THE POLITICAL ECONOMY OF TAXATION AND THE ROLES OF THE HIGH COURT

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This article argues that while the High Court perceives the political nature of taxation in a constitutional democracy, it has never displayed a similar appreciation of the economic foundations of the income tax and the implications of the design of an income tax for its role in solving tax disputes. This means that the Court has not offered guidance on fundamental issues of tax policy. The argument is advanced by analysing several recent cases which demanded a response addressing fundamental issues of principle, but which received, instead, an answer based on linguistic deconstruction.

> In the past judges have been obstructive.... They looked for the philosophy behind the Act and what they found was a Victorian bill of rights favouring ... the liberty of the individual, the freedom of contract, and the sacredness of property and which was highly suspicious of taxation.
>
> Lord Devlin[1]

INTRODUCTION

In the popular imagination, taxation is often thought simply to be the way that governments finance their activities. This belief is accurate but incomplete. On the one hand, governments finance their activities by many means of which taxation is only one.[2] On the other, they use taxes for purposes beyond the mere raising of revenue. In modern societies, the tax system has become the means to many ends.

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1. P Devlin *The Judge* (Oxford: Oxford University Press, 1979) 15. See also, I Richardson "Appellate Court Responsibilities and Tax Avoidance" (1985) 2 Aust Tax Forum 3.
2. See generally J Stiglitz *Economics of the Public Sector* 2nd edn (New York: Norton, 1988) 45–59; R A Musgrave & P B Musgrave *Public Finance in Theory and Practice* 4th edn (New York: McGraw Hill, 1984) 219–220.

If governments needed to be concerned solely with raising money to pay expenses, a benevolent government could perform this task simply by its trading activities, printing (or borrowing) money, confiscation or conscription. Instead, a tax is used, first, because of the perceived undesirable fiscal and social consequences of adopting these other practices and, secondly, because governments recognise that taxes can perform other functions which they may be seeking to achieve. Taxes are used, often as blunt instruments, to achieve economic and social goals: stabilising the economy, encouraging increased consumer spending, stimulating reductions in unemployment, increasing business investment, discouraging undesirable behaviour, and assisting the redistribution of income and wealth.

Perhaps less obviously the tax and transfer systems represent part of the constitutional framework of the state. Webber and Wildavsky express the idea thus:

> On the budgetary base ... rest the political pillars of society. An across-the-board attack on the budgetary base is equivalent to a revolution. Breaching the budget is equivalent to opening the boundaries of the social contract to renegotiation. The fundamental priorities of the regime - who will be taxed, and how much and for which purposes - are turned upside down.[3]

The tax system of a nation is one of its fundamental elements.[4] Taxation is constitutional in its function: the allocation of the burden of taxation to various groups within a society and the form of recompense given through the transfer system are pivotal in determining the distribution of wealth and income within a society. Both of these features are considered by our constitutional theorists to be crucial in forming the consent implied in contractual theories of the state. It is not surprising that Rawls devotes a great

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3. C Webber & A Wildavsky *A History of Taxation and Expenditure in the Western World* (New York: Simon & Schuster, 1986) 31. See also J Head "Tax Fairness Principles" (1992) 9 Aust Tax Forum 65; G Brennan & J Buchanan *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980) ch 1.
4. This preoccupation with the constitutional functions of taxation is best seen in the literature of public choice school of economics. See eg G Brennan & J Buchanan "Towards a Tax Constitution for Leviathan" (1977) 8 Journal of Public Economics 255; G Brennan & J Buchanan "Tax Instruments as Constraints on the Disposition of Public Revenues" (1978) 9 Journal of Public Economics 301; G Brennan & J Buchanan "The Logic of Tax Limits" (1979) 32 National Tax Journal 11; Brennan & Buchanan supra n 3. A precursor to this work can be seen in J M Buchanan & G Tullock *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962); J M Buchanan *The Limits of Liberty: Between Anarchy and Leviathan* (1975). See also M Levi *Of Rule and Revenue* (Berkeley: University of California Press, 1988). See also Head supra n 3.

deal of time to discussing the operation of the institutions of the tax and transfer systems in his analysis of the source of principles of justice within the state.[5]

Taxation involves many and varied political issues: the desirable size of government, the role of government operating as an alternative to markets, the explicit distribution of the burden of funding government operations, the implicit imposition of burdens also placed upon citizens through the indirect effect of taxes, the best method of exacting those burdens, and so on. To quote Webber and Wildavsky again, the budgetary processes — borrowing, taxing and spending — of various societies express the political regimes in which they are imbedded and justify the political order:

> To say that revenue is maximised is to say nothing about who pays or whether the proceeds will go mainly to certain private individuals, or will be distributed to equalise citizens' income, or will accrue largely to those who control government.[6]

No one could seriously doubt that members of the High Court[7] are aware that taxation is about politics and political issues. Lord Devlin's quote which heads this paper holds that this politics, so far as certain judges are concerned, is a "Victorian bill of rights", implying the superiority of the private claims of citizens to the collective claims of others expressed through the tax system and the subjugation of collective goals to private privileges. This perspective on the role of the courts expresses one interpretation of how courts regard their function in interpreting and applying tax legislation. On this view, the courts have taken upon themselves the role of protecting the citizen from the excesses of government by protecting taxpayers' property from seizure by government.

While this may be the dominant image of the High Court's role in taxation matters, other views of the role of courts in deciding tax disputes are possible. Some have suggested that the judiciary may see their role as co-operating in a joint venture with the legislature to achieve a common goal.[8] The courts' failure to adopt such a role is usually explained as an attempt by them to distance themselves from the legislature in the tradition of the

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5. J Rawls *A Theory of Justice* (Cambridge: Belknap Press, 1971) ch 5.
6. Webber & Wildavsky supra n 3, 20–37.
7. I should state at the outset that, while I will use the convention, I find the notion of referring to the High Court in some immutable and anthropomorphic sense, unsatisfactory. Nor do I find the practice of qualifying the reference by some epithet such as the *Barwick* High Court any more sensible. I should also add that I am happy to concede that an economic framework is political in most senses of the word.
8. See eg N Brooks "Computation of Business Income - Deductibility of Fines" (1977) 25 Canadian Tax Journal 16.

separation of powers and to sustain the dogma that courts do not make laws. While this role was clearly appropriate when government was conducted through arbitrary decree by autocratic monarchs whose rule derived from divine right, that has probably not been an accurate description of the Australian political scene for the last few years. One matter which is clear is that the apparent search for alleged judicial neutrality through an impartial process referred to as statutory interpretation is farce. Geoffrey Lehmann puts it thus:

> The *Duke of Westminster* style of literalism developed by the Australian High Court in the 1970's, with Sir Garfield Barwick as Chief Justice, systematically resolved uncertainties or ambiguities in tax legislation in favour of taxpayers. Literalism which incorporates a pro-taxpayer policy is not literalism in the classic sense of the word. It is a disguised policy and is political in nature. Frequently it involves the substitution of judicial policy for the policy of Parliament which is to levy taxes from citizens according to their financial capacity.[9]

I do not wish to debate further which approach, if either, members of the High Court do or ought to adopt in resolving tax disputes nor to evaluate the desirability of either position. It is sufficient simply to point out that the Court has on occasions explicitly constructed the debate in tax disputes in these terms and is aware of the perspective of political and civil rights claimed in tax disputes raised before it. Perhaps the best example of the Court's awareness is to be found in the debate between Barwick CJ and Murphy J in *Commissioner of Taxation v Westraders Pty Ltd.*[10] Barwick CJ said:

> The court is to [interpret and apply the Act] by determining the meaning of the words employed by the Parliament according to the intention of the Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.[11]

The opposing view was put by Murphy J (dissenting):

> It has been suggested, in the present case, that insistence on a strictly literal interpretation is basic to the maintenance of a free society. In tax cases, the prevailing trend in Australia is now so absolutely literalistic that it has become a disquieting phenomenon. Because of it, scorn for tax decisions is being expressed constantly, not only by legislators who consider that their Acts are being mocked, but even by those who benefit. In my opinion, strictly literal interpretation of a tax Act is an open invitation to artificial and contrived tax avoidance. Progress towards a free society will not be advanced by attributing to Parliament meanings which no one believes it

9. G Lehmann "Judicial and Statutory Restrictions on Tax Avoidance" in R Krever (ed) *Australian Taxation: Principles and Practice* (Melbourne: Longman, 1987) 293–294.
10. (1980) 144 CLR 55.
11. Id, 59.

> intended so that income tax becomes optional for the rich while remaining compulsory for most income earners. If strict literalism continues to prevail, the legislature may have no practical alternative but to vest tax officials with more and more discretion. This may well lead to tax laws capable, if unchecked, of great oppression.[12]

THE HIGH COURT'S APPROACH

The focus of this article is on a particular issue, namely, whether the High Court correctly understands the intended operation of the income tax system, from the perspective of public economics. My argument is that, while the High Court may have a very developed sense of the private claims of individuals to immunity from tax, it has never displayed a similar appreciation of the economic foundations of the income tax. My argument is that the High Court has grasped only part of the story and because of this there has been what I wish to call a "failure of judging" — that is, an inability or unwillingness to entertain, or at least to offer, guidance on fundamental issues of tax policy. Questions which demand a response by our High Court based upon fundamental issues of principle receive instead an answer based on linguistic deconstruction.

With this background in mind, I have chosen a few landmark cases to support my proposition that the High Court has failed to appreciate fundamental issues regarding the nature and design of the income tax. The cases deal with the notion of an income tax, the tax base (that is, the meaning of income and deductions), issues of timing, the meaning of tax avoidance and, for the sake of currency, the capital gains tax. They have been chosen because they are landmarks. The Court was offered an opportunity to discuss fundamental principles, often untrammelled by the demands of precedent, but in most cases it chose instead to retreat into mere linguistics.

1. *State of South Australia v The Commonwealth*

In *State of South Australia v The Commonwealth*[13] (*"South Australia"*), the plaintiff sought to impugn the imposition of Commonwealth tax on the income of a State's superannuation fund. The dispute centred on the provisions of section 114 of the Constitution, which provide that the Commonwealth "[shall not] impose any tax on property of any kind belonging to a State." The plaintiff argued that the fund was, for these purposes, the State of

12. Id, 79.
13. (1992) 92 ATC 4066.

South Australia and that imposing tax on the income of the fund under Part IX of the Income Tax Assessment Act 1936 (Cth) ("the Act") offended the terms of section 114. The drafters of Part IX had foreseen this possibility and provided in section 271(1) of the Act an escape clause — namely, "that if ... this Part would have the effect that a law imposing taxation would impose tax on property of any kind belonging to a State within the meaning of section 114 of the Constitution, this Part shall not have that effect."

Part IX had been inserted into the Act as part of the Treasurer's Economic Statement of April 1989. This Statement had foreshadowed the imposition of the 15 per cent tax rate on superannuation funds and substantial changes to the treatment of superannuation investments. The Statement had been enacted by the Taxation Laws Amendment (Superannuation) Act 1989 (Cth) and its effect was to impose a 15 per cent tax rate on the income of superannuation funds. For these purposes the income of the fund would include interest, dividends and other items generally regarded as income as well as net capital gains made by the fund on sales of investment assets. In other words, net capital gains derived by a superannuation fund were treated as income in a similar way to that applying to individuals but with a different grandfathering rule and without the benefit of indexation of capital gains. The particular dispute in this case involved two questions: (i) whether interest received by the fund on securities and loans was taxable by the Commonwealth, and (ii) whether net capital gains made by the fund were taxable by the Commonwealth.

It was held by a majority that the fund was taxable on its interest income but was exempt from paying tax on net capital gains because of section 114 of the Constitution and section 271 of the Act.

The debate before the High Court was constructed around a dichotomy, which I suggest is a false dichotomy, between a tax which is imposed upon the ownership or holding of property compared with a tax which is imposed on the use of property. The plaintiff's argument was that the income tax was either a tax upon income items which were themselves property or that the tax on interest was a tax on the fruit of property. In either case, the effect of the tax was said to amount to a tax on property for the purposes of section 114.

The judgments in the High Court adopted this dichotomy. The joint judgment of Mason CJ, Deane, Toohey and Gaudron JJ concluded that "the income tax ... imposed by the Act on income produced by property belonging to the taxpayer cannot be characterised generally as a tax on the ownership or holding of that property." This was the conclusion in respect of interest. In respect of capital gains, however, the capital gains tax was held to be a tax

on property:

> True it is that the capital gains tax is not levied on the proceeds of sale of an asset. But the net capital gains which represent part of the proceeds of sale fall into assessable income. And the reason for the imposition of the tax is the exercise by the taxpayer of the right of disposition, a right central to the concept of ownership of property. Furthermore, the capital gains tax imposed by the Act generally has the additional element already mentioned, namely, that the amount of the capital gain is computed by reference to the length of time during which the taxpayer has been the owner of the asset. Viewed in this light, the tax is a tax on the ownership or holding of property belonging to the taxpayer.[14]

The Court failed to address specifically both the purpose of section 114 and fundamental propositions underlying the operation of the tax. The object of section 114 is, within the context of a federal system, to render one level of government immune from the imposts of another. That is to say, the State governments should not be obliged to bear Commonwealth taxes.

By using "bear" in the previous sentence, the tax-literate will understand that I am drawing a distinction between the effective and nominal incidence of a tax. There is no doubt that while the nominal incidence of the fringe benefits tax is on the employer, the effective incidence of the tax is on the employee. In this respect, consider the Statement on Tax Policy of September 1992. In the ensuing Bill[15] the drafter makes the assumption, justifiable in the circumstances, that the effective incidence of the fringe benefits tax is ultimately always borne by the employee. The High Court presumably had this point in mind when deciding *State of Queensland v The Commonwealth*,[16] although one would be hard pressed to find within that judgment any reference to the notional distinction between the nominal and effective incidence of the tax.

In respect of the tax on superannuation funds, it is clear that the nominal incidence is on the trustee of the fund. It is not, however, quite so clear where the effective incidence of the tax lies. The answer may depend, at least in the transition from the non-taxation of superannuation funds to their taxation after 1988, on the terms of the superannuation fund trust deed. So, for example, in the case of an accumulation fund, where the member's benefit depends upon the employer/employee contributions, and earnings on those contributions, it is clear that the effective incidence of the tax will pass to the employee. The benefit will be reduced by the amount of the tax. If, however, the fund is a defined benefit fund, it may be that the effective incidence of the

14. Id, 4072.
15. See now Taxation Laws Amendment (Fringe Benefits Tax Measures) Act 1992 (Cth).
16. (1987) 162 CLR 74.

tax now falls upon the State of South Australia in that it will have to increase the payout to employees to meet the benefit defined in the trust deed. In other words, the burden of the tax is effectively shifted to the employer, the State of South Australia, because this is a defined benefit fund. A careful reader will look in vain to find any inkling in the judgment about the precise terms of the superannuation fund.

In summary, I suggest that the real debate should have been conducted around the ultimate incidence of the tax. If the burden of the tax was to be fully borne by the State of South Australia, and this result could only come about because of the precise terms of the Superannuation Trust Deed, then perhaps the operation of the tax imposed a tax upon the State. If, however, the terms of the Superannuation Trust Deed allowed the employer fully to shift the cost of the tax to the employee, then there is no justification in terms of tax policy for distinguishing this tax from the fringe benefits tax which the High Court had previously, and in my opinion correctly, identified as not being a tax on the State.

In addition to this difficulty, the case continues the more fundamental problem that the capital gains tax is in some way different from the income tax imposed upon interest — that is, that income and capital gains are in some way different. I am not criticising the Court for taking that line because Parliament has now implicitly accommodated the Court's view by enacting Part IIIA of the Act. At one point in the joint judgment, the majority note that, "'[i]ncome' ... is a generic term which, in the United States, has been regarded as wide enough to include capital gains for purposes of income tax."[17] Indeed, the US Supreme Court specifically rejected precisely the kind of interpretation which Australian and English courts have adopted in the interpretation of income tax. That interpretation, which has already been thoroughly explored by Professor Parsons,[18] treats the Australian global definition of income as a schedular definition. In the United States, the Supreme Court in *Eisner v Macomber*[19] specifically rejected the argument that income was the product of labour, the return on property, or a combination of both, but excluded everything else. It is this fallacy that has found its way into the interpretation of the Act. The High Court's judgment perpetuates the fallacy.

It is undoubtedly too late in the day to assert that income and capital gains are not *legally* different but this is simply because legal definitions have been constructed which make them so. There is no *economic* or practical

17. Supra n 13, 4071.
18. R W Parsons *Income Taxation: An Institution in Decay* (1991) 13 SydLR 435.
19. (1920) 252 US 189.

distinction between income and capital which is sustainable. But this is clearly a case where the Court frustrated the two expressed policies of the relevant legislation (the immunity of the States and the taxation of superannuation funds) for no real reason. The likely results of this include (i) conferring a substantial monetary gain on public servants and/or making an indirect federal grant to the State; (ii) distorting the investment behaviour of the managers of State superannuation funds and consequently affecting financial markets; and (iii) distorting the employment choices by individuals between the public and private sector.

2. The *Myer Emporium* case

I am not suggesting that the High Court should have attempted to eliminate the capital/income distinction but the futility of attempting to maintain it should have been apparent to the Court in the decision in *Federal Commissioner of Taxation v The Myer Emporium Ltd*[20] ("*Myer*"). The respondent company was a retail trader and property developer which, occasionally, acted as financier for companies within the Myer group. The company lent $80 million to an associated company for a period of seven years at 12.5 per cent interest. The loan was not to be repaid within seven years and the first payment of interest was to be made on the date that the loan was executed.[21] Three days after the loan was made, Myer assigned to Citicorp, "the moneys due or to become due as interest payments [on the loan]". In exchange for the assignment of the interest stream, Myer received $45.37 million paid to it by Citicorp. This sum was calculated as the present value of the sum of the future interest payments for the remainder of the term of the loan discounted at an appropriate rate of about 16 per cent.

Myer argued that the amount received by it as consideration for the assignment was a non-taxable capital receipt. The Tax Commissioner assessed Myer to tax on the full $45 million pursuant to section 25(1) as income under ordinary concepts and usages. The taxpayer succeeded before the Supreme Court of Victoria and the Full Federal Court, but lost in the High Court.

The case has passed into folklore primarily in relation to one question — namely, the circumstances in which a transaction outside the scope of the taxpayer's ordinary business will give rise to assessable income. This aspect of the decision has been pursued in a multitude of subsequent cases including

20. (1987) 163 CLR 199.
21. The reasons for these curious terms lie in the provisions of s 102B of the Act.

Westfield Ltd v Federal Commissioner of Taxation,[22] *Federal Commissioner of Taxation v Cooling*,[23] and *GP International Pipecoaters Pty Ltd v Federal Commissioner of Taxation*[24] where the peculiar terminology is, in reality, the capital/income dichotomy in a particular context. Because the facts occurred in 1981, the plethora of provisions that would now apply were not relevant. For example, in addition to the operation of section 25(1), this transaction could now potentially be dealt with by all of Division 16E of Part III, section 26BB, section 102CA and the capital gains tax. If, armed with this awesome battery of fire-power, the Commissioner could not tax the company on the profit from this transaction, then the drafters of our tax legislation should be summarily executed. What is curious, however, is that these various statutory provisions manage to get something close to the right result. The High Court was unable to achieve that.

By the right result, I mean taxing the taxpayer on the amount of profit which this transaction generated and in the period in which the profit was gained.[25] At the commencement of the transaction, Myer had a sum of $80 million. That single sum was then converted into two "coupons" — one worth $45 million, being the right to repayment of the interest stream, and the other worth $35 million, being the right to repayment of the principal.[26] Armed with these two coupons, Myer then sold one for $45 million. According to the High Court, Myer made a gain of $45 million on this transaction. That is because the High Court quarantined the totality of the taxpayer's costs in one coupon:

> The accounting basis which has been employed in calculating profits and losses for the purposes of the Act is historical cost ... not economic equivalence. ... [When] a debt is brought to account in the same amount as the amount of the money lent, the right to interest on the money lent is not treated as an asset at all. It does not appear in either the balance sheet or the profit and loss account of the lender. The right to interest is not distinguished for accounting purposes from the interest to which it relates. So long as the amount of the principal debt is treated as equivalent to the amount of the money lent, the right to interest cannot be treated as an additional

22. (1991) 91 ATC 4234.
23. (1990) 90 ATC 4472.
24. (1990) 90 ATC 4413.
25. Others have already pointed out that there is little evidence that Myer made a profit from this transaction. See eg D G Hill "A Pre-Bicentennial Reminder of our Heritage: *FCT v The Myer Emporium*" (1987) 22 Taxation in Aust 12.
26. These figures, of course, are only approximate and depend upon the discount rate appropriate to the circumstances. In calculating the actual price paid, it is also relevant to consider the income tax position of the potential purchaser of an income stream since not everyone would be prepared to purchase an income stream without taking into account potential income tax consequences which, to a company like Citicorp that happens to be in tax loss, would be irrelevant.

> capital asset. The making of a loan does not immediately produce a capital gain equal to the present value of the interest to be paid. The right to interest is not a capital asset which is progressively transformed into income as and when the interest is received.[27]

I take the Court to be saying that the correct accounting for an income assignment is to allocate all the taxpayer's cost to the right to repayment of the capital.

None of the new regimes would have achieved such a simplistic result. Section 159GX would apportion the taxpayer's cost in the loan between the strict securities and the retained securities. Section 160R and section 160ZH would again apportion the taxpayer's cost in its two assets between the part disposed and the part retained (although there is an argument that this would not be a part-disposal transaction but rather a section 160M(6) transaction by which a new right is created in the assignee).

If all the taxpayer's cost in this transaction is isolated within the right to repayment of the principal, taxpayers in the future would, presumably, adopt the simple expedient of selling the right to repayment of the principal, which has a face value of $80 million for $35 million, its present value. Does the taxpayer now realise an immediate revenue loss of $45 million on the transaction? If the High Court were to be consistent, this result ought to follow; but in reality the taxpayer makes neither gain nor loss on this transaction outside the income tax law.[28]

3. *Curran* schemes

This is, of course, not the first time that the High Court has managed seriously to miscalculate the amount of income or loss arising from a transaction. The most obvious example of the High Court's inability to perform arithmetic arose in *Curran v Federal Commissioner of Taxation*[29] ("*Curran*"). The consequences of this decision were horrendous to the revenue. They were eventually counteracted by the introduction of section 6BA. The High Court eventually overruled its earlier decision almost 15 years later in *John v Federal Commissioner of Taxation*[30] ("*John*").

The essence of the scheme in *Curran* was relatively straightforward. The taxpayer bought the 200 issued shares in a company for $186 000. He

27. Supra n 20, 216–217.
28. Had the Court based its decision on the need to protect the flow notion, and to treat realised flows in the same manner as continuing flows, perhaps the judgment might have had some consistency.
29. (1973) 131 CLR 409.
30. (1989) 166 CLR 417.

then arranged for the company to allot to him 191 000 bonus shares. Under the terms of section 44(2)(b), dividends paid wholly and exclusively out of "profits arising from the resale or revaluation of assets not acquired for the purpose of resale at a profit ... satisfied by the issue of shares of the company declaring the dividend" were not to be included in the shareholder's assessable income. He then sold the 200 shares originally purchased at a price of $197.52 and the other 191 000 shares for $188 000. The taxpayer accounted for these transactions in this way. On the 200 shares originally purchased he made a loss of more than $185 000, because they had a cost to him of $186 000 and were sold for $197. On the 191 000 bonus shares, he claimed that they had a deemed cost to him of the amount of profits applied to pay up their face value. This meant that his total costs came to $377 000 while the proceeds of sale realised only $188 000. He claimed the net result was a loss of $189 000 and that this was an allowable deduction to him because he was a share trader. The High Court agreed with this conclusion.

The result is ludicrous. The taxpayer bought all the issued shares of a company. He then re-denominated his interest from 200 shares worth $186 000 to 188 000 shares also worth about $186 000. He then sold all the issued shares in the company. But the result of the High Court's accounting for this regime is that in the re-denomination, the taxpayer manufactured a cost. The arguments relied on by the High Court to reach this conclusion emphasised two different sets of reasons. The first, relied on by Barwick CJ, emphasised the effect of the exemption in section 44(2) and suggested that the value of that exemption would be lost if the dividends were not to be entitled to a cost. The second reason, advanced by Gibbs J, emphasised the problem of assets moving into and out of the tax system. Non-tax assets needed to be attributed with a deemed cost if their non-tax value was to remain tax-exempt and the taxpayer to be taxed only on the income arising when the asset was within the tax system.

There are many problems with the High Court's reasoning but the one that concerns me here is this notion of cost. The transaction in these circumstances did not have a cost to the taxpayer in any sense. It was simply the re-subdivision of the taxpayer's existing interest. He had paid for the value of the retained earnings in the price paid for the 200 shares. When their value was shifted to the bonus shares, of which he was also the owner, he was simply moving value within his shareholding. To its credit, the High Court was able to discern the error of this analysis, albeit 15 years later. The error was that the notion of a deemed cost was simply misapplied in these circumstances. Unfortunately, however, in reversing the decision in *Curran*,

Brennan J managed to question not only the application of the principle but also the propriety of the principle. For Brennan J only actual costs were allowable as deductions.

This is clearly a case where the High Court should have overruled itself. But in overruling its earlier judgment, the High Court did not rectify all the consequences of its earlier decision. Not only did the overruling create the new difficulty referred to in the judgment of Brennan J, but the High Court dealt only with the deemed cost aspect of the case. If *Curran* was to be completely resolved, the Court ought to have gone further and provided that the taxpayer's original cost in the shares first purchased should thereafter be spread over the original shares and bonus shares, when a bonus issue is made. In addition, if its earlier error was not to be perpetuated in other cases, the High Court should have qualified its reasoning by making the point that if the making of the bonus issue does give rise to assessable income to the shareholder, then it is appropriate to nominate the deemed cost for the taxpayer. In other words, there are more aspects to *Curran* schemes than are solved by the High Court's decision in *John*.

4. *Hepples* case

The last case in my collection is the recent High Court decision in *Hepples v Federal Commissioner of Taxation*[31] ("*Hepples*"). This was the first attempt by the High Court to analyse the provisions of Part IIIA of the Act (the capital gains tax).

Hepples had been employed by Hunter Douglas and, upon leaving the employment of that company, agreed to execute a restraint of trade agreement in consideration of $40 000. The Commissioner assessed Hepples under the provisions of Part IIIA alleging that this was an assessable capital receipt.[32] The Commissioner argued the case on the basis of sections 160M(6) and 160M(7).[33] The High Court was unable to reach a conclusion whether the

31. (1991) 65 ALJR 650.

32. No argument was advanced that this sum might have been income under ordinary concepts and usages. The reasons for that omission are perhaps understandable to others — they are not to me.

33. At that time, s 160M(6) stated that "a disposal of an asset that did not exist ... before the disposal, but is created by the disposal, constitutes a disposal of the asset for the purposes of this part ...". S 160M(7) provided that "where (a) an act or transaction has taken place in relation to an asset ... and (b) a person has received or is entitled to receive an amount of money or other consideration by reason of the act, transaction or event ... the act, transaction or event constitutes a disposal by the person who receives or is entitled to receive the money and ... the money or other consideration constitutes the consideration

$40 000 was taxable.[34]

But for the inclusion of sections 160M(6) and 160M(7) there could be no doubt that Part IIIA of the Act is simply a "profitable asset disposal tax". By this I mean that the tax is not imposed upon capital receipts per se; it is only imposed on those profits which arise from the disposal of assets. It would have been possible to legislate for a capital receipts tax in lieu of a profitable asset disposal tax, in which case the latter would have been unnecessary, but it is clear from the framework of Part IIIA (ignoring sections 160M(6) and 160M(7)) that Parliament did not legislate a capital receipts tax.

The real issue in the interpretation of Part IIIA, insofar as the facts of *Hepples* are concerned, was whether the effect of the inclusion of these two provisions turned what was otherwise designed to be simply a profitable asset disposal tax into a capital receipts tax instead.[35]

The careful reader will look in vain for any inkling in the High Court's judgment that this fundamental design question was even being raised. Instead, we meander through statutory interpretation of the most detailed and unenlightening kind. What was called for was an evaluation of what kind of end Part IIIA was designed to achieve, or perhaps what it has achieved. Instead, we had minute attention to details which only obscured that issue. It is relatively clear that if Part IIIA was intended to impose a capital receipts tax, then Hepples should have been taxed. It is also clear that if Part IIIA was intended simply to be a profitable assets disposal tax, then Hepples should not have been taxed.

CONCLUSIONS

Why is the Court unable or unwilling to engage in a debate about fundamental issues of design and policy? A convincing case can be made that little consequence should be attached to what the High Court does in taxation

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in respect of the disposal of the asset".

34. I have to express the outcome of the case in that form because it is one of the nicest ironies of income tax law that, even though a majority of judges in the High Court thought that Hepples was taxable on the $40 000 he received, and that he was taxable on it under the capital gains tax, this result did not come about. That curious result occurred because of the different majorities formed in handing down the judgment. While a clear majority of the members of the Court (Brennan, Dawson, Toohey and Gaudron JJ) were of the opinion that Hepples was taxable under one or other of the provisions, two of the Justices (Brennan and Gaudron JJ) concluded that s 160M(7) did not apply because s 160M(6) did.

35. For what it is worth, the drafter of Taxation Laws Amendment (No 4) Act (Cth) 1992, in labelling these provisions for the purposes of the Index included at the beginning of Part IIIA, chose to label them as provisions taxing "Capital Receipts".

decisions. First, Parliament invariably steps in to remedy the deficiencies created by court decisions at all levels of the judicial hierarchy. A few examples of statutory adjustments to various High Court judgments are listed in the Table in the Appendix to this article.

Perhaps less importantly, but still pertinent to the alleged irrelevance of the High Court, is the Court's own expressed reluctance to accept tax matters on appeal, effectively abandoning the field to the Federal Court.[36] The failings of a court which will not intervene are not important. Indeed, this may be just a specific case of the increasing irrelevance of the judicial system as a whole, and especially its techniques of common law analysis, to tax disputes. Few tax issues are now able to be resolved without recourse to vast quantities of statutory and extra-statutory material; court tax lists are declining dramatically; case law and skills in common law techniques are becoming irrelevant to solving disputes; strategies, negotiations and bargaining replace the reliance on "rights" and the niceties of arcane legal argument.

While there is some substance to this point, I think that would be too short-term a view of the effects that the Court has had. There are clear economic and social consequences arising from the Court's failures.[37] Unless effected in order to solve some problem of second-best,[38] each departure from the normative tax base implies adverse flow-on effects for resource allocation, distorting the operation of markets for capital and labour. Judicial decisions which offer opportunities for changing the post-tax rate of return due to differential tax treatment will change behaviour with little obvious economic benefit. As Professor Groenewegen puts it:

> A more important form of economic waste ... is the alteration in employment and investment choices which flow from distortions included in post-tax rates of return as a result of the ability to [access preferential treatment under the income] tax.... [I]ncome spreading for the purpose of tax deferral, converting income into capital

36. Supra n 22.
37. See P Groenewegen "Distributional and Allocational Effects of Tax Avoidance" in D Collins (ed) *Tax Avoidance and the Economy* (Sydney: Australian Tax Research Foundation, 1984).
38. There is, of course, the possibility that the High Court is pursuing some more sophisticated economic goals by adopting the approach to tax issues that it invariably does. One such approach might be the approach of the optimal tax school, an approach premised on the theory of second best. The vast literature on optimal taxation was summarised in A Sandmo "Optimal Taxation - An Introduction to the Literature" (1976) 6 Journal of Public Economics 37. For a more recent survey, see J Stiglitz "Pareto-Efficient and Optimal Taxation and the New Welfare Economics" in A Auerbach & M Feldstein (eds) *Handbook of Public Economics* vol 2 (New York: McGraw Hill, 1988); Stiglitz supra n 2, ch 20.

> gains and/or additional deductions through seeking benefits through tax shelters may result in a great deal of unproductive investment from the social point of view. The reason for this is the simple one that the private rate of return after tax of this type of investment is far greater than post-tax rates of return on what might be called normal commercial investment.[39]

There is also the direct cost of increased expenditure on tax compliance as taxpayers and their advisors respond to each decision and seek to explore its limits, more or less confident in the knowledge that future decisions will be based on linguistic interpretation rather than an understanding of fundamental design. This compliance cost is exacerbated by administration cost and consumption of scarce legislative resources. These departures from a theoretically sound base also have distributional consequences since it is primarily taxpayers who derive capital income, typically in higher income brackets, who are able to access the opportunities that judicial distortions provide.

Apart from these economic costs there are other social costs to be considered. The current complexity of the tax laws can be blamed in no small degree upon the failures of principled analysis. Some of these costs identified by Professor Freiberg as arising from the "bottom of the harbour" schemes make the point in a compelling manner. He traces the institutional responses to it in the form of the McCabe-Lanfranchi inquiry, the Costigan Royal Commission, the appointment of Special Prosecutors, Gyles and Redlich, and the establishment of a Review of Systems Dealing with Fraud on the Commonwealth and suggests that the scheme also had some part in the establishment of the National Crime Authority and the appointment of a Director of Public Prosecutions.[40] He then traces the various legislative and administrative responses which followed in consequence of the bottom of the harbour schemes and identifies almost two dozen pieces of legislation enacted as a direct legislative consequences of this one tax scheme. After tracing these legislative and administrative responses to the bottom of the harbour schemes, Freiberg offers a series of observations, concluding:

> If left unchecked, the bottom of the harbour cases could have seriously undermined both the size of the tax base and its equity. There was a serious danger that the legitimacy of the taxation system could have been destroyed, if not ultimately the legitimacy of the government. Widespread cynicism is not a basis for good govern-

39. Groenewegen supra n 37, 23–38.
40. A Freiberg "Ripples from the Bottom of the Harbour: Some Social Ramifications of Taxation Fraud" (1988) 12 Crim LJ 136. The McCabe-Lanfranchi inquiry: *Navillus Pty Ltd & Others — Report of Company Inspectors*, Victoria, Legislative Assembly 1982 *Hansard* Vol 364, 424. The Costigan Royal Commission: *Report of the Royal Commission into the Activities of the Federated Ships Painters & Dockers Union: Final Report* (Chair: Frank Costigan) (Canberra: AGPS, 1984).

ment...

More specifically, the links between some white-and blue-collar crimes revealed by Costigan indicated some of the dangers to society. Legitimate businesses were being undermined because those who were able to take advantage of the frauds could run their businesses more profitably and in the long run would have an advantage over those who met their full taxation burden. Fraud also breeds corruption of government officials, law enforcement agencies, politicians and financial institutions.[41]

In addition to these economic and social costs, the legal basis of the tax system is adversely and often irreparably affected by less than thorough judicial reasoning. While Freiberg's analysis and the Table in the Appendix show major legislative efforts directed at overturning judgments of the High Court, Parliament does not reverse every judgment of which it disapproves, nor can it always act quickly where it wants to do so. More importantly, Parliament probably can never fully overturn the reasoning that leads to the result reached by a Court, only the actual outcome. The process of reversing *Curran* shows this problem. The Court made its decision, Parliament reacted by introducing section 6BA overturning the result of the case by denying a cost for the exempt bonus shares and spreading the original cost. But, with the introduction of a capital gains tax, Parliament changed the treatment of bonus shares, repealing section 44(2)(1)(b) so that the amount of the bonus issue was taxed. With this change, it is appropriate to give a cost to *Curran* for the bonus issue for the amount of the dividend that has been taxed. Parliament made the necessary adjustment to section 6BA to accommodate this change. But then in *John*, when the High Court denies the cost, it does not qualify the denial by any limitation that the denial is limited to circumstances where the bonus issue is untaxed. In circumstances where section 6BA does not apply, for example, where the issue is of bonus units in a trust, we are left with *John*. The taxpayer may have no cost, even where the bonus issue has been taxed and no judicial cost-spreading rule exists. In other words, Parliament cannot overcome defective reasoning and it remains important that the High Court develop a clear understanding of the design of the income tax.

Another problem which can be attributed more or less directly to the failings of the High Court is the state of the current legislation. Judges now appear to delight in lamenting the impenetrable prose and convoluted syntax of our legislation.[42] I must confess to some annoyance when, as the list above shows, much of the current volume and complex state of the legislation has

41. Id, 187.

42. See Mason CJ in *Hepples* supra n 31, 651 who complains of the provisions being "extraordinarily complex", "obscure" and "bewildering."

been made necessary to overturn what to my mind are simply judicial errors. Clearly some of the legislation is designed to achieve fundamental changes of policy (which may or may not be due to prior judicial failings) but even in this area, the legacy of overturned judicial pronouncements lingers and the new rules must be drafted with an eye on the potential for judges to interpret them in the same way that they have interpreted the old. It is also, if it matters, clearly costly and inefficient to rectify what could be prevented.

I wish to end where I began. The tax system of a country is one of the institutions in its constitutional framework. It is an important element in securing and maintaining consent to the social contract. Given its vital importance, it is incumbent on the courts when they resolve tax disputes to understand and address the fundamental design of the tax. In other words, taxation, like free speech or land rights, is the proper domain of the High Court, but one where the Judges must display mastery not only of the Bill of Rights but also of the causes of the wealth of nations.

APPENDIX

Table

Case	Statutory "adjustment" made by the Income Tax Assessment Act 1936 (Cth):
FCT v Cecil Brothers Pty Ltd[1]	s 31C
FCT v Curran[2]	s 6BA
FCT v Slutzkin[3]	} ss 46A, 177F
FCT v Investment & Merchant Finance Corp Ltd[4]	} ss 46A, 177F
FCT v Armco (Aust) Pty Ltd[5]	} ss 82U–82ZB
FCT v Texas Co (Australasia) Ltd[6]	} ss 82U–82ZB
FCT v Hepples[7]	ss 160M(6), (6A), (6C), 160MA
FCT v Hobart Bridge Co Ltd[8]	s 25A
FCT v Shepherd[9]	ss 102B, Div 6AA
CT (NSW) v Lawford[10]	s 101A
FCT v McLaurin[11]	s 160ZD
FCT v Miranda[12]	s 25A
FCT v Patcorp Investments Pty Ltd[13]	s 45Z
FCT v Rose[14]	ss 39A, 59AA
FCT v SA Battery Makers Pty Ltd[15]	ss 82KJ, 82KK, 82KL
FCT v Uther[16]	s 6
FCT v Westraders[17]	s 36AAA
FCT v NF Williams[18]	s 25A

1. (1964) 111 CLR 430.
2. (1973) 131 CLR 409.
3. (1977) 140 CLR 314.
4. (1971) 125 CLR 249.
5. (1948) 76 CLR 584.
6. (1970) 63 CLR 392.
7. (1991) 65 ALJR 650.
8. (1951) 82 CLR 372.
9. (1965) 113 CLR 385.
10. (1936) 56 CLR 774.
11. (1961) 104 CLR 381.
12. 76 ATC 4180
13. 76 ATC 4225.
14. (1951) 84 CLR 118.
15. (1978) 140 CLR 645..
16. (1965) 112 CLR 630.
17 (1980) 144 CLR 55.
18. (1972) 127 CLR 226.