

Some problems in legislating for economic concepts — a judicial perspective

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When I agreed on the topic for today's meeting I did not realise that the Assistant Treasurer was to issue a discussion paper on 'improving the operation of the anti-avoidance provisions in the income tax law'. That occurred on 18 November 2010 by which stage I was committed to talking on quite a different topic. Had I known of the discussion paper I would have taken that as my topic as I have written and spoken on it many times over several years.

Perhaps, however, I may be permitted to use the topic of anti-avoidance to introduce the problems which I see inherent in the topic selected for today's discussion. The general anti-avoidance provision in Part IVA emerged from what was perceived to be the inadequacies identified by the judiciary with the operation of s260. Many believe that the inadequacies lay less in the terms of s260 than in the judicial interpretation which had been given to it. However, fundamental to the weakness of s260 was the judicial interpretation it was given through what became known as the choice principle.² At the heart of the choice principle was a judicial concern that the words of s260 as they appeared in black ink on a piece of paper permitted of applications which at one extreme could never have been intended by the legislature and which at other points in the continuum between extremities, but well short of the other extreme, was inconsistent with policy objectives which gave tax advantages intended to be taken up by taxpayers. It was lawyers, that is judges, who looked at bare words on a piece of paper and said on occasion that surely the breadth of s260 was not intended to capture everything which its literal meaning might permit.³ It was the same lawyers who said that surely s260 was not intended to apply to choices which the taxing provisions elsewhere encouraged taxpayers to obtain.

These concerns eventually (at least until the post Part IVA decision on s260 in *Gulland*⁴) led to a narrowing of the operation of s260 and the elaboration of a substantial limitation where a choice could be said to have been given by the tax law. It was the ever expanding content of the choice principle that ultimately led to the demise of s260 and the perception that new provisions needed to be enacted. A similar problem is emerging now with the interpretation of Part IVA. In *Hart's*⁵ case two judges adopting the submissions by the Commissioner referred to the task required in s177D as involving a comparison between what was done and an alternative postulate.⁶ Unfortunately the language used by their Honours suggested that this was required as part of identifying the obtaining of a tax benefit in connection with a scheme in s177C. That, it seems, gave birth to the idea that s177C provided a definition of 'tax benefit'

2 *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66; *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290; *Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314; *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330.

3 *Deputy Federal Commissioner of Taxation v Purcell* (1921) 29 CLR 464, 466 (Knox CJ).

4 *Federal Commissioner of Taxation v Gulland, Watson and Pincus* (1985) 160 CLR 55.

5 *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

6 *ibid* 243 [66] (Gummow and Hayne JJ).

which required a comparison between what was actually done (the scheme) with an alternative hypothesis of what the taxpayer would otherwise actually have done if the taxpayer had not done the scheme. This has led to a series of mental gymnastics in a recent line of cases that may, in turn, either seriously undermine the operation of Part IVA or, if the emerging jurisprudence is correct, be exposing what may always have been a fundamental flaw in its drafting.⁷ In this emerging jurisprudence the judges are seeking to give linguistic meaning to words on paper. There is no inquiry into what fiscal or economic purpose is served by construing s177C as requiring a comparison of what was actually done with what the taxpayer would, or might reasonably, otherwise have done. Indeed, it may be hard to see a fiscal or economic point to such a requirement. But the words are there and the generalist lawyer's approach is to supply general linguistic meaning to them.

I begin with these observations to make what I think is a fundamental point applicable to any consideration about the problem of drafting legislation to give effect to economic concepts. That fundamental problem is that those who interpret the law, and those who effect its judicial application, are not economists or fiscalists. They are essentially lawyers who come from diverse backgrounds and interpret the words by reference to non-economic or fiscal content. Indeed, there is a general approach to legislation that its terms should be understood by an ordinary reader and not one versed in a special field of knowledge or discipline: the words used should carry their ordinary meaning unless there is a clear intention shown otherwise. There is sometimes a fundamental mismatch between the underlying economic objectives expressed in statutes and the potentially distorting tools used by lawyers to determine the meaning of words as used and to be applied. This mismatch can be seen in many aspects of judicial application of tax laws. It is not just a question about the ambiguity of words. It is a much more fundamental issue concerning a mismatch between disciplines which sees lawyers apply analytical reasoning which is different from the analytical reasoning of accountants, economists, auditors or people of business and commerce. Embedded in that mismatch of disciplines is a jurisprudential question about whether judges should, or even can, apply the disciplines and rigours of fields of learning in which they have no training or experience.

The judge interpreting tax law finds refuge not in the underlying discipline which the legislation may seek to express but in the words themselves. Sometimes those words are simply inadequate to convey sufficient meaning for a confident decision to be made about how they are to be applied in any given case. That is because the words themselves may be ambiguous and because they are intended to apply in a greater context than initially thought or expressly contemplated.

⁷ See, for example, *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255, 276 (Sackville J); *AXA Asia Pacific Holdings Ltd v Federal Commissioner of Taxation* 2009 ATC 20-151 [118] (Jessup J); *Commissioner of Taxation v AXA Asian Pacific Holdings Ltd* [2010] FCAFC 134.

Uncertainty is an inevitable feature of language.⁸ Words are frequently capable of many meanings, some of which were not, or at least may not have been, intended when used in a particular context. One such example may be seen in *Bourne (Inspector of Taxes) v Norwich Crematorium Ltd*⁹ in the context of a United Kingdom statute where the tax fell by reference to whether a building or structure was for the 'manufacture of goods or materials or for the subjection of goods or materials to any process.'¹⁰ A narrow question raised in that case was whether goods and materials subject to a process included the cremated remains of human bodies. Justice Stamp said of this:

In my judgment it would be a distortion of the English language to describe the living or the dead as goods or materials. The argument of course goes on inevitably to this; that just as 'goods and materials' [sic] is wide enough to embrace, and does embrace, all things animate and inanimate, and so includes the dead human body, so that other words to which a meaning must be given, namely 'subjection' and 'process', are words of the widest import. Parliament cannot, so the argument as I understood it runs, have intended to exclude from the definition a process whereby refuse or waste material is destroyed or consumed by fire and, putting it crudely, for it can only be put crudely, the consumption by fire of the human body is a process. I protest against subjecting the English language, and more particularly a simply English phrase, to this kind of process of philology and semasiology. English words derive colour from those which surround them. *Sentences are not mere collections of words to be taken out of the sentence, defined separately by reference to the dictionary or decided cases, and then put back again into the sentence with the meaning which you have assigned to them as separate words, so as to give the sentence or phrase a meaning which as a sentence or phrase it cannot bear without distortion of the English language.* That one must construe a word or phrase in a section of an Act of Parliament with all the assistance one can from decided cases and, if you will, from the dictionary, is not in doubt; but having obtained all that assistance, one must not at the end of the day distort that which has to be construed and give it a meaning which in its context one does not think it can possibly bear. What has to be decided here is whether what is done by the taxpayer, viz., the consumption or destruction by fire of the dead body of the human being, is within the phrase 'the subjection of goods or materials to any process'. I can only say that, having given the matter the best attention that I can, I conclude that the consumption by fire of the mortal remains of homo sapiens is not the subjection of goods or materials to a

8 Barthes, R, *Criticism and Truth* (Continuum, 2007) 25-28; Umberto Eco, *The Limits of Interpretation* (1990).

9 [1967] 2 All ER 576.

10 *Income Tax Act 1952*, 15 & 16 Geo 6 & 1 Eliz 2, c10, s271(1)(c).

process within the definition of ‘industrial building or structure’ contained in s. 271(1)(c) of the *Income Tax Act, 1952*.¹¹

To the inherent ambiguity in language one may also add determined obfuscation,¹² nurtured, perhaps by self interest or institutional objective.

Ambiguity (or at least uncertainty) may also exist in the concepts expressed in the language quite apart from the ambiguity that may be found in words. Here I have in mind the notorious difficulty of determining whether economically an amount or a part of an amount is properly to be regarded as on capital or revenue account. In *Lomax (HM Inspector of Taxes) v Peter Dixon and Son Ltd*¹³ Lord Greene MR observed:

In many cases, however, mere interpretation of the contract leads nowhere. If A. lends B. 100*l* on the terms that B will pay him 110*l* at the expiration of two years, interpretation of the contract tells us that B.’s obligation is to make this payment. It tells us nothing more.¹⁴

The 10*l* difference in the payment could be accretion to capital or it could be in the nature of interest return upon the capital. It is a simple example which may be added to. The litigation about whether discounts on bills of exchange or promissory notes considered in *Coles Myer*¹⁵ is another example. Many income producing assets (rental properties, shares, etc) carry with them returns that may economically be seen by some as referable to capital or as income. Even the nominal value of money by remaining unchanged over time may be seen either as a diminution in capital or a negative outflow of income.¹⁶ The point is that even within the disciplines of economics or accounting there may be differences about the ‘economic’ or ‘accounting’ nature of something.

The lawyer’s training and tools do not equip a judge to apply economic, accounting or business concepts with sufficient reliability. An example of the difference in approach between lawyers on the one hand, and accountants, economists, people of business, on the other hand, may be seen in the decision in *Federal Commissioner of Taxation v McNeil*¹⁷ concerning the taxability as ‘income’ of a receipt by a shareholder of \$514 from the sale on her behalf of rights to sell shares in St George Bank Limited. Mrs McNeil had previously held 5,450 shares in the bank from which, over the years,

11 *Bourne (Inspector of Taxes) v Norwich Crematorium Ltd* [1967] 2 All ER 576, 578 (Emphasis added).

12 *Pyneboard Pty Ltd v Trade Practices Commission* (1982) 57 FLR 368, 375 (Northrop, Deane and Fisher JJ).

13 [1943] 1 KB 671, 675.

14 *ibid*.

15 *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640.

16 *Burrill v Federal Commissioner of Taxation* (1996) 33 ATR 133.

17 (2007) 229 CLR 656.

she derived dividends upon which she paid tax in the ordinary way.¹⁸ In January 2001 the bank announced its intention to buy back about 5 per cent of its issued share capital at a fixed price of \$16.50 per share. Mrs McNeil thus came to have 272 rights to require the bank to buy her shares.¹⁹ These rights were separately listed for trading on the Stock Exchange which, at the time in question, had a value of \$1.89 per share.²⁰ Mrs McNeil took no steps to exercise her rights, with the consequence, under the transaction documents, that the shares were transferred to a merchant bank which sold them to the Bank for \$2.12 each for a total of \$576.64.²¹ Part of that receipt was treated as a taxable capital gain, but the bulk, \$514, was treated by the Commissioner as ordinary income under general principles.²²

The occasion by which Mrs McNeil came to have the rights was, from the company's point of view, a partial return of capital to its shareholders. Mrs McNeil, as a shareholder, and from an accounting and economic point of view, was receiving part of the capital value of her shareholding upon the sale of the sell-back rights. The High Court, by a 4-1 majority, held otherwise, focussing upon Mrs McNeil's individual receipt of the money and upon a finding that her shareholding, in legal terms, remained unchanged as a matter of legal analysis. The law treated the receipt as income although in economic terms and commercial reality her capital wealth as a shareholder in the Bank before and after the transaction had not changed (except, of course, that it was reduced by reason of the tax she had to pay).

The majority judgment in *McNeil* began its consideration of the issues by recalling that the character of the sell-back rights had to be determined from the point of view of the taxpayer (the recipient) and not from the point of view of the bank (the payer).²³ Their Honours next reasoned that 'a gain derived from property has the character of income', including a gain to an owner who receives the gain passively.²⁴ An important inquiry relevant to the ultimate issue was, therefore, whether the gain was derived from property which the taxpayer continued to hold in contrast to a receipt in exchange for a disposal of part of the capital. This led their Honours to consider whether the rights enjoyed by Mrs McNeil arose from and were 'severed from, and were a product of, her shareholding in [the bank] which she retained': in short, was the capital severed or did it remain intact; was the receipt in exchange for what was severed or did it proceed from capital which remained whole?²⁵ Critical to their Honours' conclusion that the receipt was a product of (and not in exchange for a part

18 *ibid* 660 (Gummow ACJ, Hayne, Heydon and Crennan JJ).

19 *ibid*.

20 *ibid* 661.

21 *ibid* 661-2.

22 *ibid* 662.

23 *ibid* 663.

24 *ibid*.

25 *ibid* [21].

of) the capital, was their Honours' analysis that Mrs McNeil's shareholding in the bank, as a matter of legal analysis, 'remained untouched'.²⁶

The most significant point in the conclusion of the joint judgment was that Mrs McNeil's shareholding in the bank 'remained untouched'²⁷ as a matter of legal analysis of the shares. An accountant or an economist may have analysed the transaction quite differently and may have seen the transaction from Mrs McNeil's point of view as an affair wholly on capital account (as did Callinan J).²⁸ On such an analysis, Mrs McNeil, as a shareholder, had a number of shares, and came to receive part of their actual economic and commercial value in cash in consequence of her capacity as a shareholder. The number of shares she held before and after her receipt of cash remained the same, but part of the economic value of her investment in those shares was returned to her (and did so in her capacity as a shareholder) without her doing anything and for no other reason than because she was a shareholder. From her point of view, the accounting and economic consequence of the receipt upon the sale of the rights was that her shareholding was in economic terms, and in accounting terms, reduced in value by the amount she received in cash and, on that analysis, a portion of *the value* of her shareholding was 'severed' from the worth of the whole of her shareholding and paid to her in cash. That appears to have been the view adopted by Callinan J when his Honour concluded that if one were 'to look only to what [Mrs McNeil] had in her hands', she received money 'which effectively gave shareholders access to a component of [capital] that they would not otherwise have had'.²⁹

Similar differences between the lawyer's tools and the understanding of economists and accountants may be seen on the deduction side of the distinction between capital and income. Capital losses and outgoings are not usually deductible against income receipts and the character of a loss or outgoing as either being on revenue account or on capital account can have profound consequences for fiscal outcomes. The legislative amendments and line of litigation involving convertible notes and instruments with a component of deductible outgoings illustrate this.³⁰

26 *ibid* [22].

27 *ibid*.

28 *ibid* 672 [55] (Callinan J reached the contrary conclusion from the majority of the Court placing significance on the impact upon Mrs McNeil as a shareholder when considering, as his Honour said, the 'transaction as a whole').

29 *ibid* [56]. See also Bloom, D Q.C., 'Taxpayer's Heaven: The Citylink Decision - The Opposite of Heaven: The Decision in *McNeil*', (Paper presented at the Taxation Institute of Australia, 52nd National Convention, Hobart, 16 March 2007); Justice Richard Edmonds, 'Recent Tax Litigation: A View from the Bench' (2008) 37 *Australian Tax Review* 79.

30 See, for example, *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2004) 210 ALR 508 (Federal Court); *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2005) 146 FCR 77 (Full Court).

The cases involving finance companies raising tier one capital through instruments with an obligation to pay an interest component also illustrate the tensions between the lawyer's analysis of tax law and the economic view of transactions. The raising of capital, whether by a financier or by any other taxpayer, carries with it a cost: investors buying shares expect a return on their investment and lenders who have lent money similarly require an economic return on the funds advanced. There is a cost whichever way funds are raised from the point of view of the taxpayer raising funds but the cost will differ by the impact of tax depending upon whether the funds are obtained as loans (because interest payments are deductible to the payer) or as contributions to equity (because dividends are not deductible to the payer). Similarly, from the point of view of the provider of funds (whether as investor or as lender) there will be an expectation of preserving capital as well as an economic return upon the capital, but there will be a difference in expected risk and return depending upon whether the funds are provided as investor or as lender. The parties agree in their deals to share or minimise risks and returns through the type, form and detail of the transactions they enter into and predictability of fiscal outcome is a crucial element of their negotiation and deal. Transactions differ in the type and extent of the risk exposure taken by the provider of the funds and the degree to which a company is willing to share the rewards of its risks and endeavours with those who have provided the funds that make that possible. How much risk each will take and how much of the reward each may enjoy are part of the economics of the bargain finally made. Embedded in those dealings, and which govern the shape and content of the transactions and the outcomes agreed to, is the fiscal treatment of the different forms in which transactions may take shape.

The purposive construction of all legislation requires judges to give effect to the underlying objectives which legislation seeks to achieve. Legislation drafted to give effect to economic concepts is no exception. The problem is not a lack of legislative direction but that judges do not have the training, background or resources to implement legislation as an economist, accountant or person of commerce would require. There is also a fundamental concern about how judges should act upon economic concepts. Such concepts are traditionally treated as matters of evidence to be given by experts whose evidence is subject to testing through cross-examination. The idea that a judge should apply some personally held view of economics, accounting or commerce may be inconsistent with the judge's role as independent (non-partisan) interpreter of legal text enacted by parliament in ordinary language.

Drafting legislation by reference to economic principles is unlikely in the long term to achieve the objective of ensuring that legislation is interpreted and applied by reference to economic principles. A better long term solution may be in a structural reform that places economic content into the act of decision making. Legislation seeking to implement economic concepts is an attempt to achieve that but it may fall

short if the people interpreting the words and applying them judicially lack the training or resources to give effect to the economic concepts. Two other models, however, come to mind as structural means by which economic outcomes might be integrated into and be made part of the fabric of decision making.

One model is the establishment of a specialist court with appointees who have the requisite training and experience to understand the economic concepts sought to be achieved and the training to give effect to them. Specialist courts are not popular and much can be said against their adoption.³¹ It is of fundamental importance that the courts declaring the law do so uniformly across all law. It is also desirable that there be a healthy input of non-specialist decision making in that task to ensure that the law does not become distorted through the institutionalisation of views and application of only specialist perception and lore. Many of these concerns can, however, be adequately met by ensuring that any appeal from a specialist court be to a general appellate court whose judges are drawn from a broad pool.

An alternative model, or perhaps merely a variation of the first model, might be to adopt for tax something like that adopted for Trade Practices. If economic concepts are central to the proper interpretation and development of tax laws, it may be better to establish something akin to the Trade Practices Tribunal composed of a judge, an economist and perhaps someone from business or the tax office so that the decision of the tribunal will necessarily be informed by the internal deliberations of those with the required knowledge and training. The parties to any dispute would still be able to test and argue about any economic content and would have rights of appeal on strictly questions of law, but such a specialist tribunal would ensure that the decision maker (being a composite of lawyers and others) would in part reflect other disciplines, expertise or experience.

The lesson of history is that much depends upon the identity of those given the task of interpretation, decision making and application. We have grown up with a model that assumes that words can adequately reflect the intention of an author without taking account of what the reader brings to the text when reading it and applying it. The problem is not that the writer does not know what he or she may have intended but that the reader will see the words with the reader's mind. Drafting legislation to set out the author's intention can only go so far. What ultimately is necessary is to secure the reader's adoption of what the author sought to achieve. The implementation of tax legislation by reference to economic concepts (or accounting or commercial concepts for that matter) are best secured by ensuring that the person implementing them (at

31 Kirby, M (former Justice of the High Court of Australia), 'Hubris Contained: Why a Separate Tax Court Should be Rejected', (2007) High Court of Australia <http://www.hcourt.gov.au/assets/publications/speeches/former-justices/kirbyj/kirbyj_3aug07.pdf> at 13 December 2010.

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least at first instance) has the requisite training and experience. The creation of a specialist tribunal with economists (for example) as members is a more likely way of securing the objective than the processes adopted to date.