INCOME TAXATION – AN INSTITUTION IN DECAY?

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I INTRODUCTION

My encyclopedia tells me that a super nova is a phenomenon associated with the death throes of a star. It involves a dramatic increase in the size and intensity of a star that to the astronomer who observes it is awesome. The star will in time lose a great deal of its mass and thereafter become a thin miasma – a ghost calling to its past. A metaphor is no basis of prophecy. But it may help to describe what I believe will happen to the income tax, my belief being assisted, I confess, by a conviction that it ought to happen. The super nova is already upon us. In recent years the income tax and its administration have attracted ever growing attention. It has become the stuff from which dramatic events arise – documents dumped in strange places, enquiries and criminal trials which delight the media. It is stuff that requires, it seems, almost daily announcements by the Treasurer and the Commissioner and unending streams of new legislation which match the exploits of the sorcerer's apprentice. The stream of new legislation bids fair to drown administrators, tax advisers and us all. I am sorry if I have shifted to another metaphor.

The title of the lecture is to a degree misleading. Titles are always so. It is misleading in carrying an inference that the income tax might once have enjoyed acceptance and prestige. The income tax is an institution whose policy, beyond the pursuit of revenue, was always obscure, an institution that borrowed a concept – income – from another institution, the trust, so as to spare its makers too much of a drain on their creative imaginations. In borrowing the concept, it left the tasks of definition very largely to the courts, with little to guide them beyond their own definitions already made in relation to trusts. Those definitions were directed to allocating between beneficiaries what, in a literal sense, "came in", in accordance with the actual or presumed intention of the person who created the trust. The definitions were never appropriate to determining in what items the State should share through a tax. A principle of trust law that would direct that in the circumstances an item should be allocated to the remainderman, because this was the presumed intention of the creator of a trust, is a strange basis for a conclusion that the item is not one in which the State should share through a tax.

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The analytical fabric of the income tax in the result had congenital and, I suspect, incurable defects, born as it was of a union of institutions which had no common policies. There are, I believe, other reasons why it will die. One of them would be that "income", even when understood in a sense which may give some coherence of principle and claim to fairness to an income tax, is not as appropriate a base of a tax as is expenditure. An income tax that has some coherence of principle and claim to fairness will seek to confine its base to gains, as distinct from incomings. As such it is a measure of the contribution the taxpayer has made to production. A tax on expenditure taxes by reference to what a taxpayer has taken from the pool of production. Another of these reasons would be that the income tax is not in truth a direct tax however much we assume that it is. Its effective incidence does not rest on the person who is called on to pay the tax. If the effective incidence is not on the person who pays the tax, all the agonies of debate in the *Asprey Report*[1], in the 1985 White Paper[2] and at the National Tax Summit[3] about the equity of the income tax were endured in vain. All proceeded on a false assumption. Whenever our politicians seek to conclude a bargain with labour such that relief from income tax is traded for restraint in pressing wage demands, they are in effect proclaiming that any increase in income tax is likely to be passed on in increased wages, and that labour should accordingly be prepared to pass back relief from income tax by restraint in wage demands. In the 1970s, the degree of inflation was made the more dramatic by labour pressing wage demands to recoup the ever increasing income tax which results in conditions of inflation if the rate scale remains unchanged.

Yet another of these reasons is that the extent of evasion of the income tax can never be reduced to an acceptable level. The success of the prescribed payments system has done no more than indicate that there was a great deal of evasion, but it is no indication of how much more there is to be discovered. And I confess to some distaste for a system that would make each of us a collector of his neighbour's tax.

But I must return to my discipline, which is the analytical fabric of the income tax. The income tax lacks any single underlying principle which is relevant to its function of sharing command over resources between individual and Government, and which can give it coherence and a claim to fairness. Without such an underlying principle it earns no respect and deserves none.

This year has seen what has been described as the extension of the concept of income so that it embraces capital gains. The language is that of the fiscal economist, and assumes that the base of the income tax is gains, from which until now capital gains have been excluded. The concept of income as it was received from trust law could not be "extended" to include capital gains, for

[1] Aust., *Taxation Review Committee Full Report (Asprey Report)* (Canberra, AGPS, 1975).
[2] Aust., *Reform of the Australian Tax System*, Draft White Paper (DWP) (Canberra, AGPS, 1985).
[3] Canberra, July 1985.

it did not have a notion of income as a gain, or a notion of a capital gain. It knew only a distinction between a flow that belonged to the income beneficiary, and the proceeds of capital that belonged to the capital beneficiary.

Some reworking of the received trust law concept of income within the income tax towards a concept of gain has been achieved in the recognition, as yet resisted by some judges and lawyers, that a profit on the realisation of an asset may be income. But the concept of income in the income tax remains firmly rooted in its origins. Parliament's endeavours, through the capital gains tax and other legislation are equivocal. There are aspects of recent legislation which reaffirm a flow concept of income. The capital gains tax legislation, in some of its provisions denies its name by making capital gains out of items that are no gains of any kind.

When underlying reason is absent, income tax will be seen as some kind of game. It is a dangerous game, in which the taxpayer is always at great risk, and not a game for the faint-hearted like me. It is a game in which the odds are not fair. If only because of Part IVA *Income Tax Assessment Act* 1936 (hereinafter *Assessment Act*) – the general anti-avoidance provisions – the odds favour the administrators. Yet we all must play the game, whether we like it or not, for we all must be taxed. There are penalties for losing, penalties in money and in character loss.

The administrators, too, must play the game, and they will try to be moved by underlying reason. But if reason is not written into the analytical fabric of the tax, we are ruled by the reason of the administrators and not by the law. I suppose I show my age by talking the rule of law. It has ceased to be fashionable.

We have recently introduced a system that is described by the administrators as "self-assessment".[4] The hazards for the taxpayer have increased immensely. The vital difference between the new system and the old is that the security – the finality – of the first assessment is now denied to a person who has been entirely honest in his disclosure. He is sentenced to serve three years of uncertainty. The Commissioner has another move available to him, by which he has an unrestricted power to assess again, and in which he may be able to impose penalties.

Our lives are beggared by the income tax, even though, like mine, they are simple lives. The compliance costs in money and emotion – fear for us all, and envy of another for some – cannot be counted. There is no relief for us save by the coming of the ultimate state envisaged by the Asprey Committee, when the income tax has been abolished in favour of what can be a simple tax on the consumption of goods and services.[5]

[4] For a discussion by the Commission of Taxation on the introduction of self-assessment see T. Boucher, "Self Assessment of Income Tax" (1986) 3 *Australian Tax Forum* 45.

[5] Supra note 1, p. 35.

II THE ECONOMISTS' NOTION OF INCOME TAX AS THE BASE OF A TAX

In 1938 Henry Simons published his book *Personal Income Taxation. The Definition of Income as a Problem of Fiscal Policy*[6]. The book had and continues to have a great influence on all thinking about "income" as the base of a tax. The notion of income proposed by Simons is expressed in what must be one of the most quoted passages from the writings of fiscal economists:

> "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is gain as our courts have recognised in their more lucid moments — and gain to someone during a specified time interval . . .
>
> This position, if tenable, must suggest the folly of describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc".[7]

As seen by fiscal economists who came after him, the Simons notion of income, was a magnificent revelation. Simons' writing in their eyes ranks with the scriptures.

The trust law concept of income is built on the idea of flows, which Simons rejects. The flows that are income are commonly identified, in judicial statements about the concept of income, as dividends, interest, rent and royalties and proceeds of a business. There is another flow, that from human capital, which is the judicial explanation of how it is that rewards for services are income, without regard for the costs of human capital consumed in performing those services. To describe these as flows is to call on a metaphor. Metaphors and Latin are used by lawyers as substitutes for, and not aids to analysis. It may be more helpful to say that a flow is the consequence of some act or event in relation to property, that is seen as capital, which triggers a receipt by the owner which is not a receipt in realisation of that property. The act or event may be the declaration of a dividend, or the coming of a day when interest is due, or the grant of a lease or licence, or the sale of goods in the course of business operations. The flow may be an accretion to economic power, a phrase that Simons made his own as a description of a gain, but often it will not be. In the case of a dividend on a share, there will not generally be an accretion to economic power if the dividend is received immediately after the acquisition of a share purchased cum dividend or the share has fallen in value since it was acquired. In the case of interest on debentures, there will not generally be a realised accretion to economic power if the debenture was purchased immediately before the due date for payment

[6] (Chicago, University of Chicago Press, 1938).
[7] Id. pp. 50-1.

of interest, or if, as a result of an increase in interest rates, the debenture has fallen in value since it was acquired. Nor will there generally be an accretion to economic power if the new owner of property not yet leased, immediately leases the property and takes rent in advance, or a premium. There has been only a conversion to cash of some part of the new owner's property rights – the right to possession – which one might expect to be reflected in a decline in the value of his property rights that remain following the conversion. The allowing by the owner of the use of an asset may generate flows in the form of royalties, but there will be no gain to the owner if use will cause a diminution of the value of his property below its cost, and that diminution equals or exceeds the amount of the royalty receipts. There will be no accretion to economic power if the proceeds of sale of goods do not exceed their cost.

The lawyer's response to Simons is to say that, however inspiring Simons may be, his ideas below in some other world and are beyond achievement on earth. Simons sought to answer that challenge by conceding that:

> "The proper underlying conception of income cannot be directly and fully applied in the determination of year-to-year assessments. Outright abandonment of the realization criterion would be utter folly; no workable scheme can require that taxpayers reappraise and report all their assets annually; and, while this procedure is implied by the underlying definition of income, it is quite unnecessary to effective application of that definition . . . The recognition of capital gains and losses may wisely be postponed while the property remains in an owner's possession . . ."[8]

The concession goes far towards destroying Simon's revelation. If "appraisals" of value are to be avoided, the gains in the value of property that will be included in the base of the income tax will be confined to gains realised on disposal. And flows will continue to be included whether or not they reflect gains. If flows that are income are to be confined to gains, there will be need of a valuation of the shares on which dividends have been received; of the debenture on which interest has been received; of the property on which a lease premium has been received; and of the property in respect of which royalties have been received. That valuation must be made after the receipt of the dividends, interest premium or royalties. If, for example, the payment of a dividend has reduced the value of the shares below their cost to the taxpayer who receives the dividends there is gain only to the extent that the dividends exceed the reduction in value below cost.

III THE JUDICIAL CONCEPT OF INCOME AS THE BASE OF THE INCOME TAX

This and the next part of the lecture in its written form, is an attempt to support a number of assertions made so far, and to support them in the manner one might expect of an academic lawyer.

[8] Id. p. 207.

Origins in Trust Law

If a demonstration is necessary of the fact that the Courts have adopted a meaning for income drawn from the law of trusts, as the base of the income tax it is to be found in *C.I.R.* v. *Blott*.[9] The majority of the House of Lords relied on *Bouch* v. *Sproule*[10] in reaching a conclusion that a bonus issue of shares was not income of the shareholder for purposes of the United Kingdom income tax. *Blott's* case was accepted by Dixon C.J. in the High Court *F.C.T.* v. *W.E. Fuller Pty Ltd*[11] as expressing the "natural legal meaning of income".[12] In *Bouch* v. *Sproule* that meaning directed a conclusion that, in the absence of a different intention evident in the trust instrument, the remainderman was entitled to bonus shares, not the life tenant. In *Bllott's* case that meaning directed a conclusion that the owner of shares who receives a bonus issue does not derive income for purposes of a statute imposing an income tax unless there is some express provision to this end in the statute imposing the tax.

The "natural legal meaning of income" has in the context of its development in the interpretation of income tax legislation, become the "ordinary usage meaning", a phrase which presumably seeks to attribute its parentage not to the courts but to the meaning which the community at large may give to the word. I doubt very much that the ordinary person would recognise or understand the usage attributed to him. I prefer to call it the "judicial concept".

Lawyers and accountants practising in tax insist, with more than a little judicial support, that there is a distinction between s.25(1) income, and income by specific provisions of the *Assessment Act*. Section 25(1) is not seen, as I would see it, as the central provision which brings into the category of assessable income items which are income under all the provisions of the Act, including s.25(1), and which pass tests of jurisdiction and exemption, but as a provision which deals specially with "ordinary usage" income and gives it an entrenched position within the Act. An amendment to the Act in 1984 added words to s.25(1) which assume that an item will be income for purposes of the Act if it is within the ordinary usage notion, unless there is a specific reference to it, presumably in s.25(1) itself, which says that it is not. The judicial support for this theory entrenches "ordinary usage", which is in fact not the ordinary man's usage but the trust law usage.

Entrenchment of the Judicial Concept in Trust Law and in Income Tax Law in the United Kingdom

Trust law usage has recently been given an entrenchment in the United Kingdom trust law and in the United Kingdom income tax law against a weakness that it had within itself. There are many judicial pronouncements which would say that in trust law the notion of income as developed by the courts

[9] [1921] 2 A.C. 171.
[10] (1887) 12 App. Cas. 385.
[11] (1959) 101 C.L.R. 403.
[12] Id. p. 413.

is no more than an aid in fixing the intention of the author of a trust instrument as to what should belong to the life tenant under that instrument. That might have been taken to involve a conclusion that an item is income for trust law purposes if it is an item which the express or presumed intention of the settlor directed should belong to the life tenant. Implicit in that conclusion would be that there are as many notions of income for trust law purposes as there are trust instruments. The conclusion was sternly rejected by the majority in the House of Lords in *Carver* v. *Duncan*.[13] At the same time it was assumed without question that income tax law and the law of trusts in the United Kingdom shared a common concept of income. It was argued that provisions of the trust instrument directing certain expenses should be paid out of income would necessarily reduce the amount of trust income and of income subject to income tax. Lord Templeman insisted on the inviolability of Sir Owen Dixon's "natural legal meaning"[14] against a provision of the income tax legislation allowing the deduction of expenses "properly chargeable to income".[15] The only expenses deductible were "income" expenses, expenses recognised by the natural legal meaning:

> "Income tax has been judicially pronounced to be a tax on income. In arriving at the amount of income liable to income tax, Parliament may expressly provide that certain income expenses may be deducted. The legislature may go further and expressly provide that certain capital expenditure or capital allowances may be deducted for tax purposes. Fiscal legislation of that kind does not convert capital expenditure into an income expense. If the legislature provides for capital expenditure to be deducted for income tax purposes, the legislature does not increase or reduce the income of the taxpayer but reduces the amount of the income of the taxpayer which is liable to tax."[16]

The lesson that may be drawn is that the task of the draftsman of an income tax who would refashion the definition of income so that it is exclusively a concept of gain will be difficult indeed. *Carver* v. *Duncan* has its parallel in the view of Dixon C. J. in *Fuller*,[17] that a specific provision of the *Assessment Act* cannot make an item income where that item is not within the ordinary usage notion of income. It can only require that it be treated for tax purposes as if it were income. The draftsman stands always to be defeated by the entrenchment of the "natural legal meaning".

The Inappropriateness of the Judicial Concept as it has been Received into Income Tax Law

The judicial concept of income as the base of an income tax cannot give coherence of principle and a claim to fairness. As a concept whose function is to assist in filling out what may be the inadequate expressions of intention

[13] [1985] 2 All E.R. 645.
[14] Supra note 12.
[15] Supra note 13, p. 654.
[16] Ibid.
[17] Supra note 11, p. 409.

of a settlor in a trust instrument as to what should belong to the life tenant and what to the remainderman, it is a manifestly inappropriate base for a tax. It has the effect of excluding capital gains from the base of the tax, whether or not there was any policy to exclude them. The relevant principle, as an aspect of the trust law concept, is simply that proceeds of realisation of capital assets belong to the remainderman. As the base of an income tax it has the effect of treating "flows" as income, though they do not reflect the realisation of any gain by the taxpayer. The judgment of Pitney J. in the United States Supreme Court in *Eisner* v. *Macomber*[18] has provided us with the most quoted description of an income flow:

> "The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time . . .
> Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment, but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived'*, that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description."[19]

The use of the words "gain" and "profit" must be read in context – " something . . . *proceeding from* the property". It was never true of the concept of income in trust law, or in income tax law concerned with income from property, that there should have been a gain to the person who owned the property, to be found in what "proceeded" from the property. A dividend was always income though it was paid to an owner who had just acquired the shares and who suffered a decline in the value of his shares equivalent to the dividend he received, a decline that took the value of his shares below their cost. A conclusion that the concept of income as developed in trust law does not require an element of gain follows from the rule in *Howe* v. *Lord Dartmouth*,[20] in relation to the conversion of wasting and reversionary property, and the law as to who is entitled to the income of that property pending conversion. That law may reflect a view that what belongs to the life tenant *should* be a gain unless the author of the trust instrument has given a different direction, but it is a direct recognition that gain is not an aspect of the character of income in trust law usage. The rule in *Howe* v. *Lord Dartmouth* and the law in relation to the conversion of wasting and reversionary property is necessary *becuase* the concept of income does not require that there be a gain.

[18] 52 U.S. 189 (1919).
[19] Id. paras 206-7.
[20] (1802) 7 Ves. 137; 32 E.R. 56.

Inappropriateness of the Judicial Concept in Taxing Royalties

The consequence of the flow concept of income for the income tax, that it may treat as income a flow that is not a gain, is evident in many contexts. Receipts for the use of one's property by another are income in the whole of their amount notwithstanding that the use will cause a wasting of the property. Royalties will provide an illustration. In this instance the natural legal meaning of income is reinforced by an express provision in s.26(f) of the *Assessment Act*. A so-called "capital allowance" may seek to reduce the amount of the royalty that is income so that it does reflect a gain. Section 124J does make some contribution to this end. But it is narrow in being confined to circumstances where there is a use of one's land by another who takes timber from the land. No capital allowance is provided for where the use by another involves the taking of sand or gravel from the land. In any case a capital allowance will never precisely serve the purpose of reducing the flow to its element of gain. Fixing the element of gain realised must have regard to the value of the property immediately following the flow and to the cost of the property to the taxpayer. And this must lead one to wonder whether the Simons' notion of gain is a revelation that can ever find any more than a limited expression in a feasible income tax. From the passage quoted earlier[21] in this lecture it is clear that Simons was persuaded that a feasible income tax must be confined to realised gains, which will leave the bulk of gains – unrealised gains – outside the base of the tax. And his observations relate to realised capital gains where, save in a partial realisation situation, the determination of gain does not require any resort to valuation. He made no observation in relation to gains that are realised in the flow of income from property. Yet in this context the determination of the amount of the gain cannot escape a valuation. The dismal conclusion is that the only principle that could give coherence and a claim to fairness to an income tax is beyond achieving in a feasible income tax.

Inappropriateness of the Judicial Concept in Taxing Annuity Receipts

There are many other contexts in which it is evident that the flow concept of income may treat as income proceeds of realisation that do not involve a gain. An annuity receipt under a purchased annuity will not be a realised gain in its full amount. The law in the *Assessment Act* s.27H does provide for a capital allowance, in the form of a fraction of the purchase price, which will provide some relief from tax on what is not a gain, though for this purpose the purchase price is not indexed. There are cases in which the terms of the capital allowance have been interpreted so as to deny the allowance when it clearly ought to have been available: *Just* v. *F.C.T.*[22] and *Egerton-Warburton* v. *V.D.F.C.T.*.[23] As in the case of royalties, the determination

[21] See text supra note 7.
[22] (1949) 23 A.L.R. 47.
[23] (1934) 51 C.L.R. 568.

of gain should in any case have regard to the value of the annuity immediately after the flow, and to the cost of the annuity.

Inappropriateness of the Judicial Concept of Income in the Taxing of Dividends

It is in regard to dividends that the concept of flow has taken the law furthest from the concept of gain. The distinction between a flow from property and a receipt which is a realisation of the property itself has in this area lost all substance. Yet the courts have held fast to the distinction in interpreting specific provisions which make a distribution from company profits income. The statutory provisions[24] owe very little inspiration to the concept of gain, and the blending of them with the notion of flow has produced bizarre consequences. Some of those consequences are the conclusion in *F.C.T. v. Uther*[25] that a substantial distribution which was expressed to be for a minimal reduction in the amount paid up on a share was not a flow but a receipt in the partial realisation of the share itself, and was not income. Amendments to the law[26] which may have corrected *Uther* may yet in other situations have left the possibility of a like conclusion. The Federal Court recently in *Slater Holdings* v. *F.C.T.*[27] left the possibility open. In any case the conclusion in *Uther* that the distribution was a flow from property and thus income, might have brought to tax an item that was not a gain. Gain calls for an identification of cost of the shares, and of the value of the shares immediately after the flow.

Treating a dividend as income without any regard for its character as a gain by the shareholder who receives it, gives rise to some strange consequences when the dividend carries an imputation credit and there is a tax on capital gains. A shareholder may hold shares during a period when profits are made by the company and are taxed in the company's hands. Thereafter he sells the shares. He will make a capital gain that is explained by the taxed but undistributed profits the company has made. He should have the imputation credit. In fact the imputation credit will go to the purchaser from him who receives the dividend from the company. It will go to the purchaser because he has a flow that is income, though he has no gain. There is a war between concepts, and coherent principle and any claim to fairness made by the income tax are destroyed in the battle.

Inappropriateness of the Judicial Concept of Income in the Taxing of Interest Receipts

On the face of it, a flow that is interest will be a gain where the taxpayer has held the debt during the period since the previous flow, though it may not be so if interest rates have risen since the debt was acquired. But it may not be a real gain. Whether there is a real gain involves a comparison of

[24] *Assessment Act* s.6(1) "dividend", and s.44(1).
[25] (1965) 112 C.L.R. 630.
[26] *Assessment Act* s.6(1) "dividend", paras (d) and (e).
[27] (1983) 47 A.L.R. 575.

the rate of inflation during the period of the loan to which the interest relates and the rate of interest. The defeat of any concept that income is a gain becomes complete when the element of premium provided for on repayment of a capital indexed loan is expressly made income, as it is by recent amendments to the *Assessment Act* in new Division 16E. In this instance the statutory provisions destroy any room left for excluding nominal gains from tax. Where the capital indexed loan is a Government bond, there is a crude deception practised by Government.

Inappropriateness of the Judicial Concept of Income in Taxing Income from Business.

When one comes to apply the judicial concept in the context of business operations, it loses all touch with any idea of gain. That loss of touch is to be explained by the attempt to maintain a flow concept of income, which finds expression in a willingness to find income simply in receipts from the business operations. The decisions of the courts on the judicial concept for purposes of trust law are chaotic in their logic and beyond the comprehension of lawyers, save those who practise the occult arts of equity. Most of the cases have arisen from pastoral activities in Australia and New Zealand, though one leading case involves tin smelting.[28]

The flow concept of income in the context of business operations directs that income be found not in the abstraction which expresses the notion of a profit, but in the fact of receipt which will generally be the proceeds of realisation of an asset. Some proceeds will be said to belong to the life tenant as a flow from the business, while other proceeds will be said to belong to the remainderman as proceeds of the business itself. The characterisation will be made of the whole of the receipt, thought it may be diminished by expenses which will be called income expenses or capital expenses. Income tax lawyers would know it as an accounting for receipts and outgoings. Debate and conflict of opinion surrounds the question of whose interest, the life tenant's income interest or the remainderman's interest, should bear the cost of acquiring trading stock in different situations. The facts under consideration may involve acquisition of stock in the maintaining of stock at some level of holding – the level at the time of commencement of the trust or some level to which the holding has risen or fallen – or the restoration of the level of holding to the level before some catastrophe of drought or fire occurred. In some cases the solution reached is a compromise: the remainderman's interest should presently bear the cost, though a sinking fund should be established that over a period of years will recoup that cost from the interest of the life tenant.

One decision of the High Court – *McBride* v. *Hudson*[29] – is utterly out of phase with all the other decisions on the concept of income in the context of business operations. What can only be described as a revolutionary view, thus expressed by Taylor J., prevailed:

[28] *Kelly* v. *Perpetual Trustee Co. Ltd.* (1963) 109 C.L.R. 258.
[29] (1962) 107 C.L.R. 604.

"Consideration must be given to the nature of the relevant business activity and to the manner in which it is customarily carried on and, if in the course of carrying on a business pursuant to a direction to do so trustees adopt an appropriate and conventional method of accounting in order to determine the amount of profit to which a life tenant becomes entitled during any accounting period, no exception can be taken . . .".[30]

It is in the context of an explanation of the method previously thought appropriate, that the revolutionary character of the decision in *McBride* v. *Hudson* becomes apparent. Taylor J. said:

". . . I find myself unable to subscribe to the proposition that a livestock trading account constructed only by a comparison of the amounts expended in the purchase of livestock during a particular accounting period with the amount realized by the sale of livestock during the same period, can, with any reality, reflect the profit or loss in the activity with which the account is concerned. Is it possible to say that a loss has been incurred if all we know is that in a particular year one thousand sheep have been purchased at £1 per head and five hundred sheep, being either some of those purchased or others, have been sold at £1.10.0 per head? Or can it be said that a profit has resulted if all we know is that one thousand pounds have been expended in the purchase of sheep and one thousand and five hundred pounds realized by the sale of natural increase? And, in such a case, is the answer to remain unaffected if we are allowed to know that during the course of the year five hundred sheep valued at £1 per head have died?"[31]

The conventional method of accounting thought appropriate by Taylor J. was the method of the general principles of financial accounting, directed not to the ascertainment of income in its natural legal meaning, but to the ascertainment of profit. Within that profit there might be distinguished a revenue profit from a capital profit. But the distinction thus drawn is far removed in its substance from the distinction between income in its natural legal meaning. The designation capital profit is intended to identify a profit that is not made in the ordinary course of carrying on the business. Its extraordinary nature is thus noted for the information of proprietors of the business, and where the proprietors are a company its nature may be significant when the company proposes to pay a dividend.

The authors of *Jacobs' Law of Trusts in Australia* observe "The impact of *McBride* v. *Hudson* upon the principles . . . supported by the earlier cases remains a matter for speculation".[32]

It may be that accounting for receipts, and for expenses that should be met from those receipts, with all its difficulties of determining from what source – capital or income – an expense should be taken to have been met, is appropriate when the issue is a fair treatment of life tenant and remainderman, so that it is to be preferred to the accounting proposed in *McBride*

[30] Id. p. 623.
[31] Ibid.
[32] R.P. Meagher and W.M.C. Gummow, *Jacobs' Law of Trusts in Australia* (5th ed., Sydney, Butterworths, 1986) p.497.

v. *Hudson*. But accounting for receipts and expenses is utterly inappropriate when the issue is the identification of income from business operations in trading stock for purposes of income taxation. In this context, the accounting in *McBride* v. *Hudson* is dictated. *Investment and Merchant Finance Corp. Ltd* v. *F.C.T.*[33] is seen by tax lawyers as a decision that shares in companies can be trading stock and subject to the specific statutory regime in ss.28ff. of the *Assessment Act* for the calculation of income from a business that has trading stock. The case thus resolved an issue of the same kind as that resolved in *F.C.T.*v. *St Hubert's Island Pty Ltd (In Liq.)*,[34] in which it was held that land could be trading stock within the statutory regime. The broader significance of those cases is that they enabled the High Court to escape the application of the judicial concept of income which would have produced quite unacceptable results when applied to the determination of income for tax purposes. To account for income from share trading in the fashion described by Taylor J. in the passage quoted above from *McBride* v. *Hudson*,[35] would have produced grotesque results. A share trader would have been able to grow ever richer and yet never pay income tax if he followed the simple expedient of always increasing his holding of shares at year end. He would purchase more shares at a cost that was equal to the surplus of proceeds of sale of shares during the year up to this time. That is the consequence of the receipts and outgoings approach as it is part of the natural meaning of income. The High Court in *Investment and Merchant Finance* saw the statutory regime prescribed for trading stock as an escape from this consequence. They took this line of escape by holding that the shares involved were trading stock as defined in the *Assessment Act*. Our trading stock provisions, following like provisions in financial accounting, do express a gain concept of income, in this context a notion of a specific profit. It is a regime that reflects a profit or gain concept of income which one might have thought would have suggested a general underlying principle of income for purposes of the income tax. Clearly the High Court saw the trading stock provisions as offering more appropriate underlying principle in determining the step already taken in *McBride* v. *Hudson* to rework the natural meaning of income. This may suggest that the High Court regarded *McBride* v. *Hudson* as an aberration: the natural meaning of income in trust law, and as it is entrenched in income tax law, remained secure.

The Distinct Concept of Income as a Gain Reflected in the Trading Stock Provisions, and its Reception into the Judicial Concept

The underlying principle of the trading stock provisions of the *Assessment Act* is that income is a profit, or, in a wider expression, a gain. It is true that the notion is *realised* profit or gain which retains some of the inappropriateness of the flow concept of income. It will generally ignore the unrealised

[33] (1971) 125 C.L.R. 249.
[34] (1978) 138 C.L.R. 210.
[35] See text supra note 31.

gains or losses in relation to other assets, which ought to qualify the characterisation of the consequences of a particular realisation. In fact the trading stock provisions in allowing the taxpayer to write down the value of unrealised trading stock will enable the taxpayer to confine the profit or gain that is income to a profit or gain that is not limited to realised profit or gain. But the trading stock provisions do not require such writing down.

At least for a time after *Investment and Merchant Finance*, the High Court remained apparently unmoved by the underlying principle of the statutory regime expressed in the trading stock provisions. The entrenched natural law meaning of income remained secure. We continued to be assured that profit or gain was a notion alien to the income tax, save when some express provision, like the intruder s.26(a), said otherwise. The alien notion has however infiltrated, not entirely unnoticed but only grudgingly acknowledged. The Commissioner's practice was always ahead of the courts in some areas, more especially the taxation of life insurance companies and banks in relation to the realisation of their investments. In that area a regime akin to the trading stock regime was accepted. There are two landmarks in the reworking of the natural legal meaning of income by the courts so as to embrace a specific profit. The first is the decision in *International Nickel Australia Ltd* v. *F.C.T.*,[36] in which it is openly acknowledged that in the context of transactions which involve foreign currency the item of income or loss is an exchange profit or loss. It is a sad irony that the Treasurer has promised to obliterate this landmark and to treat such profits or losses as "in the nature of interest". In this context the concept of income is to be forced back into a flow concept. We will see that there are other illustrations of a retreat into a flow concept in recent action of Government and Parliament.

The second landmark is *F.C.T.* v. *Whitfords Beach*[37] where it is acknowledged, though less openly, that s.26(a) was not an intruder, but merely expressed, perhaps more exactly, a notion of income that is part of the natural legal meaning of income.

A concept of income that occupies itself exclusively with receipts and the allowance of expenses will always be simpler and more predictable than a notion that seeks profit or gain. *Curran* v. *F.C.T.*[38] is with respect one of the most unhappy decisions to come from the High Court. At least in the judgment of the Chief Justice, it was an attempt to refine the notion of profit or gain reflected in the trading stock provisions so as to allow a cost for an item of stock that is seen as taken into the process of profit making. It was an attempt in the operation of the trading stock provisions to do what was done in *Whitfords Beach* in allowing a cost for the land, being its value at the time it became subject to a profit-making venture. It is another sad irony that the attempt to bring a new insight to the notion of income should have gone so astray. The notion of profit or gain does not require the allowing of a cost where an item is not taken into the process of profit making, but

[36] (1977) 137 C.L.R. 347.
[37] (1982) 150 C.L.R. 355.
[38] (1974) 131 C.L.R. 409.

merely arises in that process, and is not itself an item that may be seen as a realisation of profit.

A concept of income that would ignore receipts and expenses, and would seek a pure principle of gain that embraces unrealised gain – the notion that Simons espoused in theory – can cut free from flows of receipts and the allowance of expenses. But a feasible income tax – as Simons accepted both for income and capital gains – must work with realised gains, and that initially involves flows of receipts and the allowance of expenses. It is in the adjustments that are made that the approach to a notion of income as a gain can be made. Thus the trading stock provisions of the *Assessment Act* involve a pattern of adjustments, most important those that defer an outgoing for stock until the stock is sold. The consequence is to bring in an item of profit on realisation. Where the item that may give rise to a realised profit is not trading stock a like deferring is necessary. This requires a simple denial that the cost of the stock is an outgoing for purposes of the *Assessment Act*, and a recognition that the cost is relevant only to the determination of the profit on realisation of the item that will be income. That recognition is the contribution of *International Nickel* and of *Whitfords Beach*. The accounting involved might be described as specific profit accounting.

Where neither trading stock nor other property which can give rise to a specific profit on realisation is involved, the reworking of the judicial concept by adjustments that may bring out a gain that is income will concern the timing of the recognition of a receipt, and the timing of the recognition of an outgoing. Without such adjustments, accounting that is concerned with receipts and the allowance of expenses will produce consequences that are as inappropriate as would be the consequences of an accounting for trading stock which ignores the conventions of financial accounting. The receipts and outgoings accounting adopted in *New Zealand Flax Investments Ltd* [39] stands condemned by its consequences. The company was taxed substantially on its gross receipts from investors though it had given undertakings to its investors to incur expenses from those receipts which might ultimately have involved a commercial loss. The tax deprived the company of the means of financing those expenses, ensured its financial failure and undeserved losses for a great number of small investors. Dixon C.J. voiced his condemnation of the consequences:

> "If there is any ground upon which the plan adopted for conducting the operations of New Zealand Flax Investments Ltd. may be extolled, it must be for the manner in which it illustrates the difficulty of applying the provisions of the Federal income-tax law when a transaction takes more than a year to complete and the true profit arising from it cannot be ascertained until it is completed or carried further towards completion than a year allows. In such cases a satisfactory estimate of the position at the end of a year may often be made, but upon commercial principles. If that is done, a suitable provision for future outlay must be made against current receipts . . . But, under the *Income Tax Assessment Act* 1922-1930, the assessment must begin by taking, under the name of assessable income,

[39] (1938) 61 C.L.R. 179.

> the full receipts on revenue account, and only such deductions must be made as the statute in terms allows. At all events that is the interpretation which the statute has received in this court."[40]

The condemnation came strangely from Sir Owen Dixon who had, in *Fuller's Case*,[41] shown himself to be the champion of the natural legal meaning of income and had made a contribution to its entrenchment in the *Assessment Act*. The condemnation is made in terms that would attribute the blame to Parliament. Yet there is nothing in the *Assessment Act* that requires the consequences he describes. There was always room for the courts in the interpretation of the Act, more especially in the interpretation of the words "derived" and "incurred", to ensure that the *New Zealand Flax* consequences did not result. The blame is to be laid at the feet of the judicial concept of income.

Some 27 years after *New Zealand Flax* the High Court took the opportunity through the word "derived" in the *Assessment Act* to reject some of the judicial concept of income. *Arthur Murray (N.S.W.) Pty Ltd* v. *F.C.T.*[42] is a decision of great significance. A gain will only emerge when a taxpayer has incurred the outgoings that attend his "earning" of receipts – the word is adopted from *Arthur Murray*. Derivation of those receipts will be deferred until earning.

But *Arthur Murray* has not lived up to its promise, largely because of the Commissioner's unwillingness to concede that it has a wide operation. And there has been no more than a hint of judicial acceptance of a corollary of *Arthur Murray* which requires a rejection of the natural legal meaning of income when the significance of an outgoing is to be determined. An outgoing that has been in other respects incurred, but whose contribution to the making of a gain will in part relate to receipts of later years, should be treated as incurred only as those receipts are derived. The payment of interest, rent or management fees in advance does not limit a gain in the year of account, for it is matched by a continuing benefit that is bought by the payment – the right to future use of money or property, or the future provision of services. Yet, *F.C.T.* v. *Ilbery*,[43] *Creer* v. *F.C.T.*,[44] at first instance and *F.C.T.* v. *Lau*,[45] would treat the outgoings as deductions presently incurred. Only *F.C.T.* v. *Australian Guarantee Corporation Ltd*[46] offers a hint of judicial acceptance of a principle that the outgoing should not be treated as incurred save so far as the benefit from it is consumed. *F.C.T.* v. *Creer*,[47] in the Federal Court, treats rent in advance as a capital outgoing. So treating it may be appropriate in some circumstances where a very substantial

[40] Id. p. 199.
[41] Supra note 11.
[42] (1965) 114 C.L.R. 314.
[43] (1981) 81 A.T.C. 4661.
[44] (1985) 85 A.T.C. 4104.
[45] (1984) 84 A.T.C. 4929.
[46] (1984) 84 A.T.C. 4642.
[47] (1986) 86 A.T.C. 4318.

continuing benefit is acquired but deferral of the outgoing is generally the more appropriate. If the outgoing is treated as a capital outgoing an allowance in respect of it must await the expiry of the lease, when there will be a capital loss.

In one context the High Court has refused to treat an outgoing as not yet incurred though it is clearly an outgoing that limits any present gain. The decision in *Nilsen Development Laboratories Pty Ltd* v. *F.C.T.*[48] deserts any notion of income as a gain in order to serve a distinction between an obligation to pay for services already performed and an obligation to excuse an employee from the performance of services by the grant of paid leave. The distinction has been confirmed by legislation in s.51(3) of the *Assessment Act* a provision whose policy cannot be more than ensuring the collection of revenue before a gain is made and when, indeed, it may never be made.

Nilsen is, with respect, an aberration. The disposition of the High Court has been to allow the present deduction of an outgoing in circumstances where the consequence in limiting a gain is even more damaging than in *Ilbery*, *Creer* and *Lau*. The High Court in *F.C.T.* v. *South Australian Battery Makers Pty Ltd*[49] adopted the Privy Council decision in *Europa Oil (N.Z.) Ltd (No. 2)* v. *I.R.C. (N.Z.)*[50], which would find the rule of law in judging an outgoing by "legal" as distinct from "economic" reality. If the taxpayer has incurred an outgoing in pursuance of a transaction cast in some legal form, the purpose of his outgoing can be found only in the words of the transaction. The tax planning that arose from *South Australian Battery Makers* may be defeated by the complex provisions of the Act that now appear in section 82KJ and 82KL. But those sections should never have been necessary. The restoration of a principle that would judge the purpose of an outgoing by reference to all the attendant circumstances requires the overruling of *South Australian Battery Makers*.

The Impossibility of Adapting the Notion of Flow to the Notion of Gain Where the Item of Income is a Flow from Property

Some adapting of receipts and outgoings to the notion of gain by establishing principles governing the timing of the recognition of receipts and of outgoings is possible over a substantial area of what have been identified as flows from business. But in relation to other flows — those that are flows from property other than a business — adapting will remain beyond any room there is for judicial development of the law. Deductions may be allowed, for example, for interest on money borrowed to invest in shares. But such deductions will not reduce a dividend that enters the base of the income tax as taxable income to a true gain when that dividend is paid on shares which the taxpayer has purchased cum dividend. Indeed, reduction of a flow to a true gain in these areas must always require a valuation of property

[48] (1981) 144 C.L.R. 616.
[49] (1978) 140 C.L.R. 645.
[50] (1976) 76 A.T.C. 6001.

immediately after the flow and a reduction of the flow by reference to any diminution in the value of the property below its cost.

The Impossibility of Receiving the Notion of a Capital Gain Into the Judicial Concept of Income

A development of the concept of income for purposes of the income tax, so that it will include capital gains has always been more than could be expected of the courts. The notion of income in its natural legal meaning is born of a distinction between income receipts and capital receipts. To attempt an extension of the concept of income to include capital gains is simply to attract an internal contradiction. The entrenched concept of income must be deliberately rejected, and a new concept substituted by Parliament. It will be seen that the decision of Parliament is to retain the entrenched concept and make distinct provision for the taxing of capital gains.

A development of the law so that it will include only real gains and not gains that are merely nominal, is more than can be expected of the courts. The natural legal meaning that has inspired the courts had no concept of gain, real or nominal. Indexation of costs in a transaction may make some contribution to limiting the gain to real gain, but the correction it achieves may leave a real gain in some other transaction to be treated as a loss, e.g. where interest is allowed as an outgoing and the interest rate is less than the rate of inflation. The United Kingdom Courts in *Lomax* v. *Peter Dixon & Son Ltd*[51] may have left open the possibility of excluding a nominal gain where it is in the form of a premium received on the repayment of a loan. But the correction would be on a narrow front. If correction is to be achieved it must be done by Parliament. There is some correction in the indexation proposed in respect of costs in computing capital gains, but there is no correction proposed in respect of liabilities. If the experience of other countries is a guide, thoroughgoing correction is impossible.

Summary

In summary, the judicial concept of income which is the origin of judicial interpretation of the income tax concept, was always inappropriate in an income tax. Its function was far removed from the function of the concept of income in the income tax. The trust concept was not moved by any underlying notion of gain which is the only notion that could give it coherence and a claim to fairness as the base of an income tax.

There is some evidence of a judicial endeavour to give the income concept for purposes of the income tax an element of coherence and claim to fairness that would follow adaptation to the notion of gain. But the achievement is singularly haphazard, and, at times, unwilling. In two areas, the inclusion of capital gains and limiting gains to real gains, adaptation of the income concept was always beyond any judicial achievement. Adapting the notion of flow to the notion of gain, in relation to flows from property, would require

[51] [1943] 1 K.B. 671.

a valuation of property to which the flow relates after each event and this would be beyond any room there is for judicial development of the law.

The task of Parliament, if it seeks to give the notion of income coherence and a claim to fairness, has not been made easy by the disposition of the courts in interpretation to entrench the natural legal meaning of income – their own creation – in the *Assessment Act*. There is a suggestion that the natural legal meaning has a claim to truth and validity which transcends the power of the courts and Parliament. Identified as the meaning of income in section 25(1) of the *Assessment Act*, the natural legal meaning reduces the significance of other provisions in the determination of what is income for purposes of the Act. It becomes a barrier to development whether by judicial or legislative action.

IV PARLIAMENT'S CONCEPT OF INCOME AS THE BASE OF THE INCOME TAX

Until recently in the history of our income tax Parliament has played a comparatively minor and occasional role so as to contribute to a concept of income that will accommodate the notion of gain. One contribution is the adopting of trading stock provisions from the conventions of financial accounting. Some of its role has been correction to overcome an obvious unfairness to the taxpayer arising from judicial decisions defining the concept of income. Section 27H (until recently s.26AA) is an example. Section 27H in one of its aspects is directed to excluding from the base of the tax that element of an annuity receipt that is not a gain, because it is in effect a return to the taxpayer of a part of the purchase price he outlaid to acquire the annuity. The courts have not welcomed the correction of the judicial notion. There are two decisions of the High Court – *Just*[52] and *Egerton-Warburton*[53] in which the taxpayer was denied the operation of s.27H, or its predecessor, on a close construction of the provision, and Parliament has not been moved to reverse the construction.

Section 124J in one aspect is an attempt to bring some requirement of gain to the law by which timber royalties are income, law established in *McCauley's Case* v. *F.C.T.*[54]. The section gives a capital allowance related to the cost of the timber at the time the land was acquired. More appropriately there should be an allowance of the amount by which the value of the land, after the timber has been taken, is reduced below its cost. What correction to limit income to a gain is achieved by s.124J is not in any event extended to other situations, such as the grant of a licence to take sand or gravel from land in exchange for royalties.

In another situation Parliament has acted not to correct but to confirm the defeat of the notion of gain implicit in the action of the High Court in

[52] Supra note 22.
[53] Supra note 23.
[54] (1944) 69 C.L.R. 235.

denying a deduction in respect of a liability to grant long service leave. Where a right to leave has arisen, the liability to grant leave is an obvious limitation on any gain that tax accounting may reveal in business operations. Section 51(3), added before *Nilsen Development Laboratories Pty Ltd*[55] reached the High Court, confirmed in advance the decision of the High Court in that case. Section 51(3) has the effect of taxing a gain which has not been derived and may never be derived.

Preserving the Revenue Against the Consequences of Judicial Interpretation

In the circumstances arising from the decision of the High Court in *South Australian Battery Makers*[56], Parliament has moved to preserve revenue against the consequences of judicial interpretation. The effect of sections 82KJ and 82KL is to deny a deduction for what is in economic reality not an expense that limits a gain, though it may be such in a legal reality that can look only to the terms of a document for its discovery. It has protected revenue by legislative provisions which are complex beyond all tolerance, though they demonstrate beyond doubt that the judicial interpretation was unacceptable.

Other provisions which may be seen as preserving the revenue, concern the denial of a deduction for entertainment expenses and the requirement of substantiation of other expenses.[57] They have the same function as sections 82KJ and 82KL. They remove from deductibility expenses which would limit gains, but may be unreal. The price is the removal of some expenses which are real limits on gains, but are sacrificed in the cause of removing the unreal. The new tax on fringe benefits displaces the operation of the income tax on real gains by employees that may be difficult to identify, by a surrogate tax on the employer.

A Direct Rejection of the Judicial Concept of Income

Parliament's recent extension of the base of the income tax to include capital gains involves a significant achievement for Simons' theory. And the extension involves a renewed attempt by indexation of cost to limit to real gains those gains that are brought to tax. The attempt is however confined to capital gains, and the measures which sought some years ago to limit gains in respect of trading stock to real gains by indexation of cost remain discarded.

Parliament's achievement is qualified. It adopts a limitation which Simons thought inevitable: only realised gains are brought to tax. And only nominal losses are recognised. In the result the operation of the tax is haphazard. It may tax a realised gain when real realised losses are greater than real realised gains. And it may tax a realised gain when realised and unrealised real losses exceed all real gains, realised and unrealised. Indexation is confined to transactions involving the disposal of assets. It ignores a real gain that would be

[55] Supra note 48.
[56] Supra note 49.
[57] Section 51AE, ss.82KT-82KZB.

revealed by indexation in some related transaction involving the assumption of a liability where interest is less than the rate of inflation.

Perhaps because Simons and Simons' disciples did not suggest it, Parliament did not direct any attention to general provisions which will bring capital gains on the discharge of liabilities into the base of the income tax and allow capital losses on discharge. There is a specific provision allowing a loss applicable to a lessor who makes a payment to obtain a modification of his liabilities under a lease. But other situations, such as a payment by the taxpayer to obtain a release from a restrictive covenant, are not dealt with.

A Retreat into the Womb of the Flow Notion of Income

In two instances in the present year Parliament has abandoned the identification of gains, and has retreated into the womb of the flow concept of income. One instance is in provisions outside the capital gains tax. The other instance is in provisions within it.

The legislation to deal with the circumstances of *F.C.T.* v. *The Myer Emporium Ltd*[58] produces a stark demonstration that there may be income though no gain when a flow concept applies. In this instance a flow concept is applicable by legislative direction intended to make law for the future one of the Commissioner's submissions in the case. Immediately after making a loan to its subsidiary, Myer sold the rights to interest on the loan to a finance company, retaining the right to repayment of the principal sum. The legislation directs that the whole of the receipts on the sale of the rights to interest is income: new section 102CA *Assessment Act*. It will be apparent that there was no gain. The proceeds of sale of the rights and the value of the rights the company retained were in total no more than their cost — the amount of the company's loan. The failure of the law in the Myer legislation, to be concerned with gains is highlighted by the operation of other recent legislation. That legislation will require that a company in the circumstances of *Myer* will be taxed again on what this time may be thought to be gains, accruing over the period it holds the rights to repayment of the principal sum: new sections 159GZ and 159GQ *Assessment Act*. Those gains are the increases in value of the right to repayment of the principal sum as the time for repayment approaches. If that legislation does not achieve this result, the new capital gains tax legislation will find a capital gain that is taxed as income on the repayment of the principal sum. Grand ironies in the tax reform legislation of recent months will be found in the capital gains tax provisions. Those provisions are designed, we are told, to bring real capital gains to tax as income because they represent "an increase in purchasing power" and thus "should be included in any comprehensive definition of income".[59]

Yet the law retreats into the womb of flow notions of income in a number of its provisions. One illustration is that a premium taken on the grant of a lease will be a capital gain in the whole of its amount, notwithstanding

[58] (1985) 85 A.T.C. 4601, presently on appeal to the Full High Court.
[59] Supra note 2, para. 7.1.

that the grant of the lease may have brought about a reduction in the value of the property leased below its cost. There is another illustration that will take us back to *McCauley's Case*[60] and the timber. In *Stanton* v. *F.C.T.*[61] the High Court decided that a form of agreement that differed from that used in *McCauley* only in the respect that it purported to sell timber standing on land, rather than give a licence to take it, did not involve a derivation of income for the receipts were proceeds of sale of a capital asset. A provision in s.160M(7) of the new Part IIIA of the *Assessment Act* dealing with capital gains is drafted in the widest terms. Its effect is that the proceeds of sale of the timber in *Stanton* circumstances will be a capital gain in the whole of the amount without any allowance for the fall in the value of the land that results from the taking of the timber. Another effect of that provision is that the whole of a receipt for undertaking a restrictive covenant will be income notwithstanding that the taxpayer has sterilised for a period his capacity to earn income.

In these and other of its provisions the capital gains legislation enters on a rogue operation. It will tax as a capital gain a receipt which is neither a flow nor a gain. It may tax as a capital gain a subscription for units received by the trustee of a unit trust. The capital gains legislation may thus force us back to the horror of *New Zealand Flax*,[62] when receipts that reflect investments by others are treated as income of the receiver, and the levy of income tax destroys the investments by destroying the receiver.

The Prospect of a General Achievement of Simons' Revelation

The revelation of Simons is an ideal beyond any general achievement, whether by the courts or Parliament. Simons himself conceded that the ideal must be compromised by confining it to realised gains. And in the Australian context Simons' disciples have always proceeded on a false premise – that the income tax in its existing base was a tax on realised gains. One message of this lecture is that in general it is not so. Simons' concession and the false premise are at once suggested and glossed over in the opening paragraph of the White Paper as it is concerned with capital gains. The paragraph would salute Simons' impending achievement:

> "Because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income. The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of the objectives of equity, efficiency and combating tax avoidance".[63]

[60] Supra note 54.
[61] (1955) 92 C.L.R. 630.
[62] Supra note 39.
[63] Supra note 2, para. 7.1.

What new endeavours can we expect? It is true that there have been murmurings about the possibility of indexation generally in determining the base of the income tax. But there is no proposal. And the murmurings were repudiated in the Treasurer's announcement of December 28, 1985 that a premium received on a capital indexed bond will be treated as income. That announcement has been given effect in a new Division 16E of the *Assessment Act.*

The comprehensive tax base is certainly not achievable by adapting the present income tax base. The natural legal meaning of income can be rejected, it cannot be transformed. And a new income tax will always be far from the achievement. Its perspective will always be miserably narrow. It will remain a tax on realised gains. A truly comprehensive income tax would involve an annual valuation of all items of property, and, I would suggest, of all items of liability, and a universal indexation of costs. This may be high drama. But an attempt to achieve such comprehensiveness would only advance our inevitable complete disillusionment and the abandonment of the income tax.

V INCOME TAX IS A GAME

A tax will not have respect, and will not deserve respect, unless it is coherent in principle and has a claim to fairness. If the income tax ever enjoyed respect, it has lost that respect. Being taxed involves playing some kind of game involving forfeits, in which the unwary or ill advised may expect defeat. There are prizes of immunity from tax if you land on a particular square. If you land on any other you must pay a forfeit, and you will want to avoid such squares. Obviously this understates such elements of sense and policy as there are in the *Assessment Act*, but as a caricature it is instructive. A taxpayer who has invested in an indexed bond will be taxed on the premium he receives though that premium was intended to identify the element of unreal gain which he has derived from his investment. Indeed under Division 16E he may be taxed on the unreal gain as it "accrues" and before it is realised. One might think this is a sorry outcome. A taxpayer who has invested in shares on the other hand will be entitled to indexation of his cost, and thus will not be taxed on any unreal gain, either as it "accrues" or on realisation. The contrasting consequences on their face indicate to those who know these consequences what square is to be avoided.

As the law stands at present a taxpayer who incorporates his business so as to have the protection of limited liability will attract two separate income taxes. There will be one on the company on its profits and the other, a personal tax, on dividends. There is a double forfeit. Even under the new imputation system there will be a continuing double forfeit attracted by choosing corporate form if his business derives foreign source income. The effect of the compensatory tax which is an aspect of the imputation system is to deny the taxpayer the foreign tax credit which the new law is intended to give him

– a credit he might have had if he had not incorporated his business. To those income tax liabilities thus attracted there must now be added a liability to tax on a capital gain, which the shareholder will attract on the transfer or redemption of his shares. His capital gain may reflect a profit made by the company and retained, after tax, by the company. There will be a double forfeit in relation to tax on what is in substance the same gain. On the face of it, he should await the distribution of the profit before selling his shares.

A taxpayer who has invested in units of a unit trust runs the same risk of a double forfeit on the same gain. Indeed, any beneficiary runs that risk.

The Importance of Not Appearing to Want to Win

The game the taxpayer must play is one in which it has become very important that it should not appear that he played as he did to ensure that he did not land on a square that will attract a forfeit. If the way he played the game suggests that this was his purpose, the Commissioner is empowered by Part IVA to shift him on to the square it was his purpose to avoid. Part IVA is indeed the most bizarre aspect of our income tax. It is a proclamation of failure to define a notion of income that will bring to the tax coherence of principle and a claim to fairness. Part IVA must be taken to have written out the qualification on its operation which the High Court had written into s.260 the predecessor. That qualification was that the section did not give the Commissioner the power to move the taxpayer to the square which he had shown a purpose to avoid, unless there was a policy to be found in the law that he might not choose the square to which he in fact moved. The qualification has been identified as the "choice" doctrine. The function of s.260 was thus to lend aid to the achievement of a policy of the law which has been inadequately expressed in its terms. But law which is not moved by coherent principle will rarely have a policy expressed in its terms, adequately or inadequately. If the qualification is not an aspect of Part IVA, the Commissioner is given powers to formulate policy by selecting the occasions when he will exercise powers to assess under that Part. He is not controlled by any law in his selection, and the rule of law is abandoned.

Legislation in the present year has greatly increased the squares to be avoided and the Commissioner is empowered to add penalty forfeit of twice the amount of tax it was the taxpayer's purpose to avoid. Part IVA is thus a powerful deterrent to choosing to play the game. Yet we are all players of the game, albeit involuntary players, whenever we embark on some new course of action. He is a unique human being who is not gladdened by the prospect of tax relief. And an inference of purpose to enjoy that relief can only be obscured, it can never be definitively excluded. Part IVA is indeed an inhibition of any new initiative.

More important, I would think, is that Part IVA is an abdication of law and of rule by it. It is an abdication in favour of rule by the Commissioner. On the face of it, it is an abdication even though such policy as the law may have in its application in the circumstances may have intentionally invited the taxpayer to act as he has done.

Part IVA and Slutzkin

Two illustrations will demonstrate the unacceptable character of Part IVA. There was a time when a taxpayer whose company had substantial accumulated profits on which it had paid tax would look for a dividend stripper who would buy his shares. He would do this so as to obtain the release to him of the accumulated profits without bearing the tax that he would have borne had he taken those profits out in the form of dividends. His action in selling the shares was to escape what is now proclaimed as an unfairness of the law in "double taxing of company profits". The Commissioner became persuaded that selling the shares involved an avoidance of tax which the taxpayer had sought, and s.260, the predecessor of Part IVA, nullified what he had done. The Commissioner could then tax him on the proceeds of sale as if they were dividends paid by the company. The High Court in *Slutzkin* v. *F.C.T.*[64] held that s.260 did not apply. In a demonstration of the creative function of the judicial process, the Court confirmed and applied a principle that came to be known as the "choice principle". The choice principle was indeed a small triumph for an approach to statutory interpretation which might be said to qualify the power of words in deference to their policy. There was no policy of the law that the taxpayer should be subject to tax on the proceeds of sale of the shares. The person to whom the taxpayer sold – a dividend stripper – was able to take out the profits from the company without a tax liability because that person was a public company entitled to a s.46 rebate. If there was any issue as to the policy of the law raised by the case, it was the policy of s.46 and to that I will return.

Slutzkin was not well received by Government or by those who condemned what they saw as a conversion of income into a capital gain, an alchemy that had long angered the economists who believe that the income tax should tax capital gains. Three developments of the law have followed. The first is the replacement of s.260 by Part IVA which, it is said, leaves no room for the choice principle. Certainly there is no room for the principle in the terms of s.177E which, within Part IVA, deals expressly with the *Slutzkin* situation, and gives the Commissioner the power to change the rules, a power that s.260 denied him. The second development is the so-called extension of the base of the income tax to include capital gains, a development which the fiscal economists, and incidentally some lawyers like me, thought desirable. The third development is the proposal to introduce an imputation system in taxing company and shareholder, which could in a *Slutzkin* situation induce the taxpayer to take the profits out in dividends. The dividend route rather than the capital gain route is about to become the one that gives the tax advantage. Section 177E will become a quaint absurdity. Yet the general provisions of Part IVA stand ready to work a crude and gross absurdity. Attracted by the availability of an imputation credit and discouraged by the extension of the base of the income tax to include capital gains, a latter day Mr. Slutzkin will take the profits out in the form of dividends before selling his shares. In taking the profits out as dividends he will, at least in regard to recent and

[64] (1977) 140 C.L.R. 314.

current profits, attract an imputation credit which will ensure that he is not taxed on the dividends, and which may indeed pay some of the tax on his other income. After receiving the dividends any capital gain he makes on the sale of the shares will be the less. There may indeed be no capital gain to be brought to tax. The latter day Mr. Slutzkin will no doubt be pleased about the outcome, more especially since he has done what the Commissioner thought on an earlier occasion he should have done. But because he is pleased by it, and clearly wanted the outcome, Part IVA empowers the Commissioner to say that he may not have the tax consequences that appear to follow. Yet there is nothing in the law which would suggest a policy that he should not have the advantage of the line of action that will involve attracting the imputation credit.

Dividend Stripping and Coherence of Principle

Slutzkin was not concerned with the tax treatment of the dividend stripper. The law in that area had already been settled in *Investment and Merchant Finance Corp. Ltd*[65] in a way that reveals dramatically the want of coherent principle in the income tax. The dividend stripper was entitled to the rebate of tax allowed to a company receiving a dividend from another company. Section 46 in allowing the rebate has as its policy the prevention of cascade taxation when a profit that has been taxed is distributed through a series of companies. Its policy has a close kinship with the policy that lies behind the imputation system now to be adopted. Like the imputation system it may give tax relief to the wrong person. Section 46 and the imputation system proceed on the assumption that income is a flow, and a flow that may touch several persons as it flows and has not yet come to rest. As it touches a person downstream who has an interest in the person upstream who first experienced the flow, the interest of the person downstream having been diminished in value by tax on the person upstream, there should be tax relief to prevent multiple taxation of the same income. In the context thus explained, the tax relief may remain appropriate even if we accept a gain notion of income, for the context asserts that the person downstream has had his interest diminished by tax on the person who first experienced the flow. But if the person downstream has acquired his interest subsequent to the levy of tax on the person who first experienced the flow, there is no case for relief downstream under a gain notion of income. Subsequent to *Investment and Merchant Finance* complex new provisions were added to the *Assessment Act*, in several instalments, which are a less than coherent attempt to prevent section 46 tax relief being taken by the wrong person, a person designated a dividend stripper. But no attempt was made to ensure that the relief went to the right person.

In no other part of the law is there a clearer demonstration of the inappropriateness of a flow concept of income in fixing the base of a tax. Yet in no other part of the law are the problems of adjusting the law to a gain concept of income more intractable. A full integration of company tax

[65] Supra note 33.

and shareholder tax of the kind proposed by the Campbell Committee[66] is, at least in the view of the Asprey Committee,[67] beyond what is feasible in the administration of a tax. Even if it were feasible, it would not adjust the law to a gain concept of income. What is necessary to make that adjustment is even less feasible. The taxing of company profits as such needs to be abandoned. In its place there should be tax to any individual whose interest, direct or indirect, in a company has increased in value over the year of income. Where any increase in value is due to a profit made by a company, there will in some sense be a tax on the company profit, but the showing of a profit derived by the company will be irrelevant. The proposal is in fact an aspect of a regime which is the logical outcome of adopting the notion that income is a gain. But the outcome is not feasible. Simons himself so conceded. We are left with an income tax that lacks any relevant coherent principle and claim to fairness.

Part IVA and Income Shifting

My second illustration of the unacceptable character of Part IVA concerns income shifting. Three recent decisions of the High Court in regard to the now repealed s.260 bear on the operation of Part IVA. Those decisions are in *Gulland, Pincus and Watson*[68]. It may be assumed that they will be regarded as authoritative on the operation of Part IVA. My observations relate to *Gulland* though they might equally be made in relation to *Pincus* and *Watson*. If the interpretation of s.260 adopted in *Gulland* is transferred to Part IVA, that Part empowers the Commissioner to change the rules governing a husband's liability to tax. He may change those rules where the husband takes steps under the rules otherwise applicable, which result in what would have been income of his arising from personal exertion, becoming the income of members of his family. The inference of purpose to obtain a tax benefit is to be drawn, and the Commissioner, in his discretion, may deny him that benefit and impose a penalty forfeit. It may indicate the fine line between circumstances where an inference of a purpose to obtain a tax benefit is to be drawn, and circumstances where it is not to be drawn, that shifting income to a trust that would employ the husband and contribute to a superannuation fund for him was not thought to yield an inference of purpose to obtain a tax benefit, where the husband is the sole beneficiary of the trust.

There is some finding in the cases, out of deference to the choice principle in *Slutzkin*, that there is a policy in the *Assessment Act* that a person is to be taxed on his personal exertion income, and that the rules otherwise applicable were displaced by s.260 if he sought to shift that income to another. The policy is presumably confined to personal exertion income. If there is such a policy, one would not want to quarrel with the outcome in *Gulland*. Yet it is hard to see why that policy should only be made effective when the

[66] Aust. *Final Report of the Committee of Inquiry into the Australian Financial System (Campbell Report)* (Canberra, AGPS, 1981) Ch. 14.
[67] Supra note 1, Ch. 16.
[68] (1985) 85 A.T.C. 4765.

taxpayer's actions show he wanted the tax benefit of not being taxed on the income he sought to shift.

The operation of Part IVA is not it seems qualified by any requirement that there is a policy of the law to be protected. It can operate where any kind of income is sought to be shifted. It may be expected that the Commissioner will seek to change the rules in income shifting situations only where shifting is attempted within a family, including, one would expect, a de facto family. Two policies might explain such a selection. The first would be that persons who are not salary and wage earners should not be able to obtain a tax benefit by shifting income from personal exertion when the general rules of income derivation deny such a benefit to salary and wage earners. The general rules deny income shifting to salary and wage earners by providing no means of effectively shifting salary or wage income. The first policy would approve income shifting if it were available to salary and wage earners. It can be made available by amendment to the law. There will be a need in doing so to rework one aspect of the flow notion of income which would insist that there is income derived by a person only when a receipt in his hands is a flow from property or activity of his – a rule we have come to associate with *Federal Coke Co. Pty. Ltd.* v. *F.C.T.*.[69] What are in truth the politics of envy would then cease to have any room. The second, a distinct and broader policy, is that a taxpayer who will share in the enjoyment of income, should have his tax liability determined by reference to that income whether or not he has shifted it to another. The second policy is an aspect of family unit as distinct from individual unit taxation. Family unit taxation is generally, and at times fiercely, rejected by the majority of our community.

All of this may indicate that Part IVA, in its actual operation in relation to income shifting, is a sorry expression of policies that are ill-formed, unworthy and unacceptable.

The idea of an income flow underlying the notion of income leads to the possibility of tracing that income flow to a person who will be said to have derived it, and to the possibility of a taxpayer directing that flow away from himself to another. The idea of income as a gain does not comprehend the idea of directing flows. So long as we work with the notion of flows, we must find rules as to the derivation of flows, and those rules should reflect policies to which we can give our support. A recent paper by a Canadian visitor to Monash University, Neil Brooks,[70] has suggested that there is a principle, which is to be uncovered from our *Assessment Act* if we look hard enough, which would say that a flow that results from a taxpayer's personal exertion must always be taken to have been derived by that taxpayer, whatever he may have done in attempting to direct it to another. Some such policy, if not principle, may be said to have been expressed in *Gulland* in rejecting the choice principle. Neil Brooks would assert a further principle to be uncovered from the *Assessment Act* – that flows of investment income must

[69] (1977) 77 A.T.C. 4255.

[70] N. Brooks, "Preventing Income Splitting". Paper presented at Australian Tax Forum 1986 Intensive Workshop in Taxation.

be taken to have been derived by the person who commands the property from which the flow originates.

Whether or not there are such principles to be uncovered may be the subject of dispute, but at least they are principles that might command community support. The rule of Part IVA that a person must be taken to have derived income, though he has directed it away, if the inference to be drawn from his actions is that he wanted a tax advantage, is a renunciation of responsibility to formulate principles.

CONCLUSION

Overwhelming in its bulk, and intrusive into all aspects of our lives, the income tax is built on a concept of income that was designed for a purpose quite different from providing the base of a tax. As the base of a tax it is a concept lacking in any underlying principle that can command respect. The tax tests not our morality, but our submissiveness, and commands our submission with the threat of penalties. Being taxed becomes a game, albeit a dangerous game and not for the faint-hearted.

The concept of income in the natural legal meaning of the word is so entrenched by judicial decision and a ready acceptance of judicial decision by the draftsman in framing statutory provisions, that it defies change that may bring it nearer to the only notion that may give it coherent principle and a claim to fairness — the notion of gain. The income tax must start again under a new name if that is to be done, and if it can be done. The prophet of the notion of gain — Simons — compromised his revelation by accepting that it was not feasible to have a base for an income tax that extended generally to unrealised gains. In that compromise the revelation was abandoned. The notion of gain as the base of an income tax is an ideal impossible of achievement. The burdens of administration and compliance involved would press us to extinction, which may establish a correlation between the two great certainties of life.

The future belongs to consumption taxation, to a value added tax as the Asprey Committee recommended.[71] The Committee in its more romantic moments envisaged the ultimate demise of the income tax.[72] We have made two attempts to get started on the road to that future. Mr. Howard proposed some shift from income tax to a retail sales tax, but his proposal did not survive the opposition of the retailers. Mr. Keating proposed a shift to a broad based consumption tax, but his proposal did not survive the opposition of the trade unions and a consideration of the problems of compensating taxpayers on lower incomes. And there are other problems, in particular a problem of international compatability of our tax system. We cannot go it alone in abolishing our income tax. But in company with other countries

[71] Supra note 1, p. 530.
[72] Id. p. 35.

we will shift away from the income tax. The more we try to strengthen the tax, the more the lack of coherent principle will become evident and the less will be our respect for the tax. The tax must command submission if it cannot have our respect. In a liberal democratic society institutions that are maintained only by command cannot be maintained indefinitely. The liberal democratic society will itself be imperilled.