Taxation

Income Taxation: An Institution in Decay

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INTRODUCTION

In 1986 at the time of my approaching retirement from the Law School, I was privileged to give the 1986 Sir Wilfred Fullagar Memorial Lecture at Monash Law School. I began that lecture[1] with the metaphor of a super nova, which, my encyclopedia tells me, is a phenomenon associated with the death throes of a star. It involves a dramatic increase in the size and intensity of a star that to the astronomer who observes it is awesome. The star will in time lose a great deal of its mass and thereafter become a thin miasma—a ghost calling to its past. A metaphor is no basis of prophecy. But it may help to describe what I believe will happen to the income tax, my belief being assisted, I confess, by a conviction that it ought to happen.

The super nova is already upon us. At the time of the lecture we had seen a vast increase in the substance of the income tax and in the number of administrators charged with its enforcement. The pace of increase has not slackened. We have adopted a system of imputing company tax to the shareholder; a statutory extension of the law in regard to exchange gains and losses; extensive provisions in regard to thin capitalisation by non-residents; a system of self assessment; a new regime of quotation of tax file numbers; a new regime in relation to taxation and superannuation; and a new regime involving accruals taxation of foreign income derived by non-resident companies and trusts.

My continuing experience of the income tax law is now as a consultant to a law firm. The substance of the new law, as I endeavour to know it, becomes ever more complex and detailed, ground fine by statutory provisions and by explanatory memoranda that we are told must be heard in the process of interpretation, by a great outpouring of decisions of

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[1] The lecture was based on a paper I had prepared which was subsequently published in *Australian Tax Forum* and in *Monash University Law Review*. The editors of those journals have kindly permitted the use of the paper in this essay.

the Administrative Appeals Tribunal and the Federal Court, and by General Rulings of the Commissioner which, we are told monotonously, may be wrong and are subject to a different view of the law that may be taken by the Tribunal or by a Court. The different view will displace a Ruling prospectively and retrospectively for all taxpayers.

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

The analytical stock of the income tax in the result had congenital defects, born as it was of a union of institutions which had no common policies. The history of the income tax is a history of grafting new analytical stock onto the old, the new stock being directed not to what comes in but to a notion of profit. The grafting has been both by statute and by judicial decision. Where the graft is by statute, it has been taken perforce, but it created an incoherence of structure. Section 160ZA(4), which attempts to reconcile income and capital gain is a twisted scar. When the new stock is a graft by judicial decision, it is always at risk of rejection by judges who come to see it as an alien intruder on hallowed ground protected by precedent. A notion of what comes in, or a return from property, or the fruit of property, or the flow from a spring—all metaphors explaining the entitlement of the life tenant—was always in a different discourse from the notion of an increase in the value of the property, explaining the entitlement of the remainderman. Flow from property and increase in the value of the property itself were contrasted notions in trust law. Their separateness and the contrast between them were drawn, confirmed and refined in a mass of judicial decisions. To merge them rationally under a single concept of income was always impossible. When it is attempted, the income tax becomes unknowable except by rote, and will be mocked. This is enough to justify a lawyer asking that an end be made to the tax. Which is not to say that there are not other reasons why it should cease to trouble us. One of these would be that 'income' even when understood in a sense which may give some coherence of principle and claim to fairness to an income tax, is not as appropriate a base of a tax as is expenditure. An income tax that has some coherence of principle and claim to fairness will seek to confine its base to gains,

as distinct from incomings. As such it is a measure of the contribution the taxpayer has made to production. A tax on expenditure taxes by reference to what a taxpayer has taken from the pool of production.

Another of these reasons would be that the income tax is not in truth a direct tax however much we assume that it is. Its effective incidence does not rest on the person who is called on to pay the tax. If the effective incidence is not on the person who pays the tax, all the agonies of debate in the Asprey Report,[2] in the 1985 White Paper[3] and at the National Tax Summit[4] about the equity of the income tax were endured in vain. All proceeded on a false assumption. Whenever our politicians seek to conclude a bargain with labour such that relief from income tax is traded for restraint in wage demands, they are in effect proclaiming that any increase in income tax is likely to be passed on in increased wages and that labour should accordingly be prepared to pass back relief from income tax by restraint in wage demands. In the 1970s, the degree of inflation was made the more dramatic by labour pressing wage demands to recoup the ever increasing income tax which results in conditions of inflation if the rate scale remains unchanged.

Yet another of these reasons is that the extent of evasion of the income tax can never be reduced to an acceptable level without great intrusion by the administrators into our lives. We must all be tax-file numbered and indentify ourselves. We must all stand ready for audit.

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

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

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

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

It is in this context of a barrenness of reason that we have seen the introduction of a system of self assessment. The Commissioner, in the first instance, looks only to the correctness of the arithmetic of the return and ignores any claimed reason in the return for not including an amount as income or including an amount as a deduction, unless he is specifically asked by a prescribed procedure to consider the reason. The taxpayer is strongly discouraged from asking by an impression, that may not be well founded, that to bother the Commissioner in this way is to attract an unfavourable response, a response that the taxpayer will have to accept if he does not have the resources to mount an appeal, or the tax to be escaped does not justify the cost of an appeal. The hazards for the taxpayer have increased immensely. The vital difference between the new system and the old is that the security—the finality—of the first assessment is now denied to a person who has been entirely honest in his disclosure. He is sentenced to serve four years of uncertainty. The Commissioner has another move available to him, by which he has an unrestricted power to assess again, and in which he may be able to impose penalties. There is a view that would say that everyone knows what income is and what is deductible so that each of us must be conscious of legal and moral obligations to return all items of income and to claim no deduction that is not deductible. The view is that it is therefore appropriate to allow each of us to self-assess, and if this assessment is wrong in a way that is unfavourable to the Revenue, it is proper that the offender be punished under a scale of penalties that competes with the subtleties of scholasticism. Cash receipts of wages and interest on fixed interest investments aside, no-one can be wholly sure what income he has, even if he has the advantage of expert advice. Nor can anyone be wholly sure that an item of expense he has incurred is deductible. An employee has no special advantage over another who may be engaged in a business or profession. The deductibility of an employee's expenses is severely limited by judge-made rules, and is subject to statutory requirements in regard to substantiation by receipts, requirements with which, if known to the employee, he may find it immensely inconvenient if not impossible to comply. The employee, like the taxpayer engaged in a business or profession, is discouraged from saving and private investment by the prospect of tangling with rules about which there is a substantial element of doubt and which may involve him in a liability to tax which is simply punitive. If he choses his investments and changes them with any show of system, though he may have held the investments for a good many years, he may be found when he sells to have engaged in a business of investing such that a nominal but entirely unreal gain on the sale is income subject to tax. Though the value of an investment has done no more than hold against inflation, he will derive income subject to a tax that will operate as a capital levy. The rational response is to spend rather than save and invest, when the investment of saving will be depleted by tax, and may be depleted if the investment has been held long enough and inflation contines, to a point of near extinction. Meanwhile if the

taxpayer derives a flow from his investment in the form of interest or rent, the flow will have been subject to a tax which may have prevented the flow from offering a recoupment of a real loss in the value of his investment.

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

There is my thesis. May I try to support it.

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

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

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

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

The trust law concept of income is built on the idea of flows, which Simons rejects. The flows that are income are commonly identified, in judicial statements about the concept of income, as dividends, interest, rent, royalties and proceeds of a business. There is another flow, that from human capital, which is the judicial explanation of how it is that rewards for services are income, without regard for the costs of human

[5] *Supra* note 2, at 35.
[6] Chicago: University of Chicago Press, 1938.
[7] *Id.* 50-1.

capital consumed in performing those services. To describe these as flows is to call on a metaphor. Metaphors and Latin are used by lawyers as substitutes for, and not aids to analysis. It may be more helpful to say that a flow is the consequence of some act or event in relation to property, the property being seen as capital, which triggers a receipt by the owner which is not a receipt in realisation of that property. The act or event may be the declaration of a dividend, or the coming of a day when interest is due, or the grant of a lease or licence, or the sale of goods in the course of business operations. The flow may be an accretion to economic power, a phrase that Simons made his own as a description of a gain, but often it will not be. In the case of a dividend on a share, there will not generally be an accretion to economic power if the dividend is received immediately after the acquisition of a share purchased cum dividend or the share has fallen in value since it was acquired. In the case of interest on debentures, there will not generally be a realised accretion to economic power if the debenture was purchased immediately before the due date for payment of interest, or if, as a result of an increase in interest rates, the debenture has fallen in value since it was acquired. Nor will there generally be an accretion to economic power if the new owner of property not yet leased, immediately leases the property and takes rent in advance, or a premium. There has been only a conversion to cash of some part of the new owner's property rights—the right to possession—which one might expect to be reflected in a decline in the value of his property rights that remain following the conversion. The allowing by the owner of the use of an asset may generate flows in the form of royalties, but there will be no gain to the owner if use will cause a diminution of the value of his property below its cost, and that diminution equals or exceeds the amount of the royalty receipts. There will be no accretion to economic power if the proceeds of sale of goods do not exceed their cost.

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

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

[8] *Id.* 207.

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

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

Origins in trust law

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

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

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

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

Entrenchment of the judicial concept in trust law and in income tax law in the United Kingdom

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

> Income tax has been judicially pronounced to be a tax on income. In arriving at the amount of income liable to income tax, Parliament may expessly provide that certain income expenses may be deducted.

[13] (1985) 2 All E.R. 645; [1985] 1A.C. 1083 at 1122.
[14] *Supra* note 12.
[15] *Supra* note 13, at 654.

> The legislature may go further and expressly provide that certain capital expenditure or capital allowances may be deducted for tax purposes. Fiscal legislation of that kind does not convert capital expenditure into an income expense. If the legislature provides for capital expenditure to be deducted for income tax purposes, the legislature does not increase or reduce the income of the taxpayer but reduces the amount of the income of the taxpayer which is liable to tax.[16]

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

The inappropriateness of the judicial concept as it has been received into income tax law

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

> The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time . . .
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> Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit,

[16] *Ibid.*
[17] *Supra* note 11, at 409.
[18] 252 U.S. 189 (1919).

something of exchangeable value, *proceeding* from the property, *severed from* the capital, however invested or employed, and *coming in,* being "*derived*" that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description.[19] (Emphasis in the original.)

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

Inappropriateness of the judicial concept in taxing royalties

The consequence of the flow concept of income for the income tax, that it may treat as income a flow that is not a gain, is evident in many contexts. Receipts for the use of one's property by another are income in the whole of their amount notwithstanding that the use will cause a wasting of the property. Royalties will provide an illustration. In this instance the natural legal meaning of income is reinforced by an express provision in s.26(f) of the *Assessment Act.* A co-called "capital allowance" may seek to reduce the amount of the royalty that is income so that it does reflect a gain. Section 124J does make some contribution to this end. But it is narrow in being confined to circumstances where there is a use of one's land by another who takes timber from the land. No capital allowance is provided for circumstances where the use by another involves the taking of sand or gravel from the land. In any case a capital allowance will never precisely serve the purpose of reducing the flow to its element of gain. Fixing the element of gain realised must have regard to the value of the property immediately following the flow and

[19] *Id.* 206-7.
[20] (1802) 7 Ves. 137; 32 E.R. 56.

to the cost of the property to the taxpayer. And this must lead one to wonder whether the Simons' notion of gain is a revelation that can ever find any more than a limited expression in a feasible income tax. From a passage quoted earlier[21] in this essay it is clear that Simons was persuaded that a feasible income tax must be confined to realised gains, which will leave the bulk of gains—unrealised gains—outside the base of the tax. And his observations relate to realised capital gains where, save in a partial realisation situation, the determination of gain does not require any resort to valuation. He made no observation in relation to gains that are realised in the flow of income from property. Yet in this context the determination of the amount of the gain cannot escape a valuation. The dismal conclusion is that the only principle that could give coherence and a claim to fairness to an income tax is beyond achieving in a feasible income tax.

Inappropriateness of the judicial concept in taxing annuity receipts

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

Inappropriateness of the judicial concept of income in the taxing of dividends

It is in regard to dividends that the concept of flow has taken the law furthest from the concept of gain. The distinction between a flow from property and a receipt which is a realisation of the property itself has in this area lost all substance. Yet the courts have held fast to the distinction in interpreting specific provisions which make a distribution from company profits income. The statutory provisions[24] owe very little inspiration to the concept of gain, and the blending of them with the notion of flow has produced bizarre consequences. Some of those consequences are the conclusion in *F.C.T. v. Uther*[25] that a substantial distribution which was expressed to be for a minimal reduction in the amount paid up on a

[21] See text *supra* note 7.
[22] (1949) 23 A.L.J. 47.
[23] (1934) 51 C.L.R. 568.
[14] *Assessment Act* s.6(1) 'dividend' and s.44(1).
[25] (1965) 112 C.L.R. 630.

share was not a flow but a receipt in the partial realisation of the share itself, and was not income. Amendments to the law[26] which may have corrected *Uther* may yet in other situations have left the possibility of a like conclusion. The Federal Court in *Slater Holdings v. F.C.T.*[27] left the possibility open. In any case the conclusion in Uther that the distribution was a flow from property and thus income, might have brought to tax an item that was not a gain. Gain calls for an identification of cost of the shares, and of the value of the shares immediately after the flow.

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

Inappropriateness of the judicial concept of income in the taxing of interest receipts

On the face of it, a flow that is interest will be a gain where the taxpayer has held the debt during the period since the previous flow, though it may not be so if interest rates have risen since the debt was acquired. But it may not be a real gain. Whether there is a real gain involves a comparison of the rate of inflation during the period of the loan to which the interest relates and the rate of interest. The defeat of any concept that income is a gain becomes complete when the element of premium provided for on repayment of a capital indexed loan is assumed to be income, as it is by amendments to the *Assessment Act* in Division 16E of Part III. In this instance the statutory provisions destroy any room left for excluding nominal gains from tax. Where the capital indexed loan is a Government bond, there is a crude deception practised by Government.

Inappropriateness of the judicial concept of income in taxing income from business

When one comes to apply the judicial concept in the context of business operations, it loses all touch with any idea of gain. That loss of touch is to be explained by the attempt to maintain a flow concept of income,

[26] *Assessment Act* s.6(1) 'dividend' paras (d) and (e).
[27] (1983) 47 A.L.R. 575.

which finds expression in a willingness to find income simply in receipts from the business operations. The decisions of the courts on the judicial concept for purposes of trust law are chaotic in their logic and beyond the comprehension of lawyers, save those who practise the occult arts of equity. Most of the cases have arisen from pastoral activities in Australia and New Zealand, though one leading case involves tin smelting.[28]

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

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

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

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

[28] *Kelly v Perpetual Trustee Co Ltd* (1963) 109 C.L.R. 258.
[29] 29(1962) 107 C.L.R. 604.
[30] *Id.* 623.

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

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

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

It may be that accounting for receipts, and for expenses that should be met from those receipts, with all its difficulties of determining from what source—capital or income—an expense should be taken to have been met, is appropriate when the issue is a fair treatment of life tenant and remainderman, so that it is to be preferred to the accounting proposed in *McBride v. Hudson.* But accounting for receipts and expenses is utterly inappropriate when the issue is the identification of income from business operations in trading stock for purposes of income taxation. In this context, the accounting in *McBride v. Hudson* is dictated. *Investment and Merchant Finance Corp. Ltd v. F.C.T.*[33] is seen by tax lawyers as a decision that shares in companies can be trading stock and subject to the specific

[31] *Ibid.*

[32] *Jacob's Law of Trusts in Australia* (5th ed. by R.P. Meagher and W.M.C. Gummow, 1986) at 497

[33] (1971) 125 C.L.R. 149.

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

The distinct concept of income as a profit reflected in the trading stock provisions, and its reception into the judicial concept

The underlying principle of the trading stock provisions of the *Assessment Act* is that income is a profit which will reflect at least a nominal gain. It is true that the notion is *realised* profit which retains some of the inappropriateness of the flow concept of income. It will generally ignore the unrealised gains or losses in relation to other assets, which ought to qualify the characterisation of the consequences of a particular realisation. In fact the trading stock provisions in allowing the taxpayer to write down the value of unrealised trading stock will enable the taxpayer

[34] (1978) 138 C.L.R. 210.
[35] See text *supra* note 31.

to limit the realised profit or gain that is income by reference to an unrealised loss.

At least for a time after *Investment and Merchant Finance*, the High Court remained apparently unmoved by the underlying principle of the statutory regime expressed in the trading stock provisions. The entrenched natural legal meaning of income remained secure. We continued to be assured that profit or gain was a notion alien to the income tax, save when some express provision, like the intruder s.26(a) (later s.25A), said otherwise. The alien notion has however infiltrated, not entirely unnoticed but only grudgingly acknowledged.

The Commissioner's practice was always ahead of the Courts in some areas, more especially the taxation of life insurance companies and banks in relation to the realisation of their investments. In that area a regime akin to the trading stock regime was accepted. There are two landmarks in the reworking of the natural legal meaning of income by the courts so as to embrace a specific profit. The first is the decision in *International Nickel Australia Ltd v. F.C.T.*[36] in which it is openly acknowledged that in the context of transactions which involve foreign currency the item of income or loss is an exchange profit or loss. The second landmark is *F.C.T. v. Whitfords Beach*[37] where it is acknowledged, though less openly, that s.26(a) was not an intruder, but merely expressed, perhaps more exactly, a notion of income that is part of the natural legal meaning of income. In the judgments of Mason, J. and Gibbs, J., the case stands as authority that there may be an isolated business venture, a profit from which, on realisation, is income within the judicial concept of income. The taxpayer company had entered on such a venture when it decided, being moved by new controllers who had acquired the shares in the company, to develop and subdivide land it had owned for many years, and to sell that land in subdivision. In the judgment of Mason, J. will be found a warning which is the forerunner of an even stronger warning of the Full High Court in *The Myer Emporium Ltd*[38] that the mere acquisition of property for the purpose of profit-making by sale is an isolated business venture, a profit from which will be income.

Myer, as a matter of precedent, is a more limited reception of the notion of profit into the judicial concept of income. The case took a specific profit concept of income into the judicial concept of income in the context of continuing business operations, where the transaction in question is not in the ordinary course of those operations—where, as it is said, it is "extraordinary" in relation to the course of those operations. The principle adopted requires that an asset should have been acquired for the purpose of making a profit by the realisation of the asset. The taxpayer had lent money to its subsidiary, and thereafter sold the rights

[36] (1977) 137 C.L.R. 347.
[37] (1982) 150 C.L.R. 355.
[38] (1987) 87 A.T.C. 4363

to interest receipts under the loan, retaining the right to repayment of the money lent. The High Court concluded as an inference from the circumstances that the rights to interest had been acquired for the purpose of selling them at a profit, and the profit realised was income within the judicial concept of income. At the same time the warning was sounded that even if the transaction had been an isolated one—not in the course of any business operations—a profit realised would have been income within the judicial concept of income. In effect s.26(a) was always an unnecesary addition to the *Assessment Act.*

Myer in these aspects is, I suppose, epoch-making. Yet it is bewildering in the conclusion of the Court that the sale of the rights to interest immediately after their acquisition yielded a profit of an amount being the gross proceeds of sale of the rights. The notion of profit in these circumstances is not easily understood. The High Court took the view that the rights had no cost. Yet in two areas of development of a profit concept of income made by statute in the provisions of the *Assessment Act,* it had been accepted that the lending of money must be seen as the cost, first of the right to repayment of the loan and secondly of the rights to receipts of interest on the loan. The first area is Division 16E of Part III where the security is a stripped security under s.159GZ. The other area is concerned with capital gains where, as it seems to me, s.160ZI of Part IIIA requires an apportionment of money lent as a cost between the right to repayment of the principal sum and the rights to interest.

There is a second basis of judgment in the joint judgment of the Full High Court in *Myer* which relies on the judicial concept as it was before any reception of the concept of profit. The High Court found that the gross proceeds of sale of the rights to receipts of interest were income as a substitute for the interest receipts themselves, and took the character of income the interest receipts would have had. In this aspect the judgment achieved two things. It confirmed as within the judicial concept of income the provisions of s.102CA. Section 102CA had been included lest the High Court did not reach the decision it in fact reached in *Myer.* At the same time the judgment gave the appearance of a happy reconciliation of the received concept of profit and the concept of flow. There were reasons why the High Court might have been anxious to find flows that were income in their gross amounts, just as they might have been anxious, on the earlier tack, to find that the whole of the proceeds were income as a profit undiminished by any cost. If one ignores *Salomon's* case, and treats Myer and its subsidiary as one entity, the total borrowing by the entity would be seen as the amount received by Myer as the proceeds of sale of the rights to interest. The payments by the Myer subsidiary, ostensibly as interest, would be seen as substantially a repayment of the amount borrowed from the person who acquired the rights to interest from Myer. Yet a recognition of the Myer subsidiary as a separate entity appeared to require the allowance of deductions of the full amounts of the payments by the Myer subsidiary to the purchaser of the rights to interest. Treating the whole of the receipts by Myer on

sale of the rights to interest as income in the form of profit undiminished by any cost, or as flows, countered to a degree the deductibility of the whole amount of the interest payment by the Myer subsidiary. Nonetheless the consequences in other circumstances are sadly distorting. The proceeds of the sale of the rights to interest, seen as profit without allowance for cost, or as substitutes for flows, were income in the whole of their amounts without regard to the fact that the sale of the rights to interest left Myer with an asset—the right to repayment of the loan—of a value substantially less than the cost—the amount lent—of the right to repayment and the rights to interest receipts. If gain is the hallmark of income as the fiscal economists would assert, the judgment in *Myer* on its face is dramatically wrong.

Myer is a case of great importance not only for the actual bases of decision, and the warning that section 26(a) was always unnecessary so that its repeal, and the repeal of its successor section 25A, have made no change in the law, but also for an observation that:

> Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income.[39]

In this there is expressed a principle that a specific profit on the disposal of property acquired held and disposed of in the ordinary course of carrying on a business has the character of income whatever may have been the purpose in acquiring the item of property. It is a principle that focusses on a notion that I have identified as a "revenue asset". The principle was early established in relation to certain investments of a life assurance company and of a bank, and is now established in relation to a general insurance company with respect to its "reserve fund". The Commissioner has issued a ruling in relation to the investments of a general insurance company which casts the net very wide, wider I believe than the case, *The Chamber of Manufactures Insurance Ltd.*, on which the Commissioner relies, will justify.[40] The principle is also established in the decision in *London Australia*[41] in the special context of a business of investing—planned coherent and organized activity directed to the maximising of flows from investment. The principle is established in relation to liabilities in the exchange gains and losses cases, when the relevant item whose discharge can give rise to a profit or loss is identified as a "liability on revenue account".

The observation by the High Court in *Myer* does not of course establish the wide principle expressed in the observation as a matter of authority. In the now somewhat dated theory of precedent, it is an *obiter dictum.* The principle may yet be held to be less embracing. Much depends on

[39] *Id.* 4366
[40] The case was nonetheless applied recently in *R.A.C. Insurance* (1989) 89 A.T.C. 4780.
[41] (1977) 138 C.L.R. 106

the meaning that will be given to the words "ordinary course of carrying on business". But it is most unlikely that the High Court will in the future deny the principle. It must be seen as a very substantial reception of the profit concept into the judicial concept of income. The Commissioner is ready to apply the principle in the context of debt defeasance arrangements. The Federal Court has applied the principle in the context of the acquisition and sale of an asset that is an item of equipment which it is the taxpayer's business to let on hire to others, and on which he has claimed depreciation.[42] It is an indication that the reception into the judicial concept of income is a recent development of income tax law that we had no authority on the question whether a depreciable asset could in the language that now becomes current, be a revenue asset of a business. It is also an indication that the reception of a wide principle is a recent development that Pincus, J. in *Memorex*[43] found it necessary to consider whether a "net profit" could be income in circumstances where no specific statutory provision made it so.

In the last year a number of decisions by judges of the Federal Court have pushed the notion of income as a profit in the ordinary course of business to an extreme from which the High Court may be asked to force a retreat. The most recent of these cases is *Equitable Life,*[44] in which Wilcox, J. relied on *London Australia.* The taxpayer, a member of a group of companies, had at one time carried on business as a life assurance company, but had sold that business. It continued to hold share investments that had been investments of the insurance business. From time to time thereafter it bought other shares and sold shares. In 1983 it sold a number of shares from its portfolio and invested the proceeds in acquiring the shares which other companies in the group held in another company in the group. Counsel for the taxpayer sought to distinguish *London Australia* on the ground that in the latter case "the taxpayer systematically sold its shares at a profit for the purpose of increasing the dividend yield of its investments". Wilcox, J. observed[45]:

> They rightly say that, in the present case, there is no evidence of any systematic review of the applicant's share portfolio or any regular culling of poor performers.

But Wilcox, J. did not accept as to the 1983 sales that *London Australia* could be distinguished. He said[46]:

> The impression I get from the evidence regarding the purchases and sales is that the applicant reviewed and supplemented its portfolio immediately after it ceased to carry on life insurance business. Between that date and 1983 it was content more or less to retain

[42] *Memorex* 87 A.T.C. 5034; *Cyclone Scaffolding* 87 A.T.C. 5083.
[43] 87 A.T.C. 5034, at p.5049.
[44] (1989) 89 A.T.C. 4972.
[45] at 4980
[46] *Ibid.*

> that portfolio. But it did have guidelines in place which directed attention, amongst other things, to the returns available in different kinds of investments. After March 1980 there was an instruction requiring the investment committee 'to continue to rationalise the share portfolios and improve their performance'. The September 1980 resolution was not directed to advantageous disposal of shares. Although the evidence does not establish the constant 'fine tuning' found in *London Australia*, it must be assumed that the investment manager had regard to these directions in making decisions as to the acquisition and disposal of shares . . . As the record shows, the applicant was willing to sell particular shares from time to time, no doubt whenever it was thought sensible to do so having regard to the performance of the shares and the price available. Such periodical sales must be regarded as a normal operation in the course of carrying on the business of investing for profit. The sales made during the year ended 30 June 1983 were within this category. Consequently the profits realised by those sales constitute assessable income.

Two observations might be made. It would seem from *Equitable Life* that quite modest selling of shares will expose an investor to tax on income as a profit realised by the sale of shares. And there is a risk of exposure even though there is no reinvestment after sale directed to a better return. The investment after the sales in 1983 was an aspect of a group restructuring.

The second observation is that the judgment makes use of the word 'profit' both to identify a gain, albeit what may only be a nominal gain, in the value of a share, and to identify a return in the form of a dividend. The reliance on *London Australia* might be thought to indicate that it was the seeking of returns in the form of dividends that gave the shares the character of revenue assets. Yet the reinvestment of the proceeds of sale of the shares would seem to indicate that seeking a level of return in dividends was not the taxpayer's objective. If one is to know the nature of income as a profit within the judicial concept of income, a good deal more instruction in judicial pronouncement is called for.

One other recent decision of the Federal Court calls for attention. This is *Hurley Holdings (N.S.W.)*,[47] a decision of Gummow J. The taxpayer was a company which "over the years had had as its principal business investments in the hotel industry". In the year of income, it seems, it sold its remaining interest in a hotel and had become highly liquid in funds. The director who gave evidence in the Administrative Appeals Tribunal proceedings said "he intended that his two sons would take over the operations of the business in due course when they had completed their studies and in the meantime the (taxpayer) had determined to maintain

[47] (1989) A.T.C. 5033

its assets in a liquid form so as to be ready for the change in its operations when the sons assumed control of the (taxpayer)". The company then purchased a bill of exchange at a discount and received payment of the bill at maturity. It thus appears that at the time of the purchase of the bill and at the time of redemption, the company did not carry on any continuing business, unless it was a business of investing. I doubt that such a business could be constituted by only one transaction, there being no evidence of earlier transactions or of an intention to enter into later transactions of the same kind. I am not sure that I know what a business of investing may be, but it must be something different from a business of owning interests in hotels. It would follow that the transaction in the bill of exchange was not in the ordinary course of business so as to attract the general principle asserted in *Myer*, nor was it extraordinary in relation to any business carried on so as to attract the actual decision in *Myer*.

The transaction could however have attracted the observations in *Myer* in regard to *Jones v. Leeming* and *Edwards v. Bairstow*. It might have been said that the bill was acquired in order that it might be realised at a profit on maturity, and that in these circumstances the profit was income. It would have followed that if the company had suffered a loss because the acceptor and drawer were unable to pay, the loss would have been deductible.

I suspect that the Commissioner might be unwilling to accept the consequence of the observations in *Myer* in regard to *Jones v. Leeming* and *Edwards v. Bairstow*, that where a profit would be income a loss will be deductible. One might think that the deductibility of the loss is an entirely fair consequence, but the prospect is opened that in a system which knows only realised profits and losses, a taxpayer will indefinitely defer the taking of a profit where this is possible but will realise a loss.

This may be the reason why the Commissioner's arguments in *Hurley Holdings* were framed not in terms that a profit was income but in terms of "flow", "fruit" or a "return" from the investment. Gummow, J. did not however understand the Commissioner to submit that whatever the surrounding circumstances, the discount in respect of the bill was to be classified in the same way as interest secured on a loan of money. In this there does seem to be a departure by the Commissioner from a much asserted view that a discount is in the nature of interest. Gummow, J. cast doubt on the Commissioner's view in an observation that the "difference between the price at which a bill is purchased and the face value differs from interest in that the discount does not accrue from day to day". In this regard he cited *Willingdale.*[48] Nonetheless an analysis in terms of the notion of flow from or return on the company's investment was accepted by Gummow, J. in holding that the discount was income. He said[49]:

[48] [1978] A.C. 834, at 841.
[49] (1989) A.T.C. 5033 at p.5038

> The taxpayer was seeking a reasonable return upon an investment, albeit a secure one. That return is represented by the amount representing the difference between the face value and the purchase price of the bill. It was also said in the Tribunal that 'there was no fruit from the tree—the tree just grew a bit bigger'. But if one is yet again to use a metaphor as a means of conveying the meaning of legal concepts (a practice in which the Tribunal is in august company) the point is that the 'tree' is the cost of the bill and the fruit the discount between that cost and the face value, received at the end of the term of the bill.

It is a short step from the decision of Gummow, J. to a conclusion that in all circumstances where a greater amount is received on the realisation of an asset over its cost, there will be income as a return from the investment. There will have been a reception of a new notion of profit into the judicial concept of income. It is new in that it is a fusion of notions which trust law adopts by way of contradistinction, and will be a fusion presumably only for purposes of the income tax. The new notion would make the capital gains tax entirely unnecessary. The profit will, like other profits already received into the judicial concept of income, be a nominal gain—there will be no indexation of cost. And the new notion will not be attended by a related notion of loss that is deductible. There is no suggestion of a new notion of a loss being the failure of an investment to yield an expected return.

From all this it may appear that the concept of income as a profit received into the judicial concept of income has very much lost its way.

Accommodating the reception of income as a profit into the judicial concept

That there is a conflict between the concept of income as a flow and the concept of income as a profit will be apparent from the judgments of the High Court in *John.*[50] *John* overruled *Curran*,[51] a case which is, with respect, one of the most unhappy decisions to come from the High Court. At least in the judgment of the Chief Justice, it was an attempt to refine the notion of profit reflected in the trading stock provisions so as to allow a cost for an item of stock—bonus shares issued in respect of shares that are trading stock— that is seen as taken into the process of profit making. It was an attempt in the operation of the trading stock provisions to do what was done in *Whitfords Beach* in allowing a cost for the land, being its value at the time it became subject to a profit-making venture. It is another sad irony that the attempt to bring a new insight into the notion of income should have gone so astray. The notion of profit does not require the allowing of a cost where an item is not

[50] (1989) 89 A.T.C. 4101.
[51] (1974) 131 C.L.R. 409

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

One would not quarrel therefore with the action of the High Court in overruling *Curran*. *John* is nonetheless a sad demonstration that conflict between a flow concept of income and a profit concept is not only unavoidable but is, it seems, beyond even a measure of reconciliation by judicial decision, at least when the flow is itself an asset in relation to which a profit that is income may be realised. In the circumstances of both *Curran* and *John* express provisions of the *Assessment Act* prevented the bonus shares being treated as a flow, so that there was no need to reconcile the flow and the profit concepts. Then, as now, there were, however, circumstances in which bonus shares are by the *Assessment Act* made income as a flow from the shares in respect of which the bonus issue is made. Where this is so, there is conflict that calls for reconciliation. In both *Curran* and *John* the need for reconciliation is recognised, but save in the judgment of Brennan, J. in *John*, no suggestion is made as to how a reconcilation might be effected. It seems that the conflict of territorial claims must give rise to double taxation, and this is an anomaly that the taxpayer must suffer.

In the view of the principal judgment in *John*, *Curran* was wrong in allowing a deduction of the amount of share capital paid up in the bonus issue made from revaluation profits of the company. The bonus shares were trading stock because they had been received as a product of trading stock. The effect of section 51(2) is to allow the deduction of expenditure incurred in the purchase of trading stock as outgoings, though those expenses were no more than outlays in acquiring equivalent value. But in the view of the principal judgment no deduction is available in respect of notional expenses where the bonus shares are products of trading stock, or, as I would put it, items arising as flows in a process of income derivation, as distinct from items taken into that process. The principal judgment did however contemplate a deduction for notional expenses, being the value of the items, where items are taken into trading stock, where, for example, inherited land is taken into a business of land dealing as trading stock of that business. The allowance of such a deduction would appear to be required by the decision of the High Court in *Whitford's Beach*.

The conclusion of the majority judgment that no deduction is available for notional expenses where the bonus shares arise in the process of carrying on business—where they are a flow from that business—is expressly extended to circumstances where the bonus shares are made income by the *Assessment Act* as a flow. In this the principal judgment in *John* follows an observation in the dissenting judgment of Stephen, J. in *Curran*.

The principal judgment in *John* does not question the reception of the concept of income as profit into the judicial concept of income. The case was in fact concerned with a share trader to whom, on the authority of *Investment & Merchant Finance*, the trading stock provisions of the

Assessment Act are applicable. Those provisions are a statutory reception of the concept of profit as income. The separate judgment of Brennan, J. is, however, notable for its rejection of the concept of profit as income as an aspect of the judicial concept of income. His judgment is unqualified in its faith in what he would see as the concept of income, as it was adopted by the use of the word "income" in the *Assessment Act*, where there is no relevant statutory provision expressly adopting the concept of profit. The judicial concept of income remains exclusively the flow concept.

Brennan, J. calls on observations of Dixon J. in *New Zealand Flax*,[52] now fifty years ago, that would take us back to a concept of income, concerned exclusively with flows and counterflows, by which "the gross receipts on account of revenue must be taken into the assessable income and therefrom the deductions allowed must be made by the Act and no others". It is inconsistent with the scheme of the Act in the view of Brennan, J. "to construct an account containing unallowable deductions and to take the resultant profit or loss as a measure of the taxpayer's liability". There is mention in Brennan, J.'s judgment of section 26(a) as an express provision upsetting the "scheme of the Act". Brennan, J., it seems, would regard the so-called banking and life assurance cases, *London Investment*, *Whitford's Beach*, the exchange gains and losses cases, *Myer* and many others, all involving judicial development of the profit concept of income, as alien intruders and, like *Curran*, candidates for reversal.

Antiquarian in these respects, Brennan, J. is nonetheless alone of the judges in *John* in an enlightenment that would seek a reconciliation of the flow concept of income and the profit concept where, as he would see it, the latter has been made an aspect of income by express statutory provision.

In the course of his judgment Brennan, J. refers to a submission by counsel for the Commissioner that where the "par value" of the bonus shares is assessable income, it is right to allow the amount credited in payment for them to be deducted. Brennan, J. offers two replies to counsel's submission. One reply is that the "supposed anomaly" involved, if the deduction is denied, is "theoretical rather than practical".[53] It may be that the anomaly could have been described as theoretical when the anomaly was noted by Stephen, J. in *Curran*. At that time the amount credited in a bonus issue was income only when the amount credited was debited to a revenue profit. By the time of the decision in *John* section 44(2), which denied the character of income where the debit was to a capital profit, had been repealed.

[52] (1938) 61 C.L.R. 179.
[53] 89 A.T.C. 4101; at p.4118.

The second reply is cryptic[54]:

> If there be an anomaly, it arises because section 44(1) brings into the net of assessability an amount—the par value of bonus shares—which is money's worth but not money and the sale of bonus shares converts the money's worth into money. The source of the anomaly may indicate a solution, if there be a solution.

Brennan, J. is, I take it, proposing to Parliament that a crediting in a bonus issue should not give rise to an assessable dividend until the bonus shares are sold. The suggestion, I take it, is that at the time of sale the amount that was credited in the bonus issue will be income as a flow and will be excluded from the proceeds of sale in determining any profit that is income at the time of sale.

There is a hint in the second reply of a principle that would prevent double taxation even though the bonus shares are recognised as an income flow at the time of issue. The principle would assert that the recognition of the bonus shares as an income flow at the time of issue and the finding of a profit that is income on the sale of the shares, is to allow an amount to be taxed twice simply because there are two provisions of the Act—presumably section 44(1) and s.25(1)—under which it is income. An amount that is income under two provisions of the Act is not income twice. But he declined to pronounce on the existence and scope of the principle[55]:

> I would not decide these questions now, for they were not canvassed in argument and their resolution does no more than avoid a theoretical anomaly which might exist if *Curran's* case is not followed.

We are nonetheless indebted to Brennan, J. for suggesting a way of reconciling the conflict between income as a flow and income as a profit. The principle would amount to a principle against double taxation operating where property is itself assessable income as a flow and a profit on the realisation of that property is income. His judgment aside, the reconciliation of conflict between flow and profit concepts of income remains beyond the creative function of the judge in law-making.

The room to rework the concept of income as a flow so that it will reflect the concept of income as a profit.

Where neither trading stock nor other property which can give rise to a specific profit on realisation is involved, it is, I suggest possible to rework the judicial concept of income as a flow by adjustments that may bring out a profit that is income. Those adjustments will concern the timing of the recognition of a receipt that is a flow, and the timing of the

[54] *Ibid.*
[55] 89 A.T.C. at p.4119.

recognition of an outgoing that is a counter flow. Without such adjustments, accounting that is concerned with receipts that are flows and the allowance of expenses that are counterflows will produce consequences that are as inappropriate as would be the consequences of an accounting for trading stock which ignores the conventions of financial accounting. The receipts and outgoings accounting adopted in *New Zealand Flax Investments Ltd v. F.C.T.*[56] stands condemned by its consequences. The company was taxed substantially on its gross receipts from investors though it had given undertakings to its investors to incur expenses from those receipts which might ultimately have involved a commercial loss. The tax deprived the company of the means of financing those expenses, ensured its financial failure and undeserved losses for a great number of small investors. Dixon, C.J. voiced his condemnation of the consequences:

> If there is any ground upon which the plan adopted for conducting the operations of New Zealand Flax Investments Ltd. may be extolled, it must be for the manner in which it illustrates the difficulty of applying the provisions of the Federal income-tax law when a transaction takes more than a year to complete and the true profit arising from it cannot be ascertained until it is completed or carried further towards completion than a year allows. In such cases a satisfactory estimate of the position at the end of a year may often be made, but upon commercial principles. If that is done, a suitable provision for future outlay must be made against current receipts . . . But, under the *Income Tax Assessment Act 1922-1930* , the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account, and only such deductions must be made as the statute in terms allows. At all events that is the interpretation which the statute has received in this court.[57]

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

Some twenty-seven years after *New Zealand Flax* the High Court took the opportunity through the word "derived" in the *Assessment Act* to reject to some extent the judicial concept of income as a flow. *Arthur Murray (NSW) Pty Ltd v. F.C.T.*[58] is a decision of great significance. A

[56] (1938) 61 C.L.R. 179.
[57] *Id.* 199.
[58] (1965) 114 C.L.R. 314.

gain will only emerge when a taxpayer has incurred the outgoings that attend his "earnings" of receipts—the word is adopted from *Arthur Murray.* Derivation of those receipts will be deferred until earning.

But *Arthur Murray* has not lived up to its promise. And there has been no more than a hint of judicial acceptance of a corollary of *Arthur Murray* which requires a rejection of the natural legal meaning of income when the significance of an outgoing is to be determined. An outgoing that has been in other respects incurred, but whose contribution to the making of a gain will in part relate to receipts of later years, should be treated as incurred only as those receipts are derived. The payment of interest, rent or management fees in advance does not limit a gain in the year of account, for it is matched by a continuing benefit that is bought by the payment—the right to future use of money or property, or the future provision of services. Yet *F.C.T. v. Ilbery,*[59] *Creer v. F.C.T.,*[60] at first instance and *F.C.T. v. Lau*[61] would treat the outgoings as deductions presently incurred. Only *F.C.T. v. Australian Guarantee Corporation Ltd*[62] offers a hint of judicial acceptance of a principle that the outgoing should not be treated as incurred save so far as the benefit from it is consumed. *F.C.T. v. Creer*[63] in the Federal Court, treats rent in advance as a capital outoing. So treating it may be appropriate in some circumstances where a very substantial continuing benefit is acquired, but deferral of the outgoing is generally more appropriate. If the outgoing is treated as a capital outgoing an allowance in respect of it must await the expiry of the lease, when there will be a capital loss.

Parliament has now meddled with the judicial process in law-making so as to require that in circumstances not definitively defined where judge-made law would allow an immediate deduction, the outgoing must be treated as incurred as the benefit from the outgoing is consumed. The relevant provisions are ss.82KZL-82KZO of the *Assessment Act*.

In one context the High Court has refused to treat an outgoing as not yet incurred though it is clearly an outgoing that limits any present gain. The decision in *Nilsen Development Laboratories Pty Ltd v. F.C.T.*[64] deserts any notion of income as a gain in order to serve a distinction between an obligation to pay for services already performed and an obligation to excuse an employee from the performance of services by the grant of paid leave. The distinction has been confirmed by legislation in s.51(3) of the *Assessment Act,* a provision whose policy cannot be more than ensuring the collection of revenue before a gain is made and when, indeed, it may never be made.

[59] (1981) 81 A.T.C. 4661.
[60] (1985) 85 A.T.C. 4104
[61] (1984) 84 A.T.C. 4929.
[62] (1984) 84 A.T.C. 4642.
[63] (1986) 86 A.T.C. 4318.
[64] (1981) 144 C.L.R. 616.

Nilsen is, with respect, an aberration. The disposition of the High Court has been to allow the present deduction of an outgoing in circumstances where the consequence in limiting a gain is even more damaging than in *Ilbery, Creer* and *Lau.* The High Court in *F.C.T. v. South Australian Battery Makers Pty Ltd*[65] adopted the Privy Council decision in *Europa Oil (NZ) Ltd (No. 2) v. IRC(NZ)*[66] which would find the rule of law in judging an outgoing by "legal" as distinct from "economic" reality. If the taxpayer has incurred an outgoing in pursuance of a transaction cast in some legal form, the purpose of his outgoing can be found only in the words of the transaction.

The tax planning that arose from *South Australian Battery Makers* may be defeated by the complex provisions of the Act that now appear in sections 82KJ and 82KL. But those sections should never have been necessary. The restoration of a principle that would judge the purpose of an outgoing by reference to all the attendant circumstances requires the overruling of *South Australian Battery Makers.*

The impossibility of adapting the notion of flow to the notion of gain where the item of income is a flow from property

Some adapting of receipts and outgoings tax accounting to the notion of profit by establishing principles governing the timing of the recognition of receipts and of outgoings is thus possible over a substantial area of what have been identified as flows from business. But in relation to other flows—those that are flows from property other than a business—adapting will remain beyond any room there is for judicial development of the law. Deductions may be allowed, for example, for interest on money borrowed to invest in shares. But such deductions will not reduce a dividend that enters the base of the income tax as taxable income to a true gain when that dividend is paid on shares which the taxpayer has purchased cum dividend. Indeed, reduction of a flow to a true gain in these areas must always require a valuation of property immediately after the flow and a reduction of the flow by reference to any diminution in the value of the property below its cost. The multitude of valuations thus required would outdo many times the valuations called for by including unrealised gains in the base of the income tax. Simons conceded the latter was beyond what was feasible in the operation of an income tax. Valuations to determine the element of profit in flows are beyond all imagining.

The impossibility of receiving the notion of a capital gain into the judicial concept of income

A development of the concept of income for purposes of the income tax, so that it will include capital gains has always been more than could

[65] (1978) 140 C.L.R. 645.
[66] (1976) 76 A.T.C. 6001.

be expected of the courts. The notion of income in its natural legal meaning is born of a distinction between income receipts and capital receipts. To attempt an extension of the concept of income to include capital gains is simply to attract an internal contradiction. The entrenched concept of income must be deliberately rejected, and a new concept substituted. It will be seen that the decision of Parliament was to retain the entrenched concept and make distinct provision for the taxing of capital gains.

A development of the law so that it will include only real gains and not gains that are merely nominal, is more than can be expected of the courts. The natural meaning of income that has inspired the courts had no concept of gain, real or nominal. Indexation of costs in a transaction may make some contribution to limiting the gain to real gain, but the correction it achieves may leave a real gain in some other transaction to be treated as a loss, for example, where interest is allowed as an outgoing and the interest rate is less than the rate of inflation.

The United Kingdom Court in *Lomax v. Peter Dixon & Son Ltd*[67] may have left open the possibility of excluding a nominal gain where it is in the form of a premium received on the repayment of a loan. But the correction would be on a narrow front.

SUMMARY

In summary, the judicial concept of income for trust law purposes—the natural legal meaning of income—which is the origin of judicial interpretation of the concept of income for purposes of the income tax, was always inappropriate in an income tax. The trust law concept was not moved by any underlying notion of gain, which is the only notion that could give it coherence and a claim to fairness as the base of an income tax.

There is some evidence of a judicial endeavour to give the income concept for purposes of the income tax an element of fairness that might attend the reception of a concept of profit. But the achievement is singularly haphazard, and at times unwilling. And the High Court in *John* has failed to give relief from the stress between flow and profit which is inevitable.

In two areas, the inclusion of capital gains and limiting gains to real gains, adaptation of the income concept was always beyond the creative scope of the judicial process. Capital gain is simply a contradiction of the judicial concept of income. Adapting the concept of flow to the notion of real gain will involve radical development in the law as to the time of recognition of receipts and outgoings and it will require valuations of property to which the flow relates after each event, and this would be beyond the creative scope of the judicial process and, I would think, what is feasible in an income tax. And it would require the indexation of outgoings which is equally beyond that creative scope

[67] (1943) 1 K.B. 671.

and what is feasible. The development of the law so as to receive a concept of specific profit into the judicial concept of income will always be incomplete without indexation of costs so as to bring out as income only real gains. Indexation, I repeat, is beyond the creative scope of the judicial process.

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

Until recently in the history of our income tax Parliament has played a comparatively minor and occasional role so as to contribute to a concept of income that will accommodate the notion of gain. One contribution is the adopting of trading stock provisions from the conventions of financial accounting. Some of its role has been correction to overcome an obvious unfairness to the taxpayer arising from judicial decisions defining the concept of income. Section 27H (previously s.26AA) is an example. Section 27H in one of its aspects is directed to excluding from the base of the tax that element of an annuity receipt that is not a gain, because it is in effect a return to the taxpayer of a part of the purchase price he outlaid to acquire the annuity. The courts have not welcomed the correction of the judicial notion. There are two decisions of the High Court—*Just*[68] and *Egerton-Warburton*[69] in which the taxpayer was denied the operation of the predecessor of s.27H, on a close construction of the provision, and Parliament has not been moved to reverse the construction.

Section 124J in one aspect is an attempt to bring some requirement of gain to the law by which timber royalties are income, law established in *McCauley's Case v. F.C.T.*[70] The section gives a capital allowance related to the cost of the timber at the time the land was acquired. More appropriately there should be an allowance of the amount by which the value of the land, after the timber has been taken, is reduced below its cost. What correction to limit income to a gain is achieved by s.124J is not in any event extended to other situations, such as the grant of a licence to take sand or gravel from land in exchange for royalties.

In other situations Parliament has acted not to correct but to confirm the defeat of the notion of gain implicit in the action of the High Court in denying a deduction in respect of a liability to grant long service leave. Where a right to leave has arisen, the liability to grant leave is an obvious limitation on any gain that tax accounting may reveal in business operations. Section 51(3), added before *Nilsen Development Laboratories Pty Ltd*[71] reached the High Court, confirmed in advance the decision of the High Court in that case. Section 51(3) has the effect of taxing a gain which has not been derived and may never be derived.

[68] *Supra* note 22.
[69] *Supra* note 23.
[70] (1944) 69 C.L.R. 235.
[71] *Supra* note 64.

Section 102 CA confirmed in advance the decision of the High Court in *Myer* making income the proceeds of realisation of rights to interest without any allowance for cost.

In 1989 Section 26BB was added to the *Assessment Act*. It is a swinging provision making income any profit on the realisation of a "traditional security"—involving the lending of money repayable without premium. The object it seems is to ensure that any amount received on the disposal or redemption of a loan beyond the amount the taxpayer lent or the amount he paid to acquire the loan will be taxed as income. In conditions of any inflation the tax will operate as a capital levy.

The Tax on Capital Gains

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

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

Indexation is confined to transactions involving the disposal of assets. A real gain that would be revealed by indexation in some related borrowing transaction where interest is less than the rate of inflation is ignored.

There are no general provisions which might bring capital gains on the discharge of liabilities into the base of the capital gains tax and allow capital losses on discharge. There is a specific provision allowing a loss applicable to a lessor who makes a payment to obtain a modification of his liabilities under a lease. But other situations, such as a payment by a taxpayer to obtain a release from a restrictive covenant, are not dealt with. Curiously, in the context of profits that are income profits made so by Parliament, there has been a recognition of income profits arising on the discharge of liabilities. I refer to provisions added to the *Assessment Act* in 1986, in relation to profits arising from variations in rates of exchange, as Division 3B of Part III. In this Parliament has followed trail breaking by the High Court in *International Nickel*.[72]

[72] 77 A.T.C. 4383.

Some grand ironies will be found in the capital gains tax provisions. Those provisions are designed, we are told, to bring real capital gains to tax as income because they represent "an increase in purchasing power" and thus "should be included in any comprehensive definition of income".[73] Yet the law retreats into the womb of flow notions of income in a number of its provisions. One illustration is that a premium taken on the grant of a lease will be a capital gain in the whole of its amount, notwithstanding that the grant of the lease may have brought about a reduction in the value of the property leased below its cost. There is another illustration that will take us back to *McCauley's Case*[74] and the timber. In *Stanton v. F.C.T.*[75] the High Court decided that a form of agreement that differed from that used in *McCauley* only in the respect that it purported to sell timber standing on land, rather than give a licence to take it, did not involve a derivation of income for the receipts were proceeds of sale of a capital asset. A provision in s.160M(7) of the new Part IIIA of the *Assessment Act* dealing with capital gains is drafted in the widest terms. Its effect may be that the proceeds of sale of the timber in *Stanton* circumstances will be a capital gain in the whole of the amount without any allowance for the fall in the value of the land that results from the taking of the timber. Another effect of that provision may be that the whole of a receipt for undertaking a restrictive covenant will be income notwithstanding that the taxpayer has sterilised for a period his capacity to earn income.

The Prospect of a General Achievement of Simons' Revelation

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

> Because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income. The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of

[73] *Supra* note 3, at para. 7.1.
[74] (1944) 69 C.L.R. 235.
[75] (1955) 92 C.L.R. 630.

the income tax base and is similarly grounded in terms of the objectives of equity, efficiency and combating tax avoidance.[76]

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

At one stage in the run-up to the last election Mr Peacock proposed to exclude from assessable income that part of income receipts that match the rate of inflation. He abandoned the proposal when the implications of a corresponding denial of deduction of interest paid by borrowers were appreciated.

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

INCOME TAX IS A GAME

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

[76] *Supra* note 3 at para. 7.1.

consequences on their face indicate to those who know these consequences, what square is to be avoided.

The Importance of Not appearing to Want to Win

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

The choice doctrine in relation to s.260 was recently considered by the Full Federal Court in *Pettigrew*[77] which involved the operation of s.260 on events prior to its repeal and the substitution of Part IVA. The Federal Court linked the choice doctrine to the policy of the law by asserting a general policy that a tax benefit might not be taken in a transaction which is "contrived" and "artificial". The Court was thus able to deprive the taxpayer of the advantage of a full year's depreciation under s.54, when the property had been owned for only 2 days, and to deprive the taxpayer of the operation of s.59AA to allow a deduction of the balance of the cost of the asset by specifying a nominal amount as the value of the asset on its disposal when the asset had a substantial value. I would have thought that a robust assertion that the allowance of the deductions claimed was never within the policies of ss.54 and s.59AA would have been preferable. Subsequent to the events with which the case was concerned, ss.54 and 59AA were amended to make these policies explicit. A year's deduction under s.54 is now available only in proportion to the period the property was held and the deduction under s.59AA is available only by reference to the market value or the written down value whichever is less, where the value specified is less than the market value and is also less than the written down value.

A robust assertion of a specific policy is perhaps beyond the scope of the judicial process and the requirement that the transaction must have

[77] 90 A.T.C. 4124.

been artificial and contrived is some qualification on the operation of s.260, albeit a sadly indeterminate qualification.

But if the choice doctrine is not an aspect of Part IVA, the Commissioner is given powers to formulate policy by selecting the occasions when he will exercise powers to assess under that Part. He is not controlled by any law in his selection, and the rule of law is abandoned.

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

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

Part IVA and Slutzkin

Two illustrations will demonstrate the unacceptable character of Part IVA. There was a time when a taxpayer whose company had substantial accumulated profits on which it had paid tax would look for a dividend stripper who would buy his shares. He would do this so as to obtain the release to him of the accumulated profits without bearing the tax that he would have borne had he taken those profits out in the form of dividends. His action in selling the shares was to escape what is now proclaimed to be an unfairness of the law in 'double taxing of company profits'. The Commissioner became persuaded that selling the shares involved an avoidance of tax which the taxpayer had sought, and s.260, the predecessor of Part IVA, nullified what he had done. The Commissioner could thus tax him on the proceeds of sale as if they were dividends paid by the company. The High Court in *Slutzkin v. F.C.T.*[78] held that s.260 did not apply. In a demonstration of the creative function of the judicial process, the Court confirmed and applied the "choice principle". There was no policy of the law at that time that the taxpayer should be subject to tax on the proceeds of sale of the shares. The person to whom the taxpayer sold—a dividend stripper—was able at that time to take out the profits from the company without a tax liability because that person was a company entitled to a s.46 rebate. If there was any

[78] (1977) 140 C.L.R. 314.

issue as to the policy of the law raised by the case, it was the policy of s.46, and to that I will return.

Slutzkin was not well received by Government or by those who condemned what they saw as a conversion of income into a capital gain, an alchemy that had long angered the economists. Three developments of the law have followed. The first is the replacement of s.260 by Part IVA which, it is said, leaves no room for the choice principle. Certainly there is no room for the principle in the terms of s.177E which, within Part IVA, deals expressly with the *Slutzkin* situation, and gives the Commissioner the power to change the rules, a power that s.260 denied him. The second development is the so-called extension of the base of the income tax to include capital gains, a development which the fiscal economists, and incidently some lawyers like me, thought desirable. The third is the introduction of an imputation system in taxing company and shareholder, which can, in a *Slutzkin* situation, induce the taxpayer to take the profits out in dividends. The dividend route rather than the capital gain route has become the one that gives the tax advantage. Section 177E has to a degree become a quaint absurdity. Yet the general provisions of Part IVA stand ready in another way to work a crude and gross absurdity. Attracted by the availability of an imputation credit and discouraged by the extension of the base of the income tax to include capital gains, a latter day Mr. Slutzkin will take the profits out in the form of dividends before selling his shares. In taking the profits out as dividends he will, at least in regard to recent and current profits, attract an imputation credit which should ensure, if his marginal rate is not greater than the company rate, that he is not taxed on the dividends, and which may indeed pay some of the tax on his other income. After receiving the dividends any capital gain he makes on the sale of the shares will be less. There may indeed be no capital gain to be brought to tax. The latter day Mr. Slutzkin will no doubt be pleased about the outcome, more especially since he has done what the Commissioner thought on an earlier occasion he should have done. But because he is pleased by it, and clearly wanted the outcome, Part IVA empowers the Commissioner to say that he may not have the tax consequences that appear to follow. Yet there is nothing in the law which would suggest a policy that he should not have the advantage of the line of action that will involve attracting the imputation credit, save the policy that may be inferred from s.160 AQT(1)(d) That provision denies a franking rebate to a shareholder who takes a dividend by way of dividend stripping. "Dividend stripping" has no meaning, save what may be carried by the bucolic metaphor.

Dividend Stripping and Coherence of Principle

Slutzkin was not concerned with the tax treatment of the dividend stripper. The law in that area had already been settled in *Investment and Merchant Finance Corp. Ltd.*[79] in a way that reveals dramatically the want of coherent

[79] (1971) 125 C.L.R. 249.

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

In no other part of the law is there a clearer demonstration of the inappropriateness of a flow concept of income in fixing the base of a tax. Yet in no other part of the law are the problems of adjusting the law to a gain concept of income more intractable. A full integration of company tax and shareholder tax of the kind proposed by the Campbell Committee[80] is, at least in the view of the Asprey Committee,[81] beyond what is feasible in the administration of a tax. Even it it were feasible, it would not adjust the law to a gain concept of income. What is necessary to make that adjustment is even less feasible. The taxing of company profits as such needs to be abandoned. In its place there should be tax to any individual whose interest, direct or indirect, in a company has increased in value over the year of income. Where any increase in value is due to a profit made by a company, there will in some sense be a tax on the company profit, but the showing of a profit derived by the company will be irrelevant. The proposal is in fact an aspect of a regime which is the logical outcome of adopting the notion that income is a gain. But the outcome is not feasible. Simons himself so conceded. We are left with an income tax that lacks any relevant coherent principle and claim to fairness.

[80] Final Report of the Committee of Inquiry into the Australian Financial System (Campbell Report) (Canberra: AGPS, 1981) Chap. 14.

[81] *Supra* note 1, Chap. 16.

Part IVA and Income Shifting

My second illustration of the unacceptable character of Part IVA concerns income shifting. Three decisions of the High Court in regard to the now repealed s.260 bear on the operation of Part IVA. Those decisions are in *Gulland*, *Pincus* and *Watson*.[82] My observations relate to *Gulland* though they might equally be made in relation to *Pincus* and *Watson*. If the interpretation of s.260 adopted in *Gulland* is transferred to Part IVA, that Part empowers the Commissioner to change the rules governing a husband's or wife's liability to tax. The Commissioner may change those rules where the husband or the wife takes steps under the rules otherwise applicable, which result in what would have been income of the husband or wife arising from personal exertion, becoming the income of the other spouse or members of the family. The inference of purpose to obtain a tax benefit is to be drawn, and the Commissioner, in his discretion, may deny the husband or wife that benefit and impose a penalty forfeit. It may indicate the fine line between circumstances where an inference of a purpose to obtain a tax benefit is to be drawn, and circumstances where it is not to be drawn, that shifting income to a trust that would employ, for example, the husband and contribute to a superannuation fund for him, was not thought to yield an inference of purpose to obtain a tax benefit, where the husband is the sole beneficiary of the trust.

There is some finding in the *Gulland*, *Pincus* and *Watson* cases, out of deference to the choice principle in *Slutzkin*, that there is a policy in the *Assessment Act* that a person is to be taxed on his or her personal exertion income, and that the rules otherwise applicable were displaced by s.260 if he or she sought to shift that income to another. The policy is presumably confined to personal exertion income. The policy does not extend generally to the transfer of income from property, at least when the property itself is transferred.[83] If there is such a policy against the transfer of personal exertion income, one would not want to quarrel with the outcome in *Gulland*. Yet it is hard to see why that policy should only be made effective when the taxpayer's actions show he or she wanted the tax benefit of not being taxed on the income he or she sought to shift.

The operation of Part IVA is not, it seems, qualified by any requirement that there is a policy of the law to be protected. It can operate where any kind of income is sought to be shifted. It may be expected that the Commissioner will seek to change the rules in income shifting situations only where shifting is attempted within a family, including, one would expect, a de facto family. Two justifications might explain such a selection. The first, confined to personal exertion income, would be that persons who are not salary and wage earners should not be able to obtain a tax benefit by shifting income when the general rules of income derivation

[82] (1985) 85 A.T.C. 4765.

[83] See, for example, Division 6A of Part III of the *Assessment Act*, and N. Brooks, "Preventing Income Splitting" paper presented at Australian Tax Forum 1986 Intensive Workshop in Taxation.

deny such a benefit to salary and wage earners. The salary or wage earner cannot, it seems, escape the derivation of his salary or wages. This first justification would approve income shifting if it were available to salary and wage earners. It can be made available by amendment to the law of income derivation. There will be a need in doing so to rework one aspect of the flow notion of income which would insist that there is income derived by a person only when a receipt in his or her hands is a flow from property or activity of his or hers—a rule we have come to associate with *Federal Coke Co Pty Ltd v. F.C.T.*[84] What are in truth the politics of envy would then cease to have any room. The second, a distinct and broader justification, is that a taxpayer who will share in the enjoyment of income, should have his tax liability determined by reference to that income whether or not he or she has shifted it to another. The second justification is an aspect of family unit, as distinct from individual unit, taxation. Family unit taxation is generally, and at times, fiercely, rejected by the majority of our community.

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

CONCLUSION

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

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

The future belongs to consumption taxation, to a value added tax as the Asprey Committee recommended.[85] The Committee in its more

[84] (1977) 77 A.T.C. 4255.
[85] *Supra* note 2, at 530.

romantic moments envisaged the ultimate demise of the income tax.[86] We have made two attempts to get started on the road to that future. Mr. Howard proposed some shift from income tax to a retail sales tax, but his proposal did not survive the opposition of the retailers. At the time of the Tax Summit, Mr. Keating proposed a shift to a broad based consumption tax, but his proposal did not survive a consideration of the problems of compensating taxpayers on lower incomes. Most recently he has abandoned that proposal. There are other problems, in particular a problem of international compatibility of our tax system. We cannot go it alone in abolishing our income tax. But in company with other countries we will shift away from the income tax. The more we try to strengthen the tax, the more the lack of coherent principle will become evident and the less will be our respect for the tax. The tax must command submission if it cannot have our respect. In a liberal democratic society, institutions that are maintained only by command cannot be maintained indefinitely. The liberal democratic society will itself be imperilled.

[86] *Id.* 35.