STRUCTURAL FLAWS OF INCOME AS A BASE FOR TAXATION

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John Prebble
Faculty of Law
Victoria University of Wellington
New Zealand
John.Prebble@vuw.ac.nz
http;//www.vuw.ac.nz/~prebble

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Centre for Accounting, Governance and Taxation Research
School of Accounting and Commercial Law
Victoria University of Wellington
PO Box 600
Wellington
New Zealand

Phone 64 4 4636957 Fax 64 4 4636955
http;//www.accounting-research.org.nz

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Structural Flaws of Income as a Base for Taxation[1]

John Prebble[2]

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An institution in decay

Fifteen years ago Ross Parsons published his Wilfred Fullagar Lecture in the *Australian Tax Forum*. His subject was "Income Taxation–an Institution in Decay".[3] His lecture was influential. Scholars cite it regularly. This evening I shall consider Parsons's thesis and evaluate it from several points of view: factually, historically, philosophically, and as a prophecy that society would abandon income taxation.

Parsons's fundamental position was that, "The analytical fabric of the income tax … had congenital and … incurable defects, born as it was of a union of institutions which had no common policies". The institutions to which he referred were first the income tax itself, and secondly the concept of income. In Parsons's opinion, income tax adopted the concept of income from the law of trusts, which, he explained, is based on principles that are different from and irrelevant to the policies and imperatives of income tax law.[4]

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[1] This paper is a revised version of the author's inaugural Ross Parsons Memorial Lecture, delivered in Sydney on 14 June 2001. It is due to be published in due course as an article in the Sydney University Law Review. Comments, please, to John.Prebble@vuw.ac.nz.
[2] BA, LLB (hons) (Auckland); BCL (Oxon); JSD (Cornell); Inner Temple. Professor and former Dean of Law at Victoria University, Wellington, New Zealand. www.vuw.ac.nz/~prebble.
[3] (1986) 3 Australian Tax Forum 233.
[4] Id 238 – 240.

Parsons chose the Simons[5] definition as the appropriate benchmark against which to test the judicial concept of income that has developed in Australian and United Kingdom law. Essentially, Simons said that the tax base should embrace all economic gains, but that it should embrace only economic gains.[6] Parsons explained that the Australian tax base fails on both counts.

There are several fundamental problems with the judicial concept of income, that is, the concept of income that the courts employ for tax purposes. First, the judicial concept sees income as a flow, rather than as a gain. Secondly, as a consequence, it taxes some apparent flows that do not entail gains. Thirdly, it omits gains that we call capital gains. Australia attempted to remedy that shortcoming by bolting a capital gains tax onto the income tax in 1986.[7] Fourthly, it relies on legal transactions rather than on underlying economic movements. I shall return several times to this fourth point during this lecture.

Ross Parsons would agree with me that the shortcomings that I have just listed are not stand-alone defects of income taxation but symptoms of the analytical shortcomings of the concept of income. I shall continue from here in a moment, after considering some history.

History

One way in which Parsons has been influential is in respect of his opinion that tax law adopted its concept of income from trust law. Nowadays a number of other people hold this belief and have written about it. When I find these people I ask them for their source. The source is invariably Parsons.[8] On the other hand, Parsons himself cites as his only authority *Inland Revenue Commissioners v Blott*[9]. Parsons argued that the

[5] Simons, H, *Personal Income Taxation. The Definition of Income as a Problem of Fiscal Policy* (1938) Chicago, University of Chicago Press, 50-51.

[6] Idem. Simons's full definition was: "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."

[7] Income Tax Assessment (Capital Gains) Act 1986.

[8] The present author is among these people. Prebble, J, "Why is tax law incomprehensible?" [1994] *British Tax Review*, 380, 388.

[9] [1921] AC 171.

House of Lords in the *Blott* case used the trust case of *Bouche v Sproule*[10] to conclude that a bonus issue of shares was not income for purposes of the United Kingdom income tax. Even if Parsons had been correct in his analysis of *Blott's* case, it would not necessarily follow that trust law was the source of the concept of income for tax law. In fact, if anything, *Inland Revenue Commissioners v Blott* taken together with *Bouche v Sproule* establishes the opposite. The majority[11] in *Blott* first, and independently, establishes the parameters of the concept of income.[12] They then turn to *Bouche v Sproule* merely as confirmation of their conclusion,[13] not as the source of it. The two branches of the law draw separately on the same concept of income, a concept of income that exists independently from either of those two branches. As Viscount Finlay put it,[14]

> The question whether it was income or capital could not be affected by the purpose which led to the institution of the inquiry.

The fundamentals of the legal concept of income that the House of Lords deployed in *Inland Revenue Commissioners v Blott* remain with us today, but they have a history that goes back at least to the poll taxes of the seventeenth century. As their name implies, poll taxes were capitation taxes, but Parliament levied them on a progressive scale. Discovering people's income was either impractical or intrusive. Instead, the graduation used ranks and occupations as a surrogate, to tax income indirectly, on the assumption that people's income corresponded with their position in life. For instance, the poll tax of 1641 levied £100 on dukes, with rates falling through to ranks of nobility to £10 on esquires.[15]

The assessed taxes of the seventeenth and eighteenth centuries also approached income asymptotically, though they chose expenditure, not rank, as an appropriate surrogate for income. The hearth tax of 1662[16] was an early example, imposing tax on the basis of the numbers of fireplaces in people's houses. The window tax of 1695,[17] charged two shillings a year to the occupant of each dwellinghouse, with higher rates for larger houses. The tax estimated size by counting windows, assessing an additional four shillings if

[10] (1887) 12 App Cas 385.
[11] Viscounts Haldane, Finlay, and Cave. Lords Dunedin and Sumner dissented.
[12] [1921] AC 171, 184 (Viscount Haldane), 196 (Viscount Finlay), 200 (Viscount Cave).
[13] [1921] AC 171, 185 ff (Viscount Haldane), 197 ff (Viscount Finlay), 201 ff (Viscount Cave).
[14] [1921] AC 171, 197.
[15] 16 Chas I c 9.
[16] 14 Car II, c 10.
[17] 7 & 8 Will III c 18 (1695-96).

one's house had ten windows, and eight shillings for houses with twenty or more windows. In effect, the hearth and window taxes achieved a form of taxation that was doubly indirect. They used one surrogate (numbers of hearths and windows) to estimate another (size of house) which itself was a surrogate for people's income. New assessed taxes in the eighteenth century cut out one step of indirectness and imposed duties on items that were considered to be luxurious, such as horses, carriages,[18] clocks and watches,[19] dogs, and male servants.[20]

The assessed taxes proved inadequate to fund the Napoleonic Wars at the end of the eighteenth century. Parliament's initial response was to increase the rates, which resulted in the Triple Assessment of 1798,[21] promoted by Pitt as an emergency war tax. Like the assessed taxes that preceded it, the Triple Assessment used expenditure in an effort to assess income. The Triple Assessment required people to pay the same amount that they paid in 1797 again, and in addition an extra assessment of the 1797 amount, multiplied by factors that increased in proportion to the totals of the 1797 payments.

Originally, Pitt intended to triple the amounts paid on items of special luxury.[22] This intention appears to be the origin of the name, "Triple Assessment".[23] In the event the multipliers chosen varied from one tenth to five.[24] It is evident from Pitt's comments that he regarded the true tax base as income, with luxury expenditure being merely an indication of the size of one's income. In the debate on the Bill, Pitt explained that "the fairest criterion for judging of the proportions which ought to be paid by the various classes of society according to their income, was the return of the assessed taxes."[25] The multipliers employed in the Triple

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[18] 20 Geo II, c 10 (1747).

[19] 37 Geo III, c 108 (1797).

[20] 17 Geo III, c 39 (1777).

[21] (1798) 38 Geo III, c 16.

[22] Debate on Mr. Pitt's Proposition for Trebling the Assessed Taxes, December 4, 1797, Para. 1066 - 1089. At para. 1068 the clerk wrote: "It was his [Pitt's] intention, therefore, as these [taxes on servants, horses, carriages, dogs and watches] were chiefly articles of luxury, to triple the duties upon the latter."

[23] For slightly different explanations see P.E. Soos, *The Origins of Taxation as Source in England* (1997) Amsterdam, IBFD Publications 145; and B.E.V. Sabine *A Short History of Taxation* London, Butterworths (1980), 113.

[24] 38 Geo III, c 16, §1.

[25] Debate on Mr. Pitt's Proposition for Trebling the Assessed Taxes, December 4, 1797, Paras 1066 – 1089, para. 1067.

Assessment operated to create a crude progressive scale for taxing the surrogate of income that was its target. For instance, if an individual's 1797 taxes assessed on male servants, carriages, and saddle and carriage horses came to less than £25 the sum was multiplied by three, but if it was £50 or more the sum was multiplied by five.[26]

One problem with the Triple Assessment was that people who had a good portion of their wealth tied up in assets that the tax caught, but who were not hugely wealthy, risked paying a significant fraction of their income in tax: at least, a fraction that at the time people thought to be too high. This potentially inequitable result had always been a flaw in the assessed taxes' strategy of using expenditure as a surrogate for income. The greatly increased rates of the Triple Assessment, together with the steep scale created by the progressive increase in the factors used to multiply the 1797 rates, risked bringing the consequences of this flaw home to taxpayers' pockets with a vengeance.

Pitt's remedy was to add a rider to abate the tax in proportion to people's income. There was another progressive scale for this purpose. People with annual incomes under £60 had to pay a maximum of one one hundred and twentieth of their annual income. The scale rose by twenty-nine increments to ten per cent for incomes over £200 a year.[27] The schedule to the Triple Assessment set out rules for estimating income, rather than calculating it. The schedule contained nine "cases" of income, such as income from lands derived by owners and tenants, as well as income from professions, trades, vocations, annuities, interest, rent charges, and so on.[28] That is, not only did the concept of income precede the enactment of the United Kingdom's first income tax, but the schedular and case system that remains a salient feature of that tax to this day[29] has deeper historical origins.

The Triple Assessment was widely evaded and did not last long. Parliament replaced it in 1799 with the income tax proper,[30] which taxed income directly rather than via a surrogate. There was a progressive rate, which peaked at ten per cent for incomes of £200 or more. "Income" was defined as income from land, trade, annuities and professions. The

[26] 38 Geo III, c 16, §1.
[27] Cobbett, W, 33 *Parliamentary History*, (1797-1798, 38 Geo III) 1076 (Pitt).
[28] (1798) 38 Geo III, c 16, Schedule I.
[29] Income and Corporation Taxes Act 1988 (UK).
[30] 39 Geo III, c 13.

idea of schedules, carried forward from the Triple Assessment, was not used initially, but was added in 1803.[31]

The income tax of 1799 inherited the very concept of income that Parliament had used the year before to abate the Triple Assessment: a regular flow that is measured annually. This is the concept that has descended to us today. It is the same concept that has worked its way through the law of trusts. Simply, the judicial concept of income adopts the ordinary meaning of the word, little informed by the views of economists.

The foundations of income tax

Parsons may have been wrong about the origin of the judicial concept of income as a tax base, but he was correct that income taxation has congenital and incurable defects. He was also correct that these defects lie in the fact that income tax law needs a concept of income at its core. Let me first examine the defects, and then try to explain why they are incurable.

The defects are a function of the fact that income tax law is separated from its subject matter. Looked at another way, tax law's concept of income is not income itself but a simulacrum of income. The separation of income tax law from its subject matter can be seen best in the law's efforts to tax business profits. Business profits arise independently of the law, and sometimes even in spite of the law. They are not a result even of contract law, let alone of tax law. They are the result of people's economic transactions with one another. The fundamental problem of any income tax law is that it cannot tax economic transactions directly. Rather, it taxes the legal forms that we use to represent economic transactions.[32]

Let me illustrate with a comparison from criminal law. Ms Turpin and Ms Good look very much alike, but Ms Turpin is a robber and Ms Good a teacher. One of Ms Turpin's victims gets a good look at her and manages to compose an identikit

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[31] 43 Geo III, c 22.

[32] Exceptionally among common law jurisdictions, the United States of America tries to circumvent this problem by employing a substance-over-form approach in tax cases. *Gregory v Helvering* 293 US 465 (1935). The United States has not always managed to maintain this approach. See, eg, the cases known as the "Mexican railcar cases", such as *Chicago, Burlington, & Quincy R Co v United States*, 455 F. 2d 993 (Ct Cl 1972) and *Missouri Pacific Railroad Co v United States*, 497 F. 2d 1386 (Ct Cl 1974). For a recent discussion and references, see P.A. Glicklich and M.J. Miller "Appeals Court adheres to precedent, tells IRS that it's too late to issue regulations" in Glicklich & SH Goldberg, *Selected US Tax Developments*, newsletter of Roberts & Holland LLP, New York, (2001).

portrait. The portrait is a good likeness of Ms Turpin, but it looks even more like Ms Good. On these facts, nobody would suggest that Ms Good, the teacher, committed the crime. In tax law, however, a taxpayer crafts a series of legal transactions to represent an underlying economic substance. Either calculatedly or not, the legal transactions sometimes look more like some other economic substance. Perhaps what is economically a partnership looks more like a mortgage. Absent an avoidance rule, tax law will ordinarily tax the transaction as a mortgage, and not as a partnership. We can compare that characterisation to criminal law finding Ms Good guilty of robbery because the victim's simulacrum of the robber looks more like Ms Good than Ms Turpin. Criminal law does not work like that, but income tax does.

Ectopia

As I have said, tax law generally taxes the results of legal transactions rather than their underlying economic effect. The courts are always telling us that tax law does not tax on the basis of economic equivalence.[33] But the problem is deeper. In order to make income tax work at all, the law must make a number of assumptions that are not in fact correct, assumptions as to both the factual and the legal nature of the taxpayer's income. The effect of these assumptions is that the base that the law taxes is removed even further from the facts of the case.

I have written several articles on this phenomenon,[34] which I call "ectopia". "Ectopia" means "displacement" or "dislocation". We see it in "ectopic pregnancy", meaning a pregnancy that develops in the wrong place. Like the ectopia of a pregnancy in the fallopian tube, the ectopia of the concept of income is pathological and incurable.

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[33] Eg *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, 648 PC.

[34] "Ectopia, formalism, and anti-avoidance rules in income tax law" (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers*, Duncker and Humblot, Berlin, 367-383; "Philosophical and design problems that arise from the ectopic nature of income tax law and their impact on the taxation of international trade and investment", (1995) 13 *Chinese Yearbook of International Law and Affairs*, 111-139, reprinted as "Ectopia, tax law, and international taxation" [1997] *British Tax Review* 383; "Can income tax law be simplified?" (1996) 2 *NZ Journal of Taxation Law and Policy* 187; "Should tax legislation be written from a principles and purpose point of view of a precise and detailed point of view?" [1998] *British Tax Review* 112; see also "Why is tax law incomprehensible?" (1994) *British Tax Review* 380-393.

By an apt coincidence, the secondary meaning of "income", which has nothing to do with tax, involves a problem that is literally pathological. An "income" as a tumour or "a morbid affection of any part of the body".[35] My thesis is that the metaphorical pathology of income tax law is so extreme that it makes tax law a different species from other kinds of law. As physiological incomes are different from healthy flesh, so income tax law is different from other law. Some people in the audience have been kind enough to read my articles. In deference to those charitable people I shall not deal with ectopia at length, but I summarise my major themes.

The fundamental difficulty is that we cannot have an income tax without a concept of income. For a number of reasons, our concept of income must be artificial. I have mentioned one, the fact that we tax a legalistic simulacrum of transactions rather than the transactions themselves. Other reasons include the problems of place and of time.

The problem of place arises in connection with international transactions. Income tax law assumes that all income can be located in one jurisdiction or another as a matter of physical fact, or, as Isaacs J put it, as "a hard, practical matter of fact".[36] Almost any example of an international transaction will dispel this assumption. Where is the source of the profit that a multi-national company makes on selling a computer to a retail buyer in Sydney? In one sense the question makes no sense. Profit is a net concept, the difference between receipts and expenditure. A difference cannot exist physically in space.

From another point of view the question makes a little more sense, in that a fraction of the multi-national company's profit comes, no doubt, from activity at each of its manufacturing plants, its head office, its despatch department, its marketing department and its treasury administration, to name only some of the more obvious profit centres. However, anyone with the barest acquaintance with transfer pricing rules and practices will appreciate that dividing profit among these centres is an inexact process that uses surrogates for truth rather than the underlying truth itself.

The problem of time is worse. Ideally, we would wait for a business to go through its whole life, from foundation to liquidation, before determining whether there had been profits and, if so, how much they were. Of course, tax systems, like shareholders, cannot wait so long; so, like accountants, tax

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[35] Dialect, Northern or Scottish, *Oxford English Dictionary*, 2nd ed 1989.

[36] *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, 189–190.

authorities require businesses to divide their lives into periods delimited by dates. Both accountants and tax law always use twelve months, but there is no special reason for this convention apart from convenience.

One result is that Parliament must legislate so that receipts and expenses are treated not as the taxpayer actually meets them, but as they might have occurred had they been spread evenly over time. Income smoothing for farmers is a good example.[37]

I have discussed some problems of timing to show how tax law must distort facts and law in order to operate. But the major problem that relates to time is the distinction between capital and revenue. An annual taxing system must have this distinction, but the distinction causes capital and revenue to be treated differently, even though they are essentially fungible, with all the consequences that we know.

None of this is to criticise Parliament's response. Parliament cannot allow clever people to defer receipts or to create contrived interest deductions. If Parliament must create and tax a simulacrum of interest payments rather than actual interest payments that is understandable. It is probably even a good thing.[38] My point is more fundamental. It is that an income tax system cannot work without such pretences.

Criticisms of the ectopia thesis

I have tried to explain the thesis that income tax law is different in kind from most other law because of the dislocation between income tax law and the facts to which it relates. People have responded with various criticisms or questions, which are directed to suggesting that income tax law is not so very unusual. This evening, I shall address just one of those criticisms, that the law is well used to fictions. Are not the assumptions that give us our concept of income just examples of legal fictions? I shall attempt to answer that question first generally and then particularly.

Regarding the matter in general, it is a characteristic of law as an institution to enjoy an almost symbiotic relationship with its subject matter. When sovereigns legislate, they make sure that their laws relate as closely as possible to the subject matter of those laws, if only for efficiency. A sovereign who wants to forbid assault does not create an offence of consensual hugging, at least not intentionally. But a sovereign who wants to tax the profits of hire purchase transactions efficiently may pass a law that pretends that hire purchase

[37] Eg Income Tax Assessment Act 1997 (Cth) Division 392.
[38] Eg Income Tax Act 1996 (NZ) subpart EH.

transactions are credit sales. Section FC 10 of the New Zealand Income Tax Act 1994 is such a provision. Australia introduced Division 240, a provision that contains rules that have a similar effect, in the Tax Law Amendment Bill (No 3) of 1999. The new rules remain in Bill form at the time of writing, but they are expected to be enacted during 2001. Economically hire purchase transactions are credit sales, but that is neither their legal form nor their legal substance. To be effective, tax law must pretend that they are something else. Credit is as different from hire purchase as a hug is from an assault, but such recharacterisations are commonplace in tax law. The general point is that, unlike the position in respect of other forms of law, the separation between tax law and its subject matter is real, inherent, and unavoidable. I shall try to demonstrate that tax law uses fictions to bridge this separation, whereas the role of fictions in other areas of law is less fundamental.

Fictions

I pass now to legal fictions more specifically. My thesis is that the fictions of income tax law are of a different character from other legal fictions. I shall illustrate by considering several fictions from history. Roman law had many fictions. For instance the *fictio Legis Corneliae* addressed the problem of Romans dying in captivity. If a Roman was captured he lost his citizenship, and with it his capacity to make a valid testament. The Romans glossed the *Lex Cornelia* with a fiction that for succession purposes Roman citizens should be deemed to have died at the instant of capture, while still free men and citizens.[39]

That is a fiction from Roman law. Two fictions from the common law are the doctrine of trover and the concept of attractive nuisance. When you sued people for the return of your goods you pleaded that they had found them, even if the defendant had taken the goods by force. This pleading was to bring your claim within the form of action of trover and detinue, which did not allow for theft.[40] The courts well knew

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[39] Justinian *The Institutes*, translated and annotated and with commentary by T.C. Sandars, 7th ed (new impression) London 1962, 180. The *Lex Cornelia de falsis* (BC 81) provided the same penalty for forging the testament of a person dying in captivity as for forging the testament of someone dying in his own country. The law could not have intended to attach a penalty to forging a testament that was invalid. Accordingly, it must be assumed that the deceased had the power of making a testament both when he in fact made it and when he died.

[40] Blackstone III *Private Wrongs* 153, 3rd ed London 1862, 160 – 161.

what was going on and assumed the fictional fact that the defendant had indeed found the goods.

My second common law example is the attractive nuisance. An attractive nuisance is something on your land that is dangerous but that attracts children to play on it. The common law said that you did not have to worry as the children were crushed under tons of falling scrap metal or had their limbs torn off by locomotive turntables that were out of control. You did not invite the children; they were trespassers and they got what was coming to them. Occasionally the courts found all this too robust and held that people leaving attractive but dangerous articles on their land must be taken to have issued an invitation to come in and play on those articles; so the maimed children were not trespassers, and the occupiers were liable.[41]

The three fictions that I have mentioned share a common characteristic: by implication, they created rules that someone could have drafted expressly. Rome could have ruled that the wills of former citizens dying in captivity were valid. England could have created a form of action for suing a thief for one's goods or could have passed a statute providing for a greater degree of liability on the part of occupiers, as in fact England did many years later.[42]

The fictions of income tax law are very different. The classic legal fiction entails pretence, but taxation fictions entail duplicity. The pretence of the classic legal fiction is a roundabout route to a just result that courts employ when a direct route is not available. In contrast, the duplicity of a taxation fiction is a necessary part of the route of one's legal argument and even part of the result of the argument. Let me illustrate.

Rules that spread interest that is paid on day one over the life of a loan assume expressly or impliedly that the interest is paid at regular rests.[43] Rules that attribute the income of foreign trustees[44] or of foreign companies[45] to Australian residents assume impliedly that the Australian residents in question indeed derive the income.

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[41] *Sioux City & Pacific Rly Co v Stout* (1873) 17 Wall. 657 (US SC), *City of Pekin v McMahon* 154 Ill 141 (1895), and *United Zinc v Bruitt* 258 US 268, 275 (1921) per Holmes J. But see *Addie v Dumbreck* [1929] AC 358 HL.

[42] Occupiers' Liability Act 1957.

[43] Eg, New Zealand Income Tax Act 1994, subpart EH (the qualified accrual rules).

[44] Eg Income Tax Assessment Act 1936 s 97(1)(a).

[45] Eg Income Tax Assessment Act 1936 Part X, Division 2, Subdivision B.

Take a more complex example: the basic assumption of income tax law that there is a logical real-world distinction between capital and revenue is a fiction. There are innumerable pairs of cases that illustrate the flaws in that assumption, but I'll use the classic teacher's comparison between *Californian Oil Products Ltd v Federal Commissioner of Taxation*[46] on one hand and *Heavy Minerals Pty Ltd v Federal Commissioner of Taxation*[47] on the other. In both cases, the business of the taxpayer was destroyed. Both taxpayers received compensation for the loss; but Californian Oil Products's compensation was capital and Heavy Minerals's compensation was revenue. *Heavy Minerals* was the later case; so the court had to distinguish *Californian Oil Products*. Windeyer J distinguished the earlier case by explaining that Californian's business was destroyed as a matter of law, whereas Heavy Minerals's business was destroyed only as a matter of fact. That analysis is correct from the point of view of a tax *lawyer*, but a tax *payer* could be forgiven for finding it unpersuasive.

Californian's problem was that its American principal, the Union Oil Company, decided not to sell it any more oil, terminated Californian's purchasing contract, and paid compensation. Heavy Minerals's business was mining and selling the product, rutile. The company's difficulty was that the world price of rutile fell below Heavy Minerals's cost of production. The company had protected itself against this eventuality by forward sales contracts, but its customers preferred to cancel the contracts and compensate Heavy Minerals for its loss of profits rather than to buy rutile from Heavy Minerals and sell it at a loss.

In effect, Sir Victor Windeyer told Heavy Minerals to brace up and not be so feeble. It was in this case that he coined his famous apophthegm, "He ain't heavy, he's my mineral". That's thought to be a reference to Sir Peter Abeles, who was one of the principals of Heavy Minerals. His Honour told Sir Peter that unlike the poor fellows in Californian Oil Products, who had been eviscerated by the perfidious Americans, Heavy Minerals still had a good business. No one was telling Sir Peter not to mine rutile. He should just roll up his sleeves and get on with it.

As I have explained, Windeyer J's distinguishing of *Californian Oil Products* and his reasoning in *Heavy Minerals* were unexceptionable in law. The reason is that the High Court was not purporting to calculate Heavy Minerals's tax

[46] (1934) 52 CLR 28.
[47] (1966) 115 CLR 512.

liability on the basis of the profit from its actual economic business, but on the basis of the contracts that were used as the legal vehicle for that business and on the basis of the rights and duties that formed the legal context of the business. Sir Victor was correct that from a legal point of view Heavy Minerals's business remained intact, even though nobody wanted rutile at the price that they had to charge. On the other hand, Californian Oil Products's business had depended on a contractual right to buy products from the Union Oil Company. Once that right was gone there was no legal basis for their business.

All that sounds fine when you say it quickly, but it makes a nonsense of any policy of income tax law. In its most general sense, the policy of income tax law in respect of businesses must be to tax real business profits. Profits from economic activity exist in the natural world, but profits defined by law are a construction of human thought. Economic profits constitute the only reality that a government can tax. Using profits defined by law as the vehicle to do the taxing does not change the underlying reality, though the result will be to over-tax or to under-tax in individual cases.

Income tax law achieves its policy of taxing business profits as best it can by defining a surrogate of business profits in legal terms. In this respect, income tax law is an imperfect means to an end, because the definition of business profits can never be perfectly accurate. In fact, as I have tried to point out, the definition is often very inaccurate. The true, economic, business profit, which would be the proper subject of the tax base if we could ever get at it, is removed from its legal simulacrum by an ectopia.

Other law is different. For instance, if it chooses, tort law can redraft itself so as to operate without the fiction of inviting children to enter premises to play on dangerous turntables. Indeed, it did so in several Occupiers' Liability Acts in the 1950s and 1960s.[48] But income tax law cannot abandon the fiction of a logical and factual boundary between capital and revenue.

Lon Fuller, the great American jurist of the mid-twentieth century, identified several characteristics of legal fictions.[49] He said that fictions are like scaffolding. As the law develops we can abandon them without injuring the policy or vested

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[48] Eg Occupiers' Liability Act 1957 (England), Occupiers' Liability (Scotland) Act 1960, Occupiers' Liability Act 1962 (New Zealand).

[49] *Legal Fictions* (Stanford, 1967). I thank Dr Alex Frame of Wellington, who introduced me to this monograph.

interests that they are designed to sustain.[50] In contrast, it is my thesis that the fictions of income tax law are an integral part of the law's modus operandi. We need fictions because income tax law is separated from its factual subject matter. It works only by using fictions that pretend that it is not separated. Tax law works imperfectly, but it does work. This is a curious example of two wrongs making a right, or, at least, of a wrong that hides the true answer being partially corrected by a second wrong.

Explanatory utility of the ectopia concept

I hope that I have persuaded at least some people here this evening that I am correct in my conclusion that income tax law may be law as tax specialists know law, but it is not law as other people know it. Other people reasonably expect law to have a close and almost symbiotic relationship with its subject matter. Tax specialists know that income tax law's relationship with its subject matter can be so haphazard that at times it appears to be almost a matter of random serendipity when fact, law, and tax consequence coincide.

Ross Parsons identified this phenomenon. He took the view that it would lead to the demise of income taxation. I am not sure that he was correct, for reasons that I shall explore in a minute. But first, let me explain that studying the ectopia of tax law is not merely an intellectual conceit. The exercise tells us a good deal about the nature of income tax law, its inherent limitations, and the limitations on what can be done to reform it.

I have discussed these matters in a number of articles. Tonight I shall list their conclusions. First, the ectopia of income tax law explains why that law is unduly complex. People think that with good will and conscientious effort drafters should be able to compose income tax legislation that is as comprehensible as other legislation. It is true that one can make improvements, but income tax law will never be as clear as, for example, a criminal code.[51]

Secondly, people think that tax statutes could be simplified if only they were drafted in broad, principled codes, rather than in numerous, detailed, sub-codes.[52] That thought is

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[50] Id 70.

[51] "Why is tax law incomprehensible?" (1994) *British Tax Review* 380-393; "Can income tax law be simplified?" (1996) 2 *NZ Journal of Taxation Law and Policy* 187.

[52] See, eg, J Avery Jones, "Tax law, rules or principles?" (1996) 17 *Fiscal Studies* 63, 75–76.

wrong,[53] too, though again it is true that there can be some improvements. Nevertheless, because of the problem of latifundian legislation by principle I suspect Mr Ralph's recommendations for a consistent entity regime were doomed from conception;[54] (and I wrote this sentence before I heard that the consistent entity proposal had died).

Thirdly, although ectopia is present throughout the income tax system, and is seen everywhere in the distinction between capital and revenue, there are some areas of law where ectopia is particularly marked. In these areas, modern tax systems typically respond with increasingly complex remedial fictions that are calculated to bring tax law and its subject matter closer together. The many regimes of international tax law are the foremost example: increasingly complex rules about source and residence; transfer pricing; controlled foreign companies; foreign tax credits; and conduit taxation demonstrate my point.[55]

Fourthly, the ectopia of tax law leads to and, I submit, justifies, the enactment of open-ended general anti-avoidance

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[53] "Should tax legislation be written from a principles and purpose point of view of a precise and detailed point of view?" [1998] *British Tax Review* 112.

[54] *Review of Business Taxation*, last date viewed 9 July 2001. www.rbt.treasury.gov.au/publications/paper4/part5/section13.htm.

The Australian Review of Business Taxation under the chairmanship of Mr John Ralph published several reports in 1999, from J. Ralph (Chairman of Comm) Review of Business Taxation, First Report, *A Strong Foundation* AGPS (1999) to J. Ralph (Chairman of Comm) Review of Business Taxation, Final Report, *A Tax System Redesigned* AGPS (1999). The "consistent entity regime" was a version of that hoary perennial, the idea that a uniform system of taxation for all business entities, including companies, trusts, unit trusts, and so on can only be a good thing. A corollary is that a uniform system does not exist now only because tax policy has been left to people who cannot see the wood for the trees.

It seems that the Australian government had become exasperated with the increasing complexity of tax laws that appeared to have resulted from leaving tax design to tax experts. In a new approach, it intended that the Ralph review should take a practical, businesslike stance, not unduly hampered by advice from tax lawyers. As a result, the consistent entity regime built up a more formidable head of steam than such proposals usually achieve. Its demise came when eventually it was exposed to expert scrutiny. What had been reasonably clear to experts from the beginning became clear also to higher-level policy makers: that notwithstanding its common-sense, intuitive attractions, the consistent entity regime suffered from the defects that are endemic to proposals to draft income tax laws on the basis of broad, logical, principles of wide application.

[55] "Philosophical and design problems that arise from the ectopic nature of income tax law and their impact on the taxation of international trade and investment", (1995) 13 *Chinese Yearbook of International Law and Affairs*, 111-139, reprinted as "Ectopia, tax law, and international taxation" [1997] *British Tax Review* 383.

rules like Part IVA of the Australian Income Tax Assessment Act 1936 and section BG 1 of the New Zealand Income Tax Act 1994.[56] The gap between tax law and fact that is the subject of this lecture means that there are perforce gaps in the formal coverage of an income tax statute. The statute needs a general, substance-over-form rule to protect the tax base.

People often criticise general anti-avoidance rules for their lack of specificity. They say that the imprecision of anti-avoidance rules erodes the rule of law. I am not sure that I agree with that criticism. After all, in the end it is the court, not the commissioner, that decides whether a general anti-avoidance rule applies. But even if the criticism is justified, this characteristic of general anti-avoidance rules is part of the price we pay for having a tax on income. Income is imprecise; so the rules that buttress income taxation must share that imprecision.

This consideration should lead us to reflect on the history of general anti-avoidance rules. Often, critics demand specificity. Tax commissioners and occasionally Parliaments may be sympathetic. They sometimes promulgate guidelines or even enact rules to refine the scope of a general rule.[57] In principle, that approach is bad practice. The point of a general anti-avoidance rule is that it should be general. Specificity, however well intentioned, risks eroding the effectiveness of the rule.

The tax value method

A fifth consequence of ectopia is that people are forever trying to reform and improve income tax. That is not surprising. Ectopia is always with us, it is always causing problems, and people are always responding.

During 2000 and 2001 Australia has examined proposals for a major change in the way that it defines income. The new idea has been called the "tax value method".[58] The conceptual

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[56] Ectopia, formalism, and anti-avoidance rules in income tax law" (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers*, Duncker and Humblot, Berlin, 367-383.

[57] See, eg, McBarnett, Doreen and Christopher Wheelan, "The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control" (1991) 54 Modern Law Review 848, 860 ff; Lehmann, G, "Judicial and Statutory Restrictions on Tax Avoidance", in Richard E Krever, (ed) *Australian Taxation, Principles and Practice* (Melbourne 1987) 295-313.

[58] *Review of Business Taxation*, last date viewed 9 July 2001. www.rbt.treasury.gov.au/publications/paper4/part2/section4.htm#heading 1. See also footnote 54, above.

base is superficially similar to Henry Simons's definition of income,[59] that is, the increase in the taxpayer's net assets over time. A short description of the tax value method is "net cash flows plus the change in value of assets".

The tax value method is a compromise between competing policies. On one hand, there appears to be an endeavour to bring the concept of income under income tax legislation closer to true economic measurement. On the other hand, compliance considerations mandate that calculations are according to the criteria of accounting rather than of economics. In particular, the tax value method does not take account of unrealised gains nor of assets that are very hard to identify or to value, such as additional market penetration achieved by advertising expenditure. Discussion papers[60] appear to be careful to eliminate references to law as much as possible, but no doubt legal concepts will continue to play an important part. For example, there will be the question of determining whether there has been a realisation.

I hesitate to make detailed comments about the tax value method in front of an Australian audience. I would expose my ignorance very quickly, if I have not already done so. But I hope by generalisation to put the tax value method into the analytical framework of this evening's lecture. First, as Ross Parsons explained, the fundamental difficulty with income tax law is to define the concept of income. The tax value method is an effort to cope with that task. In principle, it should approach closer to the economic concept of income than the current judicial concept does, because, in principle, accounting is more concerned with economic substance than is law. In practice, concern about compliance costs and practicalities in general may mean that the tax value concept of income will not approach much closer to Henry Simons's economic benchmark[61] than does the existing judicial concept. Secondly, it seems unlikely to be possible to eliminate legal concepts entirely. That is, Australian law will still have to tax a legal simulacrum, not actual economic activity. Nevertheless, the objective is clearly to minimise the ectopia between the two. Let us hope that this occurs. Thirdly, although the tax value method addresses problems of capital and revenue and of timing in general, it faces the same problems of source and residence as does the current system, but it does not claim to mitigate those problems. They will

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[59] See footnote 6, above.

[60] Eg. Commonwealth Treasury and the Australian Taxation Office, *The Tax Value Method* Canberra 7 February 2000.

[61] See footnote 6, above.

remain with us. If Australia adopts it, the tax value method may prove to be an amelioration, but it will not be the last word. I would keep Australia's general anti-avoidance rule[62] in the statute in the meantime.

Why does income tax survive?

In his lecture, Parsons predicted the demise of income tax. Wisely, he did not put a date on his prophecy. He was well aware that there are a number of factors independent of income tax itself that make it very difficult for governments to move to different forms of taxation. He mentioned political difficulties in changing to indirect taxes,[63] though since Parsons's time Australia has worked through at least some of those. More importantly, he pointed out that Australia "cannot go it alone in abolishing [the] income tax".[64] The reason is that international fiscal relationships, for the most part crystallised in double tax treaties, are based on the assumption that all jurisdictions use income as their primary tax base. It is not practical for a single country to change to a tax that is fundamentally different. At least, that is what everyone assumes. Whether true or not, that widely held assumption might as well be true.

Parsons was certainly correct about the political and international problems of switching from income taxation. Nevertheless, his work conveys the impression that he was reasonably confident that the demise of income tax was a medium-term prospect, essentially requiring not a great deal more than international good will. Was he right?

My estimate is that Parsons was wrong on this point. Contrary to Professor Parsons, I believe that income tax is with us indefinitely. Internally, and as an institution, income tax is terribly flawed. But there are many exogenous factors that give it indirect support. I'll try to list them.

First, although the last fifteen years or so have seen modest reversals of the inexorable growth of the state, it is hard to see fiscal retrenchment going much further. Certainly, I cannot foresee any modern state reducing its revenue needs enough to be able to abandon income tax without replacing it with a tax of comparable power. If this conclusion is correct, it would seem that the only real alternative to an income tax is a direct expenditure tax such as that proposed by Kaldor[65] and

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[62] Income Tax Assessment Act 1936, Cth, subpart IVA.
[63] R. Parsons, "Income taxation, an institution in decay", (1986) 3 *Australian Tax Forum* 233, 265.
[64] Id 266.
[65] N. Kaldor, *An Expenditure Tax* (1955) London, Allen & Unwin.

taken up by the Meade Committee,[66] or some variant of an expenditure tax. Is the income tax so flawed that governments will collaborate in the immense international undertaking that would be necessary to move everyone at once to an expenditure tax?

People occasionally suggest that an indirect value added tax is a possible substitute for income taxation, but prospects are not promising. An inherent problem is that value added taxes are regressive and require compensating payments to the low-paid and to beneficiaries. A value added tax that collected anything like an income tax would require compensating payments that would reach to middle income levels. Most modern states regard the fraction of their citizens who are in receipt of benefits as already too high. People would not welcome an increase.

A practical problem with value added taxes is that, apart from New Zealand, no country has managed to enact a value added tax that is even close to comprehensive. Special interest groups and people concerned about regressivity typically combine to force Parliaments to insert all sorts of exemptions. So long as value added tax rates remain reasonably low an economy can perhaps tolerate a non-comprehensive value added tax. But a value added tax that is set at a rate high enough to replace the typical modern income tax would be very distorting. The conditions[67] that allowed New Zealand to introduce a comprehensive value added tax in 1985 are not likely to be duplicated elsewhere. As a result, states are likely to continue to settle for value added taxes at sub-optimal rates that operate in partnership with income taxes and not as replacements for income taxes.

Another problem is the special position of the United States of America. When we speak of major international tax reform that most countries will follow we are in effect speaking of a movement that America would have to lead, or at least join, but for a number of reasons America may be less inclined or able to engage in fundamental reform than may other countries. Tax is a problem for everyone, but because America has managed to keep its taxes to a lower fraction of gross domestic product than have other countries tax is not quite as serious a problem to America as it is to the rest of us.

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[66] *The Structure and Reform of Direct Taxation,* (1978) the Report of a Committee under the Chairmanship of James Meade, Institute for Fiscal Studies/George Allen & Unwin.

[67] Coincidence of: response to a fiscal crisis; steep reduction in income tax rates; numerous other regulatory reforms; unicameral legislature; single state; relatively homogeneous population.

A further factor is that America is a federal country, which makes tax reform more difficult than for some of us. Moreover, there is §9(4) of the United States Constitution. It reads:

> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

In 1895, the Supreme Court held in *Pollock v Farmers' Loan and Trust Co*[68] that §9(4) prohibited Congress from enacting an income tax. The reasons were that an income tax is a direct tax and it is not a tax that one can apportion over the states on a population basis. In 1913, the Sixteenth Amendment reversed the *Farmers' Loan* case with these words:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

On the face of it, §9(4) still prohibits a direct tax on expenditure as opposed to income, though this prohibition has not inhibited tax reformers from proposing to replace conventional income tax with something along the lines of Kaldor's suggestions. For instance, in 1995 Senators Nunn, Kerrey and Domenici sponsored a bill for the "USA" or "unlimited savings allowance",[69] essentially a Kaldor measure that would have taxed expenditure only, using a graduated scale. There is also Hall and Rabushka's "flat tax" proposal,[70] for a cleverly-modified value added tax that, despite its name, achieves rate progression at low incomes. The flat tax has found supporters in the former presidential candidate Steve Forbes[71] and Congressman Dick Armey.[72]

American scholars debate whether the Sixteenth Amendment would authorise these or similar taxes. In a lengthy and thoughtful article,[73] Jensen argues that it would not, because such taxes are both direct and unapportioned, but they are not taxes on income. Others reply that they are taxes

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[68] 157 US 429 (1895), 158 US 601 (1895).

[69] USA Tax Act of 1995, S. 722, 104th Congress.

[70] R.E. Hall and A. Rabushka, *The Flat Tax* (2nd ed 1995) Hoover Institution Press, Stanford.

[71] E. Tollerson, "Bowing Out: Forbes Quits and Offers his Support to Dole", *New York Times*, 15 March 1996, at A26.

[72] Freedom and Fairness Restoration Act of 1995, HR 2060 and S. 1050, 104th Congress (sponsored by Representative Armey and Senators Shelby, Craig, and Helms.

[73] E.M. Jensen, "The Apportionment of 'Direct Taxes': Are Consumption Taxes Constitutional?"(1997) 97 *Columbia Law Review* 2334. The author is indebted to Jensen's article for the references in these paragraphs to discussion on Article 9(4) and the Sixteenth Amendment.

on income, for such reasons as that people would use their income to pay the taxes.[74] Another argument is that the taxes may not be taxes on *all* income, but they are taxes *some* of it, that is, on the portion of taxpayers' income that they spend.[75] One scholar goes so far as to say that the Constitution more or less leaves it up to the Congress to define what it means by "income".[76] Even Jensen agrees that it is most unlikely that a court would strike down a Federal tax on the basis of unconstitutionality.[77] Instead, he implies that conscientious legislators should not enact such taxes.[78]

This summary of current American opinion[79] as to the taxing power of the Congress suggests that constitutional factors would be likely to constitute no more than a mildly inhibiting element if it were a matter of enacting an expenditure tax. Practically speaking, what is more serious is that proposals for major tax reform seem to make little progress in the United States. It is hard to think that a jurisdiction that still hews to the classical system of company taxation is ready for radical reforms.

A third reason to think that Parsons's prediction of the near-imminent demise of income tax will not come to pass is a question of point of view. Most of us who study income tax from a legal perspective tend to focus on the taxation of businesses, because that is the most interesting part of income tax and that is where most of the problems lie. But we must not forget that most income tax is paid on wages and salaries and on passive income, with very little practical difficulty. Ectopia chiefly affects business income, which produces a significant but not overwhelming fraction of tax receipts. Are the problems of taxing business income enough to persuade the modern state to undertake the upheaval of changing its tax system?

Fourthly, tax departments have a bad press, so that we tend to underestimate the very significant advances that they have made in the last twenty years or so. Increasing use of self-assessment and increasing computerisation together mean that

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[74] L. Zelenak, "Radical Tax Reform, the Constitution, and the Conscientious Legislator", (1999) *Columbia Law Review* 833, 851.

[75] Id, 847 ff. The text is a perhaps over-simplified paraphrase of Professor Zelenak's closely constructed arguments.

[76] M.E. Kornhauser, "The Constitutional Meaning of Income and the Income Taxation of Gifts (1992) 25 *Connecticut Law Review* 1, 24.

[77] Jensen, supra n 59, 2414.

[78] Id, 2419.

[79] The author thanks Hugh Ault, Professor of Law, Boston College, Massachusetts, currently of the OECD, Paris, for help with materials on matters relevant to the United States constitution.

tax commissioners can undertake more auditing with fewer resources, thus counteracting some of the shortcomings of the tax base, at least from the point of view of the state, if not of the business taxpayer.

Fifthly, the very availability of computers enables tax law to take measures to minimise at least some of the effects of ectopia. For instance, the New Zealand financial transactions rules require taxpayers to calculate income according to yield to maturity formulas.[80] This regime thus brings the relevant tax law much closer to the economic facts to which it relates. Practically speaking, that development could not have occurred without people having computers for the calculations, or at least programmable calculators.

Finally, may I advance a hypothesis. This hypothesis is that transitional and political difficulties may mean that it is in practice impossible to change one major tax for another. At any rate, no one has done it yet. For this purpose, I am not sure how I should define a "major tax": perhaps a tax that collects more than twenty per cent of gross domestic product.

It is true that countries have managed to change from one *minor* tax to another. In 1799 England changed from the Triple Assessment to the income tax. Australia has just changed from wholesale sales taxes to a value added tax.[81] But in 1799 neither the Triple Assessment nor the income tax had anything like the importance that income tax has today; and by the criterion that I have suggested neither the Australian wholesale sales taxes nor the new goods and services tax can be classed as a major tax in the sense in which I am using the term. In Australia, income tax, the real workhorse, has kept going in the background.

It may be possible that two potentially major taxes can co-exist and that Parliament can steadily increase the rate of the new tax and reduce the rate of the old tax until the old tax is gone. That might be a theoretical strategy for moving from an income tax, if there were a suitable candidate to be the new tax. But a switch from income tax to expenditure tax cannot be achieved gradually. The two taxes could not apply at the same time to the same taxpayer. It's all or nothing. Practically speaking, "all" may not be a possibility.

Conclusion

The conclusion may be shortly stated. First, Professor Ross Parsons was correct that income tax law suffers from

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[80] Income Tax Act 1994, subpart EH.

[81] A New Tax System (Goods and Services Tax Imposition – General) Act 1999 (Cth).

congenital defects. On the other hand, he was wrong in his opinion that these defects came from adopting as its core element the concept of income of trust law. True, the idea of income is the same in both branches of the law, but that is because the Australian/United Kingdom common law has but a single concept of income.

Thirdly, the source of the concept of income is in a sense not relevant, in that inherent in any income tax is a concept of income that cannot avoid being flawed. The reason is that, unlike most law, tax law cannot avoid being separated from its factual subject.

Fourthly, the separation, or ectopia, from which income tax law suffers has as one of its symptoms a number of concepts that are similar to legal fictions, but that are more fundamental to the law than are legal fictions as ordinarily understood.

Fifthly, the ectopia of income tax law offers an explanation for a number of the more puzzling aspects of this branch of the law, including its complexity and its incoherence. These same factors may justify states in adopting general, open-ended anti-avoidance rules, despite the erosion of the rule of law that seems characteristic of such rules.

Bearing these factors in mind, it is unsurprising that Professor Parsons was pessimistic about the future of income tax law and foresaw its demise. Nevertheless, Parsons may have given insufficient weight to exogenous factors. Even more pessimistically, we may predict that these factors will preserve income tax and that it will continue. Our pessimism may be tempered by the thought that however imperfect income tax is as a measure to gather revenue, as a subject of study it has never ending fascination.