

SECTION 260 RE-EXAMINED: POSING CRITICAL QUESTIONS ABOUT TAX AVOIDANCE

YURI GRBICH*

The tension between the use of taxation as an instrument for re-ordering the substantive incidents of private property and the laissez-faire doctrine of individual "freedom" is nowhere more evident than in the anti-avoidance provision of section 260 of the Australian Income Tax Assessment Act 1935-1975. Mr Grbich reviews the way in which the section has been applied, arguing that its importance in the overall tax scheme has been emasculated by the failure of the courts to pursue faithfully the legislative objectives of section 260. The complexity and technicality of the Tax Act, and the resultant inability of most people to understand its provisions, ensures that this policy-making role engaged in by lawyers is largely unsupervised. Mr Grbich asserts that, in such a situation, the appropriate corrective measure must be an acknowledgment by courts and tax lawyers of their responsibility and self interest in giving effect to all and not just some of the competing values which are in conflict in any tax system. Lastly, the author offers a redraft of the section that would make the intransigence of the courts more difficult to justify.

Tax avoidance has been defined as the art of dodging tax without actually breaking the law.¹ That influential definition is misleading in Australia. Section 260² of the Income Tax Assessment Act 1936-1975 (Cth) says clearly that arrangements which defeat or avoid any liability imposed by the Act are void for tax purposes. Tax avoidance manifestly does break the law.³ But legislation is applied by courts, and the Australian courts have not exorcised the whole range of professional assumptions contained in

* LL.M. (V.U.W. New Zealand), Ph.D. (L.S.E.); Barrister of the New Zealand Supreme Court; Senior Lecturer in Law, Monash University. Acknowledgment to the Monash students, too numerous to mention, who were active in helping form these views, but particularly: D. Allan, P. Kronberg, M. McInnis, M. P. Mourell.

¹ G. S. A. Wheatcroft, "The Attitude of the Legislature and the Courts to Tax Avoidance" (1955) 18 M.L.R. 209.

² S. 260 provides in full:

Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—

- (a) altering the incidence of any income tax;
- (b) relieving any person from liability to pay any income tax or make any return;
- (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
- (d) preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

³ "Tax avoidance" means here, the avoiding of liabilities imposed by the Act as distinguished from merely diminishing a tax bill. The definitions are crucial. See text at p. 233 *infra*.

I.R.C. v. Duke of Westminster.⁴ By the time-honoured process of divide and conquer it is easy to break a holistic provision like section 260 into its components.⁵ Broken down into parts its thrust is diffused in the detail and it becomes little more than a peripheral admonition which is then vulnerable to counter-attack by the very outdated assumptions it set out to reverse.

The real debate is a debate about choosing the right questions. When *judges* say that it is quite natural for a taxpayer to avoid tax⁶ or that a man is entitled to arrange his affairs so that he pays the least tax required by law,⁷ the statement is not wrong but it does suggest that the courts are not asking the right questions. The courts *themselves* do and must make much of the law in this uniquely complex area.⁸ When making new law, how far *ought* a court to give content to the intent communicated in the statutory words of specific provisions⁹ and bring devices designed to escape them into the tax net? How is the conflict between the legislative direction in section 260 and the traditional judicial role to be resolved? How far can precedents created in commercial and property disputes be mechanically extrapolated into the tax context where entirely new and often contradictory policy objectives are being pursued by the legislature?¹⁰

This article emphasizes the mutual dependence between the wide catch-all effects of section 260 and the judicial interpretation of the specific provisions of the Act. The section 260 authorities are one example, and not

⁴ [1936] A.C. 1 (H.L.). This case is the leading authority for the proposition that a court will not normally go behind the form in which the taxpayer chooses to clothe a transaction. The court is interested only in the legal results of what the taxpayer does.

⁵ It is now common place in systems theory that the formation of wholes is something which is, not only greater than the summation of the individual parts of a system (the popular meaning of "gestalt"), but also of a *completely different* genus. Thus the properties of a whole system like s. 260 are found not in the sum of the properties of its component words or phrases but by looking at the whole section in the whole Act. This puts more weight on the interrelation of elements in a system rather than on their individual properties. See A. Angyal, *Foundations for a Science of Personality* (1941) 243.

⁶ *Newton v. F.C.T.* (1958) 98 C.L.R. 1, 4 (P.C.).

⁷ *I.R.C. v. Westminster* [1936] A.C. 1, 19.

⁸ Proposition is supported in the text at p. 230 *infra*.

⁹ To see the issue as a choice between applying either the "spirit" of the legislation or the legislative words is to misconceive the issue. Words are an inadequate vehicle for meaning. The question raised in the cases discussed in this article is *how*, not *whether*, the courts will fill in ambiguities when they *necessarily* supplement the legislature's expressed intentions. In s. 260, considerable cut-back of literal meaning is inevitable (see text at p. 222 *infra*). In the case of s. 51, it means choosing one control device rather than another (see text to note 34 *infra*).

¹⁰ It is argued that tax is often designed to reverse the consequences of existing commercial and property norms; (See text following note 43 *infra*). For example, the mere fact that a trust is held "charitable" to save it from the rule against purpose trusts should not bind a court to find that the trust is entitled to sizeable tax privileges: Lord Cross in *Dingle v. Turner* [1972] A.C. 601, 624-625 (H.L.). See also the refusal of the House of Lords in *Oughtred v. I.R.C.* [1960] A.C. 206 to apply normal equitable rules to a blatant stamp duty avoidance scheme. A similar issue is at stake in the celebrated "reversal" of fundamental equitable doctrine in *Baker v. Archer-Shee* [1927] A.C. 844 (H.L.). This should not come as a surprise. Existing property concepts are, after all, only historically created institutionalizations of expectations about the distribution and tenure of spending power. These must often give way to changing expectations and new economic exigencies, as expressed through fiscal policy.

an atypical example of the way in which the courts have interpreted the Tax Act.¹¹ At the same time, those authorities are the judicial response to the legislature's attempt to make the courts change their interpretation.¹² A useful discussion must go right back to the realities of the tax process and use those realities to assess the utility of the underlying assumptions which determine judicial responses to section 260. Rather than re-examining well trodden details, this article assumes a basic working familiarity with the issues.¹³ In the first part the article concentrates on analysing the way in which the leading authorities have handled section 260. In the second it develops a new set of working assumptions¹⁴ as a basis for a new approach to section 260¹⁵ and, hopefully, as a tentative preliminary to a new systematic theory about taxation.

I AUTHORITIES RE-ASSESSED

The Newton Test Re-assessed

The problem in the section 260 authorities goes back to the leading decision in *Newton v. F.C.T.*¹⁶ The advice of the Privy Council was such a substantial advance on previous authorities that it seems almost heresy to criticize it. Notwithstanding its stamp of elegant completeness, the indecisive articulation of the test and its subsequent development have allowed the provision to wander down an unproductive side road. The test from *Newton* has now become almost statutory. It reads:¹⁷

. . . section [260] is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. . .

In applying the section you must, by the very words of it, look at the arrangement *itself* and see which is *its* effect—which it does—irrespective of the motives of the persons who made it. . .

In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that *it was implemented in that particular way so as to avoid tax.*¹⁸

¹¹ There is some indication in *Luceria Investments Pty Ltd v. F.C.T.* (1975) 49 A.L.J.R. 223 that the judiciary are moving into a period of changing attitudes—see particularly the outspoken words of Murphy J. at *id.*, 226.

¹² Interpretation is seen as a creative process (see text at note 50 *infra*). Necessary ambiguities in language give the courts a wide ambit of discretion (see note 50 *infra*) and the ambiguities are resolved by reference to decisional referants which are usually not present in the legislation and often depend on an unarticulated set of assumptions. For a full analysis in an administrative law context see D. J. Gifford, *Decisions, Decisional Referants, and Administrative Justice* (1972) 37 Law & Contemp. Prob. 3.

¹³ For a useful treatment of the authorities refer to: D. F. Dalton, "Avoidance of Taxation: Section 260 of the Income Tax Assessment Act" (1973) 9 M.U.L.R. 95; H. A. J. Ford, "Legislation Against Tax Avoidance: The Australian Experience" [1961] B.T.R. 247; I. C. F. Spry, *Arrangements for the Avoidance of Taxation* (1972); M. J. Trebilcock, "Section 260: A Critical Examination" (1964) 38 A.L.J. 237.

¹⁴ For general discussions of existing judicial attitudes to tax avoidance: Wheatcroft, note 1 *supra*; Flesch, "Tax Avoidance" (1968) 21 Current Legal Prob. 215; P. F. Vineberg, "The Ethics of Tax Planning" [1969] B.T.R. 31.

¹⁵ As an incidental corollary s. 260 is redrafted, see Appendix p. 000 *infra*.

¹⁶ (1958) 98 C.L.R. 1.

¹⁷ *Id.*, 8-10.

¹⁸ Italics added.

If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. . . [T]he section can still work if one of the purposes was to avoid liability for tax. The section distinctly says “so far as it has” the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose.

It is universally accepted that section 260 cannot be applied literally to all transactions which have the effect of diminishing tax. But in reading down the literal words of the provision it is very easy to go too far and to undermine its objectives. The *Newton* test has three distinct parts:

1. The effect of the transaction is determined objectively by looking at its consequences and at the steps by which those consequences were achieved.
2. From the effect and steps used, the court draws an inference about the purposes of the transaction.
3. The reasoning in *Newton* is ambiguous, but the court must then decide either:
 - (a) that one of the purposes is tax avoidance, or
 - (b) that the steps of the transaction are capable of explanation *only* by reference to a tax avoidance purpose and are not capable of explanation by reference to an ordinary business or family purpose.

The first step is the major contribution that *Newton* made and it is adopted as the basis of the argument in this article. The second step contains the imprecision and the third step is a direct consequence of it, being symptomatic of the confusion which has crept into the later authorities.¹⁹ Immediately after stating the main predication test, the Privy Council said that if a court can predicate that the transaction is *capable* of explanation as a normal business deal, then section 260 will not operate. Yet later they said that tax avoidance need not be the sole purpose. How can the two be reconciled?

The crux of the *Newton* test in the second step is glossed over in those italicized words: the court must be able to predicate that the transaction “was implemented in that particular way so as to avoid tax”. It contains two critical ambiguities. First, does avoiding tax mean any more than mere diminution of tax? Let’s leave that point till later. Second, how can a transaction have the purpose of avoiding tax? Only human beings have purposes. It is the distinguishing mark of living organisms that only they are

¹⁹ *Mangin v. I.R.C.* [1971] A.C. 739, 751, suggests it must be at least the “principal purpose”. This is rejected by Gibbs J. in *Hollyock v. F.C.T.* (1971) 125 C.L.R. 647, 655-656 (and cases cited there) as being inconsistent with *Newton*. See Dalton, note 13 *supra* at 103. The authorities before *Newton* must be treated with considerable suspicion on this point.

capable of goal-directed activity.²⁰ Does that sound pedantic? Do not rush away in disgust, the point is far more than a verbal one. When the authorities either state²¹ or imply that a *transaction* or any other inanimate object has a "purpose" they are talking about inferences they draw about the taxpayer from the relationship between the elements of that transaction and from the whole context. To ascribe purpose to the transaction is a useful form of shorthand and an easy simplification to grasp in normal discourse. But in the case of section 260, where it is the main test and must support a vast superstructure of reasoning, the inexactitude becomes critical.

Newton is on sound ground when it construes section 260 as a provision which is directed, not at the motives of individuals, but at the means they employ. It wisely substitutes a test based on inferences drawn from the overt steps in the transaction for the old test based on evidence of human motives.²² But it does not follow this reasoning rigorously through to its conclusion. The mischief attacked by section 260 is not the desire of a taxpayer to diminish or minimize tax. It attacks and only attacks the particular artificial means he uses to attain this desire. The section is aimed at transactions implemented by artificial steps and the court must concentrate on the objective steps to discover this. But it is an easy mental transition from this enquiry to the second step of the *Newton* reasoning which asserts that the enquiry is centred, not on the particular artificial steps, but on the inference that the transaction is designed to diminish tax. This undermines the advances made in the first part of the *Newton* test and reintroduces all the problems of the literal test.

In *Newton* itself this leads to the assertion that if the transaction is *capable* of explanation as a normal business or family dealing it is not caught. It is not clear exactly what the Court means but their inferential test seems to fall into the trap of measuring the steps against the tax diminution objective. Rather than invoking normal business or family dealings as a test of the artificiality of the steps, it invokes those dealings to ask whether the transaction was implemented to diminish tax. The Court is asking the wrong question. The mere fact that clear business reasons can explain the steps is not sufficient. The mere fact that the transaction did no more than diminish tax is probably not enough.²³ For example, can it really be supposed that

²⁰ See G. Sommerhoff, "The Abstract Characteristics of Living Systems" in F. E. Emery, *Systems Thinking* (1969) 147, particularly 150-151.

²¹ Williams J. spelt it out in *F.C.T. v. Newton* (1957) 96 C.L.R. 577, 630; see also *Bell v. F.C.T.* (1953) 87 C.L.R. 548, 573.

²² Thereby overturning the earlier view that all the circumstances were relevant and thus redirecting the thrust of the provision (see the High Court decision in *F.C.T. v. Newton* (1957) 96 C.L.R. 577, 630, 654). This argument is spelt out by the Privy Council in *Ashton v. C.I.R.* (1975) 75 A.T.C. 6001, 6005.

²³ On this assertion, the earlier authorities are on sound ground. In *D.F.C.T. v. Purcell* (1921) 29 C.L.R. 464, 473, it was clearly established that s. 260 did not, without more, act on dispositions which transfer the income earning source. To hold otherwise would cause the section to over-reach into contradicting basic charges and weaken it (see text at p. 222 *infra*).

section 260 is aimed against a sale of shares cum dividend which a taxpayer disposes of immediately before the end of the tax year and in which tax diminution is the only reasonable hypothesis explaining the particular timing of sale?²⁴ Questions about the relative strength of the tax diminution objective are sterile. Most transactions will combine taxation and non-taxation objectives in varying degrees. No sensible business man enters any transaction today without a firm eye on the tax consequences. Nor can he be expected not to. Section 260 is simply not directed at tax diminution as such and, *a fortiori*, not at the objective to bring about that diminution. The test attempts to prevent the avoiding or defeating of the provisions of the Act. The test is whether the steps used are imprinted with the badge of an artificial scheme to circumvent those provisions.

Now to a brief defence and elaboration of the argument. Those readers who are not academically inclined can skip it. It is easy to see how all the confusion between the purpose of humans and transactions arose. The section speaks of arrangements having the “purpose or effect” of avoiding tax. To look at the “effect” of avoiding tax seems to open the floodgates to a literal interpretation. Worse still, any arrangement with the “purpose” of avoiding tax, whether successful or not, seems to be caught. The temptation to read these words conjunctively is strong.²⁵ It is also unnecessary. Under the first step in the *Newton* test, and that is the genius of the test, a purpose secreted in the bosom of the taxpayer will not persuade a court to strike the transaction down. The court looks only at the effects of the transaction. Those arrangements which do have the effect of avoiding tax are the only ones which need concern us. They are better caught by judicially building criteria into the words “defeating . . . or avoiding any . . . liability imposed . . . by this Act” rather than constructing a tendentious purpose test amalgamating “purpose” and “effect”. Defeating liabilities imposed by the Act, or avoiding those liabilities, is not the same as merely diminishing one’s tax bill. Therefore the plain words of the Act demand some active judicial response at *this* later point.

It can be argued that this reading gives no ambit to the branch of section 260 which would strike down arrangements having the “purpose” of avoiding tax. But *Newton* is authority for the proposition that such a purpose of the taxpayer is construed from the objective steps. It is from the nature of those steps that we draw inferences about whether the arrangement satisfies the badge of tax avoidance. Since the only purpose can be a human purpose, we use the actual steps in the transaction to construct the hypothesis that the taxpayer had the “purpose” of defeating the Act. Because evidence of the taxpayer’s subjective desire to minimize his tax bill is both unreliable and uninformative, inferences drawn by the

²⁴ See the concern that such transactions would be caught in the earlier decisions including *D.F.C.T. v. Purcell* (1921) 29 C.L.R. 464.

²⁵ *Williams J. in F.C.T. v. Newton* (1957) 96 C.L.R. 577, 630 said that the two terms have no real difference in meaning.

court from the specific steps are likely to be the best evidence of this "purpose". This is an entirely appropriate step for a court wishing to give effect to the intent of section 260 but faced with implementation problems which were probably not foreseen by the legislature. This does not alter the fact that the approach suggested is in satisfaction of the "purpose" test. But, to avoid confusion, it must be repeated that this approach can give no indication that it is useful to look for a tax diminution *purpose* in the inanimate steps themselves.

At the risk of further confusion, it should be pointed out that the implications of the previous analysis should not be overstated. It is not argued that tax diminution or a purpose to diminish tax *cannot* form the basis of a test. It is clearly possible for the judiciary to manipulate inferences drawn from the steps to find that tax diminution was or was not the operative link in the causal chain which brought about the particular transaction. To take a notorious example from Tort, the courts were able to manipulate the *Re Polemis*²⁶ causal test to produce a remoteness of damage framework whose consequences were not substantially different from the "reasonable foreseeability" test in *The Wagon Mound*.²⁷ The question is whether this judicial technique provides a useful framework for balancing competing policy choices and drawing lines. To that extent the debate is only an academic debate about the most useful connotation or focus for the test. But since section 260 is and can only be a general concept—a means of communicating broad policy guidelines to the courts—its connotation is everything.

Casuarina Attacked

Section 260 has a basic contradiction at its very heart. The implications of this contradiction have not received the rigorous examination they deserve. Section 260 is a very general provision which casts a wide net overlapping the more specific provisions in the Act. Where a transaction is subject to the charges to tax imposed by those provisions, section 260 does not operate. Tax is liable without more. It operates only where a particular transaction escapes the specific provisions and it must therefore always conflict with the *existing interpretation* of the specific provisions of the Act. But, paradoxically, the very wide operative words of section 260 ("defeating . . . or avoiding . . . any liability imposed . . . by [the] Act") must draw on the norms created by decisions interpreting and giving content to those specific provisions to define the liability and therefore the degree of circumvention of it. Viewed in a static sense section 260 is either completely tautologous or it must invariably give way to specific provisions.²⁸ Viewed

²⁶ [1921] 3 K.B. 650 (C.A.).

²⁷ *Overseas Tankship (U.K.) Ltd v. Morts Dock and Engineering Co. Ltd* [1961] A.C. 388 (P.C.).

²⁸ Argument put forward in Spry (note 13 *supra* at 28) appears to go some way to support this proposition, however the argument is ambiguous (see the last lines of Spry at pp. 26 and 38).

in a dynamic sense, it is an integral part of the process of creating and revising norms construing the specific provisions of the Act.

Take the specific argument one step further. A transaction which is not caught by the specific provisions of the Act is not caught. To the extent that the Act draws lines, it clearly implies that the taxpayer has the right to choose the non-taxable side of the line. To that extent, and putting aside section 260 and all dynamic questions, the taxpayer clearly has the right to minimize tax. If the Act taxes capital gains made on an asset sold within one year of acquisition, the taxpayer can defer realisation beyond the year. If the Act taxes a man but his wife's income is below the tax threshold, he may transfer his income earning assets to her. If the Act imposes tax only on the undistributed profits of private companies, the company can be turned public. If the Act taxes only income, the taxpayer can refuse to earn any income. There is no sense getting into an empty denotational debate. All of these transactions, in a loose sense, "avoid" tax. Specific provisions "allow" them. Otherwise they would be caught. Interpreted in this way, section 260 either never operates or renders all those transactions ineffective for tax purposes. Therefore, it hardly advances the argument to say, as the Court did in *Keighery Pty Ltd v. F.C.T.*,²⁹ that section 260 will not operate where the Act contemplates a choice. Applied literally, the Court's reasoning gives no operation at all to section 260. As a means of delimiting the scope of section 260 it is not enlightening.

That is not to say that the provisions of section 260 ought not frequently to give way to the competing objectives of specific provisions in the Act. But a blanket test excluding section 260 where the Act contemplates a choice, is analytically unhelpful and is not reasonably open on a fair interpretation of the provision in its place in the Act. That point will be developed further after we have cleared the ground. Suffice to add, for present purposes, that to say the question is denotational is not to say that the question is not important or that it cannot be answered. Rather, this article develops the proposition that the question is far more rationally answered by consciously developing a series of criteria rather than searching for criteria lying hidden, waiting to be discovered in the individual legislative words of section 260.

Keighery was decided before *Newton* and was distinguished in *Newton*. *F.C.T. v. Casuarina Pty Ltd*³⁰ was decided after *Newton* but follows *Keighery*. *Casuarina* involved the avoidance of tax on the retained profits of a private company by a complex artificial device to turn it into a public company. The device involved a pyramid of interlocking subsidiaries in which the majority shares of the holding company at the head of the pyramid were held by a number of public companies. By this device the taxpayer manipulated the definition of "private company" in the then

²⁹ (1957) 100 C.L.R. 66.

³⁰ (1971) 127 C.L.R. 62.

section 103A(4) to make all the companies "public". Control and day to day management were retained by the original shareholders, but a majority of the key holding company's shares were held by public companies.

In *Casuarina*, the Court was faced with the decision in *Newton*. The whole artificial scheme was very obviously an elaborate artificial means of avoiding tax. Its steps were explicable only on that basis. Yet the transaction was not struck down by section 260. Walsh J. chose to narrow the frame of reference of the debate and focused on one critical step: the allotment of a majority holding in preference shares.³¹ By concentrating the debate on this step the answer was sealed. Obviously, the mere fact that there is an allotment of shares to a subsidiary of a public company cannot, in isolation, be tax avoidance. The really critical part of the decision lay in choosing a frame of reference within which section 260 could be applied to the facts. The Court had set the scene for the well-known debate which took place a few pages later.³² Citing *Keighery* and relying on the fact that it had been distinguished in *Newton*, Walsh J., delivering a judgment concurred in by Barwick C.J., Owen and Gibbs JJ., held that the action could not be regarded as tending to defeat a liability imposed by the Act since it was one which the Act contemplated and allowed. The rebuttal is obvious. The Act did not contemplate this sort of tortured legalistic means of achieving the concession and section 260 was expressly drafted to prohibit such arrangements which defeat the provisions of the Act. It undermines the clear intent of section 260 and clearly conflicts with the thrust of the *Newton* reasoning.

In a political sense, it is easy to see why the Privy Council in *Newton*³³ would not want to emphasize the divergence between their reasoning and the Australian High Court authorities. But those unfortunate *obiter* comments in *Newton* distinguishing *Keighery*, rather than bringing about integration, have allowed that branch of authority to continue as an anomolous growth. There has been little attempt to really follow through the implications of the contradiction between the two lines of authority.

Reach of Section 260

The *Newton* test as re-defined earlier in the article, centres on a comparison of the means used in the transaction against the normal means of achieving the business and family effects of the transaction or the concessions granted in specific provisions in the Act. This is the key to the practical day to day operation of the provision and to questions of how far it will reach into and change the output of decisions interpreting the specific provisions in the Act.

³¹ *Id.*, 97, 100 (the question as to what parts of the transaction are relevant to the main test and what the Commissioner chooses to annihilate need not be the same, unless one accepts a very narrow constructionalist argument).

³² *Id.*, 101.

³³ (1958) 98 C.L.R. 1, 9.

A test measuring artificiality must have a bench-mark against which to measure it. If the specific provisions permit the activity, so the argument in *Casuarina* goes, then it cannot be avoidance. This rather unsatisfactory test would still give the provision an ill-defined area of operation where the transaction does not so much seek to avoid a specific charge as to concentrate on income-splitting or tax deferral or the capitalizing of income. In other words, it would operate in those areas where the legislature has vacated a whole area of norm creation to the courts. Such an interpretation does not spring from the words of section 260, nor is it warranted by a broad treatment of the provision in the scheme of the Act. We must go wider in search of those answers. The question is whether such schemes as that in *Casuarina* ought to be caught and if so where the line ought to be drawn.

As a result of the earlier discussion, one proposition can be clearly stated. A transaction is struck down by section 260 where the steps used have the badge of a tax avoidance transaction and are not sanctioned by the existing interpretation of any particular provision in the Act. The badge of tax avoidance is earned if the transaction is artificial or unnecessarily tortured or complex. The particular steps used will be found to be artificial where they are materially different from the steps which a reasonable person would normally use to achieve the commercial or family effects which the transaction did achieve. For this purpose, the tax diminution effect of the transaction is ignored.

From then on, we move to more contentious ground. What happens where the transaction is not particularly artificial but it is clearly a transaction which was designed to diminish tax? Can section 260 be used usefully to create a head and framework of charge where the type of scheme is not obviously circumventing any specific provision imposing a liability? Will section 260 operate when the transaction is artificial but it appears to be sanctioned by specific provisions in the Act? We will deal with this latter question first.

We can explore the difficulties by using the well known decision in *Cecil Bros Pty Ltd v. F.C.T.*³⁴ In that case, a shoe retailer (Cecil Ltd) instead of buying their shoes from their normal wholesaler interposed a company (Breckler Ltd). Breckler Ltd was owned by the shareholders and the relatives of shareholders in Cecil Ltd. It was an income-splitting device. Breckler bought the stock from the wholesaler, added almost £20,000 and sold it to Cecil Ltd. The Full High Court held that Cecil Bros could deduct the full price, including the £20,000, under section 51 of the Act as it was incurred in producing income. Menzies J. assumed,³⁵ without deciding, that section 260 did invalidate the contracts but held the section was not effective because this would involve an "unauthorized reconstruction".³⁶ This is

³⁴ (1964) 111 C.L.R. 439.

³⁵ *Id.*, 440.

³⁶ *Id.*, 441.

difficult to understand since, once the arrangement was assumed to avoid a liability imposed, the Court could annihilate the whole deduction. This would not have caused a reconstruction problem. It may have caused an excessive, and arguably appropriate, tax bill. This may have persuaded the taxpayer not to persist with the reconstruction point. There seems no obvious reason why the Court could not use section 260 to annihilate that part of the expenditure which had the purpose of avoiding tax.

For this analysis, let us suppose that the Court did go ahead with the annihilation argument. Now the interpretation by the courts of section 51 is based on the reasoning that the courts ought not to get into deciding whether deductible expenditures were spent wisely. If the expenditure was made for business stock or plant, that is enough. In *Cecil Bros* this is extended, and wrongly so in my opinion, to exclude any enquiry into the purpose of the expenditure. Protestations to the contrary notwithstanding, the Privy Council in *C.I.R. v. Europa Oil (N.Z.) Ltd*³⁷ made exactly this enquiry under the analogous New Zealand provision. But the important point for present purposes is that by applying section 260 the court would directly reverse the more specific authorities on section 51 over a relatively wide area of operation. The enquiry section 260 demands is strikingly similar to that involved under section 51.

Should section 260 be given such a wide operation? In my opinion section 260 demands it. The legislature has asserted a criterion in section 260 which the Full High Court in *Cecil Bros* ought to have taken into account. But let us be quite clear about what is happening. The wide words of section 51 contain an ambiguous penumbral area. In defining the limits of allowable deductions, the courts have given the widest possible interpretation of the language of section 51 so that the taxpayer, provided he fulfills certain formalities, can name his own deduction figure. Clearly the courts have been an important influence in creating the operative norm. The criteria which swayed the Court in *Cecil Bros* are easy to speculate about. They may be administrative or political. A completely objective test such as that laid down in *Cecil Bros* certainly cuts down on administrative work and bureaucratic prying into deductions. It also puts the tax base at the mercy of many business taxpayers who can "socialize" their consumption as a deductible government subsidized expense and hence blunt the progression of the income tax. There is no indication on the face of the *Cecil Bros* judgments as to which of these criteria swayed the Court.³⁸ But whatever the reason, section 260 asserts a competing criterion and if this is applied the result will probably be different. The judicial process will consist of weighing this priority against the reasons for granting an almost

³⁷ [1971] A.C. 760, 772 (although the Court purported to distinguish *Cecil Bros*). There is a retreat however by the majority in *Europa Oil (N.Z.) Ltd (No. 2) v. C.I.R. (N.Z.)* [1976] A.T.C. 6001 (but Lord Wilberforce, significantly, dissents).

³⁸ If we view law as a process of structuring and checking individual discretion, then the failure to articulate the decisional criteria tends to undermine guarantees of justice. The problem is very similar to that of checking administrative discretion, as to which see K. C. Davis, *Discretionary Justice: A Preliminary Enquiry* (1969).

blank deduction cheque. That is a job of construction for the court. The solution certainly doesn't spring from those words "incurred in producing assessable income" in section 51 or the words of section 260.

If we define the scope of section 260 as limited to transactions which avoid tax, and if that avoidance must be measured by the divergence from the transactions contemplated by the *judicial interpretation* of section 51, and *if* that interpretation is taken as immutable, section 260 cannot operate here. Obviously there is a conflict between the objectives of section 260 and the interpretation, as currently perceived by the judiciary, of section 51. The scope of the problem becomes clear.

Section 260 asserts the objective of preventing the use of artificial steps which would allow a taxpayer to escape his fair share of the tax burden. Such an objective must be one of the relevant criteria in construing particular provisions in the Act. Section 260 is a legislative direction to give that factor due weight. Section 260 puts emphasis on defeating a liability imposed by the Act. It is a statutory authority and direction to the courts to prevent the use of artificial avoidance devices to escape liabilities which would normally accrue.

This interpretation, while giving a far wider scope to section 260, also emphasizes its effective limits. Since section 260 is capable of upsetting many of the norms created as a result of litigation involving the specific provisions, severe restraints on its effective reach are necessary. It can be used as a tool for reversing particular substantive norms and it can be used as a catalyst to encourage judicial change. But it cannot usefully stray too far ahead of the broad body of norms laid down in the Act. The most severe danger with such a potentially wide weapon is that it may over-reach. If it is permitted to do that it will lose all credibility. It can certainly be used much more pointedly than it is at the moment to selectively pick off the more extreme and isolated avoidance devices. But it cannot be a panacea. It cannot replace substantive reform in the main areas of avoidance and it should be used very cautiously when it is necessary to create a charge to tax where no broad legislative framework exists.

The decisions in *Newton* and *Casuarina*, if anything, are the wrong way round! Section 260 has not been applied where it clearly ought to have been. It has been applied where it is most vulnerable. That puts the subsequent difficulties in the tortured reconstruction authorities into much better perspective. That is not to say that, if the courts are willing, they ought not construct a head of charge. It is to say that they should not have attempted to do so until they had established a firm base in those avoidance cases, like *Casuarina*, in which the consequences of annihilation were a return to an obvious statutory basis of tax.

A More Rigorous Approach to Section 260

A clear thread of principle emerges from the previous analysis. The key provisions of section 260 read:

Every . . . arrangement . . . shall so far as it has the . . . purpose or effect of in any way . . . defeating, evading or avoiding any . . . liability imposed . . . by this Act . . . be absolutely void, as against the Commissioner . . .

Putting aside the authorities, the most natural interpretation is that section 260 strikes down any arrangement which circumvents the charges in the Act. The “avoiding” or “defeating” of liabilities imposed by the Act is the key concept, rather than tax diminution *per se* or the purpose or effect of diminishing tax. When people talk about section 260 as a “tax avoidance” provision they are frequently indecisive in articulating the meaning of that ambiguous word “avoidance”. The Act does not use the term “tax avoidance”. If they mean section 260 is aimed against diminution of tax, they over-extend the words of the section. Section 260 is directed against the dodging or circumventing of the reasonable ambit of operation of a framework laid down by the Act. Put in its context as a catch-all at the end of the Act, section 260 can be seen as a legislative attempt to assert a prohibition on artificial attempts to circumvent specific provisions controlling the liability to tax or granting concessions to that liability.

The central test is directed to a single enquiry. Do the particular steps in the transaction have the imprint of a transaction defeating or avoiding (in the sense of circumventing) a liability imposed by the Act? This enquiry involves two separate subsidiary questions :

1. Would its actual non-tax consequences normally bring the transaction within the objectives of any specific provision in the Act?
2. If so, are the particular steps by which the transaction was implemented so artificial, complex or tortured that they reasonably raise the inference that the transaction is materially different from the normal way in which the non-tax objectives of the transaction would be implemented by a reasonable person in the position of the taxpayer?

Now we will draw together the threads of the previous, essentially destructive, argument to support this constructive proposition. *Newton* is authority for the proposition that section 260 is directed at the objective steps by which an arrangement is implemented. One looks at those steps and draws an inference from them. But to what end? The critical test is not whether the transaction lessened tax. Nor is the test that the transaction was carried out in a particular way with the purpose of lessening tax. The test propounded in section 260 is that the particular way it was carried out was such that it had the badge of a “tax avoidance” transaction, that it was both artificial and reasonably raised the inference that it was defeating the specific provisions of the Act. This apparently subtle shift in the test is vital. The enquiry centres on how tortured or artificial or legalistic are the means used to gain the particular non-tax consequences when they are measured against normal practice and against the objectives of specific provisions in the Act. Section 260 becomes, primarily, a weapon aimed against legalistic devices used to thwart the objectives of the Act. The extent of such

artificiality is measured by comparing the actual steps used in the transaction against the steps normally used to achieve the non-tax commercial or family objectives of transactions with similar effects. In those cases where the objectives of the specific provisions of the Act comprehend tax diminution, the transaction is compared with the means normally used to take advantage of such concessions.

Using this test, there is no basis on which it can be argued that the steps in the transaction need be predicated only on tax minimization. The present pre-occupation with whether it needs to be the principal or major purpose becomes irrelevant. The central test is elevated above the detail. The only question is whether the steps used are so artificial that they reasonably raise the inference that the transaction was carried out in that way so as to defeat liabilities imposed by the Act. Normal commercial and family dealings are relevant only as a bench-mark against which the steps can be measured for artificiality. Just as a tax diminution *purpose* is irrelevant, so normal business or family purposes are irrelevant. The effect of the transaction can be observed from what is actually done. The test is not concerned with the non-tax effects in their own right. It is merely concerned to see whether the particular steps were necessary in order to attain those non-tax effects or whether they could have been attained more simply or less artificially. This gives the normal family or business dealings branch of the test a strictly proscribed operation.

Implications of the Detailed Analysis

The analysis to this point will not come as a profound revelation. It merely removes some fairly obvious intellectual blinkers which have been an impediment to a balanced application of the test in section 260. What is all the fuss about? Would it not be more helpful to develop a detailed list of criteria for deciding what section 260 covers or to concentrate on the reconstruction question?

The assertion is commonly made in the context of section 260 that the avoidance concept in the Act is so wide as to be meaningless. That assertion should not be taken too seriously. Do the phrases "reasonable foreseeability" or "unmerchantable quality" have any greater precision? Words are always an inadequate vehicle for meaning. Trying to spell out their meaning in a vacuum is unproductive. It is more useful to examine the inarticulate assumptions which translate general concepts into concrete decisions. A more helpful enquiry is why the courts have failed to go about systematically building a constructive content into the words of section 260. The analysis, to date, has set about documenting that failure. We now set about spelling out the criteria which ought to be applied when constructing that content. If the argument in this article is right, the fault will not be found, to plagiarize the language of Keynes, in isolating logical flaws in the reasoning of the decided authorities or in quibbling about particular interpretations. It will be found by pointing out that the tacit assumptions

underlying those authorities are seldom or never satisfied, in showing that the existing underlying ideas do not fairly represent current reality or that they produce decisions which do not give enough weight to important values. If we can isolate the offending assumptions, demonstrate the inadequacy of the ideas and convince the actors that the consequences of their unexamined intellectual baggage either produce results which conflict with their own values or threaten the stability of the institutions they work in, we may be able to persuade them to adopt new working assumptions. That is the only road to a significant change in the response to tax avoidance.

II NEW REALITIES FED IN

A New Set of Working Assumptions

It makes no sense at all for human beings to talk critically about taxation, much less tax avoidance, without talking in terms of a set of human ends they want to achieve. Intelligent choice of the legal norms you want to create requires conscious weighing of the range of options and the deliberate choice from among competing goals. As Weber says, a man's action is purposively rational only if he is conscious of his goals, the means of attaining them and of the side effects, and if he weighs means against goals, goals against side effects and also various possible goals against each other. A legal system is a substantively rational system only if its decisions are based on goals deliberately chosen by human beings from outside the legal system itself.

Does this merely state the obvious? To assert that tax is a policy instrument and that the tax system must be judged by human values is now trite—conveniently forgotten when we talk about section 260, but still trite. But to criticize the judiciary or specific authorities which rely on an excessively technical reading of the Act to undermine the clear objectives of provisions in the Act suddenly becomes very controversial. The critical question is what are the underlying assumptions which allow so many professionals to act as conscientious rational human beings and yet to produce such results? How is it that a profession, which loudly claims that it impartially holds the scales of justice according to law between competing groups in our society, has got to the position where its institutions appear to favour only one part of that society? How is it possible for tax institutions to frustrate collective decisions of the democratic process? How has it managed to get so constipated in its own complexity that it produces many norms which are in the interests of none of the participants in the political process and are often contrary to the values of the human beings who operate it?

Tax lawyers have involved themselves in personal political choices whether they like it or not. They are condemned to freedom. It is undoubtedly a terrible thing for prosperous experts with no claim to speak for the electorate of a democratic society to make political choices. There is only

one thing worse: the self-deception of assuming that such choices are not already being made.³⁹ What happens when the consequences of such choices are excluded as a matter of course from a lawyer's consciousness? In the same way as scientists or technologists, lawyers become slaves to the inhuman determinism of their own structures. When human beings become overawed by the paraphernalia of their own system, they cease to use that system for human ends.

Tax lawyers have failed to break free of the mesmerizing effect of a closed house of complex rules which makes its own demands and contains its own form of *internally* consistent logic. We need a much better understanding of our role as a social control mechanism which operates to integrate conflicting demands in the context of a wider political process. We need to direct much more effort into consciously constructing working hypotheses which enable the courts to act as consensus brokers and as a bonding mechanism in that sophisticated form of political pluralism evolving in twentieth century Australia. At the same time, we should contribute to the attainment of a humane society. In short, tax lawyers must redefine their whole idea of "political neutrality". Section 260 is an important part of that strategy.

The work of courts and the supportive mechanisms of negotiation and legal advice, it must be emphasized, involve creation. A court must constantly use the insufficient evidence offered by the statutory words of section 260, the specific provisions and decided cases to create a concrete decision. Anyone who is serious about norm creation must constantly go through a very demanding process of balancing the expectations of the parties to a dispute; the need for social stability; the need to adapt to new values in the community; the need for optimum power sharing with other parts of government and within the legal hierarchy; the dangers of extrapolating a norm from an area of general law into the different policy context of taxation; prediction of the impact of the decision on future disputes; the limits of the written word as a means of communication; and the unexamined bundle of attitudes and perceptions which are critical in translating words into concrete decisions.

To achieve *substantive*, as opposed to *formal* neutrality, conscious policy choices must become a normal part of a lawyer's working tools. If tax lawyers do not collectively start articulating a broad grand-strategy for steering society to human ends, the tax system *must* turn inwards for its justification and concede all initiative to the shrewd and the powerful. By concentrating on the minor details, the courts surrender power on the major issues. A tax dodger who is allowed to manipulate the frame of reference, has the main grip on the result. The only strategy which deserves the term "balanced" is one which marshals resources to create a fair society

³⁹ Acknowledgment to Paul Freund.

in a realistic framework. As Shur says,⁴⁰ legal institutions can be used to promote conscious ends. *That is not to say that they may not incorporate normative ideals and basic processes that transcend short-term political goals.* Fair processes may themselves be important goals. But legal rulings exert power and legal institutions entrench it. There are winners and losers.

The New Realities in Tax

Tax is a means by which government expropriates private property without compensation. Taxes are a tool by which an elected government imposes political power to override the spending power of private persons or aggregations of private interests. Tax decisions choose between one human being and another. They pointedly choose between one set of values and another. They necessarily use collective decision processes to override individual freedom of choice.⁴¹ Conversely, tax avoidance is the assertion of individual power to undermine collective decisions.

In sharp contrast with these realities, lawyers still approach tax as a completely isolated technical subject. Australian lawyers have never quite adjusted to the fact that tax rates rise to a marginal rate of eighty per cent⁴² and dominate all commercial and property decisions. Right or wrong, our collective society has already made massive political inroads into private property, just as concentrations of market power in capital holders and technocracies had earlier made inroads into individual freedom of choice. Rather than bemoaning collectivization of choice or the death of individual sovereignty, the job now is to build relevant devices to control that power and to adjust our conceptual framework to assimilate the new realities.

More specifically, the tax system no longer operates on the periphery of the market system merely to raise money to pay for a few isolated expenditures, like the army and police, as the influential Adam Smith depicted it two centuries ago.⁴³ Taxes in Australia have long since become a critical means of re-ordering the substantive incidents of private property. They are an important instrument by which society manages the uneasy compromise between egalitarian political and social values and the demands of economic efficiency. Our political system has traditionally acceded a large slice of economic autonomy, with its correlative power, to the private sector. As a result, political stability demands that our system must simultaneously deal with the gaping disparities in economic well-being and concentrations of power caused by our market system. Tax is a tool, however blunt, by which government exercises control over both aggregate

⁴⁰ E. M. Shur, *Law and Society: A Sociological View* (1968) 140.

⁴¹ What after all is freedom? When a law is passed to stop theft, mankind becomes more free, not less so. Once individuals see the necessity for mutual coercion they become free to pursue other goals.

⁴² A combined rate of 42.5% of company tax and a maximum marginal rate of 65% on the excess (not to account for land, payroll, and sales tax) produce an effective rate of near 80%.

⁴³ Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1961, Methuen ed., Vol. 11) 350; first published in 1776.

national demand and the distribution of spending power among the human beings in Australian society. It is a tool for channelling the growth of the capital investment towards desired objectives and controlling its use. Above all, tax, to its eternal discredit, shows a supreme disregard for the sacred legal distinction between public law and private property law.

The tax system has become a key arbiter in that national cake-slicing ceremony we call politics. The political process no longer stops on the signing of an Act. The concerted tax avoidance industry by Australian legal and accounting talent has extended the battle arena into the areas of traditional "black letter law". The politically significant forces in this competition for scarce resources are articulate interest groups and powerful individuals. It is the powerless human beings in our society who bear the brunt of the consequences of tax avoidance rather than the abstraction represented by the Commissioner or government. It is that part of the community which is unable to exploit the weakness in the defences of a ponderous legal system, the lower half of the socio-economic scale, which subsidizes the avoidance of the shrewd and powerful.⁴⁴ Eisenstein put it this way:

Our taxes reflect a continuing struggle among contending interests for the privilege of paying the least. I am not unaware that others have a loftier view of the matter. They prefer to believe that our tax laws are usually inspired by more generous motives which are then insidiously subverted for some unworthy purpose. The triumph of a special interest is considered an unfortunate deviation from the general rule. However, if we are to discuss taxes intelligently, we should gracefully abandon such pleasing illusions. In the words of an admirable conservative, we must clear our minds of cant. Tax legislation commonly derives from private pressures exerted for selfish ends.⁴⁵

Section 260 assumes a new perspective. It is no longer seen as the ultimate weapon to undermine judicial protection of the subject from an all-powerful Crown. It is *one* device to make sure that the shrewd are not too flagrant in their disregard of the rules of fair play. It becomes a sort of bill of fair play in the power-broking in the Australian political system to make sure that the complexities of the Tax Act are not the means by which some sections of the community throw a disproportionate burden on other sections of the community. Tax issues remain predominantly political. Section 260 is a means by which the courts can ensure, so far as practicable, that the major distributional debate is carried out in Parliament and public forums rather than within the complex and opaque interstices of the Tax Act.

⁴⁴ Inequalities are far higher in Australia than is popularly believed. The figures of Embury and Potter indicate that in 1967-1968 the top 10% of families earned 23.76% of the Gross National Income while the bottom 40% earned a total of 20.1%. The position was changed less than 0.1% by our supposedly progressive tax system! There has probably been some redistribution since but there is no reason to suppose it alters these figures dramatically. After tax the top 10% of families still earn almost as much income as half of the Australian population put together.

⁴⁵ Louis Eisenstein, *Ideologies of Taxation* (1961) 3.

Authoritative Tax Decisions as a Source of Power

It is simplistic to assume that real power to make choices rests with the judge who makes the formal decision effectuating those choices. But, conversely, it is not accurate to put excessive weight on one part of the power matrix, such as the ability to bring about physical or economic coercion, to the exclusion of other ingredients. Nor is it accurate to accord all real power to the legislature which passes legislation. Power is the ability by one person or group in an interaction with any other group to manipulate that other group to their own purposes. Put another way, power is no more than the measure of a prediction that one or other party to a competition will get his own way. In a complex social process, the expectation by the vast bulk of society that a particular institution will make authoritative decisions is an important source of power.⁴⁶ Such a power base will often rank in equal importance with the ability to apply coercion. Power comprises both authority and control. Authority is created by the expectations of the participants in the social process. Control is the physical ability to enforce decisions. Control without the legitimacy of authority is naked force and is hard to sustain for any period in a complex and specialized society with long historical traditions from an older culture, such as those in Australia. In a sophisticated society depending largely on substantial voluntary compliance for the operation of its social processes, authority becomes relatively more important. It is more efficient to pursue an objective by moulding shared expectations than to rely on threats of or actual control. Often the main battles are battles for the right to claim legitimacy.

The critical task is to create social control devices and use the power which authority gives our courts in order to deflect excessive concentrations of power held by other groups in society. It is not so much a question of curbing the concentrations of power; lawyers intent on minimum standards of fair play are not strong enough to confront a determined multi-national company threatening to withdraw investment or a large union intent on strike. Rather, the job for lawyers is to engineer consensus through the articulation of reciprocal longer term self-interest, to help the parties avoid damaging short-sighted escalations of power claims, to encourage the growth of a structure which will articulate and institutionalize unrepresented power claims and bring them into the mainstream of the debate, and to attempt to gradually mould the expectations of conflicting parties into the liberal Western tradition so as to temper the power game with humane ideas. This requires the ability to cut through the complexity of taxation debates to the core of disputes and then to compromise or change the expectations of the parties from the ground up. It requires a clear assessment of the most constructive means of using the power sharing between the courts and legislature.

⁴⁶ Text at p. 233 *infra*.

Why Tax Lawyers don't see the Realities?

How have tax lawyers managed to exclude the consequences of the tax process from their decisions? Why have they not carried out the periodic maintenance and the conscious redirection which is necessary?

First, because lawyers forget that they are creating policy. They are so preoccupied with operating the ponderous system that they forget what the tax system is doing and what they are doing to the system. To quote Lasswell and McDougal:

When decision-makers are asserted to be under 'obligation' to make future decision correspond to the rules employed in justifying past decisions, the prediction of future decision becomes mere extrapolation, as simple-minded as it is unreliable. The ultimate, integrative task of inventing and evaluating new rules and institutions, better designed to secure community policies, is not likely to be attended by success, even when attempted. . .⁴⁷

Because courts have not articulated conscious policy choices in their domain of choice they have no alternative but to revert back to the system itself for performance criteria. The "morality of law" or "due process" or "the rule of law" or just straight "stability" are elevated from being mere means and the rules of a fair game into the dominating end of the whole paradigm process. Section 260 is treated as an interloper on the rounded majesty of the judicial interpretations of the Act. By inviting the courts to annihilate avoidance transactions, and to talk explicitly about policy objectives, section 260 is a threat to the constricting intimidation of their own outdated assumptions. They invoke against section 260 the very bureaucratic tools against which it is directed.

Second, the technicality of tax obscures the mechanisms which give lawyer-created norms far more influence than either society or lawyers themselves realize. Because they only dimly perceive this power they have not directed it usefully. In a technical area like tax, lawyers have a virtual monopoly on effective communication. As the main source of authoritative decisions, they have a fair amount of political power. In practice, there are just not too many people with the ability and time to think about tax issues.

What do Lawyers do?

Implicit in the existing narrow perception by tax lawyers of their influence in the social process is a myopic concentration on the role of lawyers in the formal judicial interpretation process. This is often tied to an excessively restrictive view of "law"—a view which sees law as nothing more than a set of rules. Take for example, Lord Donovan's words in *Mangin v. C.I.R.*

⁴⁷ Lasswell and McDougal, "Criteria for a Theory about Law" (1971) 44 So. Calif. L. Rev. 352, 369.

. . . judges have been compelled to search for an interpretation which would make [the New Zealand equivalent of section 260] both workable and just. In doing so they inevitably approach the line where interpretation ceases and legislation begins—a line which they may not cross.⁴⁸

Rule application is only one of the impacts lawyers have on the social process. As Lord Reid has said:

There was a time when it was thought almost indecent to suggest that judges make law—they only declare it. Those with a taste for fairy-tales seem to have thought that in some Aladdin's cave there is hidden the common law in all its splendour and that on a judge's appointment there descends on him knowledge of the magic words 'Open Sesame'. . . . But we do not believe in fairy-tales any more.⁴⁹

The myth can only be preserved by use of this still pervasive half-truth about the passive role of the judiciary in adjudication and a gross over-valuation of the amount of information which statutory words can carry.⁵⁰ The open-textured words of a wide provision like section 260 give it the lie.

Most laymen are only dimly aware of the tax process and any influence they have takes place through the opaque curtain of the tax lawyer's professional language. The lawyer's function is not limited to adjudication. He also participates in teaching of the young, is the expert called into the legislative process, commentator on the media, lobbyist, author of books, a member of reform committees, and often the only politician interested in these uniquely complex areas. With their half-brothers, the accountants, lawyers hold a practical monopoly of the vital commodity, information, which is the life-blood of the animal they have created. Weiner saw the means of communication in a large complex system as a fundamental resource and an important determinant of control.⁵¹ Lawyers in the decision process exercise a great deal of power.

If we define a "system" simply as a collection of interacting elements about which some form of functional generalization is possible, we can define the members of the Australian community as a system. It is then useful to see lawyers as a sub-system controlling the social processes in the main system. In any system, according to Weiner, the information carried between the separate elements of the system is a function of its organization. When the system is too large and complex to be understood by many of the human beings who make up its constituent elements, the related communication functions tend to be concentrated in component sub-systems. Since the components of the social system must rely on communi-

⁴⁸ [1971] A.C. 739, 749 (delivering the majority judgment).

⁴⁹ Lord Reid, "The Judge as Law Maker" (1972) 12 J. Soc. Pub. T.L. (N.S.) 22.

⁵⁰ On open-textured words and the degree of participation by judges in translation of such words into decisions, see W. Bishin & C. Stone, *Law Language and Ethics* (1972) 473ff. See also the debate on the core and penumbral meaning of words by Hart (1958) 71 Harv. L. Rev. 593, 606-608, and Fuller *id.*, 630, 631-669; and see Gifford (1971) 56 Cornell L.Q. 409, 426.

⁵¹ N. Weiner, *The Human Use of Human Beings* (1967) 31ff.

cation to perceive their functions and the direction of the system, the sub-system with control of this function has the ability to control the behaviour of the system. Since a system consists of the interaction of its elements and since interactions take place through the medium of communication, the control of this factor gives its holder power in the wider system.

The decisions of courts have a direct relation to community expectations. Black letter tax, because of its technicality, presents a misleading low political profile to the public. There may be people other than tax lawyers who understand a complex tax decision well enough to assess its impact and weigh that impact against their own interests and values. But, by-and-large, most social institutions tend to adapt around the legal norm, rather than examining it. A court's decision is often just as permanent as any other decision in this mobile Australian community.

The Lawyer as Policy Maker

Any decision maker must weigh the demands for social change against the equally important demand for stability. Where section 260 conflicts with the existing interpretation of specific provisions in the Act, it demands just such an assessment. Decision makers should not underestimate the sheer inertia of their own structures or the constraints imposed by limited resources. But in creating norms, courts must be able to assess competing demands as rigorously as possible. If courts are forced to make such assessments weighed down with intellectual preconceptions, their decisions are likely to be suspect. The norms created may very well be bad norms. Section 260 should be applied cautiously because rationality demands that, considering the substantial cost of shifting policies and building new rules, the existing norms be given a head start. But tax lawyers have got out of the habit of assessing the relative demands of policy and bureaucratic imperatives altogether. Partly because they have underestimated their own impact on policy, partly because they have for so long found it inexpedient to admit that impact and partly because they have confused the role of advocate for tax avoiders and their judicial role, they have forgotten that commitment to a particular line of reasoning is a choice and it is a choice with real world consequences. Lawyers really do believe that they are nothing but bureaucrats enforcing norms created by Parliament or the traditional pressure groups. They really do believe that all the defects can be fixed up by Royal Commissions in a grand periodic spring clean or that that grand abstraction "the legislature" is eagerly awaiting and evaluating every decision.

It then becomes obvious why the Australian courts, particularly, have been so unresponsive to section 260 and have not carried out the process of balancing objectives when the section conflicts with specific provisions. They have become policy makers while pretending to themselves and others that they are mere bureaucrats. To adopt Henry Kissinger, the essence of bureaucracy is its quest for safety; its success is calculability. Profound

policy thrives on perpetual creation, on a constant redefinition of goals. Good administration thrives on routine, the definition of relationships which can survive mediocrity. Policy involves an adjustment of risks, administration an avoidance of deviation. Policy justifies itself by the relation of its measures and its sense of proportion; administration by the rationality of each action in terms of a *given* goal. The attempt to conduct policy bureaucratically leads to a quest for calculability which tends to become a prisoner of its own prior processes.

Why the Courts Can't Admit Policy Choices

The survival of any bureaucracy, and law is no exception, will be its first priority. Survival hangs on a ridiculously thin thread. A legal bureaucracy's survival turns on its ability to convince other politically significant actors in society of its legitimacy. Authoritative power is power only because people believe it is power. Admission of value choice will undermine the power of an adjudication institution. The bureaucrat will abhor the admission of any value choice which is the basis of a decision against any powerful interest group. Where such choices are inescapable, the bureaucrat will try to justify his decisions by reference to some higher level criterion, some principle standing above mere value preferences. A pluralist society always promises more freedom of choice and egalitarian distribution of basic rights than a vulnerable interdependent social fabric will allow it to deliver. Rational politics demands concessions to the powerful and sops to the weak. The need for such diversionary devices will be in direct proportion to the shrewdness of the parties' advisers and the parties' relative power. The more important the issue, the greater the need for complexity. The need will be far greater when enforcing a large tax claim against a powerful company or against the interests of a whole class of businessmen than it is when refusing the odd deduction to unorganized and poor female domestic labour.

Excessive Rigidity is the Price of Legitimacy

Paradoxically, the section 260 authorities are in the present unsatisfactory position because the courts have been too successful with their main preoccupation. Tax lawyers have been so preoccupied with elevating the myth of legitimate authority that this has over-reached and warped their perspective. They have fallen victims to their own white lie.

The advantage of vesting authority in previous process and of pretending that legal norms are some sort of universal inevitable truth springing from the legislative words is that it reinforces the authority of the courts. This reference to supra-human sources legitimates existing institutions and consolidates power. The admission of choice really can erode that power. But the price paid for excessive stability is the inhibition of institutional evolution and a rigid commitment to old ideas. Normally, of course, the common law eventually adapts to social change, when doctrine does

become excessively atrophied, by turning a blind eye to judicial delict. Denning or some other reformer pretends, and the legal world pretends with him, that his new rule and implied rejection of the old rule is mere extrapolation from existing doctrine. Thus law can allow change without appearing to concede much of its commitment to stability. But, in tax, such covert devices, devices which are anathema to systematic social engineering, have not proved adequate to provide needed adaptation of the system to rapidly changing economic and social forces. The internal forces supporting inertia are too strong. As lawyers have created a more complex tax system, they have excluded others from understanding, and hence of controlling, the structure. It has also made them prisoners of their own complex system.

Restrictive assumptions, or more accurately the assumptions which courts purport to apply in their reasoning, can possibly be justified on a balance of political or efficiency priorities. About this, a committed democrat ought to be sceptical. But this cannot obviate the need for a periodic cost-benefit analysis and this is made very difficult because the prime material, hard facts and reasoning, have been adulterated by the need to preserve legitimacy. The commitment to stability, in particular, is not examined.

A stable and predictable legal system is not an end in itself. Stability, Kissinger has said, is merely a bridge to a better and more humane society. After a certain point, a stable system can inhibit the optimization of the end it is designed to attain. Like bridge builders, lawyers must thoroughly assimilate the paradox that, in a fast changing community of human beings, a stable structure serving those human beings requires a great deal of mobility. Legal institutions require constant feedback and rigorous self-assessment, they require constant reorientation of goals to adapt to rising human expectations.

Predictability is merely one competing goal in a balance of factors going to the correctness of a decision. It is a mistake, after a certain point, to pursue a stable body of rules. Consistency is certainly an important element in the human perception of fairness and in the efficiency of any institution governed by rules. But when a fast-changing political process removes the compromise on which the rule is based, the rule itself becomes a means of holding on to old power. Human goals change too rapidly to permit certainty beyond a given point. Our legal system too often over-reaches that point substantially, and, paradoxically, predictability becomes a destabilizing influence.

Opting out of the Major Debate Predicates a Political Choice

The tax authorities rarely consider the critical issues explicitly. Questions are not asked about the realities of power sharing in a legal-political decision process where the legislature leaves effective choice in important areas to the "experts", lawyers. Questions are not asked about the causal effect which legal decisions have on the expectations of human beings in a

dynamic social process. Nor do they raise the practical effects on the balance of power when courts either consistently undermine or fail to support the spirit of legislative initiatives, particularly in an arena like tax, where the opposing interests are intelligent and mobilized.

If most lawyers are engaged in the non-purposive interpretation of minutiae, or are preoccupied with the ceremony of innocence involved in juggling the empirical referents to open-ended legislative words in a policy vacuum, or if they elevate predictability into the dominant social virtue, the result is not, as it is usually assumed to be, neutrality; it is disarray and the acceding of power to the shrewd and powerful. By refusing to identify the central conflicts involved in any tax issue and thus failing to marshal effective forces to balance them, a decision maker opts out of effective impact on the main issues.

Lawyers are then forced back to the outdated and unarticulated ideas permeating their existing methodology. They forget that the tax system is attempting to hold a balance between the rights of a tax avoider and other members of the community. They elevate the importance of formal processes out of all proportion. Milton Friedman has said⁵² that democrats often object to totalitarian societies because totalitarians regard the end as justifying the means. To deny that the end justifies the means, he says, is indirectly to assert that the end in question is not the ultimate end, that the ultimate end is the use of the proper means. Desirable or not, any end that can be attained only by the use of bad means must give way to the more basic end of the use of acceptable means. This argument is amazingly simplistic, in spite of its widespread appeal. A rational decision maker evaluating the undesirability of leaving the status quo unchanged would weigh against the status quo the sum of the undesirable means and the end sought. Weber demonstrates the weakness of the argument. As Friedman says, both ends and means are objective social phenomena which are the outputs of any process of conflict resolution. To treat the means used as excluding all other criteria for evaluating social action is no more intelligent than the actions of a totalitarian who is willing to use all means to attain his ultimate ends.

Lawyers are practitioners of means. They sell to society a set of institutions which amount to a set of rules for playing the game. As sellers of means they tend to show more concern for the rules rather than the consequences of the political game. Such an attitude invites the cynical inference that a lawyer's support for "due process" or legalism is merely a political preference for the existing power configuration. Social control by the incumbent ruling elite through reference to legalism is more cost-effective than resorting to naked coercion. If a preference for legalism is a manifestation of the rationally formed opinion that the preservation of existing processes will, in sum, optimize the chances of improvement at the

⁵² M. Friedman, *Capitalism and Freedom* (1967).

least cost, or if it genuinely consists of deferring policy to an elected government, well and good. But the line is thin and the simplistic due process slogan has a persistent tendency in normal human affairs to submerge talk about the reasonableness of particular demands or substantive fairness or the realities of the existing premises and to become a veiled preference for political conservatism. So much of the tax paradigm is merely a massive atrophied example of this doctrinaire due process emphasis taken to absurdity. In the case of tax avoidance it has led to the creation of a set of rules which is itself manifestly unfair.

A much more balanced framework for weighing competing priorities is provided by Shur:

Views of the legal system may reflect views of society in general. Those who see societal integration resulting primarily through socialization to, and through consensus about, a system of common values will view the legal system as an embodiment of such values, primarily integrative in function. On the other hand, those who emphasize that society is held together by an uneasy balance or reconciliation of continuously conflicting forces and interests, and that the equilibrium of a social system is but a representation of a continuous social process artificially stopped at a point in time . . . assess the legal system in terms of conflict and change.⁵³

Of course, neither of these models gives a complete description, and both forces need to operate simultaneously. A successful process must be able to keep both models delicately balanced. If either of the two models becomes too dominant it tends to be self-fulfilling in its effect. It is no accident, therefore, that the choice depends on the extent to which the observer feels unhappy about existing reality. So the accusation of political bias levelled against lawyers is not altogether misplaced. The political choice is inherent in the lawyer's model choice. When, for example a significant portion of society is dissatisfied with the way in which the economic cake is distributed they are not only complaining about the degree to which society reflects their own values but also about their power to change it. In response, lawyers need a far more sophisticated process for synthesizing competing demands.

The Function and Limits of Section 260

Section 260 is a wide direction to the court to prevent circumvention of the provisions of the Act, so far as that is consistent with other priorities. It must necessarily be phrased generally. Courts are made up of judges who are human beings with their own political views and professional role perceptions. In enacting section 260 or any other tax provision the legislature can only ask the courts to prevent tax avoidance. In the nature of an avoidance process which consists of resourceful professional minds looking

⁵³ E. M. Shur, note 40 *supra* at 140.

for gaps in the legislature's taxation "Maginot Line", any effective anti-avoidance provision must be phrased generally. To argue that section 260 is undesirable because an individual taxpayer ought to be able to establish with certainty the amount of tax he will bear if he attempts tax avoidance and that section 260 gives rise to undue uncertainty, implies a clear political choice. The legislature can take the courts to the water, but it cannot make them drink. There is necessarily a penumbral area. In the case of a necessarily wide provision like section 260 we have shown⁵⁴ the discretion of the courts can extend to reverse the plain inference a layman would draw from the legislative words. There is necessarily a degree of power sharing between the legislature and the judiciary.⁵⁵ A redrafted section 260 would not necessarily make the courts imbibe, but it may make it more difficult to justify their intransigence.

Anti-avoidance measures, whether specific or general, are no substitute for a coherent tax regime. Only with a simple and conceptually sound tax system will avoidance problems become manageable. Section 260 will necessarily be a mobile, selective strike weapon which is of optimum utility if it is not used to fight major battles. It must be remembered, however, that the impact of a general anti-avoidance provision is far from limited to the cases in which it is actually invoked. It has the deterrent effect of dissuading any would-be tax avoider from indulging in what is, from a national point of view, a particularly sterile use of time and innovative energy. But, more important, the clear statement in an Act of Parliament that tax avoidance is unambiguously anti-social will in time permeate community attitudes and will isolate tax avoiders. The assertion that lawyers have a duty to dodge tax on behalf of anybody proffering the proper fee, based as it is on a rather tenuous analogy with Samuel Johnson's defence of a lawyer defending a man he "knows" to be guilty, has never appealed much to me. The criminal lawyer must weigh his own belief in the client's guilt against the priority of promoting social cohesion through providing a fair adjudication process to all persons charged. A lawyer who dodges tax on behalf of a client is a hired gun, right in at the inception of the breach of law. Practically speaking, his services are available to only a small portion of the community. In consequence, the role of the legal profession in tax avoidance is socially divisive rather than cohesive. This is particularly so when the culture of the tax avoider is transported into the judicial sphere.

In an ideal world, justice should both be done and be seen to be done. In political practice, the appearance of justice is more significant than its

⁵⁴ Text at p. 212 *supra*.

⁵⁵ This analysis is well pursued in an administrative law context in P. Robertshaw, "Unreasonableness and Judicial Control of Administrative Discretion" [1975] *Pub.L.* 113, 122 where he analyses domains of authority established between the judiciary and legislature and demonstrates that the courts will react defensively when the legislature encroaches on their prerogatives. Here the argument is the converse. The legislature is perceived to be forcing unwanted policy functions on the courts.

reality. The courts depend on legitimacy for their power. In turn, legitimacy turns on the substantial acceptance by the politically significant sections of the community of the fairness of the process imposing tax. Artificial tax avoidance devices are becoming more prevalent and more visible as their sponsors are more bold in advertising them. The system is increasingly being seen by the community as one which is less than fair. The courts should take section 260 more seriously to annihilate artificial devices which circumvent the Act and assert the legislative objects of substantive provisions. Because of an unhappy convergence of a wide-spread habit of protesting lack of political involvement and the complexity of the tax process, lawyers have assumed a major responsibility for blunting the progression of income tax and death duties. They have thus compromised the effectiveness of major legislative distributional and economic tools. Section 260 supplies a route back to middle ground.

APPENDIX

Redraft of Section 260⁵⁶

This redraft should be enacted in the Income Tax Assessment Act 1936-75, the Estate Duty Assessment Act 1941-67, and the Gift Duty Assessment Act 1941-72.

- (1) Taxation avoidance transactions shall be illegal.
- (2) A "taxation avoidance transaction" shall be any transaction:
 - (a) which has the effect of diminishing or postponing any liability imposed by this Act or any possibility of future liability which may be imposed by this Act, *and*
 - (b) the particular steps by which that transaction was carried into effect reasonably raise the inference that the transaction was artificial when compared with the steps normally used to achieve substantially the same non-taxation effects, *and*
 - (c) one reasonable hypothesis explaining the artificiality of the particular steps by which the transaction was carried into effect was that a reasonable man in the position of the taxpayer would use the particular steps in the transaction in order to bring about the effects described in section 260(2) (a), *and*
 - (d) which is not excluded from the operation of section 260 by section 260(4).
- (3) This section shall override all other provisions in this Act.
- (4) (a) In interpreting the provisions of this Act proper weight shall be given to the objective of preventing taxation avoidance transactions.
 - (b) Where there is a conflict between the objective of preventing a taxation avoidance transaction and the economic, social or administrative objectives of other provisions of this Act the Commissioner shall in resolving such a conflict give proper weight to the objectives of this section.

⁵⁶ Cf. the approach in the New Zealand s.108 of the Land and Income Tax Act 1954 (as amended by Act No. 174, 1974, s. 9).

- (c) Notwithstanding section 260(1) to (3) but subject to section 260(4)(a) and (b), where the consequences of applying section 260 conflict with the consequences of applying any other provision in this Act and the inference can reasonably be drawn from that other provision that the carrying out of the transaction in that particular way was necessary to satisfy the economic, social or administrative objectives of that provision the taxation avoidance transaction shall not be illegal.
- (5) In drawing the inference that there was a taxation avoidance transaction the Commissioner shall have regard to the following matters:
- (a) whether the transaction might reasonably be expected to have been carried into effect or carried into effect using those particular steps if it had not had a tax diminution effect;
 - (b) whether a transaction having its non-taxation effects or substantially the same non-taxation effects might reasonably be expected to have been carried into effect in that way by persons dealing at arms length or *bona fide* fulfilling the normal family obligations of the taxpayer having regard to the options open to the taxpayer when he carried out the transaction and all the circumstances;
 - (c) the tax diminution resulting from the particular steps used in the taxation avoidance transaction when compared with a hypothetical transaction having the effects described in section 260(5)(b);
 - (d) the income, profit or other gain which might reasonably be expected from the taxation avoidance transaction and the difference between such income, profit or other gain and a hypothetical transaction having the effects described in section 260(5)(b);
 - (e) how unusual the steps in the taxation avoidance transaction are when compared with those in section 260(5)(a) and having regard to all the circumstances; *and*
 - (f) the extent of control the taxpayer enjoyed before and after the transaction over the subject matter of the transaction.
- (6) (a) Where there is a taxation avoidance transaction the Commissioner may but shall not be bound to treat all or any part of the taxation avoidance transaction as void for the purposes of this Act.
- (b) Where there is a taxation avoidance transaction the Commissioner may for purposes of this Act treat all or any part of the taxation avoidance transaction as effective or he may notionally construct any new steps in the taxation avoidance transaction for the purposes of this section.
- (c) Notwithstanding anything in section 260(1) to section 260(6)(b) the Commissioner shall as a result of his annihilation and reconstruction of the taxation avoidance transaction or any part thereof produce a taxable income which having regard to the matters in section 260(5) and having regard to the non-taxation effects of the transaction and all the circumstances is not unreasonable and counteracts the taxation advantages of the taxation avoidance transaction.
- (d) Notwithstanding anything in section 260(6)(a), (b) or (c), the Commissioner shall not treat any part of the transaction as void if the amount of tax diminished or postponed is not a material amount.

- (7) In any proceedings in which a taxpayer is appealing from a determination of the Commissioner under section 187 of this Act:
- (a) the onus of establishing that there was a taxation avoidance transaction shall lie on the Commissioner; and
 - (b) the onus of establishing that the taxable income resulting from the operation of section 260(6) is unreasonable shall lie on the taxpayer.
- (8) (a) The Commissioner shall supply to the taxpayer the basis on which he arrives at a new taxable income including the steps of the reconstructed transaction and the calculation of any approximations made in achieving the new taxable income.
- (b) In supplying the basis on which he arrives at a new taxable income under section 260(8)(a), the Commissioner shall not be required to use technical or legal language.
- (c) It shall not be a ground for reversing the basis on which the Commissioner arrives at a new taxable income under section 260(8)(a) that the grounds he states are inaccurate or do not justify his decision so long as all the grounds read together justify a taxable income which is not substantially different from the taxable income assessed.
- (9) In this section:
- “diminishing” includes lowering, avoiding, defeating or relieving, whether directly or indirectly, and whether wholly or in part;
- “non-taxation effects” means the effects of the transaction other than the effects defined in section 260(2)(a); *and*
- “transaction” means any thing or things done or omitted to be done whether involving conscious action or not and whether enforceable or not by any person or persons whether together or separately and whether in concert or not. Without limiting the generality of the foregoing it shall include any understanding, arrangement, agreement, plan, contract, conveyance, transfer, assignment, grant, creation, settlement, delivery, allotment of shares or debentures or convertible notes, variation of share or debenture rights, release, surrender or failure, renunciation, non-enforcement of any right for a period exceeding that which would normally be expected for the non-taxation effects of such non-enforcement, abandonment, effluxion of limitation period, exercise of any power, option or other right, or the failure to use a power, right or vote which would prevent such effects as aforesaid.