review analyses the concept “Fundamental Principle” to provide insight into and clarity on exactly what will be evaluated in this study.

1.8.3 Chapter 3: Neutral Understandable Legislation

Chapter 3 provides an extended review of the available literature on the Fundamental Principle: Neutral, Understandable Legislation and its five contributing factors, namely Simplicity, Neutrality, Optimal design, Certainty and Tax Law. The definition of each factor is considered, as well as the reason for regarding it as a component of Neutral, Understandable Legislation. This is followed by a study of the origins of the factor and its historical development, after which its current application and general trends are assessed. The chapter concludes with a summary.

1.8.4 Chapter 4: Conclusion and analysis

Chapter 4, the final chapter, contains a summary of the findings and conclusions of the research and a discussion of the contribution and limitations of the current study, and also makes suggestions regarding possible future related research.

CHAPTER 2: INTRODUCTION TO FUNDAMENTAL PRINCIPLES

2.1 INTRODUCTION

In Chapter 1, the importance of the Fundamental Principles of Taxation was discussed. One particular Fundamental Principle, namely Neutral, Understandable Legislation, was identified as the topic for this study, since a group of international experts indicated it as the highest ranking of the proposed Fundamental Principles.

The purpose of this chapter is to provide an overview of the Fundamental Principles of Taxation in general before addressing the concept of Neutral, Understandable Legislation in more detail. The chapter commences with a brief history of the Fundamental Principles and a discussion of the historical emergence and development of these Principles through the ages. The term Fundamental Principle is defined and its characteristics are discussed. Furthermore, the ideas of the most notable thinkers on the topic are discussed. To conclude the chapter, attention is given to the need for Fundamental Principles of Taxation and how they are formulated.

2.2 A BRIEF HISTORY

Taxation has a very long and complicated history and has possibly been in force since the earliest advanced civilisation (Frecknall-Hughes, 2015:9). As posited by Adams (2001:xxi), the decline and prosperity of nations have always, to some extent, featured taxes. According to Adams (2001:1), every known civilisation has levied taxes of various kinds. Along with Taxation, Fundamental Principles have developed over time to guide the nature and extent to which the populace should be taxed to avoid civil dissension (Frecknall-Hughes, 2015:20). It was, however only in the work of Adam Smith, in 1776, that these Fundamental Principles were eventually formulated and recognised (Du Preez, 2016:74). A brief overview of the endeavour to formulate Fundamental Principles for Taxation will be provided. First, the emergence of Fundamental Principles in the ancient kingdoms will be examined. This will be followed by a discussion of the development of these Fundamental Principles during the Dark and Middle Ages, and finally the advancement of the Fundamental Principles during the Modern Age will be explored.

2.2.1 Historical emergence of the Fundamental Principles of Taxation

According to Du Preez (2016), certain distinct Fundamental Principles became evident during different eras throughout history, as will be briefly discussed below.

2.2.1.1 *Ancient kingdoms*

- *A lawful and impartial tax system should lead to truthful and law-abiding taxpayers.*

In ancient times, this Principle was equivalent to the modern understanding of “equity” and “equality”, which, even though they had distinctly different meanings and applications, overlapped on occasion (Du Preez, 2016:84).

In Ancient China, around 500 BC, Confucius formulated a tax philosophy that was applied for more than two thousand years (Adams, 2001:45). He argued that, in an ideal system, taxes should be set at 10% of a taxpayer’s income. This principle was faithfully observed by taxpayers (Du Preez, 2016:84). Even the tyrannical leader Genghis Khan adhered to this principle, although he applied the 10% principle to everything, including people (Adams, 2001:46).

Numerous contributors have formally documented attempts to create fair and just tax systems since 1643, during the period of Enlightenment (Du Preez, 2016:85). During the 19th century, after numerous taxpayer revolts and even wars, governments eventually started devising tax systems that would be perceived by taxpayers as fair, just and equal (Du Preez, 2016:85).

According to Adams (2001), the levying of income tax does not support the idea of equality, but rather leads to deliberate and conscious inequality (Du Preez, 2016:85).

The idea of equality emerged to have two distinct meanings, which warrant further discussion:

- In the first instance, equality means that the taxpayer's circumstances are taken into account, for example, if two taxpayers earn the same income, the one who has more dependants might pay less tax. In this regard Du Preez (2016: 86) states that "Entities/individuals should be taxed impartially on their sustainable value".
- In the second instance, equality means that all taxpayers are treated the same, for example, all taxpayers who fall within a certain income bracket will be taxed equally, regardless of their circumstances. The reasoning for this is that all economic peers in a given society should be treated equally. Du Preez (2016: 85) articulates this as follows: "Entities/individuals should be taxed according to their economic status in the same way as their economic equals."

- *"Entities/individuals should be taxed impartially on their sustainable value"*

Du Preez (2016:85) notes that the taxes implemented by Aristides in Ancient Greece were calculated according to taxpayers' ability and level of wealth, and that this was the origin of tax equity.

Smith's ([1776] 2005) maxim of ability-to-pay also follows this dictum, as he states that "every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it". In other words, tax payments are contingent upon the taxpayer's ability to pay at a given moment and in the required manner (Du Preez, 2016:86).

- *"Entities/individuals should be taxed according to their economic status in the same way as their economic equals"*

During the 18th century, Verri declared that taxes should bring "equilibrium" (Du Preez, 2016:86). Du Preez (2016) further argues that one of the reasons for the outbreak of the American Civil War was that all taxpayers were taxed equally, regardless of their financial worth. Governments started instituting uniformity for all taxpayers when imposing taxes, as they perceived this to be fair and equal.

- *Rigorous systems and measures should be employed to promote compliance with tax legislation.*

Ancient Greece saw a rise in tax revenue in the 5th Century BC due to sound tax administration (Adams, 2001).

In approximately 30 BC, Emperor Augustus of Ancient Rome instituted decentralised tax bureaux. He negotiated terms with each provincial town and delegated the responsibility of tax collection to its people, which led to honest and reliable tax collection. The efficient collection of tax revenue, in turn, allowed Augustus to lower tax rates, which resulted in improved conditions for the poor (Adams, 2001).

Princess Olga of Russia implemented a fair and decentralised tax system in approximately 950 AD (Adams, 2001).

In circa 1750 BC, the emperors of China and Mesopotamia instituted a new practice called tax farming, a system in which private and often brutal tax collectors were contracted by the state to collect taxes. This practice was applied by various governments and rulers over the centuries, including Rome, Egypt, Greece and Great Britain. Tax farming entailed that prospective tax farmers bid at auctions for the right to collect a particular form of tax from a particular group or area and accepted responsibility for any losses. This method of collection was considered to be very effective, but tax farmers tended to abuse taxpayers (Adams, 2001). Among the most abusive of tax farmers were the Publicani of Ancient Rome, who were described as a “band of robbers” (Du Preez, 2016:87). The practice of tax farming continued to be widely used until the time of the French Revolution in 1789, when several tax farmers faced execution as punishment for their cruel practices (Adams, 2001).

According to Du Preez (2016), some researchers speculate that poor tax administration and tax evasion contributed to the fall of Rome, as very little tax revenue ultimately reached the government.

From the above it is clear that compliance is undoubtedly dependent upon the enforcement of tax legislation. Non-compliance by taxpayers should, however, be properly considered and appreciated by governments, and taxpayers' dissatisfaction with a tax system should be thoroughly heeded (Du Preez, 2016:88).

- *The redistribution of wealth should be a function of taxation*

The ability of ancient civilisations to sustain themselves was overtaken by the greed of rulers who enslaved their people through harsh tax practices, such as tax farming (Du Preez, 2016:88).

The Meade Report (1978) published in England added the redistribution of wealth to Adam Smith's ([1776] 2005) maxims. Today, governments regard the redistribution of wealth as crucial (Du Preez, 2016:88), and in South Africa especially, this has become a topic of constant scrutiny and debate.

- *Taxes should hold sustainable benefits for the public*

Taxpayers in ancient kingdoms voluntarily paid taxes to their rulers in return for protection, justice and the general welfare of the people (Du Preez, 2016:88).

Du Preez (2016) posits that taxes in ancient times were paid primarily to ensure the following:

- The welfare of the royal family and the military
- Provision for food shortages
- Maintaining law and order
- The safeguarding of the people's property and livelihood

In England, the Magna Carta of 1215 separated the power to levy taxes from the power to spend, and reigned in the king's spending by requiring him to seek the consent of the newly formed House of Commons before instituting a new tax (Adams, 2001).

Heavy taxation and insufficient government protection led to the fall of both the Roman and the Islamic Empires (Du Preez, 2016:90).

As is clear from the above, dissent among taxpayers should be prevented by ensuring that Taxation holds benefits for those being taxed. Taxpayers expect protection and infrastructure in return for their contributions (Du Preez, 2016:90).

- *A tax system should be administered as efficiently as possible by minimising waste and implementing effective procedures*

Unproductive tax administration procedures require a larger revenue authority to administer the tax system, which results in higher taxes and increased wastage (Du Preez, 2016:90). The Spanish Empire is a prime example of this kind of maladministration as large numbers of taxpayers entered the civil service to avoid having to pay taxes. Du Preez (2016) argues that any form of taxation that is expensive to administer should be avoided.

Other examples of bad taxes are taxes that subject taxpayers to complex investigation by tax officials, expose them to danger (as seen in the case of the Publicani in Ancient Rome), annoying and somewhat ridiculous taxes (such as the tax on beards introduced by King Henry VIII of England in 1535), and taxes that oppress the people, such as the taxing of Jews in Ancient Egypt (Adams, 2001).

It is clear that efficient tax administration leads to optimal revenue with the lowest possible tax burden (Du Preez, 2016:91).

2.2.1.2 The Dark and Middle Ages

- *Governments should receive income from their people, but state expenditure should be balanced with the tax burden to avoid excessive taxation.*

In the 14th century, the French king claimed the right to receive regular tax payments from his people, excluding the church and nobility, and thereby affirmed the government's right to receive income from its citizens (Adams, 2001).

When there is mutual respect between a government and its people, the rule of demanding only that which is required, and not what is desired, should apply (Du Preez, 2016:91). If this notion is ignored, it could result in tax avoidance and other adverse effects, such as uprisings. Pervasive tax evasion should be seen by governments as a warning sign that taxes may be unfair and overly burdensome (Du Preez, 2016:92).

In 1820 John Taylor, a senator from the state of Virginia in the USA, compared Switzerland to France and Italy and remarked that a government is rich when its people are poor, and the people are rich when its government is poor (Adams, 2001:186). This phenomenon seems to indicate an inverse relationship between the wealth of a government and that of its people.

- *The public should perceive taxes as transparent and understandable.*

A tax system that is seen to be equitable is likely to be more readily accepted by the general public (Du Preez, 2016:93).

Since the revolt of the Swiss against the tax practices of the Austrian Hapsburgs in 1273, taxation in Switzerland has largely been an affair for the people. In the Swiss state, matters relating to taxation have to be submitted to the voters and taxes cannot be instituted unilaterally by the government. An argument can be made that this system truly exemplifies the idea of separating the power to tax from the authority to spend. Taxes cannot be increased, or new taxes instituted, without the consent of the Swiss people. The Swiss have exceptional freedom from tax authorities at a time when the taxing powers of sovereign states seem to be ever-increasing (Adams, 2001:190).

2.2.1.3 *The Modern Age*

- *Taxes should be levied on disposable wealth, rather than on income required to produce sustainable earnings in the future.*

In 1830, Paley stated: “We should tax what can be spared” (Du Preez, 2016:93). This corresponds with Turgot’s suggestion made in 1764, several years before the French Revolution (1789), that tax should be levied on income that is not required for future revenue generation (Du Preez, 2016:93). The Asprey Review (1975) and the Meade Review (1978) also reiterated that income streams should be taxed in a sustainable manner. Governments need to ensure that taxation is applied in such a way as to preserve the wealth required for future income generation (Du Preez, 2016:94).

- *The timing, manner and amount of payment should be clear to taxpayers and there should be no uncertainty regarding taxes*

Certainty is one of Adam Smith’s ([1776] 2005) four maxims. He declares that “the time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor” (Smith, [1776] 2005:676). He further declares that, in his opinion, “a very considerable degree of inequality” is “not near so great an evil as a very small degree of uncertainty” (Smith, [1776] 2005:677).

In an attempt to create certainty regarding taxes in 19th-century England, it was proposed that noblemen be taxed at a fixed amount per year according to their rank, and commoners at 5% on their annual income, while the poor would be exempt from taxes (Du Preez, 2016:94). Arbitrary taxes were, however, sometimes introduced to obtain funding for a specific goal. Charles I, for example, imposed duties without parliamentary consent to fund naval expeditions against Spain (Du Preez, 2016:94).

Several tax reviews and reports, including the recent Mirrlees Review (2011), highlighted the importance of certainty in tax systems.

- *The tax regime should be stable, but also flexible*

According to Du Preez (2016), income taxes brought about stability for tax regimes, whereas previously governments and rulers strained to identify and comprehend what and how to tax.

In 1799, the British imposed an income tax that generated enough revenue to enable them to defeat Napoleon in the Battle of Waterloo in 1815 (Adams, 2001). After the war, the tax was repealed, but, having been so effective at raising revenue for the state, it was imposed again in 1842 and remains to this day. Today, income tax is common in many tax jurisdictions and is described by Adams (2001:345) as “the golden egg which collects more income than any other type of tax”. Adams’ observations are also true for South Africa, where personal income tax accounted for 36.4% and corporate income tax for 18.1% of the total tax revenue for the 2015/2016 fiscal year (SARS, 2016:2).

Du Preez (2016) posits that income tax should also be flexible, as a rigid income tax system will corrupt the social order and lead to tax evasion by taxpayers through illegal means, immigration and the transferring of assets to favourable tax jurisdictions (Du Preez, 2016:95). In 1998, the OECD further emphasised the idea of flexibility in a tax system (Du Preez, 2016:96).

- *The internal position of a country’s taxes should be consistent with international trends*

Modern-day globalisation requires that the internal tax system of a country should, as far as is practically possible, correspond with international tendencies and policies in taxation (Du Preez, 2016:96). To facilitate trade between countries and avoid double taxation, it is essential that the tax systems of different countries be compatible (Du Preez, 2016:96). Trade and investment are deterred when a

country's tax policies are unfavourable to traders and investors. The Meade Report, published in the United Kingdom in 1978, affirmed the necessity for a state's tax system to conform to international standards and practices when it expanded on Smith's ([1776] 2005) four maxims to include this idea in the report. Therefore, although the tax system of every country may be unique, it should take international trends and positions into account (Du Preez, 2016:96).

- *Tax policies can be utilised to influence unwanted or improper social behaviour*

The Mirrlees Review (2011) suggested that fiscal policies should be able to influence behaviour and correct market failures. An array of taxes attempt to influence the behaviour of taxpayers, for example (Du Preez, 2016:97):

- sin taxes, such as taxes on tobacco and alcohol to discourage smoking and excessive alcohol consumption, and provide state funding for campaigns to create awareness of and programmes to combat addiction;
- environmental taxes, such as taxes on carbon emissions released by motor vehicles and pollutants emitted by factories; and
- taxes on sugary drinks to encourage a healthy lifestyle, and a fat tax to curb the consumption of processed and unhealthy foods.

Du Preez (2016) maintains that taxes do not seem to be very successful at influencing social behaviour, as the demand for products on which such taxes are levied is relatively inelastic and remains constant, regardless of their price. If necessary, consumers of these products will turn to the black market where such products can be obtained at lower prices (Du Preez, 2016:97).

2.2.1.4 Concluding remarks

The rise and fall of empires and kingdoms were often dependent upon their ability to understand the intricacies of Taxation and implement effective legislation and means of collection. The importance of Fundamental Principles has been appreciated since the start of the earliest recorded civilisations, albeit not properly understood or perhaps wilfully ignored, for example, the *alcabala* of the Spanish Empire (Adams, 2001).

Different periods throughout history have produced many Fundamental Principles of Taxation, as discussed above. Every era developed Principles stemming from experiences and circumstances at the time, often after much bloodshed and sacrifice.

As Du Preez (2016) observes, guiding Principles for Taxation have been formed and proposed over many centuries by governments, individuals and committees. Yet no universal set of Fundamental Principles of Taxation currently exists and the development and refinement of the various proposed Fundamental Principles, as well as the search for new concepts, continue.

2.3 WHAT IS A FUNDAMENTAL PRINCIPLE?

The meaning of the words fundamental and principle has to be established before the concept Fundamental Principle can be defined. Since no philosophical dictionary seems to contain a definition of this concept, the definition provided by a general dictionary will be interpreted.

2.3.1 Fundamental

The Oxford English Dictionary (2013) explains the word fundamental as “forming a necessary base or core; of central importance”. The word fundamental therefore connotes that part of something that is considered to be of central importance, i.e., the most vital part of something, which must be identified in order to draw conclusions and arrive at secondary assumptions. An assumption is an estimation or approximation of the presence of a fact, based on the proven existence of another fact; therefore, the central or fundamental truth must first be known. Synonyms include the words basic, underlying and elementary.

2.3.2 Principle

A principle is generally understood to be a notion that guides judgement and conduct and represents the essential characteristics of a subject or system. Either it has to be obeyed, or preferably followed, or it is an unavoidable result of a certain action or train of thought (Du Preez 2016).

Du Preez (2016:33) suggests that a principle in the context of this study could be defined as “the source, origin or general truth that is the essence of a chain of reasoning”. To identify the principle of a subject, it is necessary to scrutinise and understand a chain of reasoning or the process of thought or logic, which will give rise to the emergence of the substance or core of a subject (Du Preez, 2016:33). The substance or core equates to the “general truth, origin or source” of the subject and hence, its principle (Du Preez, 2016:33).

2.3.3 Fundamental Principle

The above analysis indicates that a fundamental principle could be defined as the essential characteristics of a subject or system that guide the judgement and conduct thereof. These key features are at the core of a particular practice, discipline or matter, without which further inferences cannot be made. It is the basis of, and point of departure for, all further assumptions, conclusions and actions.

General dictionaries define a fundamental principle as “a principle from which other truths can be derived” (Du Preez 2016:32).

Du Preez (2016:34) formulated the following working definition of a fundamental principle:

- “It is a general truth;
- it forms the most important part of the foundation of a unique field of study;
- it is identified through a chain of reasoning; and
- theories and applied practices can be derived from it and are verified in accordance with the current knowledge available.”

2.3.4 What Fundamental Principles are not

According to Du Preez (2016:80), applications represent the function of taxation and are therefore not fundamental elements that underpin Taxation as such. Consequently, these applications cannot be regarded as Fundamental Principles of Taxation, but do, however, play a notable role in forming best practice for taxation policy. Du Preez (2016:80), provides the following examples of such applications:

2.3.4.1 Calculation of taxes

The calculation of taxes has always been a point of contention, as discussed below.

In Ancient Egypt, tax collectors, known as scribes, enforced the pharaoh's taxes through annual audits (Adams, 2001:6). Harvests were taxed at a rate of 20% (Adams, 2001:7), based on the scribe's estimate of the cultivator's crop. When calculating the tax liability, the scribe took into account certain factors, such as the level of the Nile and the status of the farmer. During the earlier Modern Age, taxes were even calculated based on the number of windows or chimneys in a taxpayer's house (Adams, 2001).

As governments today still attempt to find more suitable means of imposing taxes, some alternative suggestions have arisen (Du Preez, 2016:81):

- Taxes might be levied on the average income earned during a specified number of years or periods.
- Taxes might be levied on the economic well-being of a taxpayer.
- Taxes might be levied on the measure of consumption, rather than on income.

2.3.4.2 Liberty and taxes

Throughout history, Taxation has regularly contributed to the oppression of a country's citizens. Governments will often impose harsh taxes to finance their ambitions (Du Preez, 2016:81). Du Preez points out that Adams (2001:282) proclaimed that "taxation produces tyranny", whereas Montesquieu remarked that "the effect of excessive taxes is slavery". Direct taxes and arbitrary taxation can be seen as enemies of liberty (Du Preez, 2016:81). The American War of Independence (1775–1783) was fought for the liberation of the thirteen colonies of British North America from, among other things, being taxed by the British (Adams, 2001).

According to Du Preez (2016:82), both individual and financial privacy are also themes that may be included in the issue of liberty. The intrusion of one's home to count fireplaces is one example of an infringement upon individual privacy, and this infringement was the main reason for the cancellation of the hearth tax, i.e. taxes on fireplaces, in England. Instead, a tax on chimneys was introduced, as chimneys were visible from the outside. Individual privacy has since become an integral part of English Common Law, which states that "a man's house is his castle" (Adams, 2001:6).

A good example of financial privacy is the Swiss approach to bank secrecy, which holds that bank secrecy protects the liberty of the people from overreach by the state (Du Preez, 2016:82).

2.3.4.3 Tax immunity

Tax immunity is an ancient concept, dating back to the first recorded era of Taxation, and has been applied in different ways with different intentions in mind (Du Preez, 2016:82).

Tax reforms that were implemented after the rule of Pharaoh Akhenaten in the 13th century BC included tax exemption for temples and priests, and led to the slow decline of the Egyptian Empire over the next thousand years (Adams, 2001:5). Even the inscriptions on the Rosetta stone, which dates back to 196 BC, revolved around taxes as they honoured the pharaoh Ptolemy V, who restored tax exemptions for temples. The discovery of the stone by one of Napoleon's soldiers in 1799 was one of the most significant Egyptian archaeological discoveries as it holds the key to understanding Egyptian hieroglyphs (Adams, 2001:17–18).

Shortly after the fall of the Roman Empire, Islamic armies conquered large parts of the Middle East, North Africa and Spain. The inhabitants of these areas were given a choice – they could accept Islam as their religion and pay no taxes, or refuse to do so and pay heavy taxes (Adams, 2001:132). Many chose Islamisation over the burden of high taxes.

The Spanish Empire provided tax immunity to its civil servants. This led to large numbers of people entering the civil service, thus depriving the government of tax revenue.

In England, the despised poll tax adopted by Parliament in 1641 was repealed and replaced in 1698 by a window and house tax. Every house with more than seven windows was taxed one shilling per window. This form of taxation exempted the poor from taxation, as they rarely owned property (Adams, 2001:259).

2.4 CHARACTERISTICS OF A FUNDAMENTAL PRINCIPLE

The working definition mentioned in the previous paragraph can be analysed as follows:

2.4.1 A fundamental principle is a general truth

The Oxford English Dictionary (2013) defines the word truth as “that which is true or in accordance with fact or reality”. Du Preez (2016:35) concluded that in this instance, truth can be defined as “a fact or reality that is verified or proven according to the current knowledge available to humanity”.

2.4.2 A fundamental principle forms the most important part of the foundation of a unique field of study

Foundation, according to the Oxford English Dictionary (2013) is purported to be “an underlying basis or principle”. In other words, it provides support for something. Du Preez (2016:36) states that, in this context, a foundation is a general truth that supports and underlies a unique field of study. In this instance, the unique field of study is taxation.

2.4.3 A fundamental principle is constructed through a chain of reasoning

Du Preez (2016:36) defines a chain of reasoning as “the repeated process of thinking in a logical, sensible way in order to allow the mind to form a conclusion about something”, in this case, taxation.

2.4.4 Theories and applied practices can be derived from a fundamental principle and are verified according to the knowledge currently available

Du Preez (2016) suggests that it is essential to examine history to assist in the identification of the fundamental principles of taxation, as history most profoundly demonstrates the development of ideas and principles relating to taxation.

2.5 THE PHILOSOPHERS OF TAX THEORY ON FUNDAMENTAL PRINCIPLES

Throughout history, many thinkers have theorised about what should be the Fundamental Principles of Taxation. Modern tax theory is often argued to have started most notably with Adam Smith (Frecknall-Hughes, 2015:20). However, several renowned economists and philosophers preceded Smith, such as Thomas Hobbes (1588-1639), who believed that tax should not be connected to the wealth of a person, but rather to the debt he owed to the state for their defence and for maintaining the rule of law. William Petty (1623-1687), another such thinker, favoured consumption taxes and suggested various kinds of public charges – defence, education, governance, infrastructure, the support of the needy and things relating to the universal good (Frecknall-Hughes, 2015:20).

However, there are many reasons for the development of modern tax, especially during the so-called Age of Enlightenment, from approximately 1688 to 1800 (Frecknall-Hughes, 2015:21), when intellectuals were less repressed by religion and governments. During this period of clarification, Adam Smith and his more immediate fellow thinkers started hypothesising about a wide range of topics, including Taxation. A summary of the thoughts of the more prominent scholars of the Age of Enlightenment is provided below.

2.5.1 John Locke (1632–1704)

Although Locke wrote little, what he did write about Taxation was meaningful and established the social contract theory. He posited that the voluntary relinquishing of individual rights (i.e. handing the state the right to impose taxes) could be exchanged for state protection of property. The levying of taxes would otherwise be seen as a form of

legitimised theft. In stating that taxes should be imposed with the consent of a majority of the people, Locke identified the most fundamental tension inherent in the payment of taxes in exchange for state protection or other benefits. This inherent tension is still prevalent today and is arguably one of the reasons, and perhaps even the most important reason, for tax avoidance and evasion (Frecknall-Hughes, 2015:21–22).

2.5.2 Samuel Johnson (1709–1784)

Johnson theorised along the same lines as Locke, arguing that American colonies during the 1770s had an obligation to pay taxes in return for protection by England (Frecknall-Hughes, 2015:23).

2.5.3 David Hume (1711–1776)

Hume is seen by many as discrediting Locke's social contract theory. An inference can be made from Hume's work that he argued that a person has a civic duty to pay taxes in support of the society desired by man. He further argued that one cannot speculate as to why taxes might exist, but should accept Taxation as it has been customarily developed (Frecknall-Hughes, 2015:24).

2.5.4 Adam Smith (1723–1790)

Smith outlined his maxims of Taxation in Book 5 of his great work, *An inquiry into the nature and causes of the wealth of nations* (1776), which today remain the fundamentals of taxation theory to many, albeit somewhat flawed (Frecknall-Hughes, 2015:25).

Smith's first maxim is the concept of equity, which is today interpreted as meaning that people should pay taxes in proportion to their "ability to pay". A progressive income tax system is an example of equity – those who have higher incomes, pay more taxes. According to Smith, the introduction of consumption taxes on luxuries is another such example, as it will discourage people from lower income groups to consume goods they can hardly afford and might be a lucrative means of collecting taxes from the more affluent

(Drenkard, 2015:8). Toll fees, or user taxes, are also perceived by Smith (1776) as a form of equity, as the cost of goods or services supplied by the government is aligned with the advantage taken by the user of those goods or services.

The maxim of certainty of taxes to be paid is also difficult to achieve, as tax laws are often open to interpretation and the general public may find it difficult to comprehend complex tax laws, which are inherently subject to change, sometimes retroactively. In the United States, for example, state taxes are occasionally altered retrospectively, causing considerable uncertainty among taxpayers with regard to the amounts they should actually pay (Drenkard, 2015:10).

The convenience of payment maxim is also a contentious subject, as the exact amount to be paid is not always known at the time of payment, for example, unearned income might still be taxable at some future date. Considerable compliance costs are often incurred when audits are performed or when employers deduct tax from the income of employees and pay it to the revenue authorities. However, in South Africa, for example, the Tax Administration Act 28 of 2011 (hereafter referred to as the Tax Administration Act), provides for certain periods during which returns must be filed and dates by which assessments relating to such returns must be paid.

Efficiency is the final maxim and is relatively simple to comprehend – the cost of the administration of a tax should not exceed the amount that it contributes to the state coffers. Inefficiencies in tax systems are well documented and include high administration costs incurred by a revenue authority, including ardent auditing practices; foregone growth due to, for example, double taxation; and tax evasion due to heavy tax burdens (Drenkard, 2015:15).

2.5.5 Edmund Burke (1729–1797)

Burke theorised that a compromise must be reached between a state and its people regarding taxes – “we remit some rights that we may enjoy others” (Frecknall-Hughes, 2015:28).

2.5.6 Thomas Paine (1737–1809)

Paine extended Smith's analysis of taxes and developed the idea of the benefit expected to be received in return for taxes paid by analysing how much tax revenue should be raised and how it should be spent (Frecknall-Hughes, 2015:30).

2.5.7 Summary

The above demonstrates that philosophers and leading minds spent time to develop the Principles of Taxation. Distinct differences were identified, but also commonality of thought between thinkers, such as their ideas about the relationship between the government and the individual; the right of government to tax; the right of the individual to own property; principles contained in an "ideal" tax system; the proper application of Taxation; and the role of legislation and also of government in the implementation, application and interpretation of the relevant legislation (Frecknall-Hughes, 2015:36).

2.6 ADHERENCE TO, AND FORMULATION OF FUNDAMENTAL PRINCIPLES OF TAXATION

2.6.1 Reasoning

According to Frecknall-Hughes (2015:4-6), the reasoning behind the decision to impose taxes in a well-developed democratic country with a market economy may be as follows:

- *Providing public goods and services*
People cannot refuse to consume public goods or services, whether they want to or not. Examples are national defence and critical infrastructure, such as power plants.
- *Redistribution of wealth*
Taxes paid by one person may be redistributed to another in the form of welfare payments to promote social equality.
- *Promoting social and economic welfare*
On the one hand, the government may provide merit goods, such as education and health, which differ from public goods as they can also be provided privately. In this

case the reasoning is that society as a whole benefits from these merit goods which, for example, contribute towards ensuring a healthy and educated populace. On the other hand, society can be discouraged from consuming harmful goods, such as cigarettes and alcohol, by imposing high taxes on such goods. Because goods such as alcohol and cigarettes are quite popular, raising taxes in this manner might also be a lucrative form of tax collection for a government.

- *Economic stability*

The financial crisis of 2008/2009 provided evidence that governments are sometimes required to lend money to support their economies, for example by providing loans to enterprises or through large infrastructure projects.

According to the OECD (2014:30), the principal role of a tax system is to raise revenue. Frecknall-Hughes (2015:20) argues that there is an evident need for tax regimes. However, a delicate balance must be achieved between raising a certain level of revenue and imposing an unfair system of taxation on the populace, which may lead to civil dissent (Frecknall-Hughes, 2015:20). Adams (2001:xxi) argues that taxes move people to action, despite the denial of this by governments. Governments that institute oppressive tax regimes often face violent revolts by their taxpayers. According to Adams (2001:xxi), there are certain warning phases that can alert governments to impending rebellion by taxpayers due to perceived unfair taxes. The first warning phase comprises of schemes to avoid and evade paying taxes, the second phase is characterised by riots, and during the third phase violence and possibly even civil war will erupt. Adams (2001:xxi) warns that the imposition of unfair taxes can be catastrophic to any government (OECD, 2014: 30).

2.6.2 Formulation

Several thinkers and commissions throughout history have attempted to formulate Fundamental Principles of Taxation.

Adam Smith ([1776] 2005:676-678) first formulated the maxims of equity, certainty, convenience of payment and efficiency, which have been discussed in more detail above. Elements of Smith's maxims can still be found in most of the recent tax reviews (Du Preez, 2016:74-76). Over the next two centuries, many thinkers added to and expanded Smith's

maxims, such as Verri, who suggested that taxes should affect everyone according to their consumption, thereby facilitating equilibrium for every tax (Du Preez, 2016:76). In 1830, Paley attempted to formulate what should be taxed by declaring: “We should tax what can be spared.” Paley’s comments emphasised the opinion expressed by Turgot, who served as Minister of Finance under King Louis XVI of France, namely that tax should be levied on disposable income not needed for reinvestment (Du Preez, 2016:76). In 1861, Newmarch also expanded on Smith’s maxims by declaring that savings and capital contributions should not be taxed, and further posited that taxpayers could not assess themselves.

The Canadian Carter Report of 1966 is also of importance as it was the first to introduce the principles of transparency, accountability, flexibility and, most importantly, simplicity and neutrality (Carter *et al.*, 1966).

In Australia, the Asprey Review (1975) suggested that a good tax structure should consist of the guiding principles of simplicity, efficiency, economic and political flexibility and stability, and fairness. The report further pointed out the need to explore different bases for Taxation, for instance economic well-being and consumption, rather than income.

The Meade Report (1978), which was published in England, refined Smith’s maxims and provided an extended list of guiding principles. These principles included efficiency, effectiveness, the redistribution of wealth, equity, coherence, simplicity and ease, flexibility, stability, and also that taxes should be just, straightforward and compatible with the country’s international position.

In 1998, the OECD released a report that identified guiding principles for a framework for Taxation. Those principles were:

- certainty and simplicity;
- effectiveness and fairness;
- efficiency;
- neutrality; and
- flexibility.

The American Institute of Certified Public Accountants (AICPA) identified ten guiding principles for sound tax policy, which focus on economic growth, minimising the tax gap and revenue collection (AICPA, 2001).

In an extension of the Asprey Review in Australia, the Henry Review of 2010 confirmed the need for stability in a tax system and also included the principles of sustainability and policy consistency (Du Preez, 2016:79).

The UK's Mirrlees Review of 2011 proposed that Smith's maxims of 1776 be revisited and recommended that the adverse effects of Taxation on the welfare of society, as well as compliance cost, should be kept to a minimum, and that the tax system should be transparent and easily understandable to taxpayers (Mirrlees *et al.*, 2011)).

CHAPTER 3: NEUTRAL, UNDERSTANDABLE LEGISLATION

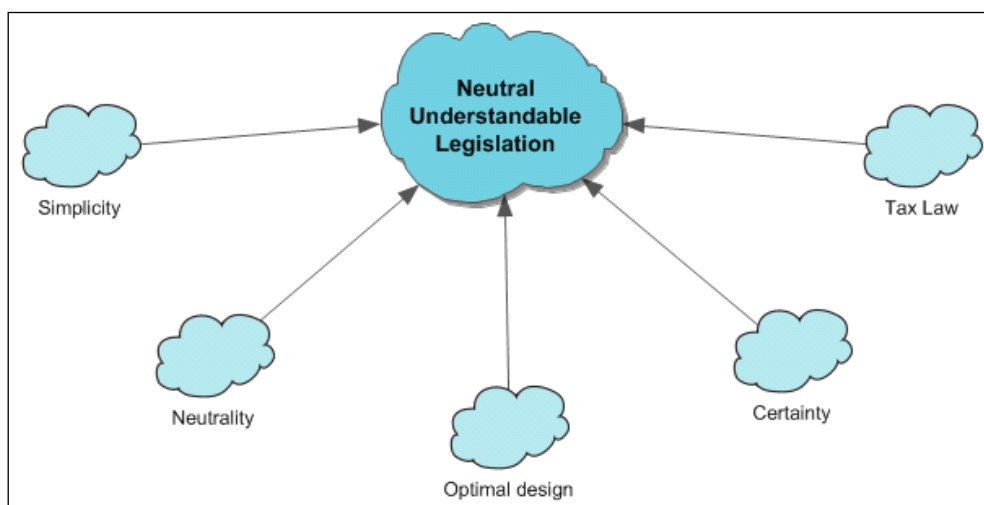
3.1 INTRODUCTION TO THE PRINCIPLE

Despite intense debate over the past 200 years about what the Fundamental Principles should entail (Du Preez, 2016:7), and the fact that several fundamental principles have been proposed throughout history (Frecknall-Hughes, 2015:20), no clear and definitive set of Fundamental Principles has yet been formulated.

Du Preez (2016) proposed such a universal set of Fundamental Principles. These principles included Neutral, Understandable Legislation which, according to her research findings, ranked first. Since this Principle is regarded as the most important, it was chosen as the topic of this study. Therefore, it is imperative to understand the origin and meaning of each of the contributing factors which underlie this Principle to further support its acceptance as a Fundamental Principle. Du Preez identified five contributing factors, namely Simplicity, Neutrality, Optimal design, Certainty and Tax Law (Figure 1).

For each factor, the definition will be considered, as well as the reasoning that led to its being considered a component of the proposed Fundamental Principle. This will be followed by a discussion of the origins of the factor and its historical development, after which its current application and general trends will be assessed.

Figure 1: Neutral, Understandable Legislation



Source: Du Preez, 2016

3.2 SIMPLICITY

3.2.1 Introduction, definition and reasoning

The American Institute of Certified Public Accountants (AICPA) defined Simplicity as follows: “The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.”

The OECD (2014) noted that Simplicity in a tax system helps individuals and businesses to comprehend their tax entitlements and obligations, while an overly complicated tax system may lead to aggressive tax planning by taxpayers, which may result in losses to the fiscus and the broader economy.

As observed by Du Preez (2016), Taxation tends to be complex, perhaps to achieve fairness and possibly also to serve other purposes, such as discouraging undesirable social behaviour (e.g. excessive alcohol consumption). Simplicity is regarded as a guiding principle since complex rules and regulations can lead to errors, reduced compliance and overall disrespect for the tax system (AICPA, 2001).

3.2.2 Origin

Throughout history, many attempts have been made to achieve Simplicity. One example of this is the tax philosophy of Confucius (circa 500 BC), who argued that taxes should be set at a fixed percentage of 10%. Another example is the despised poll tax introduced in England in 1641, which required the nobility to pay a fixed annual amount of tax, ranging from £10 to £100 per year, depending on their rank, and commoners at 5% of their annual income (Adams, 2001:259).

Simplicity was, however, only formally recognised as a guiding principle fairly recently. According to Du Preez (2016:74), it was first mentioned in the Canadian report of the Royal Commission on Taxation under Kenneth Carter (commonly referred to as the Carter Report) in 1966.

The Carter Report contains many references to the principle of Simplicity. With regard to gifts and donations, the Commission recommended that administration be simplified by granting certain annual exemptions to reduce the need to account for and value small gifts (Carter *et al.*, 1966, Volume 3:465). In another example the Commission, discussing a manufacturer's sales tax, argued that Simplicity and Certainty, on the one hand, and Neutrality on the other, shared an inverse relationship and stated that one could not be attained without sacrificing the other (Carter *et al.*, 1966, Volume 5:22). However, the Carter Report failed to provide a clear definition of what exactly Simplicity entails within the framework of the report, and it is therefore assumed that the meaning given in a general dictionary was intended.

3.2.3 Historical development

After the publication of the Carter Report (1966), the principle of Simplicity started gaining more formal recognition as a guiding principle and was frequently mentioned in reports and reviews. Simplicity as a Principle of Taxation was also mentioned in the Asprey Report (Australia, 1975), the Meade Report (United Kingdom, 1978), the O'Brien Report (Ireland, 1982), the OECD Report (International, 1998), the ICAEW Report (Wales, 1999), the AICPA Report (USA, 2001), the Alley and Bentley summary (Australia, 2005), the Report of the President's Advisory Panel on Federal Tax Reform (USA, 2005), the Henry Review (Australia, 2010), the President's Economic Recovery Advisory Board (USA, 2010) and, most recently, the reports of the South African Davis Tax Committee (2014).

The Asprey Report (1975) defines and details Simplicity within its specific terms of reference. The Report states that, after Equity, Simplicity is perhaps the most sought-after quality for a tax system (Asprey *et al.*, 1975:16). The meaning of Simplicity in the context of the Asprey Report (1975) was described as follows: "A tax will be called simple, relative to others, if for each dollar raised by it the cost of official administration is small, and if the 'compliance costs', i.e. the costs in money and effort of all kinds to the taxpayer, are also small" (Asprey *et al.*, 1975:16). The Report further states that the aforementioned definition signifies a connection between Simplicity and Certainty, as costs will be kept to a minimum if both the taxed and the taxpayer are certain of what is due and when it is due, and if additional

costs relating to consultations, enquiries, investigations and possible litigation can be avoided (Asprey *et al.*, 1975:16).

The Asprey Report (1975) further elaborates on its understanding of Simplicity as a concept by declaring that taxes can be considered simple if their computation aligns as closely as possible with calculations that the taxpayer had to perform for other uses, for example, if the taxable income or loss is calculated in much the same manner as profit or loss for accounting purposes, and used in the preparation of financial statements. Furthermore, the Report states that personal income tax is considered simple if taxpayers can easily determine their taxable income without intricate and tedious record keeping or the help of experts (Asprey *et al.*, 1975:16). The Report also observes that the fewer taxpayers there are to collect taxes from, the less complex a taxation system is required to be (Asprey *et al.*, 1975:16).

The Meade Report (1978) lists Simplicity as one of the features that define an effective tax system and states that “a good tax system should also be coherent, simple and straightforward” (Meade *et al.*, 1978:18). The Report also states that ordinary taxpayers should be certain of their tax liability and able to easily understand what is taxable and what is not (Meade *et al.*, 1978:18) and that Simplicity is a requirement for a tax system to ensure public understanding and the consequent acceptance of the system. The idea of Simplicity also applies to the ease of administration of the system, which should keep compliance costs for taxpayers to a minimum (Meade *et al.*, 1978:19–21).

The abovementioned reports highlighted the main arguments for, and characteristics of, Simplicity as a Fundamental Principle of Taxation and provided the basis and point of departure for subsequent reviews and reports.

3.2.4 Current application and general trends

According to Mirrlees *et al.* (2011:42), no tax system today is likely to be genuinely simple. As taxes become more complex, taxpayers strategically arrange their taxes in a manner that minimises their tax liability. In response to this, complex sets of rules are introduced to combat tax avoidance and “the process of avoidance becomes a game of cat and mouse played between the revenue authority and taxpayers” (Mirrlees *et al.*, 2011:42). This process

continues *ad infinitum* as new tax avoidance schemes are devised and then countered by litigation and new revisions to tax legislation, which also increases compliance costs (Mirrlees *et al.*, 2011:42).

In addition to the higher compliance costs incurred by a more complex tax system, money is also lost directly by revenue authorities (Mirrlees *et al.*, 2011:42). In the fiscal year 2008/2009, Her Majesty's Revenue and Customs of the United Kingdom estimated that approximately £42 billion had remained uncollected due to tax avoidance schemes and tax evasion. This resulted in a tax gap of approximately 8.6% (Mirrlees *et al.*, 2011:42). In 2001 the estimated tax gap in the United States of America's was 14%, while in Sweden it was 8% in 2000, with much larger gaps estimated for developing countries (Mirrlees *et al.*, 2011:43).

In the First Interim Report on VAT by the Davis Tax Committee (2014), an attempt was made to promote Simplicity. The Report states that "multiple rates add significantly to the complexity and administrative burden of the tax", and it was recommended that multiple rates be avoided. However, Simplicity remains one of the most elusive guiding principles. Tax systems are unlikely to be simple (Mirrlees *et al.*, 2011:42), and complexity invites tax avoidance, which in turn leads to ever more complex tax rules and legislation in an attempt to prevent the erosion of the tax base.

3.3 NEUTRALITY

3.3.1 Introduction, definition and reasoning

Neutrality is not one of Smith's ([1776] 2005) maxims, but is mentioned as an overarching principle of tax policy by the OECD (2014), which states that tax should be neutral and equitable across all types of business activities.

According to the AICPA (2001), Neutrality is defined as follows: "[T]he effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum." In other words, tax law should not unduly

influence taxpayers' decisions to pursue certain activities or take certain courses of action based on the effect that tax law may have on that particular activity or deed.

According to Du Preez (2016), the concept of Neutrality entails that taxes should affect all persons and kinds of activities in the same manner, and illegal activities should also be subject to taxation. From a South African perspective, the dictum that illegal activities should also be taxable was confirmed in *CIR v Delagoa Bay Cigarette Co*, 1918 TPD 391 (32 SATC 47). In *CIR v Delagoa Bay Cigarette Co*, the court found that the source of the income is of no consequence when deciding whether such income should be taxable or not (Stiglingh, 2016:18), thereby affirming the concept of intended neutrality of tax legislation in a South African context.

3.3.2 Origin

Neutrality of taxation was widely ignored by the rulers of ancient kingdoms and during the Middle Ages, and taxes were levied without taking into account the possible economic decisions of taxpayers. Not even Adam Smith ([1776] 2005) mentioned Neutrality as a maxim for taxation, and it is only fairly recently that this guiding principle started gaining recognition.

Like Simplicity, the guiding principle of Neutrality was first mentioned in the Carter Report in 1966 (Du Preez, 2016:74). This report mentions Neutrality several times, stating, among other things, that all consumer goods should be taxed on the grounds of Neutrality and that the provision of services should be included in the tax base to achieve greater economic neutrality (Carter *et al.*, 1966, Volume 5:59). The report further states that since the promotion of Neutrality leads to ever more complex calculations in a continuously changing environment, the need for Neutrality results in the increased uncertainty and complexity of a tax system and therefore contradicts the concepts of Certainty and Simplicity (Carter *et al.*, 1966, Volume 5:21).

3.3.3 Historical development

Following the publication of the Carter Report (1966), tax system neutrality was discussed in several reviews and reports, including the OECD (1998) and AICPA (2001) Reports, and the Alley and Bentley Summary (Australia, 2005) (Du Preez, 2016:75–76). The notion of Neutrality in a tax system has, however, received less attention than other concepts, such as Simplicity and Certainty, which could be an indication that committees and governments agree with the findings of the Carter Report (1966), but may be reluctant to advocate Neutrality at the expense of Simplicity and Certainty.

The 1998 OECD Report on the Taxation Framework Conditions for Electronic Commerce states that Neutrality should apply to e-commerce, and declares that Taxation should strive to be neutral between different forms of electronic commerce, and between electronic and conventional commerce. The Report further declares that taxpayers should be taxed similarly for similar transactions and should be motivated by economic, rather than tax considerations (OECD, 1998:4).

However, the AICPA (2001) argues that the principal goal of Taxation is not to influence the economic decisions of taxpayers, but to obtain revenue for the government.

3.3.4 Current application and general trends

Alley and Bentley (2005) state that “[N]eutrality has remained the single most important principle in the international discussion of the taxation of electronic commerce”, and add that, in its communications, the European Union emphasises Neutrality and non-discrimination between member states. The United States of America addressed Neutrality between different forms of commerce in its Internet Tax Freedom Act, which prohibits unfair taxation of electronic commerce (Alley & Bentley, 2005:595).

Mirrlees *et al.* (2011:40) point out that the tax systems of many modern economies, including that of the United Kingdom, contain wasteful non-neutralities that are difficult to justify and should be reformed. However, in some instances tax systems are deliberately not neutral, for example in the case of actions that harm the environment and might therefore be taxed more than other activities (Mirrlees, 2011:40). In contrast, savings, such as tax-free investments in the Republic of South Africa that are intended to serve as an incentive for

taxpayers to save, might be taxed more leniently than other forms of income (Stiglingh, 2016:132).

Tax systems are known to be non-neutral regarding an array of policies. According to Mirrlees (2011:40), inconsistencies in neutrality distort, among others, choices about different forms of employment, about either debt or equity financing, and about choices between different types of business entities. Distortions such as these create complexities, promote tax avoidance and increase compliance cost.

Mirrlees (2011:41) maintains that many distortions in the neutrality of taxation are due to a lack of sound economic principles in the design of a tax system. In certain circumstances, this situation creates an opportunity for taxpayers to choose a more desirable alternative. In response, governments institute ever more elaborate tax rules and legislation in their effort to minimise avoidance.

Greater Neutrality may occasionally lead to greater fairness, but a holistic view needs to be taken to achieve this (Mirrlees, 2011:41). In other words, a consistent understanding is required of what must be taxed – the tax base. In the United Kingdom, for example, taxpayers' decisions concerning savings are influenced by the fact that the tax base for individual taxpayers consists of an income base and an expenditure base (Mirrlees, 2011:41). The corporate tax base also creates distortions in taxpayers' decisions regarding which legal entity to choose for their business operations, as decisions about the type of financing – either debt or equity – and decisions about the extent of investment in a venture are influenced by non-neutralities.

Although non-neutralities might occasionally be desirable in a tax system, the distortions typically observed in tax regimes do not align with such deliberate non-neutralities and often create opportunities for tax avoidance, more elaborate rules and legislation to counter such avoidance, and therefore higher compliance costs (Mirrlees, 2011:41). The above may indicate that a case does indeed exist for a degree of coherence between the concepts of Neutrality and Simplicity. According to Mirrlees (2011), greater neutrality in a tax system remains a sound principle and may, in some circumstances, actually lead to increased simplicity and efficiency of the tax regime (Mirrlees, 2011:41).

Although the Carter Report argues that the pursuit of Neutrality is the very cause of ever more complex tax rules and regulations, and is therefore counterproductive to attaining Simplicity and Certainty, more recent reports, such as the OECD Report (2004) and the Mirrlees Review (2011), seem to suggest that Neutrality can assist in making tax systems simpler and more efficient.

3.4 OPTIMAL DESIGN

3.4.1 Introduction, definition and reasoning

Taxes should be so designed as to minimise their effect on the economy (Du Preez, 2016). The AICPA (2001) declares that “the tax system should not impede or reduce the productive capacity of the economy”, and in its ten guiding principles, this contributing factor is called “economic growth and efficiency”. Efficient tax administration leads to optimal revenue with the lowest possible tax burden (Du Preez, 2016:91). The OECD (2014) maintains that the proper amount of tax should be levied at the appropriate time and that double taxation and unintentional non-taxation should be avoided.

Smith ([1776] 2005) addresses the idea of Optimal design in his fourth maxim when he argues that “every tax ought to be so contrived, as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury”, and Du Preez (2016:91) states that when there is mutual respect between a government and its people, the rule of demanding only what is required, and not what is desired, should apply.

In other words, taxes should be designed in such a way that they can be levied with the least possible waste, or deadweight loss (OECD, 2014), as it is called by modern economists. Waste is very broadly defined by Smith ([1776] 2005), who includes costs in the form of lost growth, since business persons choose not to enter into enterprises that carry a heavy tax burden. Thus, Optimal design should endeavour to take into account possible losses in the form of opportunity cost, which is the loss of alternatives that might have had a greater impact on the economy if another alternative had rather been chosen.

3.4.2 Origin

Failures in the design of tax legislation are as old as civilisation itself. As is evident from the discussion of the historical development of taxes below, rulers and governments have, throughout the ages, disregarded the need for an optimal design for taxes and frequently used taxes to fund their personal ambitions or as a form of oppression, regardless of the effect on taxpayers and the economy.

The first formal reference to an optimal design was made by Smith ([1776] 2005) in his fourth maxim, which lists four inefficiencies of Taxation:

- High administration costs
- Sacrifice of economic growth
- Substantial penalties for evasion of taxes
- Unnecessary and time-consuming tax audits

The Asprey Report (1975) was the first modern report to elaborate on Optimal design by detailing the concept of Efficiency and defines Efficiency as follows: “Narrowly interpreted, efficiency requires that the resources available for public use be as near as possible to the funds withdrawn from the private sector: that is, that the process by which resources are transferred involve minimal ‘waste’.” In other words, the difference between the amount collected from taxpayers and the amount available for expenditure by the state should be approximately equal. To achieve this, the cost of administration should be as low as possible.

Optimal design is derived partially from the guiding principle ‘economic growth’, as described by the AICPA (2001), which states that “the tax system should neither discourage nor hinder national economic goals, such as economic growth, capital formation, and international competitiveness”. According to the AICPA Report (2001), the principle of economic growth is attained when a country’s tax system is aligned with its economic goals and principles.

3.4.3 Historical development

As previously mentioned, ill-conceived taxes often subjected taxpayers through the ages to complex examination by tax officials, exposed them to danger (such as abuse by the Publicani in Ancient Rome), ridiculous taxes (such as a tax on beards introduced by King Henry VIII of England in 1535), and taxes that oppressed the people, such as the taxes that were demanded from Jews in Ancient Egypt (Adams, 2001).

In the 14th century, the King of France claimed the right to receive regular tax payments from all citizens, excluding the church and members of the nobility, and thereby affirmed the government's right to receive income from the people (Adams, 2001). Excessive taxes claimed by the King of France ultimately led to the French Revolution of 1789 and demise of the French Court.

If a government collects more revenue than is needed, taxpayers might try to avoid paying taxes or take part in uprisings and other forms of protest. Some historical examples of tax exploitation and its consequences are (Adams, 2001):

- o Some argue that unfair taxation and widespread fraud contributed to the downfall of Rome, as the government did not have the necessary funds to maintain its military forces and peasants perished from starvation.
- o The Spanish empire instituted a property transfer tax called *alcabala*, which was resented by the people and led to extensive and substantial tax evasion, for example by joining the tax-exempt civil service.

In 1830, Paley suggested that “we should tax what can be spared” (Du Preez, 2016:93). This is similar to Turgot's recommendation made in 1764, several years before the French Revolution (1789), namely that tax should be levied on income that is not required for future revenue generation (Du Preez, 2016:93). The Asprey report (1975) and Meade report (1978) Reviews also reiterated that income streams should be taxed in a sustainable manner (Du Preez, 2016:94).

It has been suggested that taxes could be classified as bad if they destroy a taxpayer's means to sustain a livelihood and impede economic growth by subduing funds required for employment (Du Preez, 2016:94).

History has an unfortunate habit of repeating itself. The prosperity originally created by voluntary taxation in Ancient Greece did not last and eventually it was tyranny and harsh tax practices that brought about the decline of this civilisation. The great Spanish Empire suffered the same fate as its unpopular and oppressive tax practice, known as *alcabala*, was blindly expanded by the Spanish rulers and ultimately caused extensive tax evasion (Du Preez, 2016:94). These examples illustrate the need for governments to ensure that taxation is applied in a way that will preserve the wealth required for future income generation.

Practically all the authors who proposed taxation principles since Adam Smith ([1776] 2005) included elements of Optimal design. The names of the participants in the discussion on Optimal design and their contributions are given in Table 2 below.

Table 2 - Optimal design throughout history

AUTHOR(S)	ELEMENTS OF OPTIMAL DESIGN	TITLE OF PUBLICATION
Adam Smith – England (1776)	Fourth maxim – economy in collection	<i>Wealth of Nations</i>
Newmarch – England (1861)	Savings and contribution to capital not taxed	The Newmarch lectures of 1919
Asprey Report – Australia (1975)	Efficiency	Criteria for tax systems
Meade Report – UK (1978)	<ul style="list-style-type: none"> - Incentives and economic efficiency - Cost of administration and compliance 	Characteristics of a good tax structure
Her Majesty's Stationery Office (HMSO) Green Paper Report – UK (1981)	<ul style="list-style-type: none"> - Cost of administration - Practicality 	Requirements of a local tax system
O'Brien Report – Ireland (1982)	<ul style="list-style-type: none"> - Efficiency - Low administration and compliance cost 	Criteria for a tax system

Ridge and Smith: Institute of Fiscal Studies (IFS) Report – UK (1991)	- Economic efficiency - Administrative feasibility	Criteria for local tax
Jackson: Chartered Institute of Public Finance and Accounting (CIPFA) – UK (1994)	Economy in collection and compliance	Characteristics of an effective tax system
James and Nobles (1997)	Efficiency	Principles of taxation
Organisation for Economic Co-operation and Development (OECD) – Ottawa (1998)	- Efficiency - Effectiveness	Taxation framework conditions (for electronic commerce)
Institute of Chartered Accountants in England and Wales (ICAEW) Tax faculty (1999)	Easy to collect and calculate	Principles of a better tax system
American Institute of Certified Public Accountants (AICPA) – USA (2001)	- Economy in collection - Economic growth and efficiency	Guiding principles of good tax policy
Alley and Bentley – Australia (2005)	Efficiency	A remodelling of Adam Smith's tax design principles
The President's Advisory Panel on Federal Tax Reform (2005)	Economic growth	Report of the President's Advisory Panel on Federal Tax Reform
Henry Review – Australia (2010)	Efficiency	Australia's future tax system
Mirrlees Review – UK (2011)	- Economy in collection - Minimise negative effect on welfare and economic efficiency - Minimise administration and compliance cost	Tax by design
Davis Tax Committee – South Africa (2015)	Efficiency	First Interim Report on Macro-analysis

Source: Adopted from Du Preez (2016)

3.4.4 Current application and general trends

Regarding the first of the four inefficiencies of Taxation mentioned in Smith's ([1776] 2005) fourth maxim, high administration costs are a constant concern for revenue authorities and attempts are continuously being made to keep costs to a minimum. In the 2015/2016 fiscal year, the administrative costs for the South African Revenue Service (2016) for the year

dropped to 0.96% of the total tax revenue, compared to 1.11% in the 2011/2012 fiscal year. The second inefficiency, namely sacrificed economic growth, is most noticeable in double taxation across many forms of income, for example dividends, which are taxed twice in some countries, including South Africa and the United States – once in the form of income taxes on corporate income, and then again as dividends tax in the hands of the shareholder upon declaration of dividends. The third inefficiency – penalties on taxes – can be crippling to taxpayers. In addition to administrative penalties for late filing of returns, penalties imposed by the South African Tax Administration Act (2011) for the understatement of a taxpayer's tax liability can range between 5% and 200%, depending on the seriousness of the transgression. The final inefficiency, namely time-consuming audits of not only income tax, but also of other taxes such as VAT and estate duty, is a common occurrence. Audits of entities in the corporate environment can be especially tedious.

Mirrlees *et al.* (2011) state that all taxes reduce the wealth of the people who bear the economic burden of Taxation. They further declare that with tax design the challenge is to achieve the social and economic objectives of the state while limiting the side-effects of taxes that inherently reduce the wealth of taxpayers.

Mirrlees *et al.* (2011) expand on Adam Smith's maxims by formulating objectives for a tax system with a given distributional outcome, after which they set out the attributes of a well-designed tax system as follows:

- The negative effect of taxes on welfare and the efficiency of the economy should be minimised.
- A system that requires less administration and compliance costs is preferable.
- A tax system should be fair and non-discriminatory, procedures should be impartial and expectations justified.
- A tax system should be transparent and understood by all taxpayers.

Mirrlees *et al.* (2011) further state that a key goal of any tax system should be to minimise deadweight loss, or loss of welfare and social cost of taxes. Deadweight loss is more prevalent in the case of products with a higher degree of elasticity than for products with relatively low elasticity, i.e., if the demand for a product is sensitive to price changes, it has a high price elasticity and sales will be easily affected if the price is increased or reduced.

Ideally, society desires a tax system that is fair, transparent and easy to administer, and is able to meet its distributional objectives without any unnecessary negative impact on economic growth (Mirrlees *et al.*, 2011). These ideals and outcomes should be balanced in some way to achieve the most equitable system for all taxpayers while minimising loss of efficiency. This trade-off between the different objectives is the subject of optimal tax theory.

Optimal tax theory, which started in the 1970s, is still developing today, and although it has to deal with certain limitations, it provides methods and procedures for designing tax systems that will maximise the desired outcomes within the given constraints faced by the state. Optimal tax theory deals with decisions regarding a tax system that balances the need for government to redistribute wealth and acquire income without loss of efficiency, and identifies the optimal tax system by the balance between the objectives that have to be achieved and the constraints identified. Ideally, a tax system should be designed by first identifying the aims of the system and then constructing the system to suit those objectives. Optimal tax theory emphasises the constraints within which the tax regime has to function, especially the limitations relating to corporate and individual behavioural reactions to the taxes imposed (Mirrlees, 2011:38).

Although faced with certain limitations, optimal tax theory is a powerful tool in designing tax systems and often guides fiscal policy decisions in an attempt to construct a tax regime that delivers optimal results within the given constraints.

3.5 CERTAINTY

3.5.1 Introduction, definition and reasoning

Certainty relates to Adam Smith's second maxim (Smith, [1776] 2005), in which he stated that "the tax which each individual is bound to pay, ought to be certain and not arbitrary". Du Preez (2016) argued that taxes should ideally be published, should be clear, conclusive and properly understood, and should not be retroactively imposed.

The OECD (2014) also declares that the way in which taxes are levied "should be clear" to enable taxpayers to determine their tax obligations. AICPA (2001) holds the view that "the

tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined”.

In South Africa, the Tax Administration Act (2011) administers and guides the timing and manner of tax payments, thereby providing a high degree of clarity on these matters.

However, it appears that determining the amount to be paid is not always a straightforward calculation and that some ambiguity does exist in this regard, judging by the numerous tax court cases heard every year in several countries, including South Africa. The way in which the amount of tax to be paid should be calculated is perhaps the most contentious tax issue between any state and its taxpayers, as suggested by Smith ([1776] 2005), who cited that even an inconsiderable degree of uncertainty of what a person ought to pay is of much greater concern than a substantial level of inequality.

The Income Tax Act 58 of 1962, hereafter referred to as the Income Tax Act of South Africa, for example, contains terms and sections that may be somewhat ambiguous or not well defined, such as “in the production of income”. In cases of uncertainty, the courts are approached to provide guidance on the meaning of terms (Silke, 2016:9). In the South African context, case law therefore forms an integral part in clarifying the ambiguity created by terms or phrases of which the meanings are not quite clear and subsequently supports the contributing factor Certainty.

3.5.2 Origin

In ancient times, autocratic rulers imposed taxes as, when and how they chose, and consequently tax certainty was somewhat lacking.

Certainty as a guiding principle was formally recognised for the first time by Adam Smith ([1776] 2005), who addressed this principle in his second maxim, which concerns implementation rather than distribution. Smith ([1776] 2005) stated that the timing of taxation, the manner in which tax is to be paid and the amount payable should be clear to the taxpayer, as well as to anyone else. According to Smith ([1776] 2005) any ambiguity of

statutes or tax rules creates unnecessary opportunities for pointless audits, and retrospective changes in tax systems hamper economic decisions.

3.5.3 Historical development

The Carter Report (1966) does not define Certainty as a Fundamental Principle of Taxation, but does state that an ingrained practice in English and Canadian income tax law is to interpret statutes strictly and to give effect “to the letter of the law” only (Carter *et al.*, 1966:543). The Report further mentions that the language used in the applicable statutes should be interpreted according to their plain and ordinary meanings, regardless of what lawmakers might have intended. The aforesaid is known as the Rule of Strict Construction. The Report states that Canadian courts normally apply this rule to reach a decision about whether or not the interpretation in terms of this rule is consistent with its apparent intent by taking the words of the taxing statute as they find them and applying them as such (Carter *et al.*, 1966:546). Therefore, the Report expresses the view that the Rule of Strict Construction provides a degree of certainty to the taxpayer, as “it enables the taxpayer to plan his affairs and make business decisions with some assurance of what the tax consequences will be” (Carter *et al.*, 1966:548).

Furthermore, the Carter Report (1966) discusses legislatively enacted specific anti-avoidance rules (also known as SAARs), which are referred to by the report as the “sniper approach” (Carter *et al.*, 1966:552-554). The Report suggests that these provisions promote certainty in a tax system as follows:

- By conveying the liability to pay taxes in particular circumstances “in explicit terms and with the authority of Parliament”, rather than leaving it to the revenue authority or some other body.
- SAARs tend to be clear and accurate in their interpretation and application, and therefore create certainty in the law.

Furthermore, the Report states that greater certainty will be provided if specific provisions in income tax legislation explicitly disallow the deductibility of certain expenses that might otherwise be deductible under general provisions (Carter *et al.*, 1966:36).

The concept of Certainty was also mentioned in several other reports, such as the Meade Report published in the UK (1978), under the term 'Stability', the CIPFA Report in the UK (1994), the OECD Report (1998), ICAEW Report in the UK (1999), the AICPA Report (2001) in the USA, Alley and Bentley' Summary in Australia (2010), the Mirrlees Review in the UK (2011), and the Davis Tax Committee in South Africa (2015).

3.5.4 Current application and general trends

Mirrlees (2011:44) applies the term 'Stability' in discussing the importance of Certainty in a tax regime. The Report argues that constantly changing tax systems leads to complications in formulating long-term plans and imposes greater costs of compliance on taxpayers. Investment decisions of individuals and corporate entities are adversely impacted by the lack of a stable tax system. The Report further states that a stable tax regime is preferable to an unstable and continuously varying one.

However, Mirrlees (2011:44) also argues that stability should not be an excuse for inaction and that certain costs and pitfalls are connected with preserving an inefficient and poorly designed tax regime, rather than with the implementation of changes and improvements. If a tax regime is executed with care and proper consideration, the extent of gains in welfare due to reform can be substantial.

Benefits are undeniably attached to having clear and unmistakable approaches to amending tax regimes, and to clear strategies for long-term changes. Therefore, Certainty does not denote stagnation (Mirrlees, 2011:44). The certainty of the process of reform in a tax system is as important as the contents of those changes.

3.6 TAX LAW

3.6.1 Introduction, definition and reasoning

Du Preez (2016) states that "legitimate and democratically enacted law" should be used to impose justifiable taxation.

There are, however, countless examples where this is not the case, often with unpleasant consequences. One such example was the unilateral imposition of new taxes and reforms of existing taxes by King John of England, which contributed to a rebellion by the nobility and, ultimately, to the drafting of the Magna Carta (Frecknall-Hughes, 2015:11). Although the king had full authority to impose laws and the enactment of those tax laws may have been lawful, they were not democratically enacted. Democracy, or rather the lack thereof, seems to be a recurrent theme in tax revolts throughout history. According to Frecknall-Hughes (2015:10), many historical uprisings besides the one that led to the drafting of the Magna Carta had their origins in dissatisfaction with the way taxes were raised, for example the American War of Independence of 1775 to 1783, and the French Revolution of 1789.

History has proven that lawmakers who do not democratically enact tax legislation, even though the way they handle it may be lawful, do so at their peril, thereby providing strong support for the rationality of the contributing factor Tax Law.

3.6.2 Origin

Laws that govern taxes have been in use since ancient times, even though they were rarely, if ever, democratically enacted and were mostly imposed one-sidedly by rulers or kings.

In the year 1199, King John of England inherited a realm with very few resources left after the reign of his brother, Richard I (Frecknall-Hughes, 2015:11). Many factors had contributed to the depletion of the English coffers, including the Third Crusade co-led by Richard I, a ransom paid to Duke Leopold V of Austria for the release of Richard I, the building of an expensive castle in France, undertaken by John's brother, and the expansion of the government under John's father, Henry II. In 1204, King John ceded Normandy and its accompanying tax revenue, and funds were constantly required for wars against France and Scotland. All the above-mentioned factors led to high revenue demands, and the King's domains did not yield enough income to satisfy those demands. King John therefore imposed enormous tax demands on both the general public and the nobility (Frecknall-Hughes, 2015:11).

The king turned to innovative and extortionary measures to satisfy his ever-increasing tax demands. He implemented entirely new taxes, increased taxes demanded, and levied taxes more often (Frecknall-Hughes, 2015:11).

Finally, in 1215, the noblemen who had been adversely affected revolted and the Magna Carta was subsequently drawn up. The most important agreement in the Magna Carta was that the consent of the people, in this case Parliament, would in future be required whenever new taxes were to be imposed (Frecknall-Hughes, 2015:12), which ushered in the principle of parliamentary authority relating to taxes, and the gradual democratisation of taxes in England, and Great Britain as a whole.

3.6.3 Historical development

Many instances throughout history demonstrate the need for tax laws to be enacted with the approval of the people, rather than unilaterally. According to Adams (2001:239), tax battles in England gradually shifted from King vs Parliament to Parliament vs Taxpayer. Taxpayers revolted against several taxes instituted by Parliament. The introduction in 1379 of a poll tax that placed the tax burden largely on the poor led to a violent revolt by the peasants. The result was that they were, for several centuries afterwards, excluded from poll taxes in an effort to appease them.

Louis XVI, the last King of France, learned the ultimate lesson as a result of his enactment of tax laws without the consent of his people. In 1789, after decades of heavy taxation, the over-taxed commoners revolted and instigated the French Revolution. This ultimately led to the establishment of the First French Republic in 1792, and the subsequent execution of Louis XVI in 1793. The power to tax fell to the newly established National Assembly, which struggled to enact new taxes due to a lack of knowledge and administrative experience (Adams, 2001:349). Many of the taxes that Napoleon Bonaparte attempted to promulgate were rejected by the peasants, who burned down taxing institutions such as customs houses (Adams, 2001:351). Ultimately, a lack of tax revenue led to Napoleon's inability to sustain his armies at the Battle of Waterloo, and consequently to his defeat (Adams, 2001:351).

The American War of Independence was the result of the colonies' resentment of the way in which the British government unilaterally enacted laws levying taxes on them (Frecknall-Hughes, 2015:13). The colonists were infuriated because they were not represented in the British parliament where the laws were being passed, which gave rise to their slogan "No taxation without representation". The Sugar Act of 1764, which imposed taxes on sugar harvested from plantations, and the Stamp Act of 1765, which levied taxes on paper used for legal documents and newspapers, were examples of such taxes (Frecknall-Hughes, 2015:13). When dissatisfaction with these and other taxes reached boiling point, the War of Independence erupted in 1775.

Many lessons learnt throughout history clearly confirm that democratically enacted tax legislation is preferable, and sometimes vital, for the survival of governments.

3.6.4 Current application and general trends

Since the revolt of the Swiss against the tax practices implemented by the Austrian Hapsburgs in 1273, Taxation in Switzerland has largely been an affair for the people. All matters relating to revenue have to be submitted to the citizens of the country and cannot be instituted independently by the state. This system truly exemplifies the separation of the power to tax from the authority to spend. Taxes cannot be increased, or new taxes introduced, without the consent of the Swiss people. The Swiss have exceptional freedom from tax authorities in a time of ever-expanding taxing powers of sovereign states (Adams, 2001:190).

In the United Kingdom, the budget speech delivered by the Chancellor of the Exchequer in mid-March contains details about proposals for any new legislation pertaining to tax, or changes to existing tax legislation (Whiting & Gammie, 2013:3). The proposals are generated by officials from Her Majesty's Treasury, and Her Majesty's Revenue and Customs. The Finance Bill is then submitted to the House of Commons for debate and approval, as well as to a standing parliamentary committee of about 30 members, who study the bill in detail. By the end of June, the bill, with any applicable amendments, is presented once again to the House of Commons, at which stage it is fundamentally

enacted. The House of Lords has no authority over the bill and can make no changes to or delay its enactment (Whiting & Gammie, 2013:3). The entire process takes about four months to be completed, with no input from the monarch.

In South Africa, the Constitution of the Republic of South Africa (1996) (hereafter referred to as the Constitution) is the supreme law of the country and supersedes all other laws. If any law, including the Income Tax Act, or part of a law is inconsistent with the Constitution, that law or part of that law is null and void. The Income Tax Act must, therefore, adhere to the Bill of Rights as set out in Chapter 2 of the Constitution. Furthermore, regarding Section 39(2) of the Constitution, the Income Tax Act must “promote the spirit, purport and objects of the Bill of Rights” (Stiglingh, 2016:9).

3.7 SUMMARY

This chapter presented a review of the available literature relating to the Fundamental Principle: Neutral, Understandable Legislation and its five contributing factors. The five contributing factors, namely Simplicity, Neutrality, Optimal design, Certainty and Tax Law were explored in detail.

The literature review highlights the importance and relevance of the contributions made by each of the five contributing factors to the Fundamental Principle: Neutral, Understandable Legislation within the field of Taxation, and includes a discussion of the current application of those factors.

The next chapter will draw from the above analysis to conclude on the significance of Neutral, Understandable Legislation as a Fundamental Principle of Taxation.

CHAPTER 4: CONCLUSION AND ANALYSIS

4.1 INTRODUCTION

The main purpose of this study was to explore the development and application of one of the proposed Fundamental Principles of Taxation, namely Neutral, Understandable Legislation, by analysing the meaning and importance of Simplicity, Neutrality, Optimal design, Certainty and Tax Law, which are the five factors that contribute to this Principle. This chapter aims to conclude on the analysis of the Principle and the relevance and importance of its contributing factors. First, a summary of findings from the study is presented, together with a conclusion based on these results, in order to achieve the main objective of the study. The chapter proceeds with a summary that highlights the contribution of this study. The limitations of the research are also briefly discussed, and recommendations are made with regard to possible future research that may be relevant to this topic. The chapter then draws to a close with some concluding remarks.

4.2 SUMMARY AND CONCLUSIONS

The extended literature review undertaken for this study provides a clear indication of the significance of Neutral, Understandable Legislation as a Fundamental Principle of Taxation through the ages, from the early kingdoms to the current time.

The research objectives of this study were:

- To explore and analyse the meaning, development, historical application and importance of the Fundamental Principle: Neutral, Understandable Legislation, and the factors that contributed to its development from ancient to modern times.
- To evaluate the current application of the Fundamental Principle: Neutral, Understandable Legislation on a global scale, with specific emphasis on South Africa, by examining current legislation, tax systems and reviews of tax systems, for example, reviews by the Davis Tax Committee.

The requirement for tax laws to be certain, neutral and understandable was identified by Du Preez (2016) as a fundamental principle of taxation and consists of five contributing factors, which will be concluded upon below.

4.2.1 Simplicity

The American Institute of Certified Public Accountants (AICPA) defines Simplicity in the context of Taxation as follows: “The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.”

The OECD (2014) observes that complicated tax systems create an opportunity for aggressive tax planning and tax avoidance schemes, whereas a simple system assists taxpayers to easily grasp their rights and obligations within a system of taxation. Simplicity can, therefore, assist with ensuring cost-effective compliance.

Attempts are continually being made to promote Simplicity as a guiding principle, such as the First Interim Report on VAT by the Davis Tax Committee (2014) in South Africa, which states that multiple VAT rates would result in a significantly more complex VAT system and excessive administration.

However, no tax system today is likely to be truly simple (Mirrlees *et al.*, 2011). Du Preez (2016) notes that a simple a tax regime may not be conducive to the fairness of such a system, and that complexity may be required to attain the desired level of equity amongst taxpayers.

Therefore, a tax system should be simple enough to ensure that it can be properly understood, while also being sufficiently complex to attain a fair result for all taxpayers. As posited by Du Preez (2016), the structure and wording of tax law should be such that it is neither oversimplified nor too complex. A careful balance should be maintained to prevent elaborate tax avoidance schemes while also achieving the greatest possible degree of fairness.

4.2.2 Neutrality

Neutrality signifies that tax law should not unduly influence taxpayers' decisions to pursue certain activities or take certain courses of action based on the effect that tax law may have on that particular activity or deed (AICPA, 2001).

The many non-neutralities that can be found in tax systems all over the world result in wasteful and unjustifiable tax consequences (Mirrlees *et al.*, 2011). Deliberate non-neutrality can also be found in certain circumstances, such as harsher taxation for activities harmful to the environment, or more forgiving taxes on savings and investments, such as the current prevailing tax regime in South Africa pertaining to approved tax-free investments.

Neutrality entails that taxes should affect all persons and kinds of activities in the same manner, and illegal activities should also be subject to taxation, as is the case in South Africa. However, a lack of sound economic principles in the design of tax regimes leads to distortions of neutrality in a tax system. These distortions create opportunities for taxpayers to choose between alternatives, depending on their specific circumstances and preferences. To counter this, governments institute ever more complex tax rules to mitigate tax avoidance, which reduces simplicity. Eliminations of the distortions can lead to greater simplicity and efficiency of a tax system, while also promoting Neutrality.

Tax legislation should, therefore, create a neutral tax environment that is both stable and sustainable, and does not unduly influence taxpayers' choices.

4.2.3 Optimal design

Optimal design refers to the principle that taxes should be designed with the least possible effect on the economy and should not obstruct economic activity. The proper amount of tax should be levied at the appropriate time, and double taxation, as well as unintentional non-taxation, should be avoided (OECD, 2014). Well-designed tax legislation can also lead to more efficient tax administration, which will, in turn, lead to optimal revenue collection with the lowest possible tax burden and administrative costs.

In his fourth maxim, Adam Smith ([1776] 2005) identified four inefficiencies in tax design. The first is high administration cost, which is still a cause for concern for many governments. During the 2015/2016 tax year, administration costs for the South African Revenue Service dropped to 0.96% of total revenue, compared to 1.11% during the 2011/2012 tax year. The second inefficiency entails sacrificed economic activity, such as a loss of income for taxpayers through double taxation. The third inefficiency consists of penalties on taxes, which are often harsh. The fourth and last inefficiency concerns time-consuming audits of tax returns, including income tax, VAT, estate duty, or any other type of tax.

Mirrlees *et al.* (2011) list four requirements for a well-designed tax regime:

- The negative effect of taxes on welfare and the efficiency of the economy should be minimised.
- A system with less administration and compliance costs is preferable.
- The system should be fair with regard to non-discrimination, impartial procedures and rightful expectancies.
- The tax system should be transparent and should be understood by its taxpayers.

The objectives of the state should be balanced with the abovementioned ideals, which is the subject of optimal tax theory.

Optimal tax theory provides methods and procedures for designing tax systems to maximise the desired outcomes within the given constraints faced by the state. This theory emphasises the limitations within which the tax regime has to function and provides methods and procedures for designing tax systems that will ensure the maximisation of the desired outcomes within these constraints. Optimal tax theory is, therefore, a powerful tool in designing tax systems and often guides fiscal policy decisions in an attempt to construct a tax regime that delivers optimal results within its given restraints.

Tax legislation should, therefore, be designed in a manner that optimises tax revenue and maximises the outcomes of the objectives a government wishes to achieve, within the constraints of tax collection.

4.2.4 Certainty

Adam Smith ([1776] 2005) defines Certainty as follows: “the tax which each individual is bound to pay, ought to be certain and not arbitrary”. He further argues that even a lesser degree of uncertainty regarding what a person ought to pay is of much greater concern than a substantial level of inequality. The AICPA (2001) holds the view that “the tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined”.

The amount of tax to be paid remains a contentious issue and is regularly contested in court cases all over the world. The meaning of unexplained terms and wording in tax legislation is also regularly clarified and refined by courts. The courts therefore also constitute a valuable instrument in granting greater certainty to tax law. In South Africa for example, the courts have clarified the meaning of terms such as “in the production of income”.

Certainty and stability in a tax regime are desirable to promote taxpayers’ formulation of long-term plans for investment and expenditure, and to also allow the government to predict its revenue for a given fiscal year with a fair degree of accuracy.

Constant changes and improvements to a tax system are not only necessary, but are in fact imperative. If executed with care and proper consideration, changes to tax legislation can hold benefits for both taxpayers and the state. Certainty does not denote stagnation (Mirrlees, 2011:44) and the certainty regarding the process of tax regime reform is as important as the content of those changes.

Hence, tax legislation should lead to a certain and non-arbitrary tax liability, as well as certainty of the timing and manner of payment. Any changes to tax legislation should also be executed with proper care and consideration in order to maintain Certainty within a tax system.

4.2.5 Tax law

Du Preez (2016) states that justifiable taxation should be imposed by using “legitimate and democratically enacted law”.

Failure in this regard has often led to revolts by taxpayers, for example the drafting of the Magna Carta in medieval England, and also contributed to the American War of Independence (1775). These events indicate that even though tax legislation may be legal, it is not a given that it will be accepted by taxpayers.

The enactment of tax legislation has developed from a unilateral demand by a monarch, church or lord, to democratic ratification with the consent of the people in many countries. Examples include Switzerland, where any plans pertaining to tax have to be submitted to and approved by taxpayers before being implemented by the government. In the United Kingdom, elected members of the lower house of Parliament, known as the House of Commons, have the exclusive authority to decide and vote on tax matters with no input from the monarch. In the Republic of South Africa, Parliament votes on tax matters and any tax legislation must conform to the provisions of the Constitution of the Republic.

Impartial and democratically enacted legislation that is published and complies with constitutional requirements and other relevant legislation should, therefore, form the basis of a tax system (Du Preez, 2016).

4.2.6 Summary: Neutral, Understandable Legislation

Taxation should be supported by well-designed and democratically enacted legislation, approved by taxpayers, which will maximise revenue for the state within the constraints of fair tax collection. To ensure both efficiency and fairness, the tax regime should be neither too simple nor too complex. Tax legislation should promote a stable tax system that does not disproportionately affect taxpayers’ choices and taxpayers should have certainty regarding the amount payable and the timing and manner of payment of taxes due.

4.3 SUMMARY OF THE CONTRIBUTIONS OF THE STUDY

The extended literature review and the findings of this study provide strong support for Neutral, Understandable Legislation to be regarded as a Fundamental Principle of Taxation. The discussion and conclusions above further enhance our understanding of the underlying contributing factors, and of the important role played by Neutral, Understandable Legislation in the relationship between the taxpayer and the state. Legislators and revenue authorities may benefit from considering this Fundamental Principle when drafting and enacting new, or revising existing tax legislation.

4.4 LIMITATIONS OF THE STUDY AND RECOMMENDATIONS FOR FUTURE RESEARCH

The most apparent limitation of this study is that it dealt with only one of the Fundamental Principles of Taxation proposed by Du Preez (2016). Another limitation is that the application of the various contributing factors was only selectively explored by extracting examples from specific tax jurisdictions while many more examples of the importance and relevance of each of the contributing factors undeniably exist. These restrictions could be dealt with in future studies.

Further exploration of the remaining Fundamental Principles of Taxation proposed by Du Preez (2016) is recommended. Other examples of the manner in which the contributing factors are applied in the various international tax jurisdictions could also be examined.

4.5 CONCLUDING REMARKS

Since international trade and e-commerce have become widespread and commonplace, the borders between countries and tax jurisdictions are becoming ever more blurred. The need for Fundamental Principles of Taxation is therefore becoming increasingly essential, even though such Fundamental Principles may have to be adapted to the unique circumstances of every tax jurisdiction. To this end, Neutral, Understandable Legislation plays a central role in the functioning of any tax system, and its five contributing factors have been regarded as fundamental to the field of Taxation for centuries. The importance and relevance of Neutral, Understandable Legislation as a Fundamental Principle of Taxation is therefore warranted.

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