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JURISPRUDENTIAL PERSPECTIVES OF TAXATION LAW

CASES AND MATERIALS

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Jurisprudential Perspectives of Taxation Law

Cases and Materials

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Volume I

Legal Philosophies

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1 What is jurisprudence about?

Jurisprudence is a ragbag. Into it are cast all kinds of general speculations about the law. What is it for? What does it achieve? Should we value it? How is it to be improved? Is it dispensable? Who makes it? Where do we find it? What is its relation to morality, to justice, to politics, to social practices, or to naked force? Should we obey it? Whom does it serve? These are the questions of which general jurisprudence is comprised. They can be ignored, but they will not go away.

In his daily round, the legal practitioner can usually push aside such questions together with the office cat. But now and then they will jump on his desk. Here is client Jones, storming in with some story about his neighbour's appalling behaviour.

—Yes, well, we might try to take out an injunction – though it's not certain that what he did amounts to what the law regards as a nuisance.

—Not certain! Can't you look it up?

—The law isn't something you just look up.

—What have you got all those books for then?

—They help ... anyway, we'll have to convince the county court judge that your neighbour was acting unreasonably.

—I know the judge. A sound man! He'll agree with me.

—But he's got to apply the law. It's not just a question of the particular judge – or, at least ... you may be sure that you're in the right, but we're not here concerned with questions of abstract justice.

—What sort of justice, then?

—Look, I don't think you'll be entitled to legal aid, so you must decide ...

—I know, the law's up for sale, unless some political do-gooder has decided you're poor enough to have it on a plate. You'll be asking me next: 'How much are your principles worth?' The law's supposed to protect people like me against people like him.

—No it isn't. It is supposed to do equal justice to all.

—But you just said ...

—This sort of discussion is all very well, Mr Jones, and outside office hours I'd be glad to pursue it. Right now, we have to decide on your best course of action.

—I know what I'm going to do. I'll let down the tyres on that great monstrosity he parks outside.

—You can't do that, it's illegal!

—Why should I be the only one to obey the law? Anyway, I can't see the police bothering with a thing like that and he's not likely to waste his time coming to see someone like you.

—That's not the point. Just because you think your neighbour has been antisocial, that's no reason for you to be it too.

—So now you're preaching!

It is sometimes said that the justification for teaching jurisprudence to law students is that it will make them better lawyers. I have disagreed with this view, at least so far as general jurisprudence is concerned. People acquire those technical skills of legal reasoning and legal argumentation which make up the concept of 'good lawyer' by immersing themselves in substantive legal subjects. Jurisprudence has to do, not with the lawyer's role as a technician, but with any need he may feel to give a good account of his life's work – either to fellow citizens, or to himself, or to any gods there be. What is it that is so special about legal reasoning as against any other kind of reasoning? (see chapter 15, below). Does the lawyer contribute to the maintenance of the rule of law? If so, is the rule of law such a worthwhile ideal anyway? (see chapter 11, below). Does the lawyer's role vary from one kind of society to another? (see chapter 19, below). Of course, any lawyer may rest his case at the bar of conscience on his technique alone, and assert that it requires no justification. I recently heard a New York lawyer interviewed about his practice in advising suspected Mafia families, and that is what he did: 'I just do a job, like a surgeon.' Is that enough? Surgeons might not be flattered.

My view about good lawyers being those who have acquired special skills may be old-fashioned. A 'progressive' law teacher would insist that awareness of the social implications of law is of the essence of proper legal training. Whether for his craft or for his well-being as an informed citizen, we can all agree that a lawyer should be familiar with the social dimensions of law. But what are they? What does it mean to say that a thing like 'law' has a 'social context'? (see chapter 18, below). It is commonly urged that the lawyer should not be too parochial. He should not assume that the law of the modern state is the only kind of law. Why not? (see chapter 17, below).

The won't-go-away questions are not and should not be the lawyer's preserve. Everyone has a right to ask whether the ideal of the

rule of law has value; whether there is any moral duty to obey the law (see chapter 16, below); whether the law ought to diminish our liberty for our own physical or moral good (see chapter 10, below); what it is, if anything, that justifies the institution of punishment (see chapter 5, below). 'Out of office hours', we all stand on the same (usually shakey) ground when we debate the merits of proposed legislation in terms of the public good (see chapter 4, below), or of justice (see chapter 20, below). By 'we' I mean lawyers and non-lawyers. It may be that moral and political philosophers are better informed. Jurisprudence has to entrench upon these disciplines at many points, as well as upon those of social and political theory. It is a scavenger, as well as a ragbag; having no perimeter to its field of inquiry, save that what is studied must have a bearing on some general speculation about law.

If jurisprudence has a heartland all its own, it is legal theory. Much discussion about the moral claims of the law, and the moral claims on the law, takes the concept of law itself for granted. Yet, answers to such questions may turn on what picture of law we have. Legal theory asks: What is the nature of law (everywhere, or just in the modern state)? Some would claim that this question deserves an answer in and for itself. For others, the question is important but subsidiary – when we have defined law, we can describe its functions and its values; or, we should choose between competing definitions of law by reference to the functions we believe it has or the values we wish it to serve. Writers make different assumptions about the proper relationship of legal theory to issues of legal philosophy – that is, between an investigation of the nature of law and a discussion of the value implications of law. For Bentham and Austin, law should be defined in terms of political facts, so that it may be laid bare for criticism in terms of utility (see chapter 3, below). For Hart, the diverse social functions of the law must be incorporated into our conception of law, so that any judgments we make about it are not deflected by a distorting mirror (see chapter 9, below). For Kelsen, pure information about legal prescriptions must be separated from intrusive value judgments of all kinds (see chapter 6, below). Despite the obscurities of his esoteric language, Kelsen is the true friend of the practitioner who wants to be called on to describe the law and nothing but the law *in office hours*. For the natural lawyers and for Fuller and for Dworkin – each in their very different ways – such a practitioner cannot be satisfied. What 'the law is' is so intimately connected with what, morally speaking, 'the law ought to be', that our picture of it must include some conception of moral truth (see chapters 2, 11 and 14, below). For the 'realist', all the pictures of law we have are illusions. We must reject them in the interests both of truth and of

proper shouldering of the burden of subjective valuations (see chapter 8, below).

I have expressed the controversial opinion that general jurisprudence is not a necessary part of the training of a lawyer *qua* lawyer – it being, as I think, concerned with the more important matter of the training of the lawyer *qua* citizen and of the citizen *qua* legal critic. 'Particular jurisprudence' may, however, bear more directly on the professional lawyer's concerns. General jurisprudence deals with speculations about the law; particular jurisprudence, with speculations about particular legal concepts. Every lawyer has from time to time to analyse terms of art appearing in legal materials. When is a concept employed in the law fit for jurisprudential analysis as distinct from ordinary legal elucidation? I suggest that no line is to be drawn. There is a continuum from very concrete questions – like, what does this word mean in the context of this statute? – to very general questions – like, what is the essence of a legal right? Roughly, particular jurisprudence concerns itself with terms which are common both to different systems of law and to different branches of law. 'Base fee' is not such a concept, not because it is not difficult, but because it is peculiar to the common law. 'Rape' is not such a concept, because though it appears in all systems, it is peculiar to criminal law. Particular jurisprudence fastens on terms which are inter-branch and inter-systemic – like right, duty, possession, person and so on. Opinions vary as to the value of such analyses for the practising lawyer, but they were certainly intended to assist him (see chapter 7, below).

The two concepts investigated by particular jurisprudence which have the best claim to the attention of the practising lawyer – as indeed to that of the political scientist – are those of 'precedent' and 'legislative intention'. All modern legal systems have to deal with statutory interpretation and have some notion of precedent. The investigation of the version of these concepts employed by any particular system turns out to involve a special mixture of constitutional and conceptual issues (see chapters 12 and 13, below). That will not be news to anyone who has followed recent controversies in the United Kingdom about the law on picketing, which have forced onto the television screen those hardy old questions, of what it means to 'give effect to Parliament's intention', or what it means to be 'bound' by a decision of the House of Lords.

All these questions, then, are what jurisprudence is about. Whether the word 'jurisprudence' is a good baggage label for them matters not at all. Sometimes this word is used as a heavy word for the study or knowledge of the law. There was a time when it was used in England to stand merely for the analysis of legal concepts. In French, 'la

jurisprudence' signifies what we call case law; and 'théorie générale du droit' covers much of the same ground as what is here called jurisprudence. I believe that use of 'jurisprudence' to stand for general speculations of all kinds about the law is now fairly common in modern English usage; that 'legal theory' is used to cover inquiries into the nature of law; and that 'legal philosophy' means that branch of practical philosophy which investigates the value implications of describing something as 'legal'. Whether labels matter when it comes to the word 'law' itself – a question which is highly controversial in the areas of 'primitive law' and 'living law' (see chapters 17 and 18, below) – it is surely the case that labels do not matter in assigning the proper fields for 'jurisprudence', 'legal theory' and 'legal philosophy'. It is the won't-go-away questions which count.

This book does not break up the subject according to a systematic plan. That would be impossible without prejudging crucial questions – such as whether 'the relations of law to morality' is a different question from 'the nature of law'. Some chapters deal with particular questions (like the duty to obey the law), some with topics involving clusters of questions (like statutory interpretation), some with schools of thought (like the historical school), and some with individual theorists. My object is to introduce the reader to a bill of fare. On controversial matters, I have tried to state both sides of a question leaving it to the reader to provide an answer; but one cannot always disguise one's own view. I hope at least to have exemplified how jurists argue so that, if he wants to, the reader can join in. Welcome to the feast.

1.1. Dias, RWM, "Introduction" from *Jurisprudence* (1985) 5th ed, Butterworths, London, 3 22

Introduction

'Jurisprudence was the first of the social sciences to be born', said Wurzel[1]. Its province has been determined and re-determined because the nature of the subject is such that no delineation of its scope can be regarded as final. On torts or contracts, for example, a student may be recommended to read any of the standard textbooks with the assurance that, whichever book he does read, he will derive much the same idea as to what the subject is about. With jurisprudence this is not so. Books called 'jurisprudence' vary so widely in subject matter and treatment that the answer to the question, what is 'jurisprudence'?, is that it means pretty much whatever anyone wants it to mean—a depressing start indeed. This kind of answer suggests that something is amiss with the question. It would be better to ask: How is this word used?, or more pertinently, What is this book going to do?

Use of the word 'jurisprudence'

The Latin expression, *juris prudentia*, means either 'knowledge of' or 'skill in law'. The Roman jurists, however, never developed any such subject as '*jurisprudentia*'[2]. In the sense of 'knowledge of law', the word sometimes describes expositions of particular branches of the law, eg the name 'Equity Jurisprudence' was once given to a textbook on Equity[3]. This use of the word, current on the Continent, is no longer fashionable in common law countries. In a wide sense 'jurisprudence' is used also to describe the legal connections of any body of knowledge: so 'Dental Jurisprudence', 'Architectural Jurisprudence' or 'Medical Jurisprudence' would be titles for expositions of such aspects of dentistry, architecture or medicine as may be important in law. Some criticisms of this use of the term are somewhat misconceived. There has been a tendency to suppose that the word 'jurisprudence' has, or should have, some 'proper' meaning, which makes it inapplicable to this kind of study[4]. As will appear, no word, least of all 'jurisprudence', has a 'proper' meaning. There is also the argument that such studies as these are not 'scientific'[5], which presupposes some special meaning of the word 'science'. The reason for avoiding a term like 'medical jurisprudence' is that this kind of expression is no longer current in English-speaking countries, although occasional instances may still be found[6]. It may be noted

1 Wurzel 'Methods of Juridical Thinking' in *Science of Legal Method: Select Essays*, p 289.

2 Ulpian's remark in the *Digest*, quoted in the opening of Justinian's *Institutes*, '*Juris prudentia est divinarum atque humanarum rerum notitia, justi atque injusti scientia*' (D 1.1.10.2; *Inst* 1.1.1: jurisprudence is the concept of things divine and human, knowledge of the just and the unjust), was only a piece of rhetoric not pursued by the Romans.

3 Ames *Equity Jurisprudence*. See the comments of Stone *The Province and Function of Law* p 26.

4 Holland *Jurisprudence* p 4, n 4.

5 Gray *The Nature and Sources of the Law* pp 134, 147.

6 The term 'medico-legal jurisprudence' has largely been superseded by 'forensic medicine'.

that in French law *la jurisprudence* is the term applied to the body of law built up by the decisions of particular courts[7].

In England it was not until the time of Bentham and his disciple Austin in the early part of the nineteenth century that the word began to acquire a technical significance among English lawyers[8]. The former distinguished between examination of the law as it is and as it ought to be ('expositorial' and 'censorial' jurisprudence), and he was also much concerned with law reform ('deontology'). The latter, who was the first Professor of Jurisprudence in the University of London, occupied himself with 'expository' jurisprudence, and his work consisted mainly of a formal analysis of the structure of English law. Analytical exposition of the type which Bentham pioneered, and Austin developed, has dominated English legal thought almost to the present. It was therefore inevitable that the word 'jurisprudence' came to mean in this country almost exclusively the analysis of the formal structure of law and its concepts. This was the nearest that the word came to bearing a precise meaning.

Towards the end of the nineteenth century changing human affairs had brought about an ever-increasing preoccupation with conflicting ideologies and troubled social conditions, which resulted in a decisive shift in outlook with the result that jurisprudence came to be envisaged in a broader sense than in Austin's day. Buckland described the change vividly. 'The analysis of legal concepts', he said[9], 'is what jurisprudence meant for the student in the days of my youth. In fact it meant Austin. He was a religion; today he seems to be regarded rather as a disease'. The breadth of the modern attitude is well summed up by Julius Stone who described jurisprudence as:

> 'The lawyer's extraversion. It is the lawyer's examination of the precepts, ideals, and techniques of the law in the light derived from present knowledge in disciplines other than the law'[10].

So vast a coverage may be summed up in the proposition that jurisprudential study nowadays concerns thought about law, its nature, function and functioning, on the broadest possible basis, and about its adaptation, improvement and reform. A convenient way of obtaining an idea of its compass is by explaining this description.

Thought about law

Writings on jurisprudence are not concerned with expositions *of* law, but with disquisitions *about* law[11]. Various branches of substantive law, for example, teach how rights and duties are acquired, whereas jurisprudence would investigate such questions as: What are rights and duties? How are they used? How do they work? It also improves the use of law by drawing together insights from different branches, criminal, constitutional etc, in the solution of problems. Thought about law is also a story of movements in outlook and ever-changing ideas, and developments are taking place in contemporary physical, moral and other social sciences, which make it difficult to decide once and for all how, if at all, these should be taken into account.

7 The equivalent of 'jurisprudence' in its Anglo-American sense is *Théorie générale du droit.*

8 For their work, see ch 16 post.

9 Buckland *Some Reflections on Jurisprudence* p 2.

10 Stone *Legal System and Lawyers' Reasonings* p 16.

11 King 'Propositions about Law' (1951) 11 CLJ 31.

'Thought about law' suggests that an important, if not essential, prelude to jurisprudential study should be some thought about thought. The overall aim is not to teach students what they need to know, but how to think profitably and for themselves, as well as to educate and equip them to be efficient lawyers. Thinking is inseparably bound up with the meaning and use of words. This is an aspect of philosophy, known as semantics, which is of especial interest to lawyers since, as Lord Macmillan said, 'The lawyer's business is with words. They are the raw material of his craft'[12]. Laws are articulated in language; logic is controlled by it. Some of the needless difficulties that have arisen in jurisprudence are of linguistic origin. This is because words are not only tools of thought, but also control it; people tend to think in terms of their language structure. Accordingly, learning how to think profitably will be assisted by a sharpened awareness of the possibilities of language, not only to lead thought but also to mislead it[13].

Linguistic precepts

In the first place, the idea that a word must necessarily possess some unique or 'proper' meaning should be abandoned. An explanation of this lies at the basis of a biological theory, known as 'autopoiesis', put forward by Professor Maturana, that no one can 'know' what the world outside him or her 'really' is, for what each person 'knows' is the response of his or her nervous system to external stimuli[14]. This is not a denial of objective reality, but an assertion that no one can ever know what this is outside his or her neuronal response to it. Perception is thus a matter of personal interpretation. Equally, the meaning of a word depends on individual past experience of the contexts in which it is used, its applications as well as its non-applications. Another reason for rejecting 'proper' meanings is that the same 'thing' may be referred to by different words for different purposes, eg the same act may be called trespass to goods or theft or malicious damage in different contexts. The meaning of a word also depends upon how it is used in the context, so its function in the proposition as a whole should be considered[15]. The sense is often lost as soon as one attempts to elucidate the thing referred to, ie the referent. For instance, in the statement 'England expects every man to do his duty', it is useless to elucidate 'England' by reducing it to its referents. The sense here depends, not on the thing or things referred to, but on the function which the word performs in that sentence. The nuances of meaning imparted by context can be illustrated by taking a question and answer by, say, a husband and wife, 'where are you?' and her reply, 'I am here'. If this answer is understood referentially, it is unhelpful, for at the moment of speaking she could only be 'here' on that spot. However, against the background of her husband's knowledge of the geography of the house and the direction from which her voice comes, the answer could mean 'I am in the

12 Macmillan *Law and Other Things* p 31.

13 For a different statement of methodological and other errors, see Summers 'Legal Philosophy Today—an Introduction' in *Essays in Legal Philosophy* (ed Summers) pp 7 et seq.

14 See *Autopoiesis, Communication and Society* (a symposium, edited by Benseler, Hejl and Köck) in which there are papers by Maturana and others and references.

15 'The meaning of a word is its use in the language': Wittgenstein *Philosophical Investigations* p 43. For an application of this technique to the elucidation of legal terms, see Hart 'Definition and Theory in Jurisprudence' (1954) 70 LQR 37, especially his elucidation of 'right' at 49. For criticism, see Auerbach 'On Professor Hart's Definition and Theory in Jurisprudence' (1956) 9 Journal of Legal Education 39.

drawing room', or kitchen etc. If she were to announce 'I am here' as soon as she enters the front door after shopping, the function of the statement is not to indicate where she is (her husband knows that), but the completion of the shopping activity and her return. If the baby wakes up crying and she says 'I am here', the function is not to indicate location or completion of an activity, but reassurance (mother is at hand). Similarly, it is futile to elucidate the meaning of 'jurisprudence' by applying reductive analysis; it needs to be understood in the light of how it is used. All this does not deny that words are frequently used to refer to 'things'. Thus, a word may refer to a particular phenomenon as perceived by the user, eg the 'Mona Lisa'; or a class of things, eg 'pencil'; or an inference from a totality of factors, eg 'negligence'.

Secondly, if meaning and experience rest on individual interpretation, it follows that concerted activities can only take place within areas of similar interpretations, 'consensual domains'. It is in such areas that law, morals, ethics etc operate. Likewise, communication takes place within the consensual domain of the 'usual' meaning of words. It is generally accepted that words have an inner 'core' of settled applications surrounded by a 'fringe' of unsettled applications. Problems of interpretation arise in this 'fringe' area. Words may also have more than one usual meaning, in which case the context has to resolve which meaning is being considered, eg 'race', 'capital'. As will be seen later, words such as 'person', 'possession' and even such common legal terms as 'right' and 'duty' are of this type. An American judge has remarked that 'a good deal of warfare has its origin in the confusion that arises when a single term of broad and ill-defined content is made to do duty for two or more ideas'[16]. When a word has undergone shifts in meaning in this way, it is fruitless to speculate about the 'essence' that underlies the shifts; each shift should be elucidated on its own. Equally pointless would it be to condemn one or other application as 'improper'.

Thirdly, however useful it may be in the elucidation of words, especially abstract words, to ask how they are used, this should not imply that reductive analysis is totally valueless. In a good many kinds of discourse it will prove most helpful to identify as closely as possible the 'things' that are being referred to. This may conveniently be done with the aid of such questions as Who? What? When? Where? For instance, people argue at length about 'the class struggle', but discussion of this only becomes meaningful when it is reduced to a less abstract level. There have been many 'class struggles': who? about what? when? where? Corbin evinced a keen appreciation of the point when he said:

> 'It helps us to realize that acts are always individual; that pain and pleasure, emotions and desires, are always individual; that rules of law are made for individuals and that human and social welfare is, in the last analysis, always individual welfare. Labour is not in conflict with capital; but a labourer with no capital may fight a labourer with capital. "Interests of personality" do not conflict with "interests of property", because only *persons* have interests either factual or jural.... A state, a corporation, a group, a union, can act and can be affected only through individuals. Societal evolution can take place only by the evolution of individuals. Socialism is always some form of individualism, some combination of individual relations'[17].

16 Cardozo *The Growth of the Law* p 30.

17 Corbin 'Jural Relations and their Classification' (1920-21) 30 Yale LJ at p 227 n 2.

Because reductive analysis will not succeed with *all* statements (eg 'England expects every man to do his duty'), it is wrong to imagine that it cannot apply usefully to *some* statements. The method is unquestionably an aid to precision and a valuable corrective to sloppy thinking in terms of slogans. The two methods of elucidation, the functional and reductive, are not mutually exclusive; both are helpful.

Fourthly, some words carry an emotive element which lends illegitimate weight to a statement. Words like 'science', 'law', 'right', are heavily loaded in this way. Indeed, the word 'jurisprudence' is itself an 'imposing quadrisyllable', which, it has been said, 'is constantly introduced into a phrase on grounds of euphony alone'[18].

Fifthly, language has different functions. The most usual is communication, which requires a speaker or writer, a medium of communication and a listener or reader. Each party has a part to play. The speaker or writer should so choose a term that it is likely to be interpreted in the way he wants[19]. 'When I use a word, it means just what I choose it to mean, neither more nor less'[20] is a cavalier and unhelpful attitude unless the author clearly indicates beforehand the special meaning that he attaches to the word. The listener or reader should do his best to understand the word in the intended sense[1], and in this respect the great lesson is that of restraint in criticism. No one should criticise another for something he did not mean. Having understood, it may be proper to point out that his language is misleading, or that what he says is misconceived, or that he does not go far enough; and if indeed he is obscure, suggestions might even be made as to what he might have meant. Subject to this, it is always necessary, as Julius Stone remarked, to 'speak as faithfully as we can *with his voice before we chide him with ours*'[2].

Apart from communication, language is also used performatively, ie to accomplish results[3]. For example, the utterance 'I pronounce you man and wife', is not a communication or a report. It does not state the fact that a couple *are* man and wife, but that they *are to be* man and wife; it constitutes a new state of affairs. This function is closely connected with institutions and procedures. Thus, it is only a clergyman acting officially who can effectively pronounce two persons to be man and wife.

Sixthly, generalisation beyond the field of study should be made with care. As will appear later, some theories of law, though providing valuable insights, are spoiled by over-generalisation.

Seventhly, 'facts' should be distinguished from 'statements of facts'. Some non-verbal thing or event can be the basis of different statements of fact at varying levels of generality. For example, A drove his Rolls Royce car at 30 mph at 2 pm last Wednesday through Piccadilly Circus, knocked down B and broke his right leg. Assuming that this event occurred, the above would be a statement of those facts. It is possible, however, to restate them at a higher level of abstraction thus: a person drove a vehicle negligently on the

18 Holland *The Elements of Jurisprudence* p 4.

19 For a failure to communicate, see *J McGrath Motors (Canberra) Pty v Applebee* (1964) 110 CLR 656.

20 Humpty Dumpty in *Alice Through the Looking Glass* ch 6. For a judicial comment, see Lord Atkin in *Liversidge v Anderson* [1942] AC 206 at 245, [1941] 3 All ER 338 at 361.

1 Cf Lord Reid's protest in *Mutual Life and Citizens' Assurance Co Ltd v Evatt* [1971] AC 793 at 813, [1971] 1 All ER 150 at 164.

2 Stone *Legal System and Lawyers' Reasonings* p 2.

3 JL Austin *How to Do Things with Words.*

highway and inflicted physical injury on another person. At still higher levels of abstractness the following statements might be made: inflicting physical damage negligently on another; or, inflicting damage negligently on another; or, inflicting damage on another. In trial courts 'establishing facts by evidence' is to make statements at the lowest possible, or at least a very low, level of generality; but the concern of lawyers is not confined to this. As will be seen in Chapter 7, the possibility of formulating different statements of fact based on the same event is a clue to understanding the *ratio decidendi*, or principle, of a judicial decision. It also explains how an appellate court, while accepting the findings of the trial court, may nevertheless substitute a different opinion of them[4].

Finally, in so far as statements are capable of being checked at all, they may be checked with a view to establishing either their truth-value (verification) or their admissibility for consideration[5]. It is obvious that the criterion of checking has to lie outside the statement which is being checked, and that this criterion should never be twisted to suit the statement. Some statements may be both checked and verified, eg that a man named A drove his Rolls Royce car at 30 mph at 2 pm last Wednesday through Piccadilly Circus and ran into and injured a man named B. The statement, eg that A drove his car negligently, cannot be verified, since 'negligence' is an inference and a matter of opinion. It may, however, still be checked in order to see whether it is an admissible 'statement of fact' based on that occurrence; which it clearly is. By contrast, the statement that A caused a flood in Piccadilly Circus at 2 pm last Wednesday is inadmissible. It is evident, therefore, that the range of possible statements of fact, though wide, is not unlimited, and that there is a point beyond which they cannot go. With regard to law, propositions of law are incapable of being checked, proved or disproved, eg you ought not to steal. Propositions *about* law, on the other hand, may or may not be checkable. Thus, the statement that judges use the proposition, 'You ought not to steal', in deciding a certain type of case may be checked and verified; but neither the statement that the payment of £50 for pulling the communication cord in a train without cause is a penalty, nor the statement that such payment is only a tax on the indulgence of this pleasure[6] is capable of verification. Both are admissible; which is to be preferred has to be determined with reference to their respective utility for lawyers, and this depends on conformity with the whole background of legal doctrine and way of thinking.

In addition to these linguistic preliminaries, another aspect of thought concerns the methods of reasoning that are used and on which any discipline depends. Gray once said 'The real relation of Jurisprudence to Law depends not upon *what* Law is treated, but *how* Law is treated'[7]. Relationships, however, are seen only by the mind and Gray's use of the word 'real' is a slightly tendentious utilisation of its emotive loading. Had he spoken of the relationship which appealed to him there would be no objection. It would have been

4 Eg *Benmax v Austin Motor Co Ltd* [1955] AC 370, [1955] 1 All ER 326; *Wheat v E Lacon & Co Ltd* [1966] AC 552, [1966] 1 All ER 582; *The Wagon Mound (No 2)* [1967] 1 AC 617, [1966] 2 All ER 709.

5 See generally Waismann 'Verifiability' in *Logic and Language I* (ed Flew) ch 7 (reprinted from *Proceedings of the Aristotelian Society* Supplement 1945). Cf Popper's test of 'falsifiability': *Poverty of Historicism*. Is the statement 'Black ravens exist' falsifiable? If not, has it no meaning?

6 Holmes 'The Path of the Law' in *Collected Papers* p 173, and see p 449 post.

7 Gray *The Nature and Sources of the Law* p 147.

better had he said that this relation depends *not so much* upon what law is treated, but how it is treated, for obviously there must be some material for treatment. The main idea, however, is acceptable.

One method of treating the subject might be called the method of logical analysis which is *a priori* and demonstrative, ie breaking down a given hypothesis into its components and implications. Alternatively, there is what may be called the method of synthesis, which is constructive and empirical, ie unifying the data into a coherent whole. There is no question of one being more correct than the other, or indeed of their being kept sharply distinct. They are both useful as well as interdependent. The only point is which of them should predominate; which is a matter of preference.

The method of logical analysis starts with a given concept as embodied in a definition and proceeds to unfold its implications. The pattern into which the material falls is implicit in the definition. The chief points are:

(a) The power and penetration of the demonstration depends on the organising power of the concept.
(b) Definition is always an abstraction, that is, it is selective and does not include everything. It thus represents a model, an approximation, or a hypothetical framework[8].
(c) Emphasis is laid on the logical implications of the premise, that is, on the validity of the inference rather than on its truth-value or desirability. *A priorists* tend, as a rule, to scorn empiricism.
(d) A new concept may well be thought-provoking and offer some new way of looking at the subject.
(e) It may have persuasive force and ultimately mould practice.
(f) Logical thinking is a valuable mental training.

This method is not so much a training in thinking for oneself as thinking along a line determined by another. It may well happen that a particular way of looking at law will lead to one answer only of a problem which might with equal plausibility be resolved in some other way. It is important that each person should be left to decide such a point for himself. As Pollock once put it: 'A definition has no business to prejudge the question how far that is the case'[9]. For example, a much disputed question is whether international law is 'law'. Austin, who thought of 'law' as the sum-total of laws and defined 'a law' as the command of a sovereign supported by sanction, logically refused to apply the word 'law' to international law[10]. No harm is done as long as it is realised that this is only the logical result of *his* use of the word 'law'. What is important is that each should decide for himself and not blindly follow in the footsteps of Austin. There are many ways of defining 'law', some of which would include international law.

Secondly, logical manipulation will only reveal what has been put into a premise. The interesting part is the analysis on which it is based. Definitions, said Julius Stone, are 'essentially mnemonics for clarification. They may be preambulatory mnemonics foreshadowing elucidation to follow, or summation mnemonics recalling what has already been expounded. In either case "definition" cannot fruitfully be more definite nor more definitive than

8 Cf Stone *Legal System and Lawyers' Reasonings* pp 53, 55, and generally ch 5.
9 Pollock *A First Book of Jurisprudence* p 29.
10 See ch 22, post.

the exposition which it calls to mind'[11]. What is important is to know why certain ideas and not others were chosen and linked as they are in a definition[12].

Thirdly, obsession with a particular definition is misplaced, for there is no one proper or even supremely useful definition. Different definitions are useful for different purposes and for looking at the subject matter from different points of view[13]. Thus, definitions of law with reference to structure or function or development are all useful; and a definition may reflect the point of view of a legislator, judge, practitioner, jurist, sociologist, moralist or wrongdoer.

Fourthly, every definition is only an approximation to the detail of its subject matter. It is thus useful as a pointer to it and as clarifying the proposed use of a term by the definer. A lawyer will find a definition valuable if its logical implications correspond with the actual ways in which judges and lawyers think and act in deciding disputes. Insofar as the logical analysis of a definition fails to correspond in this way, it is misleading. 'The first call of a theory of law', said Holmes J, 'is that it should fit the facts'[14]. Not all the implications of a definition of 'law' have ever corresponded with the actual language and behaviour of lawyers because, to quote Holmes J again, 'The life of the law has not been logic: it has been experience'[15]. The result is that the method of logical analysis has tended to produce a cleavage between 'jurisprudential thinking' and 'lawyers' thinking', which is unfortunate since efforts should be made towards bridging the gulf that regrettably exists between jurisprudents and practitioners[16].

Fifthly, as to the thought-provoking and persuasive force of definitions, it is submitted that while there is some truth in this, it can be over-estimated. The thought-provoking potentialities have hitherto consisted mostly in evoking critical responses, while the persuasive possibilities would require an unattainable measure of agreement among jurists before there can be any hope of practical achievement[17]. 'In fact', said Sir Ivor Jennings, 'the task which many writers on jurisprudence attempt to fulfil in defining law is a futile one'[18]. Besides, laws develop according to needs, not the logical implications of definitions.

Finally, while nothing should be allowed to impair the value of deductive analysis as a mental discipline, it has to be pointed out that it is not the only one. The alternative constructive or empirical method of synthesis is no less worthy a discipline, about which something must now be said.

This is concerned with the evolution of a concept. Before its logical implications can be worked out, it must have been evolved in some way, which suggests that the constructive process has to precede the demonstrative.

11 Stone *Legal System and Lawyers' Reasonings* p 184; and earlier Dias 'The Mechanism of Definition as Applied to International Law' [1954] CLJ at 218-219.

12 As Kantorowicz explains throughout his book *The Definition of Law*.

13 For an amusing example of the definer and definee being at cross purposes, see Buckland *A Manual of Roman Private Law* p xii.

14 Holmes *The Common Law* p 211. See also Stone *Legal System and Lawyers' Reasonings* p 58.

15 *Holmes* p 1.

16 Cf Dicey: 'Jurisprudence is a word which stinks in the nostrils of the practising barrister', quoted in Gray *The Nature and Sources of the Law* p 2.

17 Stone *Legal System and Lawyers' Reasonings* pp 167 et seq, for reasons why no definition is likely to win wide acceptance.

18 'The Institutional Theory' in *Modern Theories of Law* (ed Jennings) p 83; *Jilani v Government of Punjab* Pak LD (1972) SC 139 at 159.

> 'The definition of a concept must precede, not the investigation of the question, but its presentation, if you wish to avoid discussing alien objects under the cover of an ambiguous word'[19].

The statement expresses the point that every definition is the product of some prior investigation.

The greater part of this book will be concerned with the kind of analysis that could serve as the prelude to the formulation of refined and elaborate definitions rather than with any particular definition. Where, then, should such a study begin? The prior investigation, which precedes the formulation of a definition, requires that the material to be examined should first be identified in some rough, provisional way. The constructive method, therefore, does not claim to dispense with all preconceptions. The point is that these should be both minimal and provisional. The matter was well put as follows:

> 'While it is true that all observation is in terms of a conceptual scheme, this does not mean that one must have a fully worked out theory in order to do any observation at all'[20].

After the material has been identified, the study may proceed in any direction and progress can be achieved by formulating tentative hypotheses, the logical implications of which may be checked as to accuracy and admissibility, as explained earlier. A 'hypothesis' here means a provisional theory or basis of explanation. No hypothesis can be evolved out of nothing. It presupposes prior knowledge of the problem presented by the material; the deeper the knowledge, the more fruitful the hypothesis. Huntingdon Cairns explained it as follows:

> 'The general pattern of the inventive process as it has been developed by psychological experiment and analysis is, first, awareness of a need, second, reflection upon the need, third, a sudden illumination, and, finally, painstaking efforts to perfect the insight. All the steps appear essential, but none more so than the demand for previous acquaintance with the subject matter'[1].

Consistently with the foregoing, two kinds of definitions can be distinguished. The first consists of those which merely identify the material for the purpose of examination. The second consists of those which organise the completed study and precede the logical unfolding of the patterns implicit in them, in short, they indicate the sense which the definers impose on their terminology. The latter are more refined than the former, and reflect the purposes and points of view of the definers. Definitions of both types are found in Kantorowicz's book, *The Definition of Law*, in which he begins with a rough definition, as he says, 'provisionally and with intentional vagueness, as an example of what will be in our minds when speaking of law before arriving at a formal definition'; and he then proceeds to refine it into a final definition at the end[2].

A convenient starting point would be to identify legal material by taking

19 Kantorowicz and Patterson 'Legal Science—a Summary of its Methodology' (1928) 28 Columbia Law Review 679 at 681n.

20 Sheldon 'Some Observations on Theory in Social Science' in *Towards a General Theory of Action* (eds Parsons and Shils) 36.

1 Cairns *The Theory of Legal Science* 58, 130; cf M R Cohen 'Law and the Scientific Method' in *Jurisprudence in Action*, p 125.

2 Kantorowicz *The Definition of Law* pp 12, 79.

the applications of the word 'law' by courts. Professor Olivecrona adopts a similar approach. 'The study cannot begin with a definition of law', he says:

> 'It is impossible to start from a definition since this would mean a *petitio principii*. Before a definition can be reached, the facts must be analysed: The method will be simply to take up such facts as are covered by the expression rules of law. No assumption is made from the beginning concerning their nature. We only use the word "law" so to say as a stick to point to the object of the investigation'[3].

An idea such as this is not precise, but it serves as a provisional means of identifying legal material. Mere identification gives no indication of its nature and prejudges no issues. It only furnishes a starting point with minimal preconceptions and is, above all, provisional and open to refinement. It will certainly bring in the 'core' of agreed applications of the word 'law' without prejudice to 'fringe' meanings, eg international law[4].

The courts have been selected as the focal point because they are observable facts and because much of a lawyer's business centres on them[5]. Whatever the angle of vision, they remain an inescapable landmark. Legislators, jurists and villains are all concerned with them in different ways, whether in trying to control, explain or circumvent their probable reactions. As Professor Cross has observed, this 'is an excellent point of departure for a discussion of the major problems of analytical jurisprudence'[6]. An objection might be advanced that some 'law' must have established courts in the first place, which would prevent 'legal material' being identified as what courts accept. The answer is that this only indicates that in the very beginning a different means of identifying 'legal material' would have been required; it does not prevent it from being so identified *now*.

The courts of every country accept some medium, or media, as capable of imparting the quality of 'law' to propositions. The usual designation for such medium is 'criterion (criteria) of validity' because if a proposition has filtered through it, then it is a valid proposition of law; if it has not done so, it is not a valid proposition of law[7]. In Great Britain the label 'English law' is

3 Olivecrona *Law as Fact* (1939) pp 25–26; elaborated in the second edn (1971) pp 1–5, 84–85. Cf Lawson *The Rational Strength of English Law* p 7. It is also to be noted that nowhere in Stone's original treatise, *The Province and Function of Law*, was there a definition of 'law', and after nearly twenty years of reflection he still did not see the need for one: *Legal System and Lawyers' Reasonings*, pp 184–185. So, too, Jennings 'The Institutional Theory' in *Modern Theories of Law* (ed Jennings) p 83.

4 Some argue that a definition of 'a law' should follow on a concept of 'legal system', eg Raz *The Concept of a Legal System* p 2. Perhaps so, but to identify material for study is not to define 'a law'.

5 'Law is basic to orderly society and courts are basic to law': per Salahuddin Ahmed J, in *Jilani v Government of Punjab* Pak LD (1972) SC 139 at 267. For a discussion of 'court' and 'judicial office', see *United Engineering Workers Union v Devanayagam* [1968] AC 356, [1967] 2 All ER 367.

6 Cross *Precedent in English Law* p 151. See also Raz 'The Institutional Nature of Law' (1975) 38 MLR 489.

7 In Roman law, for example, the remuneration, *honorarium*, for services rendered under a contract of mandate was never embodied in any of the law-constitutive media of that system, which is why mandate remained theoretically gratuitous, the *honorarium* being 'extra-legal' and recoverable by procedure *extra ordinem*.

regulated by legislation[8], judicial precedents[9], immemorial customs[10] and after Britain's accession to the European Economic Community its Regulations and Decisions. A caution has to be observed here. The mere fact that a proposition is embodied, or even applied, in a judgment does not *ipso facto* make it 'law'; it has to be enunciated and applied as such. Thus, judges constantly employ rules of arithmetic, but these do not thereby become 'English law' since they are not being applied as such[11].

The expression 'source of law' is sometimes used in this connection. 'Source' has more than one meaning. It may refer to the source of information of a rule (eg a textbook), or the origin of the material content of a rule, or the formal stamp of authority as 'law'. It is the last sense which is relevant in identifying legal material. Failure to bear the distinctions in mind, especially between the second and third meanings, introduces an element of confusion[12].

Discussion of thinking processes would be incomplete without allusion to the special kinds of reasoning involved in the judicial process. In addition to

8 'What the statute itself enacts cannot be unlawful, because what the statute says and provides is itself the law, and the highest form of law that is known to this country. It is the law which prevails over every other form of law, and it is not for the court to say that a parliamentary enactment, the highest law in this country, is illegal': per Ungoed-Thomas J in *Cheney v Conn* [1968] 1 All ER 779 at 782. It might be remarked that some natural lawyers would disagree, for they would want the courts to add the moral quality of the content to the mere fact of enactment as the criterion of validity. This will be discussed later in ch 4 and at pp 500–501. Further, statutes do not become 'law' only when judges apply them; they are applied because they are 'law' on enactment; cf Gray *The Nature and Sources of the Law* pp 125, 170–172, and pp 449, 452–453 post.

9 Cardozo CJ referred to precedent as 'the process by which forms of conduct are stamped in the judicial mint as law, and thereafter circulate freely as part of the coinage of the realm': *The Growth of the Law* p 32. See also M R Cohen: 'It is only when courts, balancing considerations of justice and policy, decide to enforce a moral or political rule that they transform it into a legal rule': 'The Process of Judicial Legislation' (1914) 48 Am LR at 170. As an example may be cited the duty of care towards rescuers, which was a rule of American law summarised by Professor Goodhart as a correct statement of what should also be English law, but which only became a rule of English law when the Court of Appeal adopted Goodhart's statement: *Haynes v Harwood* [1935] 1 KB 146 at 157.

10 By convention the writings of certain ancient jurists, the latest of whom is probably Foster, 1762, can also be quoted as 'English law', but only as 'law' at their respective periods. Lord Denning MR once remarked that in certain types of matters 'the opinion and practice of the profession certainly makes law': *R v Industrial Injuries Comr, ex p Amalgamated Engineering Union* [1966] 2 QB 21 at 28, [1966] 1 All ER 97 at 99. This should not be understood literally, but as referring only to a rule of practice.

11 Eg in *Askinex Ltd v Green* [1969] 1 QB 272 at 285, [1967] 1 All ER 65 at 71, Lord Denning MR added an appendix to his judgment working out the calculations involved in terms of mathematical formulae.

12 Noted by Pound, 'Judge Holmes's Contribution to the Science of Law' (1920–21) 34 Harv LR 449 at 452–453. Salmond in the 7th edn of his *Jurisprudence* (the last by himself) distinguished between 'formal' sources, the will and power of the state, and 'material' sources, relating to the rule itself. The latter were sub-divided into 'legal' sources, chiefly legislation, precedent, custom and 'agreement'; and 'historical' sources, those which become 'law' when filtered through a 'legal' source. The first distinction has been dropped by editors since the 10th edn (see p 530 for reasons). Allen rejected the second distinction between 'legal' and 'historical' sources arguing that the gist of the matter is whether a source will be applied: *Law in the Making* pp 271–272. Salmond's dismissal of 'historical' sources from consideration was too facile, but the difference between these and 'legal' sources is important in a way that Allen overlooks. A judge cannot ignore statute, precedent or custom, but he has a discretion whether or not to resort to historical sources. The latter work differently from 'legal' sources. See chs 2, 10 post, and see also the account in the 3rd edn of the present work, ch 2.

analysis and synthesis, use is frequently made of analogical reasoning and what, for want of a better term, might be called the 'logic of justification'. This is the interpretation and manipulation within permissible limits of the law so as to justify decisions which are thought to be right. All these place judicial reasoning in a class of its own and will be considered in Chapter 7.

Something should also be said about persuasion. When challenging highly abstract propositions, to call for supporting evidence is often asking the wrong question. With statements at a low level of abstraction whose referents are ascertainable, it is important to call for these as evidence. With high-level abstractions, however, which have lost touch with their referential bases, to call for evidence may be an effective way of scoring a debating point, but it is unfair. For instance, the assertion that 'every society has a shared morality' cannot be proved by evidence in the same way as the assertion that 'the Prime Minister inhabits No 10 Downing Street' can be proved. Whereas the acceptability of factual, or near-factual, statements depends on a balance of probability on the evidence, the acceptability of highly abstract statements depends on a 'balance of plausibility', persuasion not proof, to which the following considerations are relevant. First, is there any consideration which might defeat or reduce the plausibility of an argument? Reductive analysis in search of referents will sometimes help. The argument must not be both pro and contra, and it must be relevant, ie not used as a smoke-screen. Also, it will have different weightings according to the sympathies of the audience, which affect its plausibility. Secondly, with intuitive arguments the need is to persuade the other side of the acceptability of one's point of view. Thirdly, persons with no convictions either way on an issue may be persuaded by a balance of plausibility, but those with strong convictions one way have to be prised out of what is often an entrenched position. Here a balance of plausibility alone may not suffice since it has to combat, eg loyalty to a prior commitment, refusal to admit a change of opinion, fear of being thought liberal or illiberal, and similar reactions. In such situations it is often the case that the more persuasive an argument is, the stronger is the resistance to it; which is why debates of this kind seldom seem to 'get anywhere', and this is often the case with jurisprudential disputes.

Nature, function and functioning of law

The nature of legal material, laws and legal system is mainly the concern of this book. Suffice it to say here that law consists largely of 'ought' (normative) propositions prescribing how people ought to behave. The crucial distinction between these and the laws of science lies here. The substrata of scientific laws are the observable uniformities of nature out of which laws are derived. Legal laws express ideas as to hoped-for behaviour; the laws are not derived from the behaviour. Scientific laws, therefore, *describe* observable behaviour patterns of natural phenomena and are a basis for predicting how the phenomena will behave. The phenomena do not 'obey' the laws, and it is nonsensical to say that a scientific law is such and such, but that the phenomena do not conform to it. If they do not conform, the law is wrong and must be changed. There is thus exact correspondence between prediction and behaviour. Legal laws, on the other hand, *prescribe* how people

ought to behave.[13] It is not nonsense to say 'X ought not to steal' and also 'But X does steal'. A law is not 'wrong' because people disobey it. Therefore, prescription of behaviour and description of actual behaviour bear only a rough correspondence; the aim is to achieve as much correspondence as possible. The law also consists of material other than prescriptions and these will be dealt with in the next chapter.

The function of law connotes purpose. The 'oughts' of laws are variously dictated by social, moral, economic, political and other purposes. The overall purpose of law may be thought of as the achievement of justice, which will be considered in Chapter 4. The functioning of law concerns its working. On the one hand, there is the application of law in deciding disputes and by way of enforcement. The former involves consideration of the judicial process with all its institutional and conceptual apparatus. On the other hand, there is the extent to which laws are obeyed or disobeyed and the ways in which the behaviour of people diverges over long periods from the norms of the law. All these will be dealt with in various parts of the book.

Broadest possible basis

Law is a social institution. A society may be described as an association of people with a measure of permanence. A 'civic society' is said to comprise (1) territory, (2) perpetuity, (3) a measure of independence, and (4) a culture as manifested in its art, philosophy, law, morality, religion, fashion and opinion[14]. The last five, namely, law, morality, religion, fashion and opinion, are modes of social control in that they prescribe in various ways how people ought to behave. Law is distinguishable from the others with reference to the criteria of validity already mentioned, but the relationship between them is a matter for jurisprudential study.

More important is the inextricable interrelation between law and philosophy, sociology, ethics and politics. The training of lawyers has hitherto failed to take sufficient account of the essential unity of law and these other disciplines. They are not just related to each other, but interwoven; their pattern is not that of circles which touch at their circumferences, but of circles which overlap. Only on such an integrated basis is it possible for lawyers to approach their subject meaningfully and improve its serviceability. Indeed, jurisprudence might well be described as the lifemanship of the law. No one can be a good lawyer who only knows law. As Buckland well said, 'A man will be a better lawyer, as he will be a better architect or physician, if his mind is open to the movements of thought on the profounder issues of

13 Thus, Lord Wright said of law: 'Its purpose is to regulate man's conduct in relation to external things and persons, not merely to ascertain and explain what happens in fact': 'Precedents' (1943) 8 CLJ 124. So, too, Goodhart: 'in the physical sciences we have a *description* of conduct, while in the social sciences we have a *prescription* for conduct': *English Law and the Moral Law* p 9. The distinction was expressed by Kelsen in terms of the 'ought' and the 'is', *Sollen* and *Sein*, eg in *General Theory of Law and State* pp xiv, 35–42, and for his theory, see ch 17, post. See also Castberg *Problems of Legal Philosophy* p 53; Hart *The Concept of Law* pp 78–79. For Hall, on the other hand, the legal prescription is also to some extent descriptive of the significance of the rule: 'Concerning the Nature of Positive Law' (1948–49) 58 Yale LJ 560.

14 Johnson *Sociology* p 9.

life, beyond his immediate professional concerns. And, if his mind is so open, he can hardly fail to have some sort of philosophy of his own'[15].

Of the philosophical aspects, which are more or less useful to lawyers, that which is outstandingly relevant is logic and various kinds of reasoning. There are also questions of semantics, method and definition, which have been dealt with. Part III of this book will deal with some philosophies of law, which will reveal the manner in which people in different countries at different times have speculated about some of the problems examined in the preceding Parts. It is not enough to enhance merely the technical efficiency of a lawyer, important though this is; he should also be invited to broaden his outlook by treading along paths from which he will be able to perceive new horizons and be invigorated by scholarship in other spheres. Speculations about law by past and present thinkers are part of intellectual culture. Even where theories are open to criticism they possess value and later theories can be better understood in the light of them. This book can do no more than try to indicate directions along which such inquiries can be pursued and where the wisdom of great thinkers is to be found. It might be convenient to refer to a particular theory alongside the discussion of the problem most nearly connected with it in Parts I and II; but whether one does this, or waits until Part III is a matter of preference. Taken as a whole, therefore, jurisprudential study ranges from minute analytical dissections and sharp distinctions at one end of the intellectual scale to the broad sweep of ideas and philosophies through the ages at the other.

Sociology is a theoretical study of social existence based on descriptions of social facts[16]. From the point of view of the sociologist the administration of law is an observable social fact, while from the point of view of the lawyer it is obvious that laws can only function in a social environment, that they are bound to be influenced by the prevailing climate of opinion and tendencies and that, to a lesser extent, the continued enforcement of laws does in its turn affect people's outlook. More specifically, three aspects of sociology can be singled out as being peculiarly relevant to a lawyer's understanding of law, namely history, anthropology and economics. Historical development frequently accounts for and explains present-day doctrines; anthropology increasingly provides valuable insights into institutions of the modern state; while the influence of the economic order on the structure of both laws and society has been amply demonstrated. With regard to ethics, this, again speaking broadly, is a theoretical study of what is implied by prescriptions of what ought to be or ought not to be[17]. Insofar as the 'oughts' of laws imply aims to be achieved, the element of ethical evaluation inherent in the content of laws becomes clear.

The alleged autonomy of analytical jurisprudence, history, sociology and ethics

It used to be fashionable to draw contrasts between these, but to do so would be to paint a misleading picture. For, in the first place, the suggested

15 Buckland *Some Reflections on Jurisprudence* p 47. See also Julius Stone's treatment, *Legal System and Lawyers' Reasonings* pp 18 et seq; Jerome Hall *Foundations of Jurisprudence* (on which see p 485–487, post); Lord Radcliffe *The Law and its Compass* p 93.

16 Emmet *Rules, Roles and Relations* pp 5–6. See generally Sprott *Sociology*; Johnson *Sociology. A Systematic Introduction*, Part I.

17 *Emmet* pp 5–6.

distinction between analytical jurisprudence, on the one hand, and history and sociology, on the other, is non-existent. Ever since Bentham and Austin 'analytical jurisprudence' has been associated with the formal analysis of legal concepts, but the opposition between this and history and sociology is rooted in a confusion between the *subject matter* of a study and the *method* by which it is pursued. 'Analytical' connotes a method of approach which applies not only to formal, but also to historical and sociological study. One may analyse the structure of laws as they are found, or their purpose and operation in society, or their historical evolution. For this reason Salmond's classification, for example, is to be rejected. He divided jurisprudence into Analytical, Historical and Ethical. The former, he explained, is the analysis of the first principles of the law 'without reference either to their historical origin or development or to their ethical significance or validity'[18]. The distinction is not one of kind, but of emphasis. They are both analytical; in the one case attention is fixed on the law as it is today, in the other on development over a period of time. Moreover, insofar as history is only a branch of sociology a similar objection applies to any distinction between analytical and sociological study. Analysis is necessary to any sort of fruitful exposition, and it is misleading even to suggest that sociology is not concerned with analysis. It would be worthless if it were not. Here, too, the contrast is not that one type of study is analytical while the other is not, but that in the one, analysis is applied to the formal structure of law while in the other, analysis reaches beyond this into the way in which it works in society.

In the light of the above objection it might be thought that the word 'analytical' could be shared by these studies, but in such a way as to preserve distinctions between formal analysis, historical analysis and sociological analysis. Even such distinctions, however, are frequently untenable. In the case of many institutions, notably of the common law, formal analysis of them as they are inevitably dovetails in with their historical evolution. Formal, historical and functional analysis cannot always be separated. Legal institutions do not exist *in vacuo*, but are there for some purpose. An important point is that even the formal structure of concepts is constantly being re-shaped according to the functions they are made to perform. Indeed, all analysis is ultimately directed towards an understanding of the subject matter, and formal analysis alone will not provide a complete understanding of legal material because there has also to be an examination of the purpose for which it is there and how it works in the context of actual situations.

Just as analysis cannot be divorced from history and sociology, so, too, sociology is not independent in ethics. Social problems are grounded in ethical evaluation. For instance, as Professor Emmet has observed, the problem of juvenile delinquency is seen to be a *problem*, not because it prevails,

18 Salmond *Jurisprudence* (7th edn). Salmond's view has been discarded in the 12th edn by Fitzgerald. Stone has suggested that the separate identity, traditionally given to historical jurisprudence, sprang from its early emergence on the Continent: *The Province and Function of Law* p 35. Salmond drew another distinction between historical jurisprudence and legal history on the basis that the former was the analytical aspect of history: *Jurisprudence* (7th edn) p 6; and see Keeton *The Elementary Principles of Jurisprudence* p 7. This distinction is wholly unreal. The innuendo is that legal historians do not analyse. Nothing is more untrue, and the point is well made by Allen *Legal Duties* p 13. For a similar distinction between comparative law and comparative jurisprudence, see Wigmore, 'A New Way of Teaching Comparative Law' (1926) JSPTL 6. For a possible distinction between 'sociology of law' and 'sociological jurisprudence', see pp 422-423 post.

but because it is thought to be *bad*. Again, the most suitable method of resolving some social problem often depends upon built-in ethical considerations. As a solution to the over-population problem the periodic slaughter of all new-born babies will not even be contenanced, not because it would not solve the problem, but because it would be unworkable owing to the moral sentiments of people. Finally, many social aims, such as 'stability', 'cohesion', 'education', 'health' and the like are value-laden and are posited as goals of society because they are approved[19].

Ethical evaluation, for its part, cannot be kept apart from sociology. Moral judgment by its very nature implies decision about action in some situation, and all information relevant to that situation needs to be taken into account. Furthermore, the moral judgment passed on conduct is often dependent upon the social relationship, or role, that is involved. For example, the moral judgment on a man who turns his back on a beseeching child will depend not only on the relation of the man to the child (eg parent or stranger), but also on the role which the child is fulfilling (eg collecting for Guy Fawkes, soliciting for immoral purposes and so on).

It is evident, therefore, that the study of jurisprudence should not be insulated from these other disciplines. When it comes to practical techniques their interrelation is no less obvious. Four different techniques are discernible. (a) **Judicial technique.** A point, to be amplified later, is that laws do not of themselves decide disputes, for they have to be applied to the case in hand. This process leaves to the judge an element of choice[20], which is guided by a variety of considerations, philosophical, historical, social and moral[1]. (b) **Legislative technique.** The need to clarify the social problem that requires legislation and to evaluate the objective in view requires no further emphasis. (c) **Administrative technique.** An element of discretion in giving effect to policy decisions is inescapable and the modern tendency is to enlarge this. Such discretion is again guided by social and moral considerations. (d) **Advisory technique.** Lawyers advising clients or arguing in court have to take account, not only of laws, but also of how they are likely to be applied by courts. This combines prediction of how a court is likely to decide and persuasion of the court so that the prediction is fulfilled. They thus have to gauge as best they can the influence on judges of current social, moral and other pressures.

To insist in this way on the unity of legal, sociological and ethical study is not to dismiss purely formal analysis as valueless. All that is urged is that while this is important, it is no more an end in itself than the foundations of a house.

So far stress has been laid on the need to approach jurisprudential study with the aid of every relevant discipline. This, however, is separate from the question whether so broad-based an approach should be directed to speculating about English law in particular, or perhaps just the common law systems, or law generally. Much will depend on the level of abstractness at which the problems are presented. For example, problems of law and order are common to all systems, but problems of binding precedent can only arise in common law systems. A related question is whether the material, which furnishes the basis for speculation, should be drawn from one system, or a

19 Emmet *Rules, Roles and Relations* ch 2, especially pp 19 et seq.

20 Pp 151 et seq. post.

1 Cardozo *The Nature of the Judicial Process* pp 30–31, and passim; ch 10 post.

few, or all systems. Here the limitation is a practical one, and this is what is hinted at by the word 'possible' in the phrase 'broadest possible basis'. These questions, which have not always been distinguished, have given rise to some debate as to whether the study should proceed on a particular, comparative or general basis.

The particular basis derives its material exclusively from one system of law, the comparative basis derives its material from more than one system, while the general basis presupposes certain notions as being common to all, or a large number of systems. Many writers have paid lip-service to general jurisprudence such as Austin, Holland and Allen, but have not adhered to it in their treatment. Austin dealt mainly with English law with occasional allusions to Roman Law. It is possible that underlying his thinking was the belief that the common and civil law between them would cover the civilised world and so constitute 'general' jurisprudence. In any case, his references to Roman law are too few and superficial even for this purpose. Holland, in spite of an uncompromising adherence to general jurisprudence, proceeded mainly with an exposition of English law; Allen's treatment is comparative at most. Besides, the arguments that have been adduced in support of general jurisprudence have not always been convincing, and the following observations of Holland are worthy of comment. He supported his advocacy of general jurisprudence with an analogy drawn from geology.

> 'Principles of Geology elaborated from the observation of England alone hold good all over the globe, in so far as the same substances and forces are everywhere present; and the principles of jurisprudence, if arrived at entirely from English data, would be true if applied to the particular laws of any other community of human beings; assuming them to resemble in essentials the human beings who inhabit England.... The phrase [particular jurisprudence] may however, and probably does, mean: an acquaintance with the laws of a particular people; and the impropriety of describing such merely empirical and practical knowledge by a term which should be used only as the name of a science has been already pointed out'[2].

In the first place, the analogy is false. However true it may be that principles of geology derived from an observation of English data will apply elsewhere as well, this is so only because, as Holland himself says, 'the same substances and forces are everywhere present'. The point, however, is that the 'substances and forces' of law are not the same everywhere. Law is a social institution, and the structures of societies differ, their pressures differ, their traditions and environments differ. Secondly, he glosses over this obvious point by shifting attention from *communities* of human beings to *human beings* themselves, for it seems safe to say that at least human beings elsewhere in the world do 'resemble in essentials the human beings who inhabit England'. Everything then turns on what is signified by 'essentials': 'essential' to human beings as organic entities, or as social units, or what? This vital word is left unexplained. Thirdly, it is not easy to see what is meant by the word 'science' so that it comes to be associated with general, but not with particular, jurisprudence. Fourthly, the passage commits two of the semantic sins mentioned earlier. The word 'jurisprudence' is alleged to possess a 'proper' meaning, which would exclude the term 'particular jurisprudence' as 'improper'. Again, not only is the emotive connotation of 'science' used to evoke a

2 Holland *Elements of Jurisprudence* p 11. For criticism, much of which is adopted here, see Buckland *Some Reflections on Jurisprudence* pp 68–69.

favourable response to general jurisprudence, but the derogatory insinuation in the phrase 'merely empirical and practical' is used to evoke a correspondingly disparaging response to particular jurisprudence. It will be seen, therefore, that the passage fails to make out any case for general jurisprudence.

It has been suggested that the answer to the question whether the approach should be general or particular depends on how abstract the problem under review is. It will also depend on whether the study aims at formal or functional analysis, and, if formal, whether it proceeds constructively or demonstratively. If an analysis of form and structure is intended, those who seek to construct formal concepts will find themselves forced of necessity to confine their attention to the particular basis, or at most to the comparative[3]. Only supporters of the demonstrative method will find the general basis manageable. On the other hand, functional analysis may conveniently be conducted on either a particular or general basis. Generalised functional jurisprudence might include such things as general methods of reasoning (eg deduction, analogy etc) and general adaptability to social and moral change.

Adaptation, improvement and reform

Jurisprudence is concerned, not only with the law and its institutions as they are and with their social impact, but also with improving them and changing them in line with social developments. This brings in the pressures behind change and the machinery of change. These matters will be considered in Chapter 15.

Conceptual framework for jurisprudential study

Emphasis has been laid on the need to engage every relevant discipline for the purpose of study. These wide ranging pursuits and the functioning of law in particular make it obvious that law has to be considered in the sense of a legal system, and the conceptual framework needed to unify all this is a temporal one. A legal system, as the word 'system' implies, is a co-ordinated and purposive activity. Now, every activity must occupy some time over its functioning; from which it follows that every functioning phenomenon, together with its component elements, must continue to exist over that period of time. Therefore, the conditions essential to continued existence and factors relating to functioning are implicitly part of the concept of it as a functioning phenomenon. An analogy may help. It is usual to regard, for instance, a human being as a three-dimensional entity possessing length, breadth and depth. This, however, is the concept of an instantaneous person, who has length, breadth and depth for a moment and vanishes. In the real world there is no such thing as an instantaneous person; he or she endures over a period of time, which introduces the dimension of endurance in which length, breadth and depth endure together. The continued existence of a person depends on certain essential conditions, such as a minimum intake of calories, oxygen, parameters of temperature, of states of health and so on. A graph of an enduring human being, if such were possible, would depict a person

3 Cf *Formation of Contracts. A Study of the Common Core of Legal Systems* (ed Schlesinger) for the unwieldly result of trying to encompass a large number of systems even on a single topic.

rather like a four-dimensional worm extending in time[4]. There are thus two frames of thought, the time-frame of the present and that of continuity, ie the continuum. 'Present' does not mean 'instantaneous', but a very limited time-frame covering the immediate concern as distinct from indefinite duration. The idea of a 'four-dimensional worm' may seem abstract and remote from reality until one realises, with some sense of shock, that of the two the familiar, everyday three-dimensional conception is the more abstract and unreal, since it is that of an 'instantaneous person', which does not exist. So, too, with legal system and laws. A law is not designed to be in force for an instant or only for today, but to operate over a period of time. A 'momentary law' is as inconceivable as a 'momentary person'. More important is the point that as soon as one thinks of a legal system or a law as continuing, then everything implied by the idea of continuity becomes an *integral part* of the concept of the continuing phenomenon. Nor can one contemplate continuity without taking account of the factors relating to origin and continued existence and those relating to function (purpose) and functioning (operation).

Which, then, is more 'real': a human being or law which lasts only here and now, or a continuing human being or law? The obvious answer might lead one to reject the present time-frame entirely, but this would be a mistake. Thinking in both frames is useful in different contexts. For the purpose of accommodating persons round a table, for example, the concept of each as a three-dimensional entity suffices; the conditions of continued existence are superfluous. In situations where existence is of moment, such as a prolonged stay in a hotel or in space, the conditions essential to existence become vital. Again, the idea of a living fish implies an environment of water, and so on. Similarly, the validity of a law is all that is needed for immediate purposes, but the idea of a continuing law automatically imports the factors that brought it into being, keep it going, modify, weaken or kill it, as well as those that determine how in fact it works in its social environment.

To regard legal phenomena in a continuum will provide the unifying framework for the study of law in relation to other disciplines, especially sociology and ethics. There is much loose talk about the 'sociological' study of law, which so often ends in platitudinous generalities—the worst kind of mental training. The temporal approach offers a modest but systematic plan by asking: What factors (social, political, moral etc) brought about a rule of law? What factors keep it going? (which need not necessarily be the same as those which brought it about). How does it work? (which calls for an investigation into its structure, its efficiency in fulfilling its task and the factors that affect its working)[5]. Can it be improved? Such questions reach out into sociology, ethics and other fields with limitless ramifications.

The present book will develop this temporal approach in various contexts, and it is submitted that in a time-perspective some traditional puzzles can be resolved, while others assume different proportions. It is also worth pointing out that this approach involves no statement in the form 'Law is ...'.

4 This analogy is taken from Eddington *The Nature of the Physical World* pp 53, 87. The expression 'four-dimensional worm' is his. For the temporal approach to law explained above and its relation to Hurst *Justice Holmes on Legal History*, see Dias 'Temporal Approach Towards a New Theory of Natural Law [1970] 28 CLJ 75 at 76 n3. A temporal basis is also implicit in Hall's 'integrative jurisprudence': *Foundations of Jurisprudence* (see pp 485-487 post).

5 Cf Hall's basis of 'law-as-action': *Foundations of Jurisprudence* on which see p 486 post.

What it offers is a way of looking at laws, indeed of any phenomena, and, as such, is entirely non-committal as to the nature of law.

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Why is Tax Law Incomprehensible?

JOHN PREBBLE*

Introduction

IT is just over 100 years ago that debate started in the New Zealand Parliament on the Land and Income Assessment Bill 1891. That Bill in due course was passed to become our first income tax law. For many people, this is a centenary that they would prefer to forget. And in a sense, the passage of that bill was not the kind of unique event that we usually think of as being worthy of a centennial celebration, because we have had at least one income tax bill almost every August ever since, after the annual Budget, and in recent years four or five. But for those of us who make our living by thinking about income tax the fourth of August 1891 was indeed an important and auspicious day.

Be that as it may, the centenary of our income tax law is an important date for all of us. Income tax is the engine room of the modern state. Nowadays, it provides 63 per cent of government tax revenues. Without income tax we would not have the civic infrastructure and the health, education, and welfare systems that we have today. Since the government's 1991 Budget, it is possible that even *with* income tax we shall not have the civic infrastructure, health, education and welfare systems that we have today. But without the tax we would have even less of them.

Size of the Act

The income tax legislation that was passed in 1891 was a poor cousin to our present laws, in respect both of size and of effect. Our first Act was only 32 pages long, and that covered land tax as well. These days, the Act is huge. It was last printed by the Government Printer in 1983, when it occupied a hard-bound book of 773 pages. Nowadays, it is at least twice that size, you can only get it in paperback, and it occupies two thick volumes.

Just how many pages there are in these volumes is a closely guarded secret, known only to two trusted executives of the publishers. You cannot work it out by looking at the page numbers because they start at 1001 and finish at 63,995, with many gaps in between.

Even as I speak, the presses are rolling in Auckland to add another hundred or so pages for the annual post-budget edition.

Game

One of the favourite party games of tax practitioners when we get together and really let our hair down is to sit around a table with our copies of the Act, which we carry in our briefcases. I should mention that tax practitioners are never without their briefcases, even on the most intimate personal occasion. The object of the game is to try to be the first to count every page of the Act. But in the end it always finishes up with everyone falling

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asleep, and I've never known anyone to get beyond section 203, which relates to co-operative pig marketing, and is only half-way through the first volume and has been repealed anyway.

Effect

As well as being smaller in size, the 1891 Act was also smaller in effect. For a start, the first £300 of everyone's income was exempt. That was far above the average income in those times, so income tax really applied only to the very well-off.

Secondly, the rate was only one shilling in the pound on business and commercial incomes, and half that, only six pence in the pound, on professional incomes. I am sure that most people in the audience tonight would agree with me that Premier John Ballance's idea of taxing professional incomes at half the rate of commercial incomes was both far sighted and clearly correct, but sadly it did not last very long.

It was many years before income tax became the major source of government revenue, and not until after the Second World War that it became the significant impost that it is today for the bulk of the earning population.

Public morality

Perhaps it was because of the relatively modest bite of the original income tax that, in 1891, the parliamentary opposition's attack on Ballance's new tax was based not on economic but on moral grounds.

John Bryce M.P., leader of the opposition at the time, said that his main objection to the tax was that it would lead to public immorality.

Now, like a good many upright people, I have long held the view that there has indeed been a serious erosion of public morality over the last 100 years, but I had not realised until I read Bryce's speech that this has been caused by income tax. Again, like many upright people, I had mistakenly put the decline in morals down to things like the cinema, rock'n'roll music, Elvis Presley, Latin American dancing, violence on television, liberal theology, psychedelic drugs, and, of course, the pernicious influence of the playway scheme on New Zealand primary education. But I was wrong.

You might ask why it is that income tax leads to public immorality. As Mr Bryce explained it, the problem is that, as soon as you have an income tax, people must make returns of income. They will be tempted to lodge false returns, and they will yield to that temptation. From false tax returns it is a short step on the slippery slope to drunkenness, domestic violence, and robbing banks.

Incomprehensibility

Leaving aside the question of morality, income tax is, as I have mentioned, the engine room of the modern state. Considering the importance of the subject, it is most regrettable that of all branches of the law, income tax is the most notorious for its complexity. Professor David Walker, editor of *The Oxford Companion to English Law*, is uncompromising when it comes to income tax. He says:

> "More than any other branch of municipal law, tax law is open to the reproach of being utterly incomprehensible by the individuals affected, and even frequently by

> their legal advisers. The *enormous* complexity of the rules of law on each kind of tax gives rise to an *enormous* volume of dispute and argument, and a great deal of litigation by way of appeal from assessments ... Neither *justice* nor *reason* has any place in tax law, and many decisions of the superior courts are in plain conflict with all *sense* ..." (emphasis added).

Questions

In considering this passage three questions immediately spring to mind.

First, how is it that Oxford University Press, perhaps the world's greatest publisher, has chosen someone as author of its *Companion to Law* who is so bereft of adjectives that he has to use the word "enormous" twice, in consecutive lines, in the same sentence?

Secondly, what is Oxford University Press up to that its editors fail to pick up that kind of stylistic infelicity, despite the huge resources at their command, including the *Oxford English Dictionary*, which gathers together more words than have ever before been seen in one place? And bear in mind that a fair number of those words in the *Oxford English Dictionary* are synonyms for "enormous".

Thirdly, turning to the substance of what Walker says about tax law, and thinking about myself, what sort of person could make his career studying such unpromising material, not to mention commemorating the centenary of its origin by inflicting a lecture on 200 blameless citizens of Wellington who would all prefer to stay outside and have another drink?

Answers

The answer to the first two questions is that it is the fault of the subject-matter, not of the author. Professor David Walker is an excellent writer, and OUP has excellent editors. But nobody can write with style about income tax. It is not well known, for example, that the novelist Jane Austen once wrote a couple of essays about income tax. But despite the fact that Jane Austen is arguably the greatest prose stylist in the English language those essays are virtually unreadable.

The third question relates to me. What sort of person spends his life studying tax law?

The Chancellor told me shortly before we came into this lecture theatre that, judging from the acceptances for tonight's address, a good half of the audience is here in a spirit of pure scientific inquiry, in the hope of finding an answer to that very question during the next hour by having a good look at me.

In an attempt to answer the question myself, may I turn to the old definition of a tax lawyer, a definition that many people here will know: a tax lawyer is someone who is very interested in taxation, but who lacks the personality to become an accountant. But I am prompted by the entry in *The Oxford Companion to English Law* that I have quoted to offer you another definition: a tax lawyer is someone who is quite interested in law, but who is indifferent to justice, reason, and common sense.

Difficulty of the law

Having said all that, however, David Walker is right. Tax law is very complex and often incomprehensible, but why is this? Why is it that very competent parliamentary

draftsmen, who are capable of writing laws that are comprehensible to lawyers most of the time and to other people some of the time, when it comes to income tax produce legislation that almost nobody can understand at any time?

One simple, but correct, answer is that income tax law suffers from inherent difficulties that do not afflict other areas of law in the same way. I shall explain why in due course. Now, I want to illustrate that the difficulty of income tax legislation is not a recent phenomenon. The very first Act in 1891 was seriously flawed because the draftsman had not been able accurately to express what he meant.

The flaws

I shall take just two examples. First, as I have mentioned, the Act provided for the first £300 of people's income to be exempt from tax. By mistake the exemption was drafted on a firm-by-firm basis. Thus, solicitors practising by themselves each enjoyed an exemption for the first £300 of their income, but three solicitors in partnership had an exemption of only £100 each, which was not at all what Parliament had set out to achieve.

Secondly, the 1891 draftsman, like all subsequent drafters, had trouble with companies and shareholders. The solution adopted in principle was to tax corporate profits only, in the hands of the company, and to make dividends tax free in the hands of shareholders. In practice, the drafting got out of hand, and, if you followed the Act carefully, it was not difficult to ensure that corporate profits would be tax free both to the company and to the shareholder, so long as the profits were distributed as dividends in the year when the profits were derived. Under that regime, paying tax on business income would have been even more optional than it was in the early 1980s (and I do not say that it is exactly compulsory even now).

An early example of retrospectivity

Luckily, most of the worst mistakes in the 1891 Act were quickly discovered and the legislation was extensively amended in 1892, in time for the first assessments, raised for the financial year that finished on March 31, 1893.

Most of the 1892 amendments had to be retrospective, dating back to the commencement of the 1891 Act. This was necessary because the amending Act was not passed until October 11, 1892, when the financial year to which the laws had to apply had already been in progress for six months.

Considering that New Zealand's first, and, relative to the size of the Act then, most extensive, amendments to the income tax legislation were unashamedly retrospective, it says something for our respect for the rule of law that retrospective tax legislation is still greeted with dismay 100 years later. Only in July 1991, seven government backbenchers abstained rather than vote for such a measure.

Tension between natural and artificial law

Why is it that income tax law is so complex and difficult? The primary reason is that income tax law, more than any other branch of the law, tries, but fails, to reconcile natural law on one hand with the laws of men and women on the other. What I mean by "natural law" is the laws of nature, of physical things, and of facts.

One law of nature is that people experience accretions to their wealth. Businesses make profits, not always, but at least sometimes. People manage to earn wages, salaries, or other income, not all people, but at least some.

Gains, therefore, are something that certainly exist in the factual world, independently of formal laws. On the other hand, our income tax system demonstrably cannot cope with these gains in a way that can be understood by ordinarily literate people, and the system often has difficulty in dealing with these gains at all.

Darwinian view

If you take a Darwinian view of life you might ask, why is it, with all the opportunity that tax law has had to evolve, someone has not made a better job of it?

After all, since 1891 the income tax law has received far more attention than any other body of New Zealand legislation. There have been seven Royal or ministerial commissions of inquiry, and the statute has been completely reconsolidated six times, not to mention annual or more frequent amendments. But look at the chaotic mass of verbiage that all this evolution has produced.

The answer is that the tax system cannot be understood in Darwinian terms. It is much more amenable to analysis that uses the simpler logic of creationism and the flat earth theory. The fundamental problem is that when God created the concept of gain, she failed to appreciate that eventually some government would try to tax that gain.

Taxation requires that the gain must be identified and defined. But it is one thing for us all to agree that it is a law of nature, or of economics, that people derive gains. It is another to define those gains in legal terms that are administratively practical, and there lies the problem.

There is thus a tension between natural, economic law on one hand and the laws of men and women on the other.

This tension is such that it can never be relieved. That is, there are some things about income tax law than can never be resolved in a logical and consistent manner. The main problem areas can each be identified by a single word:

- Geography
- Time
- Capital

Geography

The problem of geography is the problem of national jurisdiction. Each country can tax only its own residents or citizens, or only income that has its source within the country.

But how do we know where a person is resident who has homes in several different countries? And how can we say that a company is resident anywhere at all? Bear in mind that a company is no more than a convenient legal fiction that does not exist in nature, but that has been created by the laws of men and women to make it easier for people to co-operate in carrying on business together. How can a company reside anywhere in any

real sense of the word? And yet it must be made to reside somewhere if the tax system is to work.

And take the problem of source. What is the source of the income of an American airline that flies a Canadian from New Zeland to Australia on a ticket bought in Germany using a credit card issued by an English bank? Which country can tax that income?

Solutions

A modern income tax law must contain answers to these questions, and answers to questions of the same kind but of much greater complexity. For the most part, New Zealand income tax law does contain these sorts of answers, and does draw lines between what we say is New Zealand source income and what we say is income sourced elsewhere. But the rules from which we derive these answers cannot be traced to any *a priori* principle. They are ultimately arbitrary, as they must be, because a gain is something that exists in nature. A gain does not recognise national borders. Borders are created by humans.

Thus, the rules of source, likewise the rules of residence, cannot ever be wholly comprehensible, because they try to impose laws that we have made upon things that exist in nature.

Time

The problem of time is similar to the problem of geography. The difficulty is that most businesses go on turning over regardless of the calendar.

Take a farm, for example. In some years prices go up and profits increase. In other years, prices go down, sometimes disastrously, as occurred in New Zealand over the 1991–1992 season, and there are not profits but losses. Expenses may fluctuate wildly, too, if more or less fertiliser is applied, or if more or less land is cleared for pasture.

Over a 10 year period it may be that the farm does no more than break even. But if there have been several good years during that time the farmer will have made good profits and paid high taxes. The government does not return the money in the later years when the farmer makes losses.

The tax year

This is just one illustration of the problem of time that any tax system faces. For the purposes of assessing and collecting tax the continuing income earning activities of any taxpayer must be broken up into manageable periods. The period chosen for tax purposes is 12 months. We tend not to think too much about it because we use the year to organise so many other things in our lives that years seem natural enough for tax purposes, too. But from an economic point of view the year can be just as arbitrary a period as, say, 11 months.

The trouble is that as soon as we draw the lines to divide income into periods delimited by time we must have whole bodies of rules to allocate receipts and expenses to their correct years. Otherwise, people are able to arrange their affairs to defer the derivation of income from one year to another, and thus to defer their liability to tax.

Also, we must have other bodies of rules to try to minimise the unfair effects that strict year-by-year accounting otherwise has on people like farmers who have incomes that are lumpy, in that they fluctuate in amount.

Broadly speaking, these bodies of rules are internally consistent. But over all, the rules suffer from the handicap that their whole reason for existence is to divide something factual, the continuing flow of income, into a pattern that is imposed by the laws of men and women. For this reason, these rules are often difficult to understand, and sometimes incomprehensible.

The capital/revenue distinction

The tension between natural law and lawyers' law is seen in many areas, but nowhere so markedly as in the distinction between capital and income. We know that, broadly speaking, the Income Tax Act taxes income, not capital. But what do we mean by capital? May I illustrate this by example. Take that thriving business, Inferior Bicycles Ltd. How does Inferior Bicycles Ltd calculate its income?

First, it adds up all its sales of bicycles. These are its receipts.
Then, it adds up its expenses: cost of bicycles, heat, light and power, staff wages, and so on.
Third, it deducts the expenses from the receipts, and the difference is income. All the items I have mentioned are labelled as being "on income account".

Premises

I missed out one item: the cost of the premises occupied by Inferior Bicycles Ltd. If the company rents its shop, then the rent is an additional cost of doing business and is subtracted in calculating taxable income.

But if the company buys a shop for itself this is a capital transaction and is not taken into account in calculating taxable income. That is so even though it costs much more to buy the shop than to rent it, and even though, as a result of buying the shop, the company has no money left to pay its tax. On the other hand, in several years' time, when Inferior Bicycles Ltd comes to sell the shop and move to somewhere bigger it will not have to pay tax on the capital gain that it makes.

Capital, revenue, and time

The distinction between buying the shop and renting it is primarily one of time. The benefit of owning the shop will remain with Inferior Bicycles Ltd for years and years, but the benefit of the rent is available only for the period over which it is paid. That is, broadly speaking, capital items are things that last a long time and income items are things that last a short time.

From this explanation we see that the distinction between capital and revenue is a particular example of the broader problem that I described earlier, the question of time. However, questions of capital and revenue loom so large in any income tax regime that they merit separate discussion, and I treat them separately here.

Imprecision of the distinction

Explaining the difference between capital items and income items in terms of time illustrates the difficulty of drawing a distinction between the two concepts at all. Most

people would agree that 10 years is a long time and that 10 weeks is a short time, but where do we draw the line? It is impossible, and yet the distinction between capital items and revenue items is fundamental to our tax system; so the courts spend many pages of their judgments trying to explain it.

But the problem is worse than that. Not only do the concepts of income and capital merge into one another, but it is often quite easy to change income to capital or vice versa. And the changes need not be between things that are close to the dividing line between capital and income. Things that appear to be quite clearly income can be massaged to emerge as capital, and clearly capital items can be reconstituted as income.

Take this example.

Example

Suppose I have $10,000. One way to benefit from that money is to put it on deposit in a bank and collect the interest. But I will have to pay tax on the interest because it is income.

An alternative would be for me to set up a company in Vanuatu, and to give the money to the company. The company then deposits the money in a German bank. Since 1985, Germany has not charged tax on interest paid to non-residents, and Vanuatu is a tax haven, so the interest accumulates tax free in my Vanuatu company.

When I want the money back I count up all the funds that are in the company: the original $10,000, plus several years of interest, say $15,000 in total. I then sell the shares in the company to a friendly Vanuatu bank for the cash value of the company. The bank pays me, say $14,800, and keeps $200 for its trouble.

The bank causes the company to pay dividends to it that represent the $5,000 of interest. The dividends are not taxable to the bank, again because Vanuatu is a tax haven. The bank liquidates the company to get access to the $10,000 of original capital, giving the bank $15,000 in cash less its expenses.

In principle, none of the money that I receive is taxable because it is the proceeds of the sale of my shares in the Vanuatu company, and that is a capital transaction.

Anti-avoidance rules

I say "in principle" because as one might expect there are provisions in the Income Tax Act that are designed to prevent people succeeding with these sorts of tactics, and these provisions often achieve their aim.

But such provisions are extremely complicated. They must have many facets in order to catch not just the simple transactions that I have described, but also the myriad of more sophisticated variations that are possible.

Also, they must have many exceptions so that they do not catch transactions that they are not meant to catch.

And the exceptions must have many sub-exceptions, so that people cannot wiggle into them who should not be able to do so. And there are provisos to the sub-exceptions to cope with specially meritorious taxpayers who should not be caught, and sub-provisos to the provisos to cope with people who pretend to be specially meritorious taxpayers, but who are not really very meritorious at all.

The controlled foreign company rules

One example of these anti-avoidance regimes is the collection of rules that prevents people using Vanuatu companies in the way that I have described. This is called the controlled foreign company regime. It was enacted in 1988 and occupies 58 pages in the Act. In 1990 the Inland Revenue Department achieved the truly Herculean task of publishing an official translation and explanation of these 58 pages. The translation takes 164 A4 pages. Judging by announcements in the 1992 budget, the controlled foreign company regime is about to grow by another 20 or 30 per cent, and will require further translation.

Some people blame the law drafters for this sort of thing; others blame the Inland Revenue Department; in the particular case of the controlled foreign company regime, some people blame the Consultative Committee of non-government experts that formulated the rules. Everybody blames the Treasury, partly because it proposed the rules in the first place, and partly because people blame the Treasury as a matter of course. But they are all wrong. What is to blame is the fundamentally unsound premise of the Income Tax Act that capital can be distinguished from income, and the problem that tax jurisdiction is confined to national boundaries. The more we try to rationalise or work round these facts, the more incomprehensible the drafting becomes.

The capital/revenue distinction

As I hope the examples that I have given show, the problem is that the lawyers' and accountants' distinction between the income and capital is not a distinction that is fundamental to natural law, nor to economics, for that matter.

Since the distinction is not natural but artificial, one result is that a good deal of income tax legislation, and even more of the income tax law that is set down by the judges in their reported decisions, is taken up with rules that help us to distinguish between capital and income. Even more of it is taken up with rules that hamper people in their efforts to convert a taxable income gain into a non-taxable capital gain. I say "hamper" rather than "prevent," because these rules are not always successful. They are not successful because their objective is ultimately illogical. That is, in the end there is no logically sustainable distinction between capital gains and income gains. Because of this fundamental lack of logic the rules are sometimes very difficult to understand.

Reasons for the distinction: trust cases

Why is it that New Zealand tax law draws the distinction between capital and income? After all, economists have known for years that the distinction is without a difference.

The traditional answer is that when nineteenth-century judges in the United Kingdom faced the question of defining income they turned to trust law, which seemed to provide a useful analogy. Trust lawyers have been obliged for centuries to distinguish between capital and income so that they know what belongs to a life tenant, entitled to the income of an estate, and what belongs to those who will succeed to the capital on the death of the life tenant.

It was a short step to apply these centuries of law to the new idea of income tax, though a moment's thought shows that the analogy is not apposite. Judges in trust cases divide gains between two citizens. but judges in tax cases decide what portion of a citizen's property is taken for the state by taxation.

Human nature

Be that as it may, I believe that the influence of the old trust cases is far from the only reason why judges in tax cases developed the legal concept of income as we know it, though it is true that the old cases provided the rationale for judges' decisions. An equally significant factor is human nature. No matter how often the economists prove to us that there is no rational distinction between capital and income, we still believe that there is.

For instance, in the middle of the nineteenth century United Kingdom income tax was still in an early stage of development. The lawyers had not yet wrenched policy away from the economists, and Peel in his 1848 budget still espoused a tax that was a tax on gains in general.

Cobden

The statesman Cobden found fault with this feature of the tax. Because he was a statesman he used words that are sonorous and impressive, but, presumably because he was talking about income tax, the words he chose are barely recognisable as English. From reading Dickens, and from other sources, we know very well that many Victorians were capable of making themselves understood in the English language. But this did not apply to Cobden, so a translation is necessary.

What Cobden meant to say was that he thought there should be no tax on capital gains. What he actually said was: "If a distinction were made between permanent and precarious incomes ... you would have no remonstrances."

Like Cobden, and like us, English judges of the nineteenth century were human. At least many of them were, apart from those that had also trained as economists. The reaction of a human judge is that Parliament cannot possibly have intended to tax long term or sporadic gains. To use Cobden's words, the judges' "remonstrance" against income tax was to make sure that it applied only to regular, annual gains, rather than to windfalls or to gains on assets held for long periods.

Adoption by the legislature

In New Zealand, Ballance's government of the early 1890s was, like many liberal governments, often influenced by principle. Thus, the 1891 Act charged all business profits and gains to income tax, making no distinction between capital and income.

Of course, no one took this seriously, and New Zealand practice followed the law as interpreted by the English judges. But in case of excessive zeal on the part of the tax authorities, Parliament knocked most of the capital gains provisions out of the Act by the time it was consolidated in 1900.

For example, by section 59(3) of the Land and Income Assessment Act 1900 gains from real property were put outside the tax net, unless the vendor was a dealer in land. Gains from personal property remained taxable but, quaintly, there was a specific exemption for shares, which perhaps constitute both the form of personal property that is most likely to yield a gain on sale, and, along with livestock, the form that people are most likely to acquire with the hope of realising a gain.

Except in the context of a dealing business, gains on other forms of personal property are uncommon. However, such gains do exist, and, strictly speaking, people who realised profits on selling even personal jewellery or pictures should have included their gains in

returns of income filed pursuant to the Act of 1900. One suspects that this obligation was honoured only in the breach.

Nowadays, the distinction between capital and income gains is firmly entrenched in our tax legislation. One result is that people spend a great deal of time and effort organising their affairs so that they derive capital rather than income. They succeed in this endeavour because, economically, the two sorts of gain amount to the same thing. I shall not inflict them on you this evening, but there are many tax minimisation strategies that depend on the distinction between capital and income in order to succeed, and many sections of the Income Tax Act exist solely to frustrate people who would take advantage of that distinction.

Thesis

My thesis is that there are fundamental problems of principle with the income tax law. The judges have long been aware of this, and often tell us that it is not possible to interpret taxing statutes by reference to underlying principles. The most often quoted passage is from the case of *Cape Brandy Syndicate v. Inland Revenue Commissioners* [1921] 1 K.B. 64 at page 71, where Rowlatt J. said:

> "... in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing implied. One can only look fairly at the language used."

This passage and others like it appear in many tax judgments. And judges sometimes give one explanation or another as to why tax statutes must be approached in this manner. But I have not seen a judgment that gives what to my mind is the ultimate, unanswerable reason: that is, that tax laws are not in fact based on a foundation of interrelated, logical principle.

These problems of tax law arise from the attempt to fit rules of law around natural facts of economic life. The problems are insoluble, but tax law purports to solve them. As a result, tax law is often incomprehensible.

People with a legal or philosophical frame of mind may object to my line of reasoning. They might say, tax law is not unique in applying laws to facts. Indeed, that happens with all law. The actions of people are facts, but laws are norms. It is in the nature of the exercise of applying laws to facts that one encounters difficulty from time to time, but it is the lawyer's function to deal with this difficulty. Perhaps the problem with income tax comes about not because of the difficulty with applying laws to facts, but because tax lawyers are not as clever as lawyers in other disciplines.

Explanation

But there is a difference. With most laws, there is a symbiotic relationship between the law and the activity that it regulates. The activity creates the need for the law, and the law defines the activity that it regulates. For example, criminal activity begets criminal law, and the criminal law defines criminal activity. Business bargains beget the need for a law of contract, and the law of contract defines what is an enforceable bargain.

This is a feature of the nature of law that is so obvious that ordinarily it is hardly worth

mentioning. After all, if someone sets out to create some criminal law it surprises no one if the result is legislation about criminal activity.

But the usual relationship between law and the activity that it regulates is absent in the area of taxation. Business or other economic activity begets business law or economic regulation, not tax law. In fact, as anyone in business will tell you, businesses would manage much better without tax law at all.

This is not to say that there is no relationship between tax law and taxable activities. Of course, a government tries to fit its tax laws around the shape of the economic activities within its jurisdiction, in order to make the laws effective, and in order to ease compliance costs for taxpayers.

But in the end, the purpose of tax law is to raise money, not to facilitate economic activity. Consequently, the imperatives of *geography* and *time* that I have mentioned must be imposed on the nation's economic activity. Thus, as long as the world is divided into separate, independent countries, and as long as it is necessary to assess tax every year, there can never be a perfect fit between the tax system and economic activity.

Comparison

Another way of explaining the dislocation between tax law and its subject matter is to compare tax law with another area of law that is similarly out of sympathy with its subject matter. But that is easier said than done; examples are few.

An example that springs to mind exists more as hypothesis than as fact. The example is of a conqueror who imposes a monogamous law of marriage onto a conquered nation that practises polyandry. Family court judges perhaps *could* apply the imposed monogamous law in disputes between a wife and one of her husbands. With greater difficulty they might even apply the law in disputes between two husbands of the same wife. But the result would be in the nature of a camel: a horse created by a committee. Concepts would have to be redefined, princples rephrased, and rules bent. The whole operation would work poorly.

It is probably for such reasons that in practice conquerors usually do not impose their family laws onto subject nations. Thus, the British in India left Hindu and Muslim marriage laws alone. But a legislature does not have the option of seeing a prosperous, continuing multi-national business and leaving it undisturbed. A parliament must draft laws that impose themselves on that business, and that carve out of the business a taxable income that represents a year's profit derived within the jurisdiction of the parliament.

Capital and income

The imperative of the distinction between capital and income differs somewhat from the imperatives of geography and time. That is, it is impossible to have a tax system that will perfectly match time and geography. But, at least theoretically, one could have a tax system that treated capital gains and income gains in the same way. Unlike New Zealand, most Western economies tax both forms of gain, partly in order to raise revenue, and partly because there are considerable advantages in adding capital gains to an income tax system. I shall mention several.

- The tax system becomes fairer to the poor, who rarely derive capital gains and whose circumstances do not let them convert income into capital as richer people can. Thus, the

poor in New Zealand are now excluded from a tax advantage that is available to other people.

- Secondly, a good many of the anti-avoidance rules in the Income Tax Act could be repealed if there were no longer any advantage in converting income to capital.
- Thirdly, there would be less distortion in the economy as people ceased to favour investments that produce capital gains rather than income gains.

It is politics, rather than natural law, that prevents us from having a capital gains tax and enjoying these advantages.

Capital gains tax

The problems that the capital/income distinction pose for tax law would not be wholly solved by the enactment of a capital gains tax.

A capital gains tax would not solve the problems because a capital gains tax must operate differently from an income tax. As I have explained, it is difficult enough to force income gains into an annual taxing system. For capital gains the problem is much greater, because capital assets are held for long periods.

Consequently, if a tax system starts to tax capital gains there must be some sort of separate regime for taxing them, and rules to decide which regime any particular gains falls into, but there are incidental advantages.

For instance, the New Zealand Treasury's Consultative Document on capital gains tax that was published in 1990 dealt with techniques of adjusting capital gains for inflation. The document demonstrated that the same techniques should also be applied in certain areas of *income* taxation, where failure to adjust for inflation currently leads to over taxation of certain classes of taxpayer. Manufacturers are a good example.

Most countries decide that the cost of having a capital gains tax is worth bearing for the sake of a better tax system, but there is a cost, and as long as the annual taxing cycle is maintained the draftsman cannot eliminate all the elements of tax law that attempt to make a distinction between capital and income.

Holmes

Ultimately, therefore, there is no solution. Income tax law will never exactly fit the economic activity to which it relates. The compromises and adjustments that must be made to make the system work mean that there can never be a single, coherent system of income taxation. This is sad, but bearable once you get used to it. However, the lack of basic principle does distinguish taxation from other branches of the law.

Oliver Wendell Holmes said in his book *The Path of the Law*:

> "The remoter and more general aspects of the law are those which give it universal interest.
>
> It is through them that you connect your subject with the universe and catch an echo of the infinite, a glimpse of its unfathomable process and a hint of the universal law."

Clearly, he was not referring to income tax law. As I hope I have demonstrated, tax law is far from connected with the universe and with universal law. On the contrary, it is barely connected to the natural law of our own planet.

Tax law is founded not on principle, but on practicality. There is no echo of the infinite about tax law, only the discordant clash of the immediate.

But we cannot run a democracy without taxation. As Holmes said on another occasion, "Taxes are what we pay for civilised society."

Challenge

Tax law is of immense importance to society, but considering its lack of principle, where is the interest for the legal scholar?

It is the challenge. Even the astrophysicist probing the secrets of the universe knows that it is at least theoretically possible that one day someone will find the ultimate answer to the laws of nature. But the tax lawyer knows that the ultimate answers in taxation can never be found.

It is the province of most legal scholarship to build a coherent intellectual discipline on foundations of tested and true principle. The tax lawyer tries to build a coherent intellectual discipline on foundations of sand and clay. That is the real challenge.

There is a more mundane answer. Students often ask me, "What shall I do when I graduate?" I reply, "Have you ever thought of taking up a career?"

There are three possibilities: the dole, working and taxation. The dole has the attraction that recipients have plenty of spare time, but the money is poor. Working pays better, but it does involve work. The great merit of practising tax law is that it pays nearly as well as a job and is better than having to spend your time working for a living.

Tax Law
Volume I

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Contents

Introduction[1]

The title of these volumes promises rather more than two volumes can possibly deliver. Part of the reason is that taxes come in so many forms. Governments seek to raise revenue in a variety of ways and for myriad reasons. Among the kinds of things which have historically been taxed are property, wealth, income, transactions, specified activities and status. The schemes which governments have selected for implementing their revenue raising choices have also varied in complexity. In some countries, such as the United States, some of them have been enormously complex and technically difficult. Another reason why the title 'Tax Law' is necessarily overbroad is that tax law of whatever kind is essentially statutory. Even among common law countries there is less in the way of shared principles in the tax realm than in many other areas such as tort, contract or criminal law.

As a consequence of all of this statutory variety and complexity, tax scholarship has evolved in a curiously insular fashion. Predictably, perhaps, there has been less in the way of discussion across international borders in the tax area than in many other spheres of legal theory. Indeed a review of the footnotes of most of the articles which have appeared in major American, Canadian and British law reviews in recent years shows a remarkable lack of cross-fertilization. This insularity is not solely geographic, but separates disciplines as well. Most noteworthy has been the relatively distinct evolution of tax scholarship within the fields of law and economics. Both lawyers and economists have written extensively about a wide variety of tax topics, but most lawyers do not know the economics literature well nor economists the legal literature. With a few important exceptions, scholars in the two disciplines do not publish in the same journals and do not respond to each other's work.

Somewhat surprisingly, perhaps, philosophers and political theorists have been largely omitted from contemporary discussions of tax theory. Occasional bows are made in the direction of John Rawls or Robert Nozick, but legally trained tax theorists have not shown much interest in the kind of foundational justificatory questions that philosophers might help them with, while the technical details of tax law doubtless inhibit those in other disciplines from focusing directly on issues of taxation.

In selecting the essays for these volumes, I have not sought to portray tax scholarship in either an interdisciplinary or an international light. Instead, my aim has been to present essays which reflect the tenor of American tax theory scholarship in the legal arena over the past few decades. Income tax has dominated these discussions and thus is preeminently the subject of these volumes. I include here the work of some economists, ones who have both participated in and importantly influenced discussion within the community of legal scholars. I make these choices because I take the overall purpose of these volumes to be a reflection of significant debate as it has actually occurred.

Chapter 1 in this collection is Richard A. Epstein's 'Taxation in a Lockean World', chosen because it begins near the beginning: it seeks to explore the justification for a government's taxing its citizenry by asking what limitations ought properly to be placed on the sovereign's ability to tax. Epstein presumes a somewhat Lockean social contract wherein, in exchange

for a similar promise by others, the citizen surrenders to the state his unrestricted freedom to behave as he chooses. He describes a bargain wherein the loss of liberty can be justified only if the collective gain outweighs the sum of the individual losses. Arguing from within this framework, Epstein defends several limiting principles. Ideally, equity would demand that each person's tax burden be proportional to the benefit he receives from the government. This goal can best be approached if taxes are levied upon cash and cash equivalents at the time of their receipt, and if rates are flat rather than progressive. Epstein's paper is rare in the American legal tax literature in beginning where it does, but the principles which it defends are central to the very rich debates which characterize this literature at its best. The subsequent 14 essays in this volume exemplify this richness.

The decision about *what* to tax is central to any government's scheme of taxation. In the US the federal income tax accounts for roughly 60 per cent of the government's total tax receipts (and about 90 per cent if employment taxes are excluded). One might imagine, therefore, that there is some clearly defined notion of 'income' which is by common consensus subject to taxation. Such an inference would be wrong on at least two counts. Even though there is a statutory system of revenue assessment and collection in place which succeeds fairly well in demarking some items as income and hence subject to taxation, and others as different from income and hence not subject to taxation, significant debate has been provoked. This concerns whether it is possible to give a theoretical definition of income and whether it is either useful or desirable to enshrine such a definition as the standard to which an income tax system should aspire and be held.

The idea that a touchstone concept of income can be systematically defined and used as a normative tool in the design of a tax system comprises the heart of the debate of the next three papers. Boris Bittker's 'A "Comprehensive Tax Base" as a Goal of Income Tax Reform' takes the pragmatic approach characteristic of all of his work. Bittker argues that the Haig-Simons definition of income favoured by economists is not clear enough to serve as a normative standard for the income tax system. Moreover, he argues, no such definition is needed. Tax provisions do and ought to encompass more than judgments about whether they conform to a theoretical definition of income. For example, they reflect judgments about how best to stimulate economic growth, about how best to encourage socially useful behaviour, and about administrative efficiency.

The next two chapters, both by distinguished economists, were written in response to Bittker. Richard Musgrave develops the view that a basic concept of income is not only desirable but necessary in an equitable income tax system. Horizontal equity demands that like taxpayers be treated alike; thus a common standard must exist by which similarity can be determined. He acknowledges that equity is not the only appropriate normative goal of a tax system, and that sometimes other goals may conflict with and even override its requirements. He argues, however, that this does not obviate the need for a uniform standard by which to determine what the demands of equity are.

In 'What is a Comprehensive Tax Base Anyway?', Henry Aaron takes something of a middle position. He argues that it is possible to devise a theoretically precise definition of income (which would be somewhat different from the Haig-Simons definition) but that, in practice, such a definition could not be consistently applied. Nonetheless, he acknowledges the usefulness of the notion of a comprehensive tax base as a standard to which to refer in making *ad hoc* judgments about individual provisions. It helps in asking the right questions and in thinking clearly about answers.

The Haig-Simons definition of income has formed the traditional starting point in considering how to describe the ideal base of the income tax. Roughly, that definition equates a taxpayer's taxable income with the combination of his consumption during some period and the increase or decrease in his net worth during that same period. The next several essays examine whether income so conceived *should* form the base of the tax system or whether it would be fairer simply to tax a taxpayer's consumption during the relevant period – thus eliminating his savings from his tax base. This alternative conception of the desirable tax base has come to be called a 'consumption' tax. Unlike an income ideal, a consumption ideal does not reflect differences in the form of taxpayers' savings. The tax base only includes amounts consumed. It would not, for example, favour the accumulation of wealth in the form of appreciation in the value of property already owned over its accumulation through the saving of currently-acquired cash or assets.

Although early arguments for taxation based on consumption can be found in Thomas Hobbes and John Stuart Mill, and although the idea gained currency in economists' circles considerably earlier than it did in American legal literature, William Andrews's 'A Consumption-Type or Cash Flow Personal Income Tax' (published in 1974 and reprinted here as Chapter 5) is the paper which sparked a debate which has been central to legal academic discussions of tax policy over the last 20 years. The debate has spread from learned journals to the back rooms of Congress and the editorial columns of the *Wall Street Journal*. Although the US has yet to enact any form of a federal consumption tax, the seeds of the idea are firmly planted in the legislative consciousness.

Andrews's paper challenges the adequacy of the income ideal in the context of the taxation of individuals by arguing that it does not deal satisfactorily with savings. He spells out the difficulties he perceives and then develops a consumption ideal which he argues is better suited to dealing with a taxpayer's savings in a fair and simpler manner which is also administratively practical. He argues that even if a pure income tax, unencumbered by practical difficulties, could be implemented, a pure version of a consumption-type tax would be fairer.

This last claim is the focus of the next two essays, both by Alvin Warren. In 'Fairness and a Consumption-Type or Cash Flow Personal Income Tax', Warren examines Andrews's argument that a consumption ideal would yield a fairer tax because it 'ultimately imposes a more uniform burden on consumption, whenever it may occur, than does an accretion-type tax'.[2] Warren argues that, by reducing the after-tax return on invested savings, a tax based on an income ideal *would* indeed change the relative positions of taxpayers who differ in their preferences about whether to save now or in the future but that a tax based on a consumption ideal is unable to achieve any systematic redistributive effect among taxpayers of different wealth. It is not obvious, in Warren's view, which of these consequences an equitable tax system would be best advised to avoid. Warren further develops this theme in 'Would a Consumption Tax Be Fairer Than an Income Tax?' (Chapter 7). Here he argues that a comparison of the equity of a consumption-type tax with that of an income-type tax is indeterminate so long as the choice is conceived as an abstract comparison of the consumption ideal and the income ideal independent of considerations of how wealth ought to be treated. Considerations of wealth raise many issues; indeed, wealth should never be ignored in thinking about how best to construct a fair tax base.

Another objection to Andrews's claim that a tax based on a consumption ideal is inherently fairer than one based on an income ideal is explored in Mark Kelman's imaginative piece,

'Time Preference and Tax Equity' (Chapter 8). Kelman, like Warren, exploits the fact that Andrews does not give a systematic account of what the concept of 'fairness' might entail when applied to a tax scheme. Kelman examines both Andrews's claim that an income tax is less fair than a consumption tax because it does not distinguish between people who consume in the present and those who save and thus defer consumption, and also Warren's suggestion that the saving taxpayer might in fact be better off because of the interest earned on his savings. Kelman argues that the question of whether a fair tax system would distinguish between the current consumer and the saver is a complicated one which depends on one's conception of the 'origin' of interest. He spells out four quite different accounts of what interest might represent. Three of these conceive of interest as having essentially psychological roots, while the fourth views it purely as a function of market forces. In Kelman's view, no one view is obviously superior to the other three.

Finally, Barbara Fried's recent essay, 'Fairness and the Consumption Tax', is an ambitious contribution to the debate concerning the relative fairness of consumption and income taxes. Fried analyses the argument made by consumption tax proponents that it is unfair to tax unconsumed returns to capital. This argument apparently comes in three versions, each resting on a different concept of fairness. These three concepts are mutually inconsistent, yet each version of the argument ultimately rests on the claim that an income tax is likely to 'disadvantage savers relative to consumers, as compared to the respective positions of such parties in a no-tax world'.[3] She concludes, first, that it is not even clear that a tax on income from capital does favour spenders relative to savers and, second, that certainly the case has not yet been proved that it would be unfair if it did.

The design of a tax system requires more, of course, than the choice of a tax base. Another essential feature is a rate structure which determines what proportion of an individual's tax base the taxing entity will seek to collect. A system's rate structure can be more or less complex and/or systematic, but a complete description of it would focus on the effective tax burdens imposed on taxpayers, taking into account all exemptions, preferences, credits and other adjustments built into the system.

There are an infinite number of rate patterns which a system could employ, but academic discussion (for no very good reason that I can think of) has focused almost entirely on three: rate structures which are progressive, proportionate and regressive. Under a progressive tax, the percentage of the tax base claimed by the government increases as the tax base increases; under a proportionate tax, the rate does not vary with the size of the tax base, while under a regressive scheme the rate varies inversely. Since a regressive rate structure is widely thought to be unfair, it has been given considerably less attention than the other two.

Without doubt, the most influential analysis of the relative merits of progressive and proportionate rate patterns in American legal literature was written in 1952 by Walter J. Blum and Harry Kalven, Jr. Their article, 'The Uneasy Case for Progressive Taxation', was first published in the *Chicago Law Review* and has since been republished as a monograph (and hence is ineligible for inclusion here). Blum and Kalven note the broad and strong intuitive appeal of a principle of progressivity; they then proceed – meticulously, systematically and critically – to examine the foundations of this idea and the justificatory arguments which might be made on its behalf. As its title suggests, their piece concludes inconclusively with the following observation:

> [T]he theory of progression is a matter of major importance for taxation. The adoption of progression necessarily influences the positive law of taxation more than any other factor. But in the end it is the implications about economic inequality which impart significance and permanence to the issue and institution of progression. Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem.[4]

Despite, or perhaps because of, its careful irresolution, Blum and Kalven's essay did not spawn a large body of serious scholarship plumbing the deep issues associated with the choice of a rate structure. It is itself the classic discussion and has importantly shaped the views of tax scholars in the four decades since being written. The short piece by Walter Blum in this collection (Chapter 10) is included largely in recognition of the central role that Blum and Kalven's original paper has played in people's thinking about rate structures. Blum's 1981 paper, 'Revisiting the Uneasy Case for Progressive Taxation', focuses briefly on four features which were characteristic of the US economic situation at that time and explores the implications of a progressive rate structure for each.

In 1987 another pair of legal scholars published an ambitious paper seeking to examine the underpinnings of progressivity. In Chapter 11 entitled 'Social Welfare and the Rate Structure: A New Look at Progressive Taxation', Joseph Bankman and Thomas Griffith argue that any rate structure must both presume and be measured by a theory of distributive justice. They criticize Blum and Kalven's method of analysis for not being grounded in such a theory of distributive justice and for treating proportionate taxation as if it were a natural default position rather than one which, no less than progressive taxation, requires affirmative justification. Bankman and Griffith concentrate on what they call 'welfarist' theories of distributive justice – those which measure the goodness of a social state by the well-being of its citizens. They evaluate the benefits and costs of progressivity using the tools of a branch of economics known as optimal taxation. Through the use of economic models, optimal taxation purports to be able to provide a means of calculating a tax rate structure in which, under a given theory of distributive justice, revenues would equal expenditures and social welfare would be maximized. The rate structures produced by optimal tax models will vary significantly according to the assumptions made about a variety of different features concerning the structure of the economic system and the determinants of individual utility. Nonetheless, Bankman and Griffith argue, using plausible assumptions about these two features, optimal tax models suggest that, under any 'welfarist' theory of distributive justice, the optimal tax is progressive but not characterized by graduated rates.

The concept of horizontal equity is often cited as an appropriate goal for any tax system, regardless of its rate structure. Horizontal equity is the requirement that equals be treated equally. The next three essays address the normative status of horizontal equity. The first of these, 'Horizontal Equity: Measures in Search of a Principle', by Louis Kaplow, argues that the principle in fact has no normative content independent of that of vertical equity. Vertical equity is the requirement that there be 'appropriate' differentiation among unequals. Kaplow's analysis concludes that compliance with vertical equity ensures compliance with horizontal equity, and that horizontal equity does not provide an adequate measure by which a tax system should be judged. In Chapter 13, 'Horizontal Equity, Once More', Richard Musgrave takes the position that horizontal equity does have independent normative content. He argues that, whereas the requirements of vertical equity vary significantly depending on the view of

distributive justice presumed by the tax system, the requirements of horizontal equity remains unchanged. Paul McDaniel and James Repetti respond to the debate in 'Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange' (Chapter 14). They take the position that neither horizontal nor vertical equity has any normative content independent of an underlying theory of distributive justice. Indeed, they conclude that, in all probability, neither principle serves as a useful standard for analysing a tax system's provisions.

The normative choices which a government makes in the design of its tax system must necessarily comply with the strictures of the structural requirements, if any, which logically underlie *any* tax system. I conclude this volume with an essay of my own, 'Realization, Recognition, Reconciliation, Rationality and the Structure of the Federal Income Tax System', which seeks to isolate and articulate the underlying structure on which the content of the tax law hangs. I argue that by examining the necessary structure of a tax system (apart from its particular content or goals), we can better understand the role played by its most characteristic features.

Together the contributions in this volume cover a considerable range. My essay, like Epstein's, is unusual in the American legal tax literature in beginning where it does. We are both exploring the *foundations* of the taxing enterprise, his paper in asking whether taxation can be justified as a matter of political theory, and mine in asking whether there is a conceptual structure undergirding all systems of taxation – a sort of metaphysics of tax. The 13 papers in between represent the best of contemporary mainstream debate about what to tax and how to do so fairly.

Notes

1 I benefited in the selection of essays for these volumes from suggestions made by Jeffrey Lehman and Lawrence Zelenak. My research assistant, David Wood, was unfailingly helpful. Work on this volume was supported by the University of Michigan Law School's Cook Endowment for faculty research.
2 Andrews, Chapter 5, p. 171 quoted in Warren, Chapter 6, p. 196.
3 Fried, Chapter 9, p. 287.
4 Blum and Kalven (1952), 'The Uneasy Case for Progressive Taxation', *University of Chicago Law Review*, **19**, at 417, 520.

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ASOMATOUS INCOME

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1. Introduction

The expression 'psychic income' is sometimes used to refer to forms of imputed income that are not derived in cash or kind, but that arise from the an individual's use or enjoyment of his or her assets or abilities. The term 'imputed income' is also used to refer to these forms of income. However, since New Zealand and Australia changed to an imputation system for the taxation of companies and shareholders the term 'psychic income' is preferred by some commentators, as being less likely to lead to confusion with questions of company taxation. But this is not a perfect solution.

One difficulty is that 'psychic', although referring to things of the mind (the sense in which it is used here), is more commonly thought of as referring to matters spiritual, something that leads to its own confusion. The author's suggested solution is to use the term 'asomatous', in the sense of 'unembodied'.

Examples of asomatous income include the use of a home that one owns. Anyone is better off living in her own home than renting a home from someone else. Should the home user be taxed on the value of her home that she uses? Another example is self service. Should the carpenter who renovates her house be taxed on the value of her labour that she consumes in the process? The importance of these questions, and of the answers to them, is best understood against a background of some broad policy questions that underlie our tax legislation.

2. Definition of income

Most economists discussing questions of tax policy accept what is known as the Haig-Simons definition of personal income, that is, the '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 the end of the period in question.' (H.C. Simons, *Personal Income Taxation*, University of Chicago Press, 1938, p. 50.) The Haig- Simons definition is known as a 'comprehensive' definition, because it comprehends all value that accrues to a person or that he consumes. Fundamental to the Haig-Simons definition is an emphasis on the earning, the increase, and the consumption, of wealth.

It will be observed that the formulation takes for granted one of the obvious truths about income, that is, that any concept of income can have meaning only in relation to time; before talking about someone's income one must first establish the duration of the period over which it is proposed that the income should be measured. Leaving to one side this question of duration for the moment, the meaning of the Haig-Simons definition can be illuminated by an example.

Take a man who owns net assets worth $50,000 at the beginning of a year, who earns a salary of $30,000 during the year, who spends $40,000 on personal consumption, and who finishes the year with a net worth of $55,000. According to the Haig-Simons definition, his income for the year is $40,000 + $5000, = $45,000.

We know that $30,000 of the income was salary. How does one account for the rest? It may have been derived in several different forms. Perhaps, for example, he inherited a legacy of $5000, he won $5000 gambling, and one of his assets increased in value by $5000. These forms of increase in purchasing

power are customarily not subject to income tax in most countries. Nevertheless, the purchasing power of the man increased during the year by precisely the same amount as the purchasing power of his wife, who earned a salary of $45,000, but who enjoyed none of the other increments to wealth. The Haig-Simons definition of income does not say that the man and woman in this example should pay the same amount of income tax, but it points out that their separate incomes are such that, in principle, they could do so.

3. Practical difficulties with the definition

In that it attempts to be comprehensive, the Haig-Simons definition tries to do justice fairly between different taxpayers who derive their wealth in different forms. But while the definition is all very well in theory, in practice it gives rise to certain problems. The correct treatment of asomatous income is one of these problems, but it is only one among many. Most of them will be familiar to anyone who has followed this decade's reforms in Australia, New Zealand, and other parts of the world. Among the difficulties of the definition are questions of how certain receipts should be dealt with; questions of timing and of defining the period over which income shall be measured; and questions of the form of income.

Doubtful items

The example of the operation of the Haig-Simons definition given above highlights several of the problems of matching any comprehensive definition of income with the definitions that are employed in most income tax systems. Though some systems employ more comprehensive definitions than others, the items mentioned in the example give rise to questions that must be answered for purposes of the laws of most jurisdictions that tax income.

Why should lottery or other gambling winnings be free of income tax? What about legacies, or inter vivos gifts, for that matter? There is no question but that these are all accretions to wealth. Tax jurisprudence suggests that the notion of windfall, and the fact that gambling winnings and gifts are not earned by labour or by the ownership of property, explain their status as non-taxable receipts. But these reasons have no a priori, fundamental force that compels their acceptance without other justification. Indeed, if any sort of receipt is to be free of income tax, an appeal to a priori notions (at least, to a priori notions of protestant morality) might suggest that, for example, the hard-earned wages of the labourer should qualify for non-taxable status before the winnings of the gambler.

Why should accretions to the value of capital assets be free of income tax while dividends, rent, royalties or interest from those assets be assessable along with the rewards of labour? Statistics, and, indeed, common sense, tell us that the greatest beneficiaries from the exemption from tax of capital gains are the wealthy, because they own most wealth.

Period for measurement

All income tax systems with which one is familiar adopt the year as the period for measurement of income. Any shorter period (a week?, a month?, a quarter?) leads to misleading fluctuations of income for too many taxpayers. (Consider manufacturers of Easter eggs, Christmas crackers, and fireworks.) Any longer period would result in unacceptable delays for a government that needs to raise money.

The year as a measurement period is itself imperfect and able to be exploited by the tax planner. Consequently, increasingly large portions of the revenue laws of most jurisdictions have the function of forcing taxpayers to accelerate the recognition of receipts and to defer the deduction of expenses.

Where capital gains are concerned the question is particularly acute. Take a taxpayer who buys a capital asset for $100 at the beginning of year one. At the end of year one it is worth $200, and at the end of year two the taxpayer sells the asset for $300. Suppose that at the end of year one the taxpayer mortgaged the asset for $180, on the basis of the valuation of $200. The accretion to value has not only increased the purchasing power of the taxpayer; that increase in purchasing power has actually been deployed. Assuming that the gain is to

be taxed, how and when is this to be done?

Legislators generally give up on this task and pass laws that tax accretions only when the asset in question is realised. In these circumstances, ancillary rules may be enacted in order on the one hand to mitigate the bunching of taxable gains at the point of realisation, and on the other hand to counteract the advantage of deferring the recognition of gains until that point.

Forms of income

What form must a receipt take before it is taxable as income? The most obvious form is money, but cash cannot be the complete answer. Otherwise, people would arrange to be paid in goods or services. Indeed the occassional proliferation of swap clubs is evidence of a belief in many quarters that if a receipt is not cash it is not income. This belief is certainly incorrect in general in Australia and New Zealand, though it has some accuracy in limited circumstances.

In the generality of cases, the concept of 'money's worth' ensures that the value of a taxpayer's non-cash receipts is taken into account as assessable income.

The principal exception has been in the area of employment-related fringe benefits. Because of an idiosyncrasy of the drafting of the New Zealand legislation it was formerly held that, to be taxable, non-monetary receipts from employment had to be not only valuable but also able to be convertible into cash. Thus, for example, the availability for use of a motor vehicle as part of a remuneration package was not assessable because the employee was typically not permitted to convert the value of the car to cash. He could not sell it or rent it.

In New Zealand, this gap in the tax system was plugged by the introduction of fringe benefit tax in1985. Since then, the fringe benefit tax regime has steadily extended. Now, virtually all non-cash benefits provided to employees are classed as fringe benefits, the tax on which is assessed to the employer. Employees are taxed only on monetary remuneration, which is widely defined, and on the value of one or two fringe benefits for which the Income Tax Act already contained a code at the time that the fringe benefit tax regime was introduced. A salient example is the value of employer-provided housing, which is taxed to the employee directly.

Income in kind gives rise to problems of valuation, but at least income in kind is not much more difficult to recognise than income in cash. Not so asomatous income. Asomatous income, which is by definition not derived in any ordinary sense, gives rise first to the problem of its identification, before one reaches the issue of valuation.

4. Home ownership

The best example of asomatous income is the benefit enjoyed by the householder who owns her own home. Take two taxpayers, Ms A, who owns her home, and Mr B, who rents his. Suppose Ms A's home is of equal value to Mr B's, for which he pays rent of $24,000 a year. Suppose they each earn a salary of $50,000 a year. Ms A is clearly better off than Mr B, because she has an asset worth $24,000 a year in respect of which she pays no tax.

5. Investment in home or other asset

The problem can be further illustrated by going back one step, to the situation that obtained before Ms A bought her house. Suppose both parties have $250,000 in cash. Ms A buys a house with her money, and Mr B buys shares yielding dividends of 10%. The parties keep their $50,000 salaries, so Ms A has an assessable income of $50,000, and Mr B an income of $75,000. Mr B still has to pay his rent of $24,000, and both parties suffer tax on their total assessable incomes of one third.

Ms A therefore pays tax of $16,666, leaving income after tax and housing costs of $33,334. Mr B pays tax of $25,000 and rent of $24,000, leaving him $26,000. One way of equalising the position (or nearly so, on these facts) would be to allow Mr B a deduction in respect of his rental payments. On this basis his assessable income would be $51,000, which would bear tax of $17,000, leaving him with disposable income of $34,000, nearly the same as that of Ms A. This is not a solution commonly adopted in the world'd tax systems.

Now approach the example from a different angle. Suppose that, instead of buying the shares, Mr B buys the house next door to Ms A, but he does not move in. He stays where he is, paying his rent, but he in turn rents the house he owns to someone else, for $25,000 a year. Mr B's after tax position will be identical to his position after buying the shares; that is, he is left with $26,000 in disposable income.

6. Consequences

From these examples it may be seen that one result of not taxing asomatous income is a breach of the principle of horizontal equity. This is the principal that says that people of similar means should bear a similar proportion of tax on their incomes.

A second result is that there is a subsidy for owner occupied housing. Of course, it may be a good thing to subsidise owner-occupied housing. But to do so in this manner, through the tax system, is objectionable in principle. First, subsidies delivered through the tax system are more or less invisible, depending on the subsidy and its precise form. Secondly, this particular subsidy is regressive, because richer people tend to have more valuable houses than poorer people, and tend to pay tax at a higher marginal rate than poor people. Furthermore, those who do not own houses at all tend to be poorer than those who do own houses. Clearly, not to be taxed at 33% on the enjoyment of a house worth $24,000 a year is preferable in two senses to not being taxed at 28% on the enjoyment of a house worth $12,000 a year. And either state is better than not deriving the asomatous income at all, through not owning a house in the first place.

7. Intensifications

Bearing in mind the factors mentioned in the previous paragraphs, one might expect that, if a tax system did not tax the asomatous income of the householder, it might instead claw back that benefit in some other way. In fact, the opposite tends to be true.

Take first the example of capital gains taxes. Regimes that tax capital gains tend to exempt gains on owner-occupied housing. Thus, when the New Zealand government issued its consultative document on the taxation of income from capital the Minister of Finance announced that, whatever regime was adopted, gains from owner occupied homes would be exempt.

This policy has interesting consequences for the example given above. Suppose both the house of Ms A and the shares of Mr B go up in value. When the assets are sold, under most capital gains tax regimes Ms A's gain will be tax free, but Mr B's gain will be taxable; Ms A obtains a doubled benefit, and Mr B suffers a doubled detriment. It is this consideration that causes the value of houses to increase substantially when a capital gains tax is introduced. No doubt, this influence was a significant factor in fuelling the boom in Sydney house prices that occurred in 1988 and 1989.

A second feature of tax systems that exempt asomatous income is that they often permit a deduction for interest paid on money borrowed to buy owner-occupied houses. As explained above, if one wants to treat owners and renters in the same manner one approach is to allow a deduction to the renter. To follow the opposite route and to allow a deduction for mortgage interest only exacerbates the result, and enhances the tax subsidy for owner-occupied housing. Mindful of this problem, some reformers in the United States of America, where all interest is deductible, are currently proposing that deductibility of interest should be permitted in respect of a maximum of two houses per family!

8. Consumer durables

The remarks above about owner occupied housing apply in a similar manner in respect of other assets held for private use, such as motor cars, refrigerators, and so on. Take two music lovers, each with $2000. The first spends his money on a gramophone and some records, which he plays to himself. The second places the money in a deposit account and spends the after-tax interest on concert tickets. The first thus enjoys the return on his $2000 tax-free, while the second can spend the after tax sum only.

Be that as it may, the results of not taxing the enjoyment of consumer

durables may be less marked than the results of not taxing asomatous income from housing. One reason is that consumer durables seem to be less frequently rented than housing. A second reason is that the value of housing in the community is probably greater than the value of consumer durables. Nevertheless, it seems likely that there is a correlation between the value of one's house and the value of one's chattels. Thus, those whose asomatous, tax free, income from housing is greatest are likely to be those who also enjoy the greatest asomatous income from chattels.

9. Bank deposits and prepayments

Items that are not strictly asomatous income, but that are somewhat similar, include the benefits of bank deposits and most forms of prepayments. Some banks waive charges to customers who maintain certain minimum deposits in their cheque accounts. The customer who benefits from this practice will be better off than the customer who deposits her money at interest and uses the net income to pay the bank's charges.

Take, also, someone who pays five years of insurance premiums all at once, enjoying discounts for early payment and for the consequent reduction in administration costs incurred by the insurance company. The early payer will never be taxed on the value of the discounts, but his neighbour who pays his premiums annually from after tax income will not get the same benefit.

10. Services

After owner occupied housing, it may be that the greatest source of asomatous income is self services. The carpenter who builds himself a house is better off than the carpenter who engages someone else to build the house for him, paying the builder out of after tax income. Indeed, the same can be true of anyone who builds himself a house. Depending on the relative earning power of carpenters and solicitors, and on the marginal rate of taxation, it may be worthwhile for a solicitor to eschew some of her earnings from the law and instead to build herself a house.

A tax system that encourages people to provide for themselves by self service rather than by working in the occupation where they have the greatest skill, where their work produces the greatest value, tends towards an overall reduction in the welfare of its society. One benefit of reducing tax rates is that the lower the rates the less attractive it is for taxpayers to forego opportunities to earn taxable money by performing the tasks at which they are most skilled, in favour of non-taxable benefits obtained from self service.

The benefits of self services are no doubt a drain on all tax systems, but the drain is in the end self regulating. The carpenter cannot enjoy more than a certain number of houses. The motor vehicle restorer cannot store or use more than a certain number of cars. The gardener can eat only so many vegetables. Once production goes beyond these limits, and the taxpayers start selling to others, they are of course back into the assessable portion of the economy.

(The rules relating to the consumption of produce by farmers raise different issues. Farmers have taken deductions for the cost of producing their crops or animals. Thus, for matching purposes they must be taxed on the value of the produce they consume. The same considerations apply to, for example, grocers who feed their families from the shelves of their shops.)

11. Housework and child care

Some beneficiaries of self services face a different problem. These are those whose services are by way of housework or child care. For them, there is an additional cost of giving up their astomatous income: they must pay someone else to do the work for them.

Take two couples, the A's and the B's, where the wives each earn salaries of $50,000, and the husbands look after the houses and children. Husband A decides to change, and takes a job that also pays $50,000. To do so, he incurs housekeeping and nanny expenses of $20,000, which are not deductible. After paying the $20,000 plus tax of, say, $16,666, the A's have only $13,334 left out of the extra salary of $50,000. Common experience suggests that this $13,334 will be eroded to, say, $10,000 by the extra expenses incurred in any

household where both spouses are in paid employment. Husband B, on the other hand, stays at home, and the B's are not better off by the $10,000 net derived by the A's. The B's enjoy an after tax income of $33,333, the A's of $43,333.

At first sight this result does not seem unreasonable. But test it by altering the facts slightly. Suppose Mr A does not go out into the regular workforce, but takes work as a housekeeper for the B's at $20,000 a year. Mr B, on the other hand, works for the A's in the same capacity for the same salary. Both men are such good workers that the two households operate just as efficiently as when they each worked at home. But the difference is that now the A's income is $50,000 less tax of $16,666, and less $20,000 paid to Mr B, plus the net $13,333 that Mr A earns housekeeping for the B's, a disposable income of $26,667. The income of the B's is the same.

Why is the B's income so much better when Mr B is contributing $20,000 worth of housekeeping to his own house than when he is going next door to do the same work for the A's? The reason is that when Mr B works at home the B's are not taxed on the asomatous income that they derive from Mr B's services.

In the example given here it has been assumed that Messrs A and B can earn much more in employment other than child care and housekeeping. It might be suggested that the example perpetuates the under-valuing of these home duties. That may be so. But suppose the nanny-housekeepers were to be paid, say, $30,000, instead of $20,000, the results of the example would be even more pronounced. In working for the A's rather than for himself (and engaging Mr A as his housekeeper) Mr B would see his disposable family income drop to $23,333.

12. Solutions

One solution is to tax spouses who work at home at housekeeping or child care on the value of their asomatous income. But this solution is impractical. A feature of asomatous income in general is that it is hard to value. That is particularly so in the case of self services that produce no identifiable asset able itself to be valued.

An alternative is to focus on the position of the spouse who does go out into the paid workforce, and to allow him or her a deduction for child minding or housekeeping costs. But this solution contains its own problems. These costs are currently non-deductible by virtue of the general prohibition against the deduction of private expenses in calculating assessable income. If that prohibition were relaxed in respect of child minding, is there any reason of principle for not relaxing it in other respects?

Take the childless rentier with investments that provide him with enough to live on, who spends his time looking after a large house and garden. His alternative of taking a job and paying a gardener and housekeeper from his after-tax income is not a sufficiently attractive prospect for him to opt for it. Should tax law solve the problem by allowing the rentier a deduction for these housekeeping and gardening expenses?

This question is simply a particular example of the larger question of whether tax law should subsdidise private consumption, a question that is almost always answered in the negative. The question arises in many circumstances. Should the commuter be permitted to deduct her travel costs, so that she may be encouraged to take a higher paying job further away from home? If one is to allow deductions for any such costs should there be any limits? For example, if commuting expenses are to be allowed, should the allowance be limited to the cost of using public transport?

Once considerations of this nature intrude, serious problems for the administration of the whole tax system arise. These problems may be contrasted with certain aspects of the existing tax system. One reasonably elegant feature of this system is that it is not necessary for the law to question, and the law does not question, the amount or wisdom of expenses incurred in the production of income. The rationale is that, in the typical case, the taxpayer and the tax gatherer share a common interest in maximising assessable income. The taxpayer winds up with more net income to consume or to save, and the tax gatherer winds up with more tax. The parties thus have a similar interest in

minimising expenses. Of course, the lower the tax rate, the higher is the interest of the taxpayer in this activity.

These considerations do not apply where the expense is on personal consumption. For the taxpayer, the matter then depends on personal preference, on choice between consumption and saving, and on and what he can afford. It is for reasons such as these that, in the end, tax systems do not allow a deduction for expenses of a private nature even though the opposite policy might in many circumstances lead to an increase in productivity of individual taxpayers.

13. An alternative approach to child minding expenses

In the preceding discussion it has been assumed that expenses of child minding are similar in kind to other private expenses that may enable someone to enter the paid workforce, or to undertake more paid work. That is, child minding expenses have been categorised as private consumption, as, indeed, they usually are in most tax systems.

This categorisation is questionable. Child rearing is something in which the community as a whole has an interest; it may be shortsighted to regard child minding as simply a question of private consumption. Consequently, a case can be made on philosophical grounds, and perhaps on the grounds of long-term economic benefit to the community, for treating child minding expenses differently from private expenses in general.

This sort of reason no doubt justifies the limited deduction for child care that is currently permitted by the New Zealand tax system. But it may have more forece than this. Could one justify treating child care expenses like business expenses, and not imposing any limit as to kind or amount? Alternatively, could one justify the administrative costs that would be entailed in the imposition of such limits? Would the political fallout from allowing a deduction for these costs lead to other erosions of the tax base that would outweigh the benefit of a more generous child care deduction?

Pressure would come from two sides. First, analogies would be drawn with aspects of private consumption that can be made to appear to have some intrinsic merit: home ownership, and travelling to work, for example. Secondly, there would be constant pressure on any limits of kind or amount that were imposed on the child care deduction itself.

Past experience with deductions that are not related strictly to the production of assessable income suggests that governments are not good at resisting these pressures. One thinks of the former fourth schedule to the Income Tax Act 1976, listing a miscellaneous and administratively complex range of deductions permitted in respect of employment income. One thinks of such curiosities as section 114A of the Act that, until 1986, allowed a deduction for the cost of fitting 'safety devices' to taxi cabs. Contrary to what one might have thought, 'safety devices' were not such useful things as headlights, windscreen wipers, or seat belts. Rather, they were fences installed behind the driver to keep back seat passengers at bay. Section 114A was justified by reference to section 114, which allowed a deduction for safety devices attached to tractors.

The Concept of Income

VICTOR THURONYI*

I. INTRODUCTION

The concept of income serves as a touchstone against which the rules of the current income tax can be evaluated and is, therefore, of critical importance in the debate over what those rules should be. The meaning of income is also of interest to those charting the distribution of income, so as to have a quantitative measure of the degree of economic inequality in a society. In the United States, one frequently hears statements like: "The top [20%] collect[s] 44 percent of all income, compared with less than 5 percent for the bottom [20%]."[1] The increased inequality of income distribution in the Reagan years has intensified interest in this subject.[2]

Once the distribution of income is measured, the effects of various proposed policy changes on income distribution can be analyzed. Because tax policy is intimately concerned with income distribution, analysts routinely quantify the effects of proposed tax changes on the distribution of income,[3] but the same can be done for proposals in any other area of public policy. The concept of income also has important uses in the social sciences, such as studying how income affects behavior.

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[1] E.g., A. Malabre, Within Our Means 42 (1991).

[2] See id. at 42-45; Harrison, Tilly & Bluestone, Rising Inequality in the Changing American Economy 111 (1986).

[3] For example, recently, it was calculated that taxpayers with income of $200,000 and above would reap about 66% of the benefits of a 30% exclusion for long-term capital gains. See Joint Comm. on Tax'n, 101st Cong., 2d Sess., Estimate of Administration Proposal for a Reduction in Taxes on Capital Gains of Individuals (Comm. Print 1990). Without a concept of income, such a statement could not be made. In this particular exercise, the Joint Committee used a concept of income that is substantially narrower than the Haig-Simons concept, see text accompanying note 6, although broader than adjusted gross income under current law. For example, it does not include unrealized gains (although it does include inside build-up on life insurance policies), gifts or bequests.

Given the importance of these uses of the income concept, the manner in which income is defined can make a difference. For example, if it is considered desirable for the income tax to approximate the ideal concept of income as closely as possible, it becomes important whether that ideal treats gifts and bequests as income. Moreover, the pattern of income distribution and the effects of a change in tax or other policy on that distribution can vary significantly depending on how income is defined.

The income concept that is now widely accepted by analysts was formulated by Henry Simons in the 1930's,[4] and is commonly referred to as Haig-Simons income, to acknowledge the prior contribution of Robert Haig.[5] It holds that an individual's income is the sum of his consumption plus accumulation during the taxable period. Despite its wide acceptance, Haig-Simons income remains elusive and ambiguous, since the terms "consumption" and "accumulation" are open-ended. In light of the slipperiness of these terms, some writers have questioned whether the Haig-Simons formulation is, at base, a coherent one and is really helpful in deciding what is income.[6] Indeed, one noted economist has concluded that "the problem of *defining* individual Income, quite apart from any problem of practical measurement, appears in principle insoluble."[7] Despite these theoretical objections, the term "economic income," or Haig-Simons income, is commonly employed as if it were a relatively well-defined or well-understood concept.[8] The fact that some use economic income as a workable concept while others question its validity suggests that the nature of the concept is not well understood and has not been fully explored, despite the inordinate volume of literature on the subject. This article begins with an inquiry into the nature of the income concept appropriate for tax policy. A selective survey of the extensive literature on the definition of income suggests that there is confusion about the philosophical groundwork supporting the Haig-Simons concept, largely because the concept was borrowed from economics to be used in law. While the language used to define income has meaning in economic theory, that meaning collapses when it is applied in the real world.

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[4] H. Simons, Personal Income Taxation 50 (1938).

[5] See, e.g., Pechman, Comprehensive Income Taxation: A Comment, 81 Harv. L. Rev. 63, 64-65 (1967). Some writers have referred to the "Schanz-Haig-Simons" definition of income to acknowledge the contribution of George von Schanz. E.g., S. Surrey & P. McDaniel, Tax Expenditures 4 (1985).

[6] See, e.g., Bittker, A "Comprehensive Tax Base" As a Goal of Income Tax Reform, 80 Harv. L. Rev. 925 (1967) [hereinafter Bittker, Comprehensive Tax Base].

[7] N. Kaldor, An Expenditure Tax 70 (1955) (emphasis in original).

[8] E.g., C. McLure, J. Mutti, V. Thuronyi & G. Zodrow, The Taxation of Income From Business and Capital in Colombia 19-20 (1990); Block, The Trouble With Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986, 40 U. Fla. L. Rev. 689, 693-95 (1988); Fellows, A Comprehensive Attack on Tax Deferral, 88 Mich. L. Rev. 722, 723-24 (1990); Shaviro, Selective Limitations on Tax Benefits, 56 U. Chi. L. Rev. 1189, 1190, 1191, 1201-02 (1989).

II. Nature of the Income Concept

A. Haig-Simons Tradition

In his seminal 1938 work, Simons says: "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."[10] Thus, income can be described as the sum of accumulation (that is, the change in the taxpayer's net wealth) plus consumption during the taxable period. While this definition does pin down the concept of income to some degree, it involves considerable ambiguity, given the open-endedness of the terms "consumption" and "wealth," and does not specify criteria for resolving the ambiguity. Despite (or perhaps because of[11]) this ambiguity, the Haig-Simons formulation has been widely accepted. It is not clear, however, that it is appropriate to pay so much deference to Simons' formulation of the income concept. As a perusal of his book demonstrates, his was only one of numerous formulations by various writers, and even Simons himself defined income in different ways within the same work.[12] To arrive at an understanding of income, it is necessary to begin by asking what the concept is about, and what criteria should be used in deciding whether a particular item should be taken into account in determining an individual's income.

In formulating these criteria, it is useful to go back to Simons' work. Simons reasoned that "[s]ince it is widely agreed that income is a good tax base, its meaning may be sought by inquiring what definition would

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[10] H. Simons, note 4, at 50.

[11] The popularity and acceptability of the Haig-Simons definition may be due partly to the flexibility of the concept, which allows it to be interpreted as considered appropriate in any particular case. See Bittker, A Last Word, in A Comprehensive Tax Base?, 125, 126-27 (1968).

[12] Compare H. Simons, note 4, at 50, with id. at 49.

provide the basis for most nearly equitable levies."[13] He went on to describe "what is requisite to satisfactory definition of income": "Income must be conceived as something quantitative and objective. It must be measurable; indeed, definition must indicate or clearly imply an actual procedure of measuring. Moreover, the arbitrary distinctions implicit in one's definition must be reduced to a minimum."[14]

Surprisingly, Simons' analytical groundwork has been paid relatively little heed, perhaps because his exposition was not completely clear.[15] Simons did not discuss what it meant to define income in terms of equity, and failed to show how his definition of income flowed from the statements quoted in the preceding paragraph.[16] A careful reading of Simons suggests, however, that he did intend his definition to flow, at least in part, from judgments about tax equity. For example, in discussing leisure, Simons found that "income per hour of leisure, beyond a certain minimum, might well be imputed to persons according to what they might earn per hour if otherwise engaged."[17] Simons reasoned, however, that leisure could be excluded from income if the resulting relative tax burdens were equitable.[18] This approach suggests a general principle

[13] H. Simons, note 4, at 42. Simons restates the point as follows: "Indeed, it may be regarded as a sort of thesis that income, as already described, is essentially identical with that base on which it would be most nearly equitable to levy upon individuals." Id. at 106. And again, in introducing the discussion of special problems in defining income, Simons states: "We turn now to various problems involved in making income taxation more equitable." Id. at 109.

[14] Id. at 42-43. Simons's stricture against arbitrary distinctions can be seen as subsumed in the basic criterion of equity: Since arbitrary distinctions are inconsistent with equity, the need to minimize such distinctions is implied if one defines income in terms of equity.

[15] For example, Professor Warren asserts that Simons' income concept "does not provide a standard for deciding whether a given receipt, transaction, event or whatever is income in some abstract sense" and merely "permits the interpersonal allocation or attribution of income to individuals." Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081, 1084-85 (1980). Professor Warren's article does not explain how the view of Haig-Simons income asserted therein, namely that Haig-Simons income merely allocates among individuals the annual social product, can be reconciled with the analytical approach of Henry Simons. Indeed, Warren asserts that Simons himself erroneously interpreted his own income concept. See id. at 1088.

[16] Thus, his famous definition appears in H. Simons, note 4, on pages 49-50 almost out of the blue. He does not tie it explicitly to his above-quoted statements on pages 42-43. See also Koppelman, Personal Deductions Under An Ideal Income Tax, 43 Tax L. Rev. 679, 705 (1988) (Simons and Surrey "provide no persuasive rationale for adopting" power-to-consume standard).

[17] H. Simons, note 4, at 52.

[18] See id. at 52-53. Simons repeats this point on page 113: "On what grounds may one defend this policy of including one sort of income in kind and ignoring the other? The answer, in general terms, is that the exemption of '*earned* income in kind' leads to no serious inequity in the distribution of the tax burden. . . . If such considerations support exemption of the one class of items, they argue quite as strongly for inclusion of the other. Income from consumers' capital is often a large part of total income for individuals in the upper brackets. To exclude it is to introduce a bias inconsistent with the system of progression and to differentiate flagrantly among persons of really similar financial circumstances." Id. at 113-14 (emphasis in original).

that the exclusion of a particular item from the definition of income is acceptable if the resulting distribution of the income tax burden would be considered equitable. In other words, income is to be defined in such a manner as to lead to an equitable distribution of tax burdens.

Nevertheless, Simons did not rely unequivocally on the criterion of equity. He did, as noted, fail to connect his definition of income to this criterion.[19] His thesis that income constitutes the most nearly equitable levy can be read as simply an argument that income is the most equitable basis for taxation, not that income can be defined only in terms of equity.[20] Furthermore, Simons opined that:

> [t]he criterion of equity, by itself, leads only to a vague and elusive ideal, not to a sound and workable income tax. Indeed, it leads away from income entirely or (what is the same) to casuistic definition. So, one must face the fact that income is an actual tax base and that income taxes must finally be appraised in terms of general rules of procedure which best define their nature. Hence arises the need for rigorous, objective definition.[21]

Thus, for Simons, "objectivity" and "rigor" were important factors in defining income, even if the result might be considered inequitable. This view suggests that, in defining income, Simons' principal concern was to propose objective, general rules as a bulwark against ad hoc exceptions that would erode the tax base in response to political whim.[22]

Other writers also have spoken of defining income in terms of equity.[23] For example, Professor Musgrave discusses how the concept of horizon-

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And again, in discussing the issue of imputed income from consumer durables, he states: "In general, the disregard of income in kind from the less durable forms of personal tangibles will occasion no serious inequities in relative tax burdens." Id. at 119.

[19] See note 13.

[20] See H. Simons, note 4, at 106.

[21] Id. at 139.

[22] See Hettich, Henry Simons on Taxation and the Economic System, 32 Nat'l Tax J. 1, 5 (1979).

[23] See J. Dodge, The Logic of Tax 85-101 (1989) [hereinafter J. Dodge, Logic]; N. Kaldor, note 7, at 25; W. Klein, Policy Analysis of the Federal Income Tax 7-8 (1976) [hereinafter W. Klein, Policy Analysis]; Goode, The Economic Definition of Income, in Comprehensive Income Taxation 1, 2 (J. Pechman ed. 1977); Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 Harv. L. Rev. 1177, 1185 (1978) [hereinafter Dodge, Beyond Estate Tax Reform]; Feldstein, On the Theory of Tax Reform, 6 J. Pub. Econ. 77, 87 (1976); Klein, An Enigma in the Federal Income Tax: The Meaning of the Word "Gift," 48 Minn. L. Rev. 215, 224-25 (1963); Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1967) [hereinafter Musgrave, In Defense]; Popkin, Tax Ideals in the Real World: A Comment on Professor Strnad's Approach to Tax Fairness, 62 Ind. L.J. 63, 63-65 (1986); Sneed, The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567, 577-80 (1965) [hereinafter Sneed, Criteria]; see also D. Bradford, Untangling the Income Tax 19-21 (1986) ("the

tal equity is relevant in specifying the tax base.[24] The principle of horizontal equity holds that people in equal positions should pay the same amount of tax. The key question, of course, is how "equal position" is to be defined. Professor Musgrave's preferred approach to measuring equal position "is to look for a general index of economic well-being which broadly measures a person's capacity to contribute,"[25] and the "most appropriate choice" for such an index is income.[26] Professor Musgrave says that, alternatively, consumption could be chosen, the choice between the two being "essentially one of value judgment."[27]

Professor Musgrave argues that, once income is chosen over consumption, the matter of defining income does not involve a value judgment.[28] The case for the Simons definition of income is, he states, "clear" and "follows as a matter of consistent thinking once the income approach has been decided upon."[29] Professor Musgrave's reasoning cannot be sustained. If the goal is to develop an index that will assure horizontal and vertical equity, one cannot simply assert that Haig-Simons income meets that criterion and move on. Without inquiring into the details of the meaning of income, it is impossible to say whether Haig-Simons income is an appropriate criterion for equity, since the concept is burdened with considerable ambiguity.

The fact that economists (such as Professor Musgrave) have tended to downplay the ambiguity of the income concept can be understood in light of the nature of economic theory. According to the assumptions of neoclassical economic theory, individuals maximize a "utility function," the components of which are commodities (goods and services, consumed now and in the future) and leisure.[30] Individuals are endowed with resources, namely, a supply of labor and capital. Labor time either can be used to earn money to pay for consumption or can be enjoyed directly as leisure time. Under this view of "economic man," one's eco-

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preferred policy is to be sought not in abstract reasoning but in concrete comparisons of the effect on tax burdens").

[24] See Musgrave, In Defense, note 23, at 45.

[25] Id. at 45-46.

[26] Id. at 46.

[27] Id.

[28] Id. at 47.

[29] Id. at 47-49. Musgrave contrasts this reasoning with what he terms the "ad hoc" approach to tax equity, which would deal "piecemeal with each specific characteristic of households (including various aspects of income, consumption and other features), asking in each case whether it does or does not constitute a proper tax base, and doing so without the guidance of a general principle by which to relate specific decisions." Id. at 50. Musgrave criticizes the ad hoc approach, stating that "even if the possibility of such an approach were granted, and I doubt whether it can be, it would surely lead to a broad bundle of taxes, and not to an income tax per se." Id.

[30] See Rosen, An Approach to the Study of Income, Utility, and Horizontal Equity, 92 Q.J. Econ. 307 (1978).

nomic well-being is determined by her consumption of goods and services and leisure. Income, defined as the increase over the time period in a particular individual's power to consume, is, therefore, an appropriate measure of economic well-being.[31] The only shortcoming of the Haig-Simons income concept under this theory of income is that it omits some of the components of the utility function, in particular, leisure and public goods.[32]

Thus, as a matter of neoclassical economic theory, the ideal measure of income would include leisure and would include in "consumption" all goods and services that are components of the utility function. As Haig stated, "[m]odern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences."[33] According to Professor Aaron, comprehensive income would include a household's consumption of goods and services provided by governments and nonprofit institutions.[34] Professor Aaron argues that the Simons definition of income is arbitrary because it leaves out these elements of consumption. Simons would not, I think, have disputed this conclusion, but might have argued that omitting public goods and services is not fatal so long as they are distributed roughly in line with income.[35]

Under the traditional view of economists, the basis for the concept of income is obvious: Income is a measure of the economic utility experienced by the individual, the only issue being whether the underinclusiveness of the Simons definition is fatal to its validity.[36] Professor Koppelman's recent suggestion that income should be considered as a measure of economic well-being[37] is in line with this tradition.

My quarrel with considering income as a measure of economic well-being, in the technical sense that is specified by a utility function, is that the concept of utility has meaning only in the abstraction of economic theory, and cannot be applied to the real life problem of equity in the distribution of the tax burden. Even if one grants that individual utility is a function of goods consumed and leisure, there is no way to measure levels of individual utility and, hence, of comparing one person's utility

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31 See Menchik, Some Issues in the Measurement of Income Inequality, in Value Judgement and Income Distribution 227, 228 (R. Solo & C. Anderson eds. 1981).

32 See Rosen, note 30.

33 Haig, The Concept of Income—Economic and Legal Aspects, in American Economic Ass'n, Readings in the Economics of Taxation 54, 55 (1959).

34 See Aaron, What Is a Comprehensive Tax Base Anyway?, 22 Nat'l Tax J. 543 (1969).

35 Cf. H. Simons, note 4, at 52-53, 111, 113 (treatment of leisure).

36 See R. Tresch, Public Finance: A Normative Theory 265 (1981) (issue is whether income is "the best possible surrogate for individual utility").

37 See Koppelman, note 16, at 700; see also Shaviro, note 8, at 1191 (consumer surplus theoretically constitutes income).

with that of another.[38] More fundamentally, the notion that individuals maximize a utility function whose components consist of commodities and leisure may have some usefulness as a means of predicting consumer behavior and evaluating economic policy, but it holds no particular claim to being an accurate description of the well-being of real people. Moreover, even if the well-being of particular individuals could be quantified, it is not clear why we would want to base our tax system on such a measure. "Well-being" is not an operational concept and, even if it could be made operational, it is largely irrelevant to issues of tax policy. Someone with large amounts of money income may report a very low level of well-being, while someone with modest amounts of income may be blissfully happy. Surely the latter should not pay more tax than the former. Finally, even within the terms of the neoclassical model, the criticism of Professor Aaron and others is telling. The omission of significant elements of the consumption function—leisure and public goods—makes it impossible to equate income with economic utility or well-being. If these elements were included, income would be a more meaningful measure, but would lose its practical usefulness.

B. Proposed Approach to Defining Income

1. The Role of Equity

It is often said that people with the same income should pay the same amount of tax.[39] This can be true only if income is defined in terms of equity: Two individuals, *A* and *B*, should be considered as having the same income if, and only if, it is considered fair that *A* and *B* pay the same amount of tax. Defining income in these terms suggests why there has been so much dispute over the meaning of income. The inquiry into the meaning of income goes well beyond technical issues and involves fundamental value judgments about tax equity. Because people have different views of tax equity, there is no "true" concept of income. The best we can do is engage in reasoned debate and evaluate the implications of alternative assumptions about how to determine fairness, but we cannot prove that one set of assumptions is superior to another or is scientifically correct.

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[38] See R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 91 (4th ed. 1984).

[39] E.g., House Comm. on Ways and Means, 86th Cong., 1st Sess., Tax Revision Compendium ix (Comm. Print 1959); 1 U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 14 (1984); W. Klein, Policy Analysis, note 23, at 7; J. Sneed, The Configurations of Gross Income 3 (1967) [hereinafter J. Sneed, Configurations]; Feldstein, note 23, at 87; Musgrave, In Defense, note 23, at 51; Shaviro, note 8, at 1220; Sneed, Criteria, note 23, at 579; Surrey, The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted, 70 Harv. L. Rev. 1145, 1146 (1957).

III. Specific Problems in Defining Income

This section considers various issues in defining income, focusing particularly on cases where it may make a difference whether one adopts the Haig-Simons formulation of the income concept or whether one uses tax fairness as the premise. As I demonstrate, there is not necessarily a radical difference in result between the two approaches. Almost invariably, the Haig-Simons formulation can be interpreted as being consistent with a result that follows from judgments based on fairness. The Haig-Simons formulation, however, like any set of words, can be interpreted in different ways. A focus on fairness provides a basis for choosing one interpretation over another. Of course, there is no "correct" answer as to what an individual's income is under a fairness analysis, and some may disagree with my conclusions as to how income should be specified because

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81.1, 1981). For a review of historical definitions of poverty, see generally 1 S. Oster, E. Lake & C. Oksman, The Measure of Poverty: A Review of the Definition and Measurement of Poverty 3-17 (U.S. Dep't of Health, Education, and Welfare Technical Paper III, 1975).

[69] See S. Surrey, Pathways to Tax Reform 21-22 (1973); Newman, The Deductibility of Nondiscretionary Personal Expenses, 6 Am. J. Tax Pol'y 211, 215 (1987); Turnier, Personal Deductions and Tax Reform: The High Road and the Low Road, 31 Vill. L. Rev. 1703, 1712-13, 1716-19 (1986); Pechman, note 5, at 65-66; Taubman, On Income Taxes, in Federal Tax Reform 91, 98-99 (M. Boskin ed. 1978).

[70] See IRC §§ 61, 63. The Code does, however, in some cases refer to "income" in a more unitary sense. E.g., IRC §§ 446(b), 482 (secretary may make adjustments in order to clearly reflect the taxpayer's income).

[71] Cf. Griswold, An Argument against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943) (statutory provisions allowing deductions should be construed in same manner as other statutory provisions).

their views of what is fair differ from mine. This does not disturb me because it is, I think, inherent in the nature of the income concept.

A. Taxable Period

As defined by Henry Simons, income is "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."[72] In contrast to the other elements of this definition, little attention has been given to Simons' reference to the "period in question." It apparently has been assumed that the taxable period is not of great importance, and, in any event, is not central to the concept of income.[73] Simons himself did not discuss the relevance of the length of the taxable period, but referred in the abstract to "the accounting period" and (in adopting Haig's definition) to the accretion of economic power "between two points in time."[74] At some points during his discussion, Simons' referred to "year-to-year assessments" and "annual" reporting,[75] suggesting that he thought of the accounting period in terms of one year. This is not surprising, given that income taxes commonly are, in fact, assessed on an annual basis. It appears that Simons believed that the specification of the taxable period was not of great importance. This attitude is consistent with Simons' general approach of downplaying the importance of tax deferral.[76]

Consideration of the matter reveals, however, that the length of the taxable period can have an appreciable effect on the relative incomes of individuals. Therefore, one cannot define income without specifying the period over which income is to be measured. Furthermore, considerations of fairness suggest that the concept of income is best defined with reference to an infinitesimal accounting period. Thus, in terms of the Haig-Simons formulation, the term "period" should be taken as referring to an infinitesimal length of time. Continuous taxation[77] would, of course, not be operational. An actual tax system must operate with a longer accounting period. Continuous taxation does, however, provide a

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[72] H. Simons, note 4, at 50.

[73] See Pechman, note 5, at 65. In explaining its version of the Haig-Simons definition of income, the Carter Commission stated: "The choice of any time period is inherently arbitrary. The conventional choice is, of course, the calendar year." 3 Report of the Royal Commission on Taxation 23 (Can. 1966); see also S. Surrey & P. McDaniel, Tax Expenditures 188 (1985) ("The S-H-S [Schantz-Haig-Simons] definition does not specify the period to be used in calculating income.").

[74] H. Simons, note 4, at 206.

[75] Id. at 207.

[76] See, e.g., id. at 208.

[77] I will refer to the adoption of an infinitesimal accounting period for purposes of defining income as continuous taxation. This follows the terminology of Strnad, Periodicity, note 52, at 1828.

theoretical norm against which the rules of current law can be evaluated. In some cases, the results of continuous taxation can be approximated fairly closely, such as by withholding tax from wages and requiring estimated tax payments.[78]

The proposal that the concept of income should be considered to involve continuous taxation is not as novel as it may seem. Most analysts have, in fact, implicitly taken this view of Haig-Simons income.[79] The use of simplifying assumptions in the literature ensures that transactions are, in effect, accounted for on a continuous basis for the purpose of theoretical discussion. There has, therefore, been an instinctive, implicit adoption of continuous taxation on the part of a number of analysts.[80]

Despite the acceptance of continuous taxation as a working assumption, the Haig-Simons concept of income often apparently is still thought

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[78] It is beyond the scope of this article to consider in detail the various ways that continuous taxation could be approximated in an operational tax system, or to evaluate the extent to which current law departs from the norm. There are other techniques that could be used to approximate continuous taxation. For example, where one party to a transaction is not subject to continuous taxation, the other party may be subject to substitute taxation. See generally Halperin, Interest in Disguise: Taxing the Time Value of Money, 95 Yale L.J. 506, 508 (1986) [hereinafter Halperin, Interest]. Rules relating to the accrual of income over the taxable year may reach approximately the same result as those under continuous taxation. The timing of a deduction may be matched with a related item of income, thereby indirectly reaching a result similar to that of continuous taxation.

[79] For example, Professor Halperin has characterized the Haig-Simons definition as follows: "increases and decreases in net worth should be accounted for as they occur." Halperin, Interest, note 78, at 551. This will occur only if an infinitesimally short accounting period is used. See Goode, note 23, at 29 ("The definition implies that income should be taxed at the time when an accretion to economic power accrues, but its adherents have not consistently stressed this point."); Musgrave, In Defense, note 23, at 58-59. Professor Halperin assumes away any differences between current law and continuous taxation by using stylized models involving transactions occurring at the end of the year, with the assumption that the tax for the year is due at this time. See Halperin, Interest, note 78. Professor Fellows adopts a similar approach by assuming that transactions occur at the beginning of each period and that there are no partial periods. See Fellows, note 8, at 743 n.54. In Halperin, Commentary, in M. Graetz, Life Insurance Company Taxation: The Mutual vs. Stock Differential 5-1, 5-2 to 5-3 (1986), he also points out that an inclusion of income in one year could offset exactly a deduction in another year "if income were measured daily." Professor Klein's analysis of time value of money issues uses examples with transactions occurring at the beginning and end of taxable years, but assumes (without explanation of why this would occur under current law) that tax is due at the time the transaction occurs. See Klein, Tax Accounting for Future Obligations: Basic Principles, 36 Tax Notes 623 (Aug. 10, 1987).

[80] Other analysts have used models in which cash flow is a continuous function of time, and have assumed explicitly that income taxation occurs continuously, without discussing the importance of the point, relating it to the Haig-Simons formulation, or noting the discrepancy between this assumption and current law. See, e.g., Bradford, Tax Neutrality and the Investment Tax Credit, in The Economics of Taxation 281 (H. Aaron & M. Boskin eds. 1980); Samuelson, Tax Deductibility of Economic Depreciation to Insure Invariant Valuations, 72 J. Pol. Econ. 604 (1964). More recently, Professor Strnad has argued that continuous taxation flows from "wealth-related norms" although he argues that it is not mandated by the Haig-Simons income formulation. Strnad, Periodicity, note 52, at 1821-22.

of in annual terms.[81] As stated by Simons, however, the Haig-Simons definition of income is silent on the length of the accounting period. Thus, it is important to decide what accounting period should be used in defining income. Given the basic judgment that it is fair to tax people on accessions to their wealth, it easily can be shown that considerations of tax fairness call for using an infinitesimal accounting period in defining income. Suppose that *A* receives $100 on midnight of Day 1 and that *B* receives $100 just after midnight (that is on Day 2). Assume that *B*'s right to receive the $100 has not accrued before its receipt—both the transfer of the cash and the accrual of the right to receive it occur just after midnight with respect to *B* and just before midnight with respect to *A*. If Day 1 and Day 2 fall on either side of the accounting period, B's tax is deferred until the end of the accounting period, while *A* must pay tax immediately. Because *A* and *B* are in the same economic position, having received income at essentially the same time, it would be unfair to defer *B*'s tax in comparison to *A*'s. To avoid deferral of *B*'s tax, the accounting period for defining income must be infinitesimally short.

The contrast between continuous taxation and a rule providing for an annual accounting period with payment of tax at year end also can be illustrated by the following example. Suppose that *C* performs services on the first day of the year and is paid $100 on that day, while *D* performs services on the last day of the year and is paid $100 at the end of the year. Alternatively, one can think of the $100 accession to wealth as deriving from an increase in the value of an asset owned by *C* or *D*, respectively, on the first and last days of the year. Assume that both *C* and *D* must pay an income tax of 25% at the end of the year. *D* is left with $75 after tax. *C* invests his earnings at a 10% interest rate for the one-year period between the time he receives them and the time the tax is due, receiving $10 of interest income. After tax of $27.50, *C* has $82.50. If instead *C* had been taxed at the time of receipt of the $100, *C* would have had only $75 to invest, which would have grown to only $80.62 after tax. The effect of annual accounting is to exempt from tax *C*'s interest income for the period between the receipt of the earnings and the time the tax on the earnings is due.[82]

Annual accounting does not distinguish appropriately between *C* and *D* because, even though *C* and *D* both receive $100, they are not in the same economic position; the timing of their accession to wealth differs. Admittedly, in the above example *C* is taxed on *C*'s interest income, but this is an insufficient tax burden on *C*, since the deferral of tax on the

[81] See Strnad, Tax Timing and the Haig-Simons Ideal: A Rejoinder to Professor Popkin, 62 Ind. L.J. 79 (1986) (Haig-Simons ideal "as conventionally stated" contemplates annual accounting period).

[82] *C* earns $7.50 in interest after tax, which represents a 10% return on his after-tax wages. See Halperin, Interest, note 78, at 519 n.47.

$100 receipt allows *C* to invest $100, instead of only $75. Continuous taxation solves this problem.

The effect of the accounting period is even more dramatic if the period used is the taxpayer's lifetime. Using a lifetime taxable period, with tax due at death, Haig-Simons income would be equal to the taxpayer's total consumption over her lifetime plus the market value of the taxpayer's net wealth at her death. This assumes that the taxpayer's beginning wealth is zero (any wealth accruing to the taxpayer at the time of her birth should be treated as an accession to wealth as of that time). It also is assumed, in accordance with Simons' own statement,[83] that the recipient of a gift would include it in her tax base, and that the donor would not be allowed a deduction for a gift. Note that, because of the identity of lifetime income and outgo, under a lifetime accounting period, the Haig-Simons income tax ends up being equivalent to a widely accepted version of a personal consumption tax, if such tax also is levied using a lifetime accounting period.[84] This is because the base of such a consumption tax also equals the taxpayer's total lifetime consumption plus the value of the taxpayer's wealth at death, the latter amount being treated (under this version of the consumption tax) as nondeductible personal consumption of the decedent.[85] The equivalence of the income and consumption taxes under a lifetime accounting period demonstrates the importance of specifying the length of the accounting period. This equivalence also helps us make the choice as to what accounting period should be used for purposes of the Haig-Simons definition. As the accounting period becomes longer, the income tax begins to look more and more like a consumption tax. Only an accounting period of infinitesimal length is acceptable for purposes of specifying a pure income tax.

B. Taxable Unit and Treatment of Gifts

Like the accounting period, the specification of which individuals are to be included in the taxable unit conventionally has been regarded as separate from the definition of income.[86] Specifying the taxable unit is, however, an inherent part of defining income. Since the definition of in-

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[83] See H. Simons, note 4, at 136.

[84] See Goode, The Superiority of the Income Tax, in What Should Be Taxed: Income or Expenditure? 49, 53 (J. Pechman ed. 1980); Stiglitz, Tax Reform: Theory and Practice, in The Economics of Tax Reform 9, 14-15 (B. Harik ed. 1988).

[85] See H. Aaron & H. Galper, A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform, in Options for Tax Reform 106, 112 (1985); C. McLure, J. Mutti, V. Thuronyi & G. Zodrow, note 8, at 356.

[86] See J. Sneed, Configurations, note 39, at 134; S. Surrey & P. McDaniel, note 73, at 190; Bittker, Comprehensive Income Taxation: A Response, 81 Harv. L. Rev. 1032, 1037 (1968); Pechman, note 5, at 65; see also D. Bradford, note 23 (no discussion of taxable unit in Chapter 3, which discusses details of income tax).

come is based on fairness as between two different taxpaying units (each containing one or more individuals), it is impossible to conceive of such fairness, and hence to define income, unless we know who is in the taxpaying unit.[87]

A separate issue is how the theoretical ideal can be implemented. The filing unit adopted for purposes of tax administration may differ from the taxable unit specified in the theoretical definition of income. For example, the appropriate taxable unit as a matter of theory may be the individual, but joint returns[88] and the kiddie tax[89] may be appropriate as a practical administrative matter. Only in this sense is the specification of the taxable unit an issue that is separate from the definition of income.

1. Individual vs. Family

Under the approach of defining the income of *B* as being equal to that of *A*, if and only if it is considered fair for *B* to pay the same amount of tax as *A*, it is necessary to know whether *A* and *B* are individuals or families before determining *A*'s and *B*'s income. For the most part, tax analysts seem to have thought of the taxable unit in this sense as an individual, even though they have not always made this clear. Simons refers to the income of "a person,"[90] therefore suggesting that he thought of the taxable unit as the individual and not the family. The focus on the individual is consistent with a society in which we generally treat each individual as a separate, independent person.[91] Perhaps in a medieval society it would make sense to focus on fairness as between families. In our current society, however, an individual typically considers himself as relatively autonomous from his family group, at least once he leaves home.[92] Treating the individual as the taxpaying unit allows us to conceive of a taxpayer's total income over his lifetime.[93] It seems to make sense as a general matter that two taxpayers whose total lifetime incomes have the same present value ideally should pay the same amount of tax in present value terms.[94]

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[87] Cf. Musgrave, In Defense, note 23, at 60-61 (definition of taxable unit is related to definition of income).

[88] See IRC § 6013.

[89] See IRC § 1(i).

[90] H. Simons, note 4, at 49; see also id. at 107, 125.

[91] See generally McIntyre, Fairness to Family Members Under Current Tax Reform Proposals, 4 Am. J. Tax Pol'y 155, 157 (1985).

[92] This seems to be a reasonable working assumption for the United States; there may be some countries for which it is not applicable, but an investigation of this point is beyond the scope of this article.

[93] See Galvin, More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR, 81 Harv. L. Rev. 1016, 1017 (1968).

[94] The statement may require qualifications. For example, where the lifetime incomes of two individuals have the same present value, but one individual experiences fluctuations in

To make a choice between the individual and the family as the taxable unit, it is necessary to know what constitutes a family unit. The family taxable unit usually seems to be thought of as including husband, wife and any minor children. If the taxable unit is the family, presumably transactions between family members should be ignored, along the lines of § 1041.[95] Payments for services would be treated similarly (if the family is truly the unit, any intrafamily services would be in the nature of self-provided services, which are not part of the tax base). Intrafamily gifts also would be ignored. A key question under a family taxable unit is the treatment of individuals reaching majority. If attaining majority severs the taxable unit, the issue is whether at that time the individual should be treated as having taxable income in the amount of his or her net wealth, at least to the extent attributable to gifts received while a family member. Such inclusion in income, of course, would be appropriate only if gifts generally are included in income.

2. *Treatment of Gifts and Taxable Unit*

These considerations suggest that the taxable unit choice is related to the treatment of gifts.[96] The possibilities are set forth in the simple matrix that follows:

	Deduction for Gifts	No Deduction for Gifts
Individual Taxable Unit	Option 1	Option 2
Family Taxable Unit	Option 3	Option 4

In their article on the taxable unit, Professors McIntyre and Oldman proposed that the Haig-Simons definition of income be interpreted as calling for each family member to be taxed on the items she actually

income that leave him in a near-poverty position at certain times, it may be appropriate to impose a lower tax burden on such a person when he is at a low point, largely because such an individual may experience restricted borrowing opportunities. In addition, the existence of a progressive rate structure, combined with the fact that people live for different lengths of time, means that we would not necessarily want to tax equally all individuals with the same lifetime incomes, although we might want to tax equally those who have the same lifetime income and die at the same age.

[95] IRC § 1041 (providing nonrecognition and carryover basis treatment for transfers of property between spouses).

[96] For convenience, I use the term "gifts" to refer to both inter vivos transfers and to transfers at death.

consumes or accumulates.[97] This approach (which assumes that the individual is the appropriate taxable unit) essentially is equivalent to including gifts in the income of the donee and deducting them from the income of the donor, and corresponds to Option 1.[98]

Under Option 2, gifts would be taxed to the donee and nondeductible by the donor, even if made while the donee is part of the donor's household.[99] This raises the issue of the treatment of support payments. If support is treated the same as a gift, it would be inappropriate to allow any deductions for dependents and, indeed, dependents would have to include support received as income. This would be a radical departure from current law. An alternative approach, which seems more appropriate given the apparent societal judgment that the tax system should take account of one's obligation to support dependents, is to compute income as a theoretical matter by allowing a deduction for support to the donor, but taxing support to the donee. (In the actual administration of the income tax, it would be easier to handle support payments by ignoring them, that is, by treating them in the same way that gifts are treated under current law. Under this approach, it also might make sense to allow a dependency exemption to the payor in lieu of a personal exemption for the payee, as also is done under current law.[100]) Although the concept of support is a slippery one, in general terms, support represents amounts paid for subsistence of a dependent family member. Support can be distinguished from a gift on the basis that, while a gift is voluntary, support is mandated by state law.[101] Although the treatment of support under state law is instructive, it should not be dispositive, particularly because the definition of support varies from state to state.[102] Rather, it would be appropriate to specify as a matter of federal law what amounts are to be considered support, and hence deductible by the payor as a nondiscretionary expense that is not available for the payor's consumption.

The third option would be similar to current law, in that there would be no double taxation of gifts. The major differences would be that the kiddie tax rules would be expanded to include all income of family members until the children reach majority, and that, instead of excluding gifts

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[97] See McIntyre & Oldman, Taxation of the Family in a Comprehensive and Simplified Income Tax, 90 Harv. L. Rev. 1573, 1576 (1977).

[98] See id. at 1598 n.90.

[99] This approach is advocated by J. Dodge, Logic, note 23, at 103.

[100] IRC §§ 102, 151-152.

[101] See Dodge, Beyond Estate Tax Reform, note 23, at 1202.

[102] See Adams, Reconciling Family Law with Tax Policy: Untangling the Tax Treatment of Parental Trusts, 46 Tax L. Rev. 107, 109 (1991).

from the donee's income and allowing no deduction to the donor, gifts would be deductible by the donor, but taxable to the donee.[103]

The fourth option would finesse the support problem by ignoring intrafamily transactions, including gifts, until children reach majority. At this point, however, the child would have to include in income gifts previously received from family members, to the extent not previously consumed.[104]

The basic attractiveness of the family taxable unit is that it calls for taxing the income of children of wealthy parents at a high marginal rate. On the basis of their lifetime incomes, these children are not likely to be low-income individuals, and should not receive the benefit of a graduated rate structure designed to impose a lower tax burden on lower income people. Even with an individual taxable unit, it is possible to achieve a result similar to taxing the income of minor children at the marginal rate of their parents. This can be done by providing different rate schedules for children and adults. A much more steeply progressive schedule with a smaller personal exemption would more appropriately reflect the difference in ability to pay between a rich child and a poor one.[105]

The treatment of gifts and bequests is one of the most critical issues in defining income, not so much because of its impact on the aggregate tax base, but because of the implications for the top of the income distribution. If gifts and bequests are included in the income of both the donor and the donee, the distribution of income will be much more unequal than if these items are excluded from the donor's or the donee's tax base.[106]

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[103] This is not as great a departure from current law as it may seem. Under Option 3, the donor can pass the same after-tax amount on to the donee as under current law (at the same after-tax cost) by increasing the amount of the gift, assuming the donor's and donee's rates are the same, which they will be if the donee is included in the family unit.

[104] See 3 Report of the Royal Commission on Taxation, note 73, at ¶30-39.

[105] Thuronyi, The Kiddie Tax: A Reply to Professor Schmolka, 43 Tax L. Rev. 589, 592 (1988) [hereinafter Thuronyi, Kiddie Tax]. The suggestion to tax minor children under a rate schedule that is steeper than that for adults was made previously by Dodge, Beyond Estate Tax Reform, note 23, at 1207, but Professor Dodge's suggestion appears to be linked to excluding support payments from the child's income. In my view, a more progressive rate schedule for children would be appropriate even if support received were included in the child's income. This is simply because children tend to have lower amounts of income than adults, so that a compressed rate schedule is required to reflect the differences between wealthy and poor children. Note that while I am advocating a compressed rate schedule for children as a matter of theory, the kiddie tax may be a better means of implementing this theory, because it avoids the complexity involved in taxing earned income of children at a high rate. See Thuronyi, Kiddie Tax, note 105, at 601-02.

[106] Current law, of course, excludes a large portion of gifts and bequests from both the donor's and the donee's income by virtue of the facts that (1) gains are not taxed at death, (2) basis is nevertheless stepped up to fair market value (IRC § 1014), and (3) gifts and bequests are excluded from the income of the donee (IRC § 102). If gains were taxed at death, but § 102 were left unchanged, bequests generally would be included in the donor's tax base, but excluded from the donee's base. To bring the current tax system closer in line with the ideal,

Discussion of the appropriate treatment of gifts and bequests under the Haig-Simons concept of income usually has posed the question whether gifts and bequests constitute consumption by the donor. It is clear that gifts differ from the types of expenditures normally thought of as consumption. Gifts are transfers to others and do not involve an expenditure by the donor on consumer goods. For this reason, some have argued that gifts should be deducted in computing the donor's income, with the present law approach of ignoring gifts being an administratively feasible manner of taxing a gift only once.[107] The traditional counterargument to the assertion that gifts are not consumption by the donor is that the donor does enjoy a form of consumption by making the gift. If the donor were not as pleased with the transaction as much as with spending the money on herself she would, after all, presumably not have made the gift.[108]

Although verbal formulation is not everything, Simons' alternative statement of the concept of income, which is not quoted as frequently as his "consumption plus accumulation" formulation, may be helpful in supporting the taxation of gifts and bequests to the donor. He stated that a taxpayer's income is "the value of rights which he might have exercised in consumption without altering the value of his store of rights."[109] Under this view, what should be taxed is the amount available for consumption, regardless of what the taxpayer chooses to do with such amount. Even if a gift or bequest is not considered consumption, would it not be accurate to say that it represents an amount that the donor or testator could have consumed had she chosen not to make the gift? Under this formulation, what is critical is the voluntary nature of the

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one would have to tax gains at death and also tax the fair market value of gifts and bequests to the donee. See generally Dodge, Beyond Estate Tax Reform, note 23.

[107] See Andrews, Personal Deductions, note 49, at 348. The current-law approach of excluding the gift and allowing no deduction to the donor also can be justified because of a concern that allowance of a deduction to the donor would allow taxpayers to shift income into lower brackets. Under a steeper rate schedule for minors, as suggested above, this would not be a serious problem. See also 2 U.S. Treasury Dep't, note 39, at 92-95.

[108] See H. Simons, note 4, at 57-58. Although this notion of intangible psychological pleasure upon the making of a gift makes sense as a matter of economic theory, many have found it strained. McIntyre and Oldman call the notion of "a psychic benefit equal to the amount of the gift" an "esoteric concept of benefit." McIntyre & Oldman, note 97, at 1598 n.90. Consider, for example, a taxpayer who dies unexpectedly without leaving a will. Does it make sense to say that at the moment of his death he experienced a psychological pleasure at the prospect of leaving his estate to his heirs and accordingly should be charged, for tax purposes, as having spent his wealth on personal consumption?

[109] H. Simons, note 4, at 49. Atkinson's formulation is similar: "[I]ncome in a given period is the amount a person could have spent while maintaining the value of his wealth intact." A. Atkinson, The Economics of Inequality 39 (1975).

transfer: The donor could have consumed the value of the gift, but chose instead to transfer it to someone else.[110]

While gifts can be included in the donor's income under this formulation, the real issue is whether it is appropriate for the donor's income to include gifts. To use a concrete example, should the following two individuals pay the same amount of tax: *A*, who earns $100,000 in salary and makes a gift of $30,000 to her grown child, and *B*, who earns $70,000. Assume that both *A* and *B* spend $70,000 on their own consumption. *A*'s child chooses not to work and lives off the $30,000 gift, while *B*'s child works and earns $30,000. It is not difficult for me to conclude that *A* should pay more tax than *B*. In fact, I don't see why *A* should not pay the same amount of tax as *C*, who also earns $100,000 and accumulates or consumes it all, without making any gifts.

The objection may be raised that a focus on *A* alone is misleading. The failure to allow *A* to deduct the gift means that the gift will be taxed twice, once to *A* and once to *A*'s child. While double taxation, in this sense, undeniably exists, it is not clear what is wrong with it. If individuals should be treated separately, the fact that the donor paid tax should be irrelevant to the treatment of the donee. It cannot be denied that the gift gives rise to taxpaying capacity on the part of the donee. Thus, a donee can fairly be assessed a tax in the same amount as is imposed on another who earns the same amount by hard work. If anything, the donee is treated better, since he does not need to work to obtain the property. Moreover, it is not accurate to say that *the gift* is taxed twice. What is taxed is, first, the amount earned by the donor and, second, the amount transferred to the donee. The gift is taxed only once, to the donee. Thus, a gift is no more subject to double taxation than is a payment for personal services, which is also "taxed twice"—once when earned by the payor and again when received by the payee. Of course, the counterargument is that a payment for personal services is different from a gift, in that the payee is providing a service to the payor, and the payor is appropriating some of society's scarce labor resources by means of the payment. The making of a gift involves no increase in the social product.[111] This argument is decisive if one adopts a view that the aggregate tax base should equal the product of society's capital and labor during the accounting period, with the Haig-Simons definition of income used to allocate this product among individual taxpayers.[112] While this is, of course, one possible way to define income, it generally is not consistent

[110] See Dodge, Beyond Estate Tax Reform, note 23, at 1186 ("[T]he making of a gift represents the voluntary exercise of the donor's economic power. In other words, the donor's voluntary transfer of the gift itself indicates the donor's ability to pay.")

[111] See Warren, note 15, at 1088.

[112] See id. at 1085-86.

with the approach advocated in this article.[113] Only by coincidence would the aggregate tax base elaborated according to judgments of interpersonal tax fairness equal the aggregate social product. Indeed, the aggregate tax base under my approach is meaningless, since what is important is not the absolute amount of income, but the relative incomes of individuals.

Despite the above arguments, proponents of taxing gifts have an uphill fight, particularly in light of the entrenched practice reflected in current law. The perceived unfairness in taxing gifts may derive from a judgment about the taxable unit: Gifts should not be taxed because they represent private, intra-family transfers, and such transfers should not be treated as giving rise to additional taxable capacity. This theory may explain current law better than an approach holding that gifts should not be taxed because they are not consumption or do not contribute to the aggregate social product. If gifts are not consumption, the proper approach would be to allow a deduction to the donor and to tax the donee. But, if the theory is that intrafamilial transfers should be ignored, the current law approach of including gifts in the donor's tax base, but excluding them from the donee's, makes sense. Thus, the exclusion of gifts can be seen as based on a family taxable unit, extended throughout the donee's lifetime, at least for purposes of taxing gifts. This notion of the taxable unit does not correspond neatly to the possibilities contained in the matrix discussed above. This is because gifts would be treated as a private, intra-unit transaction, even if the gift is between persons whose taxable capacity is otherwise evaluated separately. This view is similar to the argument that, as a matter of principle, people should not be taxed on what they could earn, or on what they produce outside the marketplace, unless they voluntarily commoditize their leisure time by entering into the market.[114] Whether based on notions of personal liberty or privacy, the same argument suggests that gift transactions should not be subject to governmental intrusiveness. The tax system should not treat as a taxable transaction a transfer that the parties intend as a private, noncommercial transaction motivated by human affection.

The above analysis suggests the possibility of an alternative approach that would exclude many gifts. If a family filing unit were adopted, and gifts to persons outside the unit were taxed—Option 4 above—gifts would be excluded from the donee's income to the extent they were consumed before the donee attained majority. Under this approach, a child attaining majority would be taxed on his or her net wealth, to the extent attributable to gifts received while a family member, and also would be taxed on any gifts received after that point. As noted above, this ap-

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[113] See text accompanying notes 192-96.

[114] See Kelman, Personal Deductions, note 46, at 838-44.

proach also would deal with the thorny support issue that would otherwise arise if gifts were taxed under an individual taxable unit. Any intrafamily transfers that were consumed during childhood—presumably including all support—would go untaxed, without the need to distinguish support from gifts explicitly.

There is no scientific way to choose among the above alternatives. I would be inclined to Option 4 described in the preceding paragraph, but I suspect that most people would opt for Option 1, or for current law, which can be seen as a variant of Option 1. While a preference for current law can be defended with reference to a social product approach to income, in my view it is clearer to attribute differences of opinion about the treatment of gifts to differing judgments about tax fairness.

An intriguing issue is the extent to which one's choice among these options relates to one's views on the legitimacy of inheritance. Those who believe that inherited private wealth is "deserved" and should be protected from the incursions of the state are likely to support a deduction for the donor or an exclusion by the donee. Those who, like me, are less sympathetic to inherited wealth and who, in terms of the above example, believe that *A* and *C* are in like positions, and that recipients of gifts are in at least as good a position as those who earn the same amount, will choose to define income by denying a deduction for gifts to the donor and including gifts in income of the donee. This is not, however, the most radical position. One could make the argument that equality of opportunity calls at a minimum for everyone to start off on the same financial footing,[115] and that, therefore, gifts and bequests should be confiscated by the state. To tax them under the relatively modest rates of the income tax might be viewed as a moderate stance.

A complicating factor is that the income tax is not the only way to reach transfers of wealth. One might, for example, favor a stiff estate or inheritance tax, but believe that gifts and bequests are not appropriately included in both the donor's and the donee's income tax base. One's view as to whether it is fair to treat gifts and bequests as income may depend on estate and gift tax provisions. Although it may seem strange for the definition of income to depend on what the transfer taxes provide, it makes sense under a fairness analysis, because one's judgments about income tax fairness necessarily depend on the nature of the entire society and legal structure outside the income tax law.

One also could ask: What would be the desirable tax treatment of gifts and bequests, considering the effects of the income and transfer taxes together? The principal issue here is one of rates. Should all transfers by a single donor be taxed at the same rate (which seems to be the general

[115] This is particularly so given that much value can be transferred to children by informal and nontaxable means, including education, social contacts and status.

approach of our current transfer tax system, although the system does not completely conform to this norm), or should the rate depend on cumulative transfers received by the donee? The latter approach is virtually equivalent to including transfers in the donee's income, with perhaps an additional inheritance tax on top of the income tax otherwise due. If transfers were taxed fully to the donee, however, and were nondeductible to the donor, perhaps a separate transfer tax would not be required. Thus, instead of debating whether gifts are income, perhaps the discussion should focus on the type of transfer tax, if any, needed if gifts are treated as income. The answer is by no means clear, and may depend on the income tax rates as well as the availability of averaging.

3. Entities

The preceding sections focused on the issue whether the taxable unit should be the individual or the family. The tacit assumption was that entities should not be considered taxpayers. I now face this issue explicitly: Should an entity (that is, a legal person other than an individual) be considered as having income in its own right? Does it make sense to say that *X* corporation's income for 1990 was $1 million?

Before considering this question, it should be made clear that a determination that entities should not be treated as having income as a matter of tax fairness does not imply that an entity-level tax is not justified as part of the tax system of a particular country.[116] One might conclude that entities do not have income in their own right as a matter of theory, but that in practice they should be treated as taxpayers. The reason, as noted above, is simply that there are tax policy criteria other than fairness. One reason for an entity-level tax is that it is more convenient as a matter of administration. Taxation of the entity can be justified as a matter of surrogate taxation of the individual beneficiaries of the entity's profits, particularly in cases where it is difficult to allocate the entity's income among its owners. The surrogate taxation rationale comes from an integrationist point of view, although it does not achieve perfect integration, because the entity's income generally will not be taxed at the owners' rates. A classical system, such as that in the United States, perhaps can be justified best under the "old tax is a good tax" theory. Under this view, integration would lose revenue (which would have to be made up by necessarily distortive taxation elsewhere) and would bestow windfall gains on owners of corporate equity.

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[116] The point is similar to that made in connection with the discussion of the family filing unit. See text accompanying notes 90-95.

It is not uncommon to find references to the Haig-Simons income of corporations.[117] The implicit assumption is that income is a disembodied concept that can be applied to corporations in the same manner as to individuals, without further analysis of the matter. The inconsistency of such an approach with a fairness based analysis should be evident. If income results from a judgment about the fair relative tax burdens of those persons who have income, a person (natural or legal) can be treated as having income only if we believe that it is appropriate to apportion the burden of the income tax to that person.

In my view, income, in the technical sense in which it is used here, is best considered an attribute that only individuals can have. A corporation cannot have income, any more than it can have a blood type. As with any statement specifying the definition of income, this point cannot be proven. A number of anomalies and inconsistencies, however, would spring up if entities were considered to have income in their own right. Consider, for example, the distribution of income. Would it make any sense to show the distribution of income in society, lumping together individuals, corporations and other entities? To treat corporations as having income, it obviously is necessary to distinguish between those entities whose assets are considered owned by the individual owners and those entities which are treated as separate taxable units, an exercise that cannot be performed without an unseemly reliance on legal form. The consequence of multiple tiers of corporations on the amount of taxable income also presents an insoluble dilemma. For example, if a corporate group is formed with one or more tiers of subsidiaries, does the tiered structure increase the income of the group? If intercorporate dividends within a controlled group of corporations are not counted as income, then must all intercorporate dividends, including those on portfolio stock, also be excluded from income?

More fundamentally, application of the Haig-Simons definition of income to a corporation requires ascertaining the increase in the corporation's net worth over the taxable period. On a balance sheet, corporate assets are always offset by liabilities, that is, the claims on such assets by various third parties who have supplied capital to the corporation. The net worth of a corporation in this sense is always zero; therefore, a corporation can never experience an increase in its net worth and cannot have income in the Haig-Simons sense. The only way a corporation can be treated as having a positive net worth is to categorize the suppliers of capital to the corporation as shareholders and creditors, subtracting only the claims of the latter from the corporate assets in determining net worth. While it is possible to divide the suppliers of capital to the corpo-

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[117] E.g., Brown & Bülow, The Definition of Taxable Business Income in Comprehensive Income Taxation 241, 242-43 (J. Pechman ed. 1977).

ration into these categories, the division involves little economic logic. As a matter of economic reality, the interests held by various suppliers of capital do not fall on either side of any simple dividing line, and there is no coherent policy rationale for treating these claims differently on a theoretical level.

The fairness approach, therefore, strongly suggests that the appropriate taxable units under an ideal income tax are individuals, not entities. It is the distribution of income among individuals, the rich and the poor, to which considerations of tax fairness should be addressed.

C. Imputed Income

Imputed income may be defined as the benefits to the individual from (1) self-performed services and leisure, and (2) the use of consumer durable goods, including housing, owned by him.[118]

1. Self-Performed Services and Leisure

The concept of income derived from economic theory would include leisure and self-performed services; their exclusion could be justified only as a matter of administrative necessity. From the economic point of view, including them would bring the concept of income closer to the utility function and, moreover, would make the income tax virtually a lump-sum levy, which is considered desirable in terms of work incentives.[119] However, the inclusion of leisure would work only in a formal model. It is not simply that including the value of leisure in income would be impractical; it is impossible, as a conceptual matter, to place a value on leisure. Presumably, if one were to attempt to value leisure, the valuation would be based on the amount that the taxpayer could have earned if she had worked.[120] Given the counterfactual and speculative nature of this standard, the resulting valuation could not be more than a guess.

From a fairness approach, the answer is not so clear. On the one hand, one might think it fair to levy the income tax on the opportunity to earn (regardless of whether the taxpayer chooses to squander that opportunity) and on the value of leisure time and nonmarket activities, on the basis that time spent not working is of value to the taxpayer. On the

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[118] See Chancellor, Imputed Income and the Ideal Income Tax, 67 Or. L. Rev. 561 (1988). In both cases, income is imputed because there is no market transaction.

[119] A lump-sum levy is a levy that cannot be avoided by taxpayer behavior. Economists consider it desirable since it fosters economic efficiency; it does not distort behavior. A levy that included leisure and that, more generally, was based on earning capacity, rather than on actual earning, would be in the nature of a lump-sum levy except insofar as the development of earning capacity is under the control of the taxpayer.

[120] See Chancellor, note 118, at 595.

other hand, it could be considered an elemental principle of fairness in taxation that taxpayers should not, in effect, be forced to work at the most remunerative occupation and that, with respect to activities outside of work, it is illegitimate for the government to step in and assert that an individual's private time has commercial value and should be a subject of taxation.[121]

A compromise position is available. The government generally could respect the taxpayer's decision about how many hours to work but, in the case of taxpayers choosing to work less than a normal working week, the government reasonably could assert that it has a claim on that excess free time that is similar to its claim on the proceeds from time spent working. The government could offer taxpayers a choice of paying tax on this leisure time at the taxpayer's usual rate of pay, or satisfying her obligation in kind, that is, by working a certain percentage of the excess leisure time for the public good. Even this limited incursion on leisure time would, however, be problematical. It would not always be clear whether the taxpayer is working a full week. For example, how could one know whether a university professor, a free-lance writer or a real estate agent who is not required to punch a clock is working a full week (and, indeed, what activities should be considered "working" for this purpose?).

I raise the above-described approach of taxing leisure time (with an election to "pay" the tax in kind) not so much to defend that approach, but to illustrate that the appropriate treatment of leisure in formulating the concept of income is hardly clearcut. While it is probably simpler to define income as excluding the value of leisure time, it should be recognized that this is not the only reasonable approach as a matter of tax fairness, and that the line between taxable work and nontaxable leisure is to a large extent an arbitrary one. Accordingly, one should be practical, not dogmatic, in defining this line.

The treatment of farmers who produce farm products both for home consumption and for sale illustrates the problems that arise in drawing this line. Under current law, a farmer is not allowed to deduct the expenses (feed, seed, fertilizer and the like) attributable to production for household consumption.[122] For example, if a dairy farmer's household consumes 1% of the milk produced on the farm, 1% of the cost of producing the milk is not deductible. Alternatively, the farmer's income could include the value of the milk consumed within the household. As an administrative matter, this would be a simpler approach than current law. Estimating the value of milk consumed in the household would be

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[121] See Kelman, Personal Deductions, note 46, at 842.

[122] Nowland v. Commissioner, 244 F.2d 450, 453-54 (4th Cir. 1957).

easier than accounting for the production costs of the milk.[123] If the value of the milk were included in the farmer's income, all production costs would be deductible. No separate accounting for production costs attributable to home consumption would have to be made. For this purpose, the milk should be valued at the same amount that it is sold for by the farmer, the wholesale value. Such valuation is called for as an administrative matter, since that price is readily ascertainable. It also reflects what the milk is worth to the farmer. Use of wholesale value would not put the farmer completely on a par with those who buy milk in the store; the favorable treatment of the farmer is, however, due to the fact that the farmer has access to the product at a cheaper price than urban consumers. The tax system generally does not take into account the benefit that a consumer obtains from being able to purchase a product cheaply. To a certain extent, this balances out; the farmer has to pay more for certain products that can be purchased more cheaply in the city. Moreover, to the extent that the ablity to obtain a lower price reflects where a taxpayer lives, that benefit is counterbalanced by other considerations. Housing may be cheaper in the country, but the attractions of a city are absent. Of course, valuing consumption at market prices favors certain consumers with idiosyncratic preferences: Those who prefer goods that are priced cheaply not only can subsist with lower money incomes, but also are relieved of tax liability. However, such preferences are not ascertainable for purposes of measuring income. Obtaining a lower price also can be due to extraordinary efforts on the part of the consumer. Nontaxation of the fruits of such efforts is, in effect, part of the nontaxation of imputed income from self-performed services.

The determination that it is appropriate to tax a farmer in this situation does not necessarily imply that everyone who has a home garden should be treated as having income amounting to the excess of the value of the produce over expenses. For one thing, a person who produces food as an avocation is likely to have to work much more per unit of food produced (thereby giving up leisure time), and incur far greater unit costs, than the farmer. (A farmer is likely to have to incur little extra time and expense in supplying his family with farm produce.) As a practical and conceptual matter, specification of the input costs would be problematic. For example, in the case of someone who grows vegetables in an urban backyard, would the rental value of the square footage devoted to gardening be an appropriate deduction, or should the taxpayer

[123] To estimate the value of milk consumed, one needs to know only the quantity of milk and its price. The quantity is something that must be known in any event. The price is available from the farmer's own sales records. Accounting for production costs is more difficult. To account for such costs, one needs to allocate all expenses over the various products produced by the farmer. The farmer would have to keep track of depreciation, overhead costs and costs allocable to inventory.

be denied a deduction on the basis that use of the backyard for gardening generally does not diminish the consumption benefits otherwise derived from a backyard? Moreover, accounting for the costs would be prohibitively complicated, and would impose a disproportionate burden in light of the amounts of income that would be involved in most cases. Perhaps an arbitrary rule excluding small home gardens, but treating larger gardeners as farmers, would be most appropriate. On the other hand, one could argue that focusing on gardens would be inappropriate if income attributable to leisure time activities generally is left out of account. Is it not unfair to tax the individual who gardens, but fail to tax the individual who repairs her own car, thereby probably saving more in repair costs than the gardener saves on his food bill?

Questions such as these may cause one to throw up one's hands. Certainly, they should suggest that there is no perfect, clearcut rule.[124] The separation of labor (taxed) from leisure (untaxed) is arbitrary and necessarily will lead to some unfairness. The task is to develop a set of rules that minimizes unfairness while, at the same time, leading to a measurable specification of income. My general conclusion is that current law, which generally excludes nonmarket activity, is, by and large, appropriate, except possibly in the case of people who save substantial amounts by providing goods and services in their usual line of work to their own households.

In contrast to this practical approach to the problem of imputed income, the approach suggested by Professor Thomas Chancellor in a recent article[125] perhaps can be described accurately as a dogmatic one. Professor Chancellor rejects the notion that "income equates to satisfactions, consumption, or well-being,"[126] arguing that "individual satisfactions are too idiosyncratic to constitute a tax base. Income must mean something that is measurable, and, even in theory, satisfactions are not."[127] So far, we are in agreement. Where we differ is that Professor Chancellor jumps from his justified criticisms of the economic income concept to the assertion that only goods or services purchased in market transactions should be taken into account in determining income.[128]

Professor Chancellor offers little justification for this requirement. His principal argument seems to be that since "the purpose of the personal income tax is to provide the means to divert goods and services from private to public purposes," the consumption component of income "should be limited to the preclusive appropriation of limited societal re-

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[124] See generally J. Sneed, Configurations, note 86, at 79-97.

[125] See Chancellor, note 118.

[126] Id. at 562.

[127] Id.

[128] See id. at 591.

sources."[129] This argument is fallacious. While the income tax undoubtedly does divert resources from private to public hands, the real issue is the fairest way to levy the tax in order to raise the requisite revenue. Private preclusive consumption does not have any special claim as the fairest tax base.[130] In any event, it is not clear that the enjoyment of leisure time does not constitute the "preclusive appropriation of limited societal resources." Since one's time is limited, the devotion of a portion of one's time to leisure, as opposed to market activities, is arguably a private preclusive consumption of that limited resource.

Professor Chancellor perhaps is closer to the mark when he argues that "a definition of income that requires, for example, an individual to account to society for the time spent reading a book, helping a child with homework, going to church, or acting as a volunteer would introduce notions repugnant to a democratic society."[131] This statement is completely consistent with the fairness approach. The basic objection to treating the above-described activities as part of the taxpayer's income is that it would be unfair to do so. This furnishes a sufficient justification for excluding them from income. It does not necessarily mean, however, that all nonmarket activities must be excluded from income. It may be that a judgment about tax fairness would result in the inclusion of income from certain nonmarket activities, for example, the farmer's produce grown for domestic use. Parenthetically, some people undoubtedly would believe it unfair to tax the farmer on domestic consumption. This fairness judgment cannot be said to be incorrect. Accordingly, in my view, it cannot be posited as a general principle that income does, or does not, include the value of the farmer's domestically consumed production. All that one can say is that a particular specification of income, based on a certain set of fairness assumptions, does or does not include this item. Moreover, one can explain the reasoning behind, and the appropriateness of, the particular assumptions that one makes, and one's belief that those who hold different opinions are benighted Neanderthals, but this is in the realm of political argument, not scientific theory.

2. *Consumer Durables*

The equity case for taxing the imputed income from consumer durables is well known,[132] and can be illustrated as follows. Consider

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[129] Id. at 590; see also id. at 593. This argument mirrors that of Andrews, Personal Deductions, note 49, at 325-27.

[130] See also Kelman, Personal Deductions, note 46, at 834; Kelman, Time Preference, note 53, at 652.

[131] Chancellor, note 118, at 596.

[132] See, e.g., M. Chirelstein, Federal Income Taxation 23-25 (5th ed. 1988); H. Simons, note 4, at 114-15; Hellmuth, Homeowner Preferences, in Comprehensive Income Taxation 163 (J. Pechman ed. 1977); Marsh, The Taxation of Imputed Income, 58 Pol. Sci. Q. 514 (1943).

taxpayer *A* who lives in a house worth $100,000 with a rental value of $10,000 per year. Assume that there is no depreciation. Taxpayer *B* owns an identical house, also worth $100,000, but *B* has had to move. Instead of selling her old house, *B* rents it out for $10,000 and uses the rent to pay rent on an identical house in her new location. There is no problem in concluding that *B* has rental income of $10,000. *A* is really in the same economic position as *B* was in before the move. *B*'s resources did not increase as a result of the move: *B*'s rental income merely allows her to live rent free in her new residence, which is what she did before the move. *A* and *B* are therefore economic equals and should be considered as having the same income. *B*'s income from homeownership takes the form of cash; *A*'s is imputed in the sense that it does not take the form of observable cash flow.

As a conceptual matter, it would be appropriate to impute income with respect to all consumer durables, not just housing. In this context, a consumer durable should mean any consumer good that is not immediately destroyed in consumption. Of course, it would not be practicable to keep track of the value of all items that individuals own. Tax equity would not suffer appreciably if smaller items, or items that are relatively short-lived, were excluded.

The treatment of depreciation with respect to consumer durables often causes confusion. For example, Professor Marvin Chirelstein makes the statement that "the exclusion of imputed rents actually falls short of being a total exclusion. The reason it does is that no allowance for depreciation is permitted to . . . the home owner."[133] I disagree that the disallowance of depreciation implies that imputed rents on consumer durables are not fully excluded from tax. Under current law, the net income from ownership of housing and other consumer durables is completely excluded. If a depreciation deduction were allowed in addition to the exclusion, the tax base would both exclude the imputed income from ownership of the durable and allow a deduction for the purchase price of the durable over its life. To see this point, consider Professor Chirelstein's example of the homeowner, *A*, who owns a home worth $50,000, the fair rental value of which is $4,000 (the interest rate is assumed to be 8%). Professor Chirelstein goes on to assume that there is $1,000 of depreciation. Because the depreciation is not deductible, he asserts that "the overall effect is to limit *A's* real exclusion to the net amount of $3,000." The error here is that, if the house depreciated at the rate of $1,000 per year, one would expect the fair rental value to be $5,000.[134]

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[133] M. Chirelstein, note 132, at 24.

[134] This point also is illustrated correctly by Chancellor. See Chancellor, note 118, at 605-06.

The net amount excluded by current law is therefore $4,000, which is equal to the entire net income from the property.

Moreover, current law, far from reducing the exclusion for imputed income from homeownership by denying a deduction for depreciation, actually excludes substantially more than the imputed income from the homeowner's equity investment in the house. Because interest on home mortgages is, in most cases, fully deductible,[135] the net effect is to exclude the entire imputed income from the homeowner's equity plus to allow an additional deduction for what is, in effect, rent paid to the holder of the mortgage. The existence of inflation and the exclusion of gain from the sale of owner-occupied housing make the situation even more complicated and favorable for the homeowner in an inflationary environment.[136] The portion of the interest paid to the bank that is attributable to inflation is in the nature of repayment of principal. A deduction for this interest, coupled with exclusion of the gain on resale of the home, results in allowing the homeowner to deduct a portion of the purchase price of the taxpayer's equity in the home. Moreover, any equity buildup is not taxed when the home is sold. The analogy to a savings account would be to allow a deduction for a portion of amounts placed into the account, but to levy no tax when these amounts are withdrawn.

Professor Chancellor objects to the inclusion in income of the imputed return on consumer durables on the basis that "housing and other consumer assets are a form of consumption, not a form of investment,"[137] and, therefore, cannot be said to produce an investment return. This statement seems to be based on some confusion regarding the nature of consumer durables. Thus, he states that "[i]t is inappropriate to say, for instance, that an individual who has spent $1,000 (after-tax income) for a vacation cruise should thereafter be taxed each year on the profit she could have realized from investing the $1,000 rather than taking a vacation. This is treating a consumption expense as an investment. It is no different to argue that a homeowner should be taxed on the income which could have been received had the house been rented."[138] The home is, however, different from the vacation cruise. When the taxpayer purchases a home, she has purchased a valuable asset, which can be sold in the future. The amount spent on the vacation cruise does not result in the acquisition of an asset, but is consumed immediately. This is why it is appropriate to think of the home as an investment. Like all investments (and unlike the vacation cruise), the home generates an annual

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[135] IRC § 163(h).

[136] Homeowners also are favored by being allowed to deduct real property taxes. Regardless of whether the deduction for state and local taxes is considered appropriate in determining net income, current law favors homeowners over renters in this respect.

[137] Chancellor, note 118, at 609.

[138] Id. at 605.

return. The amount of this return is the fair rental value of the house, which provides a financial benefit to the taxpayer by saving her from having to incur this rental expense. It is this return which constitutes the taxpayer's consumption. Again, the view that income should be defined as including imputed income from consumer durables cannot be proven to be correct. It seems, however, to lead to a fair result, by including in income a return on capital, regardless of the form that the capital takes.

D. Human Capital

Human capital has been defined as "the present value of the flow of future satisfactions that an individual can command in the course of his life."[139] In terms of the Haig-Simons formulation, the issue is whether human capital should be included in the taxpayer's wealth for purposes of calculating the change in net wealth over the taxable period. The logic of the Haig-Simons formulation of income would call for including human capital in wealth.[140] Investments in human capital are important. Increases in wealth due to human capital are substantial (for example, a graduate of a good medical school is substantially better off than a department store clerk of the same age, even if both have the same financial resources, excluding human capital). Admittedly, what is at stake is timing—the medical school graduate will be taxed on her income when she earns it—but many income tax issues involve only questions of timing and timing is what principally distinguishes an income tax from a consumption tax.

The fundamental argument against including increases in human capital in income is that so doing would impose a tax on earnings capacity, as opposed to actual earnings, which would violate the freedom to choose whether to work and what type of work to do.[141] Professor Paul Stephan criticizes this argument on the basis that "denying that these opportunities (i.e. opportunities made available by investment in human capital) exist, or at least refusing to think about them, seems a perverse way to pursue the goal of individual dignity and liberty."[142] But the argument that a tax should not be imposed on earnings capacity does not deny that the earnings capacity exists and may be increased by education and other means; the argument is that it is unfair to impose a tax on that capacity because to do so would force the taxpayer to use that capacity to make

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[139] Stephan, Federal Income Taxation and Human Capital, 70 Va. L. Rev. 1357, 1358 (1984).

[140] See Klein, Timing in Personal Taxation, 6 J. Legal Stud. 461, 479 (1977) [hereinafter Klein, Timing].

[141] See Gunn, The Case For an Income Tax, 46 U. Chi. L. Rev. 370, 381-82 (1979); Kelman, Personal Deductions, note 46, at 842; Klein, Timing, note 140, at 467-69; Warren, note 15, at 1114-15. But see W. Klein, Policy Analysis, note 23, at 37.

[142] Stephan, note 139, at 1365.

money rather than to pursue other choices that may result in a lower amount of earnings. For example, a top law school graduate may have the capacity to earn an astronomical starting salary as an associate in a corporate law firm and a virtually obscene salary upon making partner, but may choose instead to work for a public interest group on a subsistence salary. If the graduate were taxed on earnings capacity, he could not afford to work at the public interest job, or, even if he perhaps could, he would be impoverished. To respect his right to work in the public interest is not to deny the existence of his earnings capacity, but to affirm his right not to exercise it without penalty. Professor Stephan also asserts: "I fail to see how taxation in principle violates personhood any more than the manifold other ways in which society imposes costs on those who choose not to work."[143] He cites cases where contract law forbids one who breaches a personal service contract from accepting other employment, imposes alimony regardless of the choice not to work, and imposes taxes on unrealized gains, thereby "forcing the taxpayer either to sell his labor or part with some other possession to pay the tax collector."[144] One answer is that the cases Stephan cites can be distinguished as not imposing as severe a burden as would full taxation of earnings capacity. Nevertheless, it is true that the law does not fully validate a decision not to work. Complete validation of such a decision presumably would require relieving the taxpayer of all obligations that cannot be satisfied out of his actual earnings. Presumably, the reason that the law does not do so currently is that there are competing policies to hold individuals to obligations they assume, such as a contractual obligation or a support obligation. Because of these competing policies, it is not surprising that there is not a hard and fast rule exonerating an individual from all obligations when she chooses not to work. In the case of human capital, the taxpayer has taken no action, other than the acquisition of the human capital itself, that creates an obligation. Thus, taxation of earnings capacity would constitute a much more serious incursion on the taxpayer's right to choose than would enforcement of unrelated obligations incurred by the taxpayer.[145]

The relevance of the above discussion to the argument of this article is that principles of fairness, in particular the unfairness of taxing unrealized earnings capacity, suggest that a taxpayer's income should be determined without regard to increases or decreases in the value of the taxpayer's human capital. There is nothing new about this fairness argu-

[143] Id. at 1366 n.14.

[144] Id.

[145] In this context, it is also noteworthy that in some cases obligations are relieved when the taxpayer chooses to work in a less remunerative occupation. For example, many law schools relieve student loans for graduates that enter public interest work.

ment.[146] What is relevant here is that the fairness argument is not inconsistent with the income tax ideal: The ideal income tax is based on fairness, and so one may conclude that increases in human capital are not income on the basis that it is not fair that they be treated as income.[147]

E. Personal Interest

At first blush, the Haig-Simons income formulation appears to contemplate a deduction for all interest. Interest constitutes a reduction in net wealth and it is not consumption. However, Professor Stanley Koppelman has argued that, under an interpretation of "consumption" as including expenditures that produce a "current personal benefit" to the taxpayer, personal interest should be treated as nondeductible.[148] As he puts it, "one who earns money which is spent on personal interest is presumed better off than one who does not earn that money."[149] Professor Koppelman's discussion of the problem is a good one, and it is not necessary to reiterate it here. What I would like to investigate is whether a focus on fairness can add anything to the analysis. I start at the beginning by asking what is meant by "personal interest." Professor Koppelman defines personal interest as "an amount paid for the use of money which is attributable to a personal use of the borrower. It thus includes interest on (1) loans to finance a vacation and (2) various credit card purchases for items such as meals at a restaurant."[150] The key issue in this definition is the phrase "attributable to": When is interest attributable to a personal expense? Consider the case of individual *A* with investment assets worth $10,000 who wishes to take a vacation today costing $10,000. *A* borrows this amount at a 10% interest rate, takes the vacation, and, a year later, pays off the loan with $10,000 in after-tax earned income, using the $1,000 earned from the investments to pay the interest on the loan. *A*'s friend *B* is in the same position as *A* except that *B* chooses to liquidate his investments in order to take the vacation, investing the after-tax earnings one year later. Thus, *A* and *B* start off and end the same after one year, the only difference being that *A*'s position is leveraged in the meantime (so that *A* could have gained or lost depending on whether the actual income from *A*'s investments matched the interest payable).

From a fairness point of view, it seems reasonable to say that, given the equivalence in their financial positions, it would be fair to impose the same amount of tax on *A* and *B*. The only relevant difference between

[146] See note 141.
[147] See Klein, Timing, note 140, at 467 n.25.
[148] Koppelman, note 16, at 716.
[149] Id. at 728.
[150] Id. at 714.

them is *A*'s greater leverage, which generally is not treated as giving rise to (or diminishing) taxable capacity in and of itself, unless it results in a gain or a loss. This conclusion can be reconciled with Professor Koppelman's definition, since the interest expense incurred by *A* can be viewed as not "attributable to" *A*'s vacation, but rather as attributable to *A*'s continued holding of her investment assets. As a general rule, one could say that interest expense is attributable to a personal expense only to the extent that the taxpayer could not have liquidated assets to finance the expense.[151]

If personal interest is so defined, its treatment becomes a relatively small issue, because personal interest will be incurred only by taxpayers whose debt exceeds their investment assets. Returning to the above example, what would happen if *A* borrowed an additional $1,000 in order to take an $11,000 vacation instead of a $10,000 vacation? Professor Koppelman would deny the deduction for interest on the additional $1,000. What if sitting right next to *A* on a lawn chair is *C*, who also chooses to take the more expensive vacation, but who has ample net worth? Is it fair to let *C* take the deduction for interest on his credit card while *A* cannot? The answer relating to fairness as between *A* and *C* seems to be less clear than the comparison between *A* and *B*, given that *A* and *C* are in different positions. Nevertheless, it is disturbing to let *C* have the interest deduction, while denying *A*'s deduction as a consumption expense, just because *C* is wealthier.

Considerations of fairness thus suggest the appropriateness of deducting all interest expense. A fairness focus does not dispose completely of arguments about the personal interest deduction.[152] However, a focus on fairness is helpful in making concrete an otherwise rather abstract argument about "consumption" and "personal benefit." The fairness focus also reminds us that there is no correct solution to this problem, and that our specification of income ultimately depends on judgments about what the relative tax burdens of taxpayers in different specific positions should be.

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[151] Professor Michael McIntyre has reached the same conclusion. See McIntyre, An Inquiry Into the Special Status of Interest Payments, 1981 Duke L.J. 765, 772; see also Goode, note 23, at 23. Koppelman recognizes the possibility that in the case I pose the interest could be treated as investment interest, without clarifying whether he would so consider it at all times. See Koppelman, note 16, at 724 n.194. For aficionados of the various interest allocation rules in the Code, the proposed rule can be seen as the reverse of the interest allocation rule in § 263A(f). Section 263A(f)(2) stacks debt first against the disfavored activity (that is, construction or production of property); there is no tracing or proration of interest expense. By contrast, the proposed rule would stack debt first against the taxpayer's business or investment assets, thereby making interest deductible unless such assets were insufficient to absorb the associated debt.

[152] For an extensive analysis of these arguments, see Koppelman, note 16, at 715-27.

Professor McIntyre's differing conclusion as to the deductibility of consumer interest under a Haig-Simons income tax illustrates the difference that a fairness-based analysis can make. Professor McIntyre considers the case of Mr. Ant, who finances a vacation by cashing in previously accumulated funds, and Mr. Grasshopper, who finances an identical vacation by borrowing.[153] Professor McIntyre argues that, despite Mr. Ant's economic advantage over Mr. Grasshopper, a deduction for Mr. Grasshopper's interest is inappropriate: "Differences in economic conditions must reflect differences in income before they merit response in an ideal income tax system."[154] Under a fairness analysis, his assertion begs the question: If it is considered fair to reflect Mr. Ant's economic advantage in an increased tax burden for Mr. Ant relative to Mr. Grasshopper, income can be defined in such a manner as to allow Mr. Grasshopper to deduct the interest expense. Professor McIntyre's view apparently is premised on a strict view that an ideal income tax must be based on income as defined by Henry Simons and that under the Haig-Simons definition, interest is treated appropriately as a consumption expense to the extent that it is traceable to financing of consumption. In my view, Professor McIntyre's approach is not right or wrong. It does differ, however, from the approach advocated in this article.

F. Damages for Personal Injuries

Damages for personal injuries are nontaxable under current law. The current law exclusion has been held to extend even to nonphysical injuries and to punitive damages.[155] In terms of the proposed framework for analysis, the issue in terms of defining income is whether it is fair to include such damage awards in income.[156] On one level the answer clearly is no. The existence of the current law exclusion suggests a congressional sentiment that it would be unfair to tax damage awards, and one certainly can envision the reaction of a member of Congress to a proposal to tax such awards. Opponents of taxation would not even need to strain to conjure up the proverbial orphan or injured person that would be hurt by such a measure.

Putting aside any emotional reaction, it is possible to develop a fairness argument by comparing the situations of three hypothetical persons: *A* (the uninjured party), *B* (the injured, but uncompensated party), and *C* (the injured and compensated party). The primary argument for not tax-

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[153] See McIntyre, note 150, at 775.

[154] Id.

[155] See, e.g., Church v. Commissioner, 80 T.C. 1104, 1110 (1983). Punitive damages awarded in a case not involving physical injuries are no longer excludable. IRC § 104(a).

[156] See J. Dodge, Logic, note 23, at 107-17; Knickerbocker, The Income Tax Treatment of Damages: A Study in the Difficulties of the Income Concept, 47 Cornell L.Q. 429 (1962).

ing damage awards is that the award puts *C* in roughly the same position as *A*, and to impose a tax on *C* would be to work an injustice. The answer to this argument is that *C* is better off than *B* by the amount of the award, and, therefore, is appropriately taxed. The only way to achieve perfect equity among *A*, *B* and *C* would be to allow *B* a deduction for the injury (and to allow *C* to exclude the award). But there is no way to allow such a deduction. Therefore, we are forced to choose between two regimes, both of which are imperfect from the point of view of equity: no deduction for *B* and either taxation or exclusion for *C*.

The analysis is complicated by noting that a damage award also may include an element of punitive damages, and that the bulk of the award is likely to be compensation for lost earnings. There is no compelling fairness argument for excluding either of these. Thus, under the alternative of excluding the portion of the award that represents compensation for pain and suffering and other noncommercial losses, the award must be divided between taxable and nontaxable elements. Such division is difficult or impossible as a practical matter. It may be impossible even in some cases as a conceptual matter. Where an award involves compensation for both lost earnings and pain and suffering, an allocation between the two amounts would require some estimate of the dollar value of pain and suffering. Even in cases that involve no lost earnings and no punitive damages, it still is not certain that the award contains no element of windfall over and above the plaintiff's actual pain and suffering (however that might be determined). The jury may have made a high estimate or may have inflated the figure out of a desire to punish the tortfeasor. There is simply no way to ascertain whether and to what extent this is the case.

In the face of this uncertainty (which calls into operation the measurability constraint on the definition of income), the inconclusive result produced by a fairness analysis, and the empirical observation that the bulk of damage awards are likely attributable to compensation for lost wages and punitive damages, it may be reasonable to include in income the entire amount of personal injury damage awards. Under such a rule, however, it would be appropriate to exclude a portion of the award, in the amount of attorney's and other fees of obtaining the award and medical and other related expenses incurred as a result of the injury. I would exclude the medical expenses regardless of the normal floor applicable in determining the deduction for such expenses.[157]

This application of fairness analysis to the issue of personal injuries illustrates the arbitrariness and inconsistency of the concept of income and again suggests that there are no neat theoretical solutions for determining income. Either the current law treatment or the proposed treat-

[157] IRC § 213(a) (7.5% of adjusted gross income).

ment whereby damage awards generally would be included in income are defensible on the basis of fairness. Even if fairness analysis does not resolve this problem, it exposes the relevant considerations more clearly than does the Haig-Simons income formulation.

[158] Important details are, however, lost under any such aggregation.
[159] See Musgrave, In Defense, note 23, at 52-53.
[160] See generally Sneed, Criteria, note 23.

A THEORY OF JUSTICE[1]

John Rawls

The Main Idea of the Theory of Justice

My aim is to present a conception of justice which generalizes and carries to a higher level of abstraction the familiar theory of the social contract as found, say, in Locke, Rousseau, and Kant. In order to do this we are not to think of the original contract as one to enter a particular society or to set up a particular form of government. Rather, the guiding idea is that the principles of justice for the basic structure of society are the object of the original agreement. They are the principles that free and rational persons concerned to further their own interests would accept in an initial position of equality as defining the fundamental terms of their association. These principles are to regulate all further agreements ; they specify the kinds of social cooperation that can be entered into and the forms of government that can be established. This way of regarding the principles of justice I shall call justice as fairness.

Thus we are to imagine that those who engage in social cooperation choose together, in one joint act, the principles which are to assign basic rights and duties and to determine the division of social benefits. Men are to decide in advance how they are to regulate their claims against one another and what is to be the foundation charter of their society. Just as each person must decide by rational reflection what constitutes his good, that is, the system of ends which it is rational for him to pursue, so a group of persons must decide once and for all what is to count among them as just and unjust. The choice which rational men would make in this hypothetical situation of equal liberty, assuming for the present that this choice problem has a solution, determines the principles of justice.

In justice as fairness the original position of equality corresponds to the state of nature in the traditional theory of the social contract. This original posi-

tion is not, of course, thought of as an actual historical state of affairs, much less as a primitive condition of culture. It is understood as a purely hypothetical situation characterized so as to lead to a certain conception of justice. Among the essential features of this situation is that no one knows his place in society, his class position or social status, nor does any one know his fortune in the distribution of natural assets and abilities, his intelligence, strength, and the like. I shall even assume that the parties do not know their conceptions of the good or their special psychological propensities. The principles of justice are chosen behind a veil of ignorance. This ensures that no one is advantaged or disadvantaged in the choice of principles by the outcome of natural chance or the contingency of social circumstances. Since all are similarly situated and no one is able to design principles to favour his particular condition, the principles of justice are the result of a fair agreement or bargain. For given the circumstances of the original position, the symmetry of everyone's relations to each other, this initial situation is fair between individuals as moral persons, that is, as rational beings with their own ends and capable, I shall assume, of a sense of justice. The original position is, one might say, the appropriate initial status quo, and thus the fundamental agreements reached in it are fair. This explains the propriety of the name "justice as fairness" : it conveys the idea that the principles of justice are agreed to in an initial situation that is fair. The name does not mean that the concepts of justice and fairness are the same, any more than the phrase "poetry as metaphor" means that the concepts of poetry and metaphor are the same.

Justice as fairness begins, as I have said, with one of the most general of all choices which persons might make together, namely, with the choice of the first principles of a conception of justice which is to regulate all subsequent criticism and reform of institutions. Then, having chosen a conception of justice, we can suppose that they are to choose a constitution and a legislature to enact laws, and so on, all in accordance with the principles of justice initially agreed upon. Our social situation is just if it is such that by this sequence of hypothetical agreements we would have contracted into the general system of rules which defines it. Moreover, assuming that the original position does determine a set of principles (that is, that a particular conception of justice would be chosen), it will then be true that whenever social institutions satisfy these principles those engaged in them can say to one another that they are cooperating on terms to which they would agree if they were free and equal persons whose relations with respect to one another were fair. They could all view their arrangements as meeting the stipulations which they would acknowledge in an initial situation that embodies widely accepted and reasonable constraints on the choice of principles. The general recognition of this fact would provide the basis for a public acceptance of the corresponding principles of justice. No society can, of course, be a scheme of cooperation which men enter voluntarily in a literal sense ; each person finds himself placed at birth in some particular position in some particular society, and the nature of this position materially affects his life prospects. Yet a society satisfying the principles of justice as fairness comes as close as a society can to being a voluntary scheme, for it meets the principles which free and equal persons would assent to under circumstances that are fair. In this sense its members are autonomous and the obligations they recognize self-imposed.

One feature of justice as fairness is to think of the parties in the initial situation as rational and mutually disinterested. This does not mean that the parties

are egoists, that is, individuals with only certain kinds of interests, say in wealth, prestige, and domination. But they are conceived as not taking an interest in one another's interests. They are to presume that even their spiritual aims may be opposed, in the way that the aims of those of different religions may be opposed. Moreover, the concept of rationality must be interpreted as far as possible in the narrow sense, standard in economic theory, of taking the most effective means to given ends. I shall modify this concept to some extent . . . but one must try to avoid introducing into it any controversial ethical elements. The initial situation must be characterized by stipulations that are widely accepted.

In working out the conception of justice as fairness one main task clearly is to determine which principles of justice would be chosen in the original position. To do this we must describe this situation in some detail and formulate with care the problem of choice which it presents ... It may be observed, however, that once that principles of justice are thought of as arising from an original agreement in a situation of equality, it is an open question whether the principle of utility would be acknowledged. Offhand it hardly seems likely that persons who view themselves as equals, entitled to press their claims upon one another, would agree to a principle which may require lesser life prospects for some simply for the sake of a greater sum of advantages enjoyed by others. Since each desires to protect his interests, his capacity to advance his conception of the good, no one has a reason to acquiesce in an enduring loss for himself in order to bring about a greater net balance of satisfaction. In the absence of strong and lasting benevolent impulses, a rational man would not accept a basic structure merely because it maximized the algebraic sum of advantages irrespective of its permanent effects on his own basic rights and interests. Thus it seems that the principle of utility is incompatible with the conception of social cooperation among equals for mutual advantage. It appears to be inconsistent with the idea of reciprocity implicit in the notion of a well-ordered society. Or, at any rate, so I shall argue.

I shall maintain instead that the persons in the initial situation would choose two rather different principles : the first requires equality in the assignment of basic rights and duties, while the second holds that social and economic inequalities, for example inequalities of wealth and authority, are just only if they result in compensating benefits for everyone, and in particular for the least advantaged members of society. These principles rule out justifying institutions on the grounds that the hardships of some are offset by a greater good in the aggregate. It may be expedient but it is not just that some should have less in order that others may prosper. But there is no injustice in the greater benefits earned by a few provided that the situation of persons not so fortunate is thereby improved. The intuitive idea is that since everyone's well-being depends upon a scheme of cooperation without which no one could have a satisfactory life, the division of advantages should be such as to draw forth the willing cooperation of everyone taking part in it, including those less well situated. Yet this can be expected only if reasonable terms are proposed. The two principles mentioned seem to be a fair agreement on the basis of which those better endowed, or more fortunate in their social position, neither of which we can be said to deserve, could expect the willing cooperation of others when some workable scheme is a necessary condition of the welfare of all. Once we decide to look for a conception of justice that nullifies the accidents of natural endowment and the contingencies of social circumstance as counters in quest for political and economic advantage,

we are led to these principles. They express the result of leaving aside those aspects of the social world that seem arbitrary from a moral point of view.

The problem of the choice of principles, however, is extremely difficult. I do not expect the answer I shall suggest to be convincing to everyone. It is, therefore, worth noting from the outset that justice as fairness, like other contract views, consists of two parts : (1) an interpretation of the initial situation and of the problem of choice posed there, and (2) a set of principles which, it is argued, would be agreed to. One may accept the first part of the theory (or some variant thereof), but not the other, and conversely. The concept of the initial contractual situation may seem reasonable although the particular principles proposed are rejected. To be sure, I want to maintain that the most appropriate conception of this situation does lead to principles of justice contrary to utilitarianism and perfectionism, and therefore that the contract doctrine provides an alternative to these views. Still, one may dispute this contention even though one grants that the contractarian method is a useful way of studying ethical theories and of setting forth their underlying assumptions....

The merit of the contract terminology is that it conveys the idea that principles of justice may be conceived as principles that would be chosen by rational persons, and that in this way conceptions of justice may be explained and justified. The theory of justice is a part, perhaps the most significant part, of the theory of rational choice. Furthermore, principles of justice deal with conflicting claims upon the advantages won by social cooperation ; they apply to the relations among several persons or groups. The word "contract" suggests this plurality as well as the condition that the appropriate division of advantages must be in accordance with principles acceptable to all parties. The condition of publicity for principles of justice is also connoted by the contract phraseology. Thus, if these principles are the outcome of an agreement, citizens have a knowledge of the principles that others follow. It is characteristic of contract theories to stress the public nature of political principles. Finally there is the long tradition of the contract doctrine. Expressing the tie with this line of thought helps to define ideas and accords with natural piety. There are then several advantages in the use of the term "contract." With due precautions taken, it should not be misleading....

The Original Position and Justification

I have said that the original position is the appropriate initial status quo which insures that the fundamental agreements reached in it are fair. This fact yields the name "justice as fairness." It is clear, then, that I want to say that one conception of justice is more reasonable than another, or justifiable with respect to it, if rational persons in the initial situation would choose its principles over those of the other for the role of justice. Conceptions of justice are to be ranked by their acceptability to persons so circumstanced. Understood in this way the question of justification is settled by working out a problem of deliberation : we have to ascertain which principles it would be rational to adopt given the contractual situation. This connects the theory of justice with the theory of rational choice.

If this view of the problem of justification is to succeed, we must, of course, describe in some detail the nature of this choice problem. A problem of rational decision has a definite answer only if we know the beliefs and interests of the par-

ties, their relations with respect to one another, the alternatives between which they are to choose, the procedure whereby they make up their minds, and so on. As the circumstances are presented in different ways, correspondingly different principles are accepted. The concept of the original position, as I shall refer to it, is that of the most philosophically favoured interpretation of this initial choice situation for the purposes of a theory of justice.

But how are we to decide which is the most favoured interpretation ? I assume, for one thing, that there is a broad measure of agreement that principles of justice should be chosen under certain conditions. To justify a particular description of the initial situation one shows that it incorporates these commonly shared presumptions. One argues from widely accepted but weak premises to more specific conclusions. Each of the presumptions should by itself be natural and plausible ; some of them may seem innocuous or even trivial. The aim of the contract approach is to establish that taken together they impose significant bounds on acceptable principles of justice. The ideal outcome would be that these conditions determine a unique set of principles ; but I shall be satisfied if they suffice to rank the main traditional conceptions of social justice.

One should not be misled, then, by the somewhat unusual conditions which characterize the original position. The idea here is simply to make vivid to ourselves the restrictions that it seems reasonable to impose on arguments for principles of justice, and therefore on these principles themselves. Thus it seems reasonable and generally acceptable that no one should be advantaged or disadvantaged by natural fortune or social circumstances in the choice of principles. It also seems widely agreed that it should be impossible to tailor principles to the circumstances of one's own case. We should insure further that particular inclinations and aspirations, and persons' conceptions of their good do not affect the principles adopted. The aim is to rule out those principles that it would be rational to propose for acceptance, however little the chance of success, only if one knew certain things that are irrelevant from the standpoint of justice. For example, if a man knew that he was wealthy, he might find it rational to advance the principle that various taxes for welfare measures be counted unjust ; if he knew that he was poor, he would most likely propose the contrary principle. To represent the desired restrictions one imagines a situation in which everyone is deprived of this sort of information. One excludes the knowledge of those contingencies which sets men at odds and allows them to be guided by their prejudices. In this manner the veil of ignorance is arrived at in a natural way. This concept should cause no difficulty if we keep in mind the constraints on arguments that it is meant to express. At any time we can enter the original position, so to speak, simply by following a certain procedure, namely, by arguing for principles of justice in accordance with these restrictions.

It seems reasonable to suppose that the parties in the original position are equal. That is, all have the same rights in the procedure for choosing principles ; each can make proposals, submit reasons for their acceptance, and so on. Obviously the purpose of these conditions is to represent equality between human beings as moral persons, as creatures having a conception of their good and capable of a sense of justice. The basis of equality is taken to be similarity in these two respects. Systems of ends are not ranked in value ; and each man is presumed to have the requisite ability to understand and to act upon whatever principles are adopted. Together with the veil of ignorance, these conditions define the princi-

ples of justice as those which rational persons concerned to advance their interests would consent to as equals when none are known to be advantaged or disadvantaged by social and natural contingencies.... [pp. 11-19]

Two Principles of Justice

I shall now state in a provisional form the two principles of justice that I believe would be chosen in the original position. . . .

The first statement of the two principles reads as follows :

First : each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others.

Second : social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all....

By way of general comment, these principles primarily apply, as I have said, to the basic structure of society. They are to govern the assignment of rights and duties and to regulate the distribution of social and economic advantages. As their formulation suggests, these principles presuppose that the social structure can be divided into two more or less distinct parts, the first principle applying to the one, the second to the other. They distinguish between those aspects of the social system that define and secure the equal liberties of citizenship and those that specify and establish social and economic inequalities. The basic liberties of citizens are, roughly speaking, political liberty (the right to vote and to be eligible for public office) together with freedom of speech and assembly ; liberty of conscience and freedom of thought ; freedom of the person along with the right to hold (personal) property ; and freedom from arbitrary arrest and seizure as defined by the concept of the rule of law. These liberties are all required to be equal by the first principle, since citizens of a just society are to have the same basic rights.

The second principle applies, in the first approximation, to the distribution of income and wealth and to the design of organizations that make use of differences in authority and responsibility, or chains of command. While the distribution of wealth and income need not be equal, it must be to everyone's advantage, and at the same time, positions of authority and offices of command must be accessible to all. One applies the second principle by holding positions open, and then, subject to this constraint, arranges social and economic inequalities so that everyone benefits.

These principles are to be arranged in a serial order with the first principle prior to the second. This ordering means that a departure from the institutions of equal liberty required by the first principle cannot be justified by, or compensated for, by greater social and economic advantages. The distribution of wealth and income, and the hierarchies of authority, must be consistent with both the liberties of equal citizenship and equality of opportunity.... [pp. 60-61]

The Veil of Ignorance

The idea of the original position is to set up a fair procedure so that any principles agreed to will be just. The aim is to use the notion of pure procedural justice as a basis of theory. Somehow we must nullify the effects of specific contingencies which put men at odds and tempt them to exploit social and natural circum-

stances to their own advantage. Now in order to do this I assume that the parties are situated behind a veil of ignorance. They do not know how the various alternatives will affect their own particular case and they are obliged to evaluate principles solely on the basis of general considerations.

It is assumed, then, that the parties do not know certain kinds of particular facts. First of all, no one knows his place in society, his class position or social status ; nor does he know his fortune in the distribution of natural assets and abilities, his intelligence and strength, and the like. Nor, again, does anyone know his conception of the good, the particulars of his rational plan of life, or even the special features of his psychology such as his aversion to risk or liability to optimism or pessimism. More than this, I assume that the parties do not know the particular circumstances of their own society. That is, they do not know its economic or political situation, or the level of civilization and culture it has been able to achieve. The persons in the original position have no information as to which generation they belong. These broader restrictions on knowledge are appropriate in part because questions of social justice arise between generations as well as within them, for example, the question of the appropriate rate of capital saving and of the conservation of natural resources and the environment of nature. There is also, theoretically anyway, the question of a reasonable genetic policy. In these cases too, in order to carry through the idea of the original position, the parties must not know the contingencies that set them in opposition. They must choose principles the consequences of which they are prepared to live with whatever generation they turn out to belong to.

As far as possible, then, the only particular facts which the parties know is that their society is subject to the circumstances of justice and whatever this implies. It is taken for granted, however, that they know the general facts about human society. They understand political affairs and the principles of economic theory ; they know the basis of social organization and the laws of human psychology. Indeed, the parties are presumed to know whatever general facts affect the choice of the principles of justice. There are no limitations on general information, that is, on general laws and theories, since conceptions of justice must be adjusted to the characteristics of the systems of social cooperation which they are to regulate, and there is no reason to rule out these facts. It is, for example, a consideration against a conception of justice that in view of the laws of moral psychology, men would not acquire a desire to act upon it even when the institutions of their society satisfied it. For in this case there would be difficulty in securing the stability of social cooperation. It is an important feature of a conception of justice that it should generate its own support. That is, its principles should be such that when they are embodied in the basic structure of society men tend to acquire the corresponding sense of justice. Given the principles of moral learning, men develop a desire to act in accordance with its principles. In this case a conception of justice is stable. This kind of general information is admissible in the original position.... [pp. 136-138]

Background Institutions for Distributive Justice

The main problem of distributive justice is the choice of a social system. The principles of justice apply to the basic structure and regulate how its major institutions are combined into one scheme. Now, as we have seen, the idea of justice as fairness is to use the notion of pure procedural justice to handle the contingen-

cies of particular situations. The social system is to be designed so that the resulting distribution is just however things turn out. To achieve this end it is necessary to set the social and economic process within the surroundings of suitable political and legal institutions. Without the proper arrangement of these background institutions the outcome of the distributive process will not be just. Background fairness is lacking. I shall give a brief description of these background institutions as they might exist in a properly organized democratic state that allows private ownership of capital and natural resources. These arrangements are familiar, but it may be useful to see how they fit the two principles of justice. Modifications for the case of a socialist regime will be considered briefly later.

First of all, I assume that the basic structure is regulated by a just constitution that secures the liberties of equal citizenship.... Liberty of conscience and freedom of thought are taken for granted, and the fair value of political liberty is maintained. The political process is conducted, as far as circumstances permit, as a just procedure for choosing between governments and for enacting just legislation. I assume also that there is fair (as opposed to formal) equality of opportunity. This means that in addition to maintaining the usual kinds of social overhead capital, the government tries to insure equal chances of education and culture for persons similarly endowed and motivated either by subsidizing private schools or by establishing a public school system. It also enforces and underwrites equality of opportunity in economic activities and in the free choice of occupation. This is achieved by policing the conduct of firms and private associations and by preventing the establishment of monopolistic restrictions and barriers to the more desirable positions. Finally, the government guarantees a social minimum either by family allowances and special payments for sickness and employment, or more systematically by such devices as a graded income supplement (a so-called negative income tax).

In establishing these background institutions the government may be thought of as divided into four branches. Each branch consists of various agencies, or activities thereof, charged with preserving certain social and economic conditions. These divisions do not overlap with the usual organization of government but are to be understood as different functions. The allocation branch, for example, is to keep the price system workably competitive and to prevent the formation of unreasonable market power. Such power does not exist as long as markets cannot be made more competitive consistent with the requirements of efficiency and the facts of geography and the preferences of households. The allocation branch is also charged with identifying and correcting, say by suitable taxes and subsidies and by changes in the definition of property rights, the more obvious departures from efficiency caused by the failure of prices to measure accurately social benefits and costs. To this end suitable taxes and subsidies may be used, or the scope and definition of property rights may be revised. The stabilization branch, on the other hand, strives to bring about reasonably full employment in the sense that those who want work can find it and the free choice of occupation and the deployment of finance is supported by strong effective demand. These two branches together are to maintain the efficiency of the market economy generally.

The social minimum is the responsibility of the transfer branch.... The essential idea is that the workings of this branch takes needs into account and as-

signs them an appropriate weight with respect to other claims. A competitive price system gives no consideration to needs and therefore it cannot be the sole device of distribution. There must be a division of labour between the parts of the social system in answering to the commonsense precepts of justice. Different institutions meet different claims. Competitive markets properly regulated secure free choice of occupation and lead to an efficient use of resources and allocation of commodities to households. They set a weight on the conventional precepts associated with wages and earnings, whereas the transfer branch guarantees a certain level of well-being and honours the claims of need. Eventually I will discuss these commonsense precepts and how they arise within the context of various institutions. The relevant point here is that certain precepts tend to be associated with specific institutions. It is left to the background system as a whole to determine how these precepts are balanced. Since the principles of justice regulate the whole structure, they also regulate the balance of precepts. In general, then, this balance will vary in accordance with the underlying political conception.

It is clear that the justice of distributive shares depends on the background institutions and how they allocate total income, wages and other income plus transfers. There is with reason strong objection to the competitive determination of total income, since this ignores the claims of need and an appropriate standard of life. From the standpoint of the legislative stage it is rational to insure oneself and one's descendants against these contingencies of the market. Indeed, the difference principle presumably requires this. But once a suitable minimum is provided by transfers, it may be perfectly fair that the rest of total income be settled by the price system, assuming that it is moderately efficient and free from monopolistic restrictions, and unreasonable externalities have been eliminated. Moreover, this way of dealing with the claims of need would appear to be more effective than trying to regulate income by minimum wage standards, and the like. It is better to assign to each branch only such tasks as are compatible with one another. Since the market is not suited to answer the claims of need, these should be met by a separate arrangement. Whether the principles of justice are satisfied, then, turns on whether the total income of the least advantaged (wages plus transfers) is such as to maximize their long-run expectations (consistent with the constraints of equal liberty and fair equality of opportunity).

Finally, there is a distribution branch. Its task is to preserve an approximate justice in distributive shares by means of taxation and the necessary adjustments in the rights of property. Two aspects of this branch may be distinguished. First of all, it imposes a number of inheritance and gift taxes, and sets restrictions on the rights of bequest. The purpose of these levies and regulations is not to raise revenue (release resources to government) but gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity. For example, the progressive principle might be applied at the beneficiary's end. Doing this would encourage the wide dispersal of property which is a necessary condition, it seems, if the fair value of the equal liberties is to be maintained. The unequal inheritance of wealth is no more inherently unjust than the unequal inheritance of intelligence. It is true that the former is presumably more easily subject to social control; but the essential thing is that as far as possible inequalities founded on either should satisfy the difference principle. Thus inheritance is per-

missible provided that the resulting inequalities are to the advantage of the least fortunate and compatible with liberty and fair equality of opportunity. As earlier defined, fair equality of opportunity means a certain set of institutions that assures similar chances of education and culture for persons similarly motivated and keeps positions and offices open to all on the basis of qualities and efforts reasonably related to the relevant duties and tasks. It is these institutions that are put in jeopardy when inequalities of wealth exceed a certain limit ; and political liberty likewise tends to lose its value, and representative government to become such in appearance only. The taxes and enactments of the distribution branch are to prevent this limit from being exceeded. Naturally, where this limit lies is a matter of political judgment guided by theory, good sense, and plain hunch, at least within a wide range. On this sort of question the theory of justice has nothing specific to say. Its aim is to formulate the principles that are to regulate the background institutions.

The second part of the distribution branch is a scheme of taxation to raise the revenues that justice requires. Social resources must be released to the government so that it can provide for the public goods and make the transfer payments necessary to satisfy the difference principle. This problem belongs to the distribution branch since the burden of taxation is to be justly shared and it aims at establishing just arrangements. Leaving aside many complications, it is worth noting that a proportional expenditure tax may be part of the best tax scheme. For one thing, it is preferable to an income tax (of any kind) at the level of commonsense precepts of justice, since it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned). Again, a proportional tax on total consumption (for each year say) can contain the usual exemptions for dependents, and so on ; and it treats everyone in a uniform way (still assuming that income is fairly earned). It may be better, therefore, to use progressive rates only when they are necessary to preserve the justice of the basic structure with respect to the first principle of justice and fair equality of opportunity, and so to forestall accumulations of property and power likely to undermine the corresponding institutions. Following this rule might help to signal an important distinction in questions of policy. And if proportional taxes should also prove more efficient, say because they interfere less with incentives, this might make the case for them decisive if a feasible scheme could be worked out. As before, these are questions of political judgment and not part of a theory of justice. And in any case we are here considering such a proportional tax as part of an ideal scheme for a well-ordered society in order to illustrate the content of the two principles. It does not follow that, given the injustice of existing institutions, even steeply progressive income taxes are not justified when all things are considered. In practice we must usually choose between several unjust, or second best, arrangements ; and then we look to nonideal theory to find the least unjust scheme. Sometimes this scheme will include measures and policies that a perfectly just system would reject. Two wrongs can make a right in the sense that the best available arrangement may contain a balance of imperfections, an adjustment of compensating injustices.

The two parts of the distribution branch derive from the two principles of justice. The taxation of inheritance and income at progressive rates (when necessary), and the legal definition of property rights, are to secure the institutions of

equal liberty in a property-owning democracy and the fair value of the rights they establish. Proportional expenditure (or income) taxes are to provide revenue for public goods, the transfer branch and the establishment of fair equality of opportunity in education, and the like, so as to carry out the second principle. No mention has been made at any point of the traditional criteria of taxation such as that taxes are to be levied according to benefits received or the ability to pay. The reference to commonsense precepts in connection with expenditure taxes is a subordinate consideration. The scope of these criteria is regulated by the principles of justice. Once the problem of distributive shares is recognized as that of designing background institutions, the conventional maxims are seen to have no independent force, however appropriate they may be in certain delimited cases. To suppose otherwise is not to take a sufficiently comprehensive point of view.... It is evident also that the design of the distribution branch does not presuppose the utilitarian's standard assumptions about individual utilities. Inheritance and progressive income taxes, for example, are not predicated on the idea that individuals have similar utility functions satisfying the diminishing marginal principle. The aim of the distribution branch is not, of course, to maximize the net balance of satisfaction but to establish just background institutions. Doubts about the shape of utility functions are irrelevant. This problem is one for the utilitarian, not for contract theory.

So far I have assumed that the aim of the branches of government is to establish a democratic regime in which land and capital are widely though not presumably equally held. Society is not so divided that one fairly small sector controls the preponderance of productive resources. When this is achieved and distributive shares satisfy the principles of justice, many socialist criticisms of the market economy are met. But it is clear that, in theory anyway, a liberal socialist regime can also answer to the two principles of justice. We have only to suppose that the means of production are publicly owned and that firms are managed by workers' councils say, or by agents appointed by them. Collective decisions made democratically under the constitution determine the general features of the economy, such as the rate of saving and the proportion of society's production devoted to essential public goods. Given the resulting economic environment, firms regulated by market forces conduct themselves much as before. Although the background institutions will take a different form, especially in the case of the distribution branch, there is no reason in principle why just distributive shares cannot be achieved. The theory of justice does not by itself favour either form of regime. As we have seen, the decision as to which system is best for a given people depends upon their circumstances, institutions, and historical traditions.... [pp. 274-280]

. . . I now wish to give the final statement of the two principles of justice for institutions. For the sake of completeness, I shall give a full statement including earlier formulations.

First Principle

> Each person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all.

Second Principle

Social and economic inequalities are to be arranged so that they are both :
(a) to the greatest benefit of the least advantaged, consistent with the just savings principle, and
(b) attached to offices and positions open to all under conditions of fair equality of opportunity.

First Priority Rule (The Priority of Liberty)

The principles of justice are to be ranked in lexical order and therefore liberty can be restricted only for the sake of liberty.
There are two cases :
(a) a less extensive liberty must strengthen the total system of liberty shared by all ;
(b) a less than equal liberty must be acceptable to those with the lesser liberty.

Second Priority Rule (The Priority of Justice over Efficiency and Welfare)

The second principle of justice is lexically prior to the principle of efficiency and to that of maximizing the sum of advantages ; and fair opportunity is prior to the difference principle. There are two cases :
(a) an inequality of opportunity must enhance the opportunities of those with the lesser opportunity ;
(b) an excessive rate of saving must on balance mitigate the burden of those bearing this hardship.

General Conception

All social primary goods — liberty and opportunity, income and wealth, and the bases of self-respect — are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favoured. [pp. 302-303]

NOTE

1. John Rawls, *A Theory of Justice* (Cambridge, Mass. : The Belknap Press of Harvard University Press, 1971), pp. 11-303.

The Atavism of Social Justice*

I

To discover the meaning of what is called "social justice" has been one of my chief pre-occupations for more than 10 years. I have failed in this endeavour — or, rather, have reached the conclusion that, with reference to a society of free men, the phrase has no meaning whatever. The search for the reason why the word has nevertheless for something like a century dominated political discussion, and has everywhere been successfully used to advance claims of particular groups for a larger share in the good things of life, remains however a very interesting one. It is this question with which I shall here chiefly concern myself.

But I must at first briefly explain, as I attempt to demonstrate at length in Volume 2 of my *Law, Legislation and Liberty,* why I have come to regard "social justice" as nothing more than an empty formula, conventionally used to assert that a particular claim is justified without giving any reason. Indeed that volume, sub-titled *The Mirage of Social Justice* is mainly intended to convince intellectuals that the concept of "social justice", which they are so fond of using, is intellectually disreputable.

Some, of course, have already tumbled to this; but with the unfortunate result that, since "social" justice is the only kind of justice they have ever thought of, they have been led to the false conclusion that all uses of the term "justice" have no meaningful content. I have therefore been impelled to show in the same book that rules of just individual conduct are as indispensable to the preservation of a peaceful society

* The 9th R.C. Mills Memorial Lecture delivered at the University of Sydney on October 6, 1976.

of free men as endeavours to realise "social" justice are in compatible with it.

The term "social justice" is today generally used as a synonym of what used to be called "distributive justice". The latter term perhaps gives a somewhat better idea of what is intended to be meant by it, and at the same time shows why it can have no application to the results of a market order. There can be no distributive justice where no one distributes. Justice has meaning only as a rule of human conduct, and no conceivable rules for the conduct of individual persons supplying each other with goods and services in a market order would produce a distribution which could be meaningfully described as just or unjust. Individuals might conduct themselves as justly as possible, but as the results for separate persons would be neither intended nor foreseeable by others, the resulting state of affairs could neither be called just nor unjust.

The complete emptiness of the phrase "social justice" shows itself in the fact that no agreement exists about what social justice requires in particular instances; also that there is no known test by which to decide who is right if people differ; and that no preconceived scheme of distribution could be effectively devised in a society whose members are free, in the sense of being allowed to use their own knowledge for their own purposes. Indeed, individual moral responsibility for one's actions is incompatible with the realisation of any such desired overall pattern of distribution.

A little inquiry shows that, though a great many people are dissatisfied with the existing pattern of distribution, none of them has really any clear idea of what pattern he would regard as just. All that we find are intuitive assessments of individual cases as unjust. No one has yet found even a single general rule from which we could derive what is "socially just" in all particular instances that would fall under it — except the rule of "equal pay for equal work". Free competition, precluding all the regard for merit or need and the like, on which demands for social justice are based, tends to enforce the equal pay rule.

II

The reason why most people continue firmly to believe in "social justice", even after discovering they do not really know what the phrase means, is that they think there must be something in the phrase, if almost everyone else believes in it. The ground for this almost universal acceptance of a belief, the significance of which people do not understand, is that we have all inherited from an earlier different type of society, in which man existed very much longer than in the present one, some now deeply ingrained instincts which are inapplicable to our present civilisation. In fact, man emerged from primitive society when in certain conditions increasing numbers succeeded, by disregarding those very principles which had held the old groups together.

We must not forget that before the last 10,000 years, during which man has developed agriculture, towns and ultimately the "Great Society", he existed for at least a hundred times as long in small food-sharing hunting bands of 50 or so, with a strict order of dominance within the defended common territory of the band. The needs of this ancient primitive kind of society determined much of the moral feelings which still govern us, and which we approve in others. It was a grouping in which, at least for all males, the common pursuit of a perceived physical common object under the irection of the alpha male was as much a condition of its ntinued existence as the assignment of different shares in e prey to the different members according to their impor- nce for the survival of the band. It is more than probable at many of the moral feelings then acquired have not merebeen culturally transmitted by teaching or imitation, but ve become innate or genetically determined.

But not all that is natural to us in this sense is therefore cessarily, in different circumstances, good or beneficial for e propagation of the species. In its primitive form the little nd indeed did possess what is still attractive to so many ople: a unitary purpose, or a common hierarchy of ends, d a deliberate sharing of means according to a common ew of individual merits. These foundations of its coherence, wever, also imposed limits on the possible development of

this form of society. The events to which the group could adapt itself, and the opportunities it could take advantage of, were only those of which its members were directly aware. Even worse, the individual member of the group could do little of which others did not approve.

It is a delusion to think of the individual in primitive society as free. There was no natural liberty for a social animal. Freedom is an artifact of civilisation. An individual person had in the group no recognised domain of independent action; even the head of the band could expect obedience, support and understanding of his signals only if they were for conventional activities. So long as each must serve that common order of rank for all needs, which present-day socialists dream of, there can be no free experimentation by the individual.

III

The great advance which made possible the development of civilisation and ultimately of the Open Society was the gradual substitution of abstract rules of conduct for specific obligatory ends — and with it the playing of a game for acting in concert by following common indicators, by which a spontaneous order was self-generated. The great gain attained by this was that it made possible a procedure through which all relevant information widely dispersed was continuously made available to ever-increasing numbers of men in the form of the symbols which we call market prices. But it also meant that the incidence of the results on different persons and groups no longer satisfied the age-old instincts.

It has been suggested more than once that the theory explaining the working of the market be called catallactics from the classical Greek word for bartering or exchanging — *katalattein*. I have fallen somewhat in love with this word since discovering that in ancient Greek, in addition to "exchanging", it also meant "to admit into the community" and "to change from enemy into friend". I have therefore proposed that we call the game of the market, by which we can induce the stranger to welcome and serve us, the *"game of catallaxy"*.

The market process indeed corresponds fully to the definition of a game which we find in *The Oxford English Dictionary*. It is "a contest played according to rules and decided by superior skill, strength or good fortune". It is in this respect both a game of skill as well as a game of chance. Above all, *it is a game which serves to elicit from each player the highest worthwhile contribution to the common pool from which each will win an uncertain share.*

The game was probably started by men who had left the shelter and obligations of their own tribe to gain from serving the needs of others they did not know personally. When the early neolithic traders took boat-loads of flint axes from Britain across the Channel to barter them against amber and probably also, even then, jars of wine, their aim was no longer to serve the needs of known people, but to make the largest gain. Precisely because they were interested only in who would offer the best price for their products, they reached persons completely unknown to them, whose standard of life they thereby enhanced much more than they could have that of their neighbours by handing the axes to those who no doubt could also have made good use of them.

IV

As the abstract signal-price thus took the place of the needs of known fellows as the goal towards which men's efforts were directed, entirely new possibilities for the utilisation of resources opened up — but this also required entirely different moral attitudes to encourage their exploitation. The change occurred largely at the new urban centres of trade and handicrafts, which grew up at ports or at the cross-roads of trade routes, where men who had escaped from the discipline of tribal morals established commercial communities and gradually developed the new rules of the game of catallaxy.

The necessity to be brief forces me here somewhat to over-simplify and to employ familiar terms where they are not quite appropriate. When I pass from the morals of the hunting-band in which man spent most of his history, to the morals which made possible the market order of the open society, I am jumping over a long intermediate stage, much

shorter than man's life in the small band, but still of much greater length than the urban and commercial society has enjoyed yet, and important because from it date those codifications of ethics which became embodied in the teaching of the mono-theistic religions.

It is the period of man's life in tribal society. In many ways it represents a transitional stage between the concrete order of the primitive face-to-face society, in which all the members knew each other and served common particular ends, and the open and abstract society, in which an order results from individuals observing the same abstract rules of the game, while using their own knowledge in the pursuit of their own ends.

While our emotions are still governed by the instincts appropriate to the success of the small hunting band, our verbal tradition is dominated by duties to the "neighbour", the fellow-member of the tribe, and still regarding the alien largely as beyond the pale of moral obligation.

In a society in which individual aims were necessarily different, based on specialised knowledge, and efforts came to be directed towards future exchange of products with yet unknown partners, common rules of conduct increasingly took the place of particular common ends as the foundations of social order and peace. The inter-action of individuals became a game, because what was required from each individual was observance of the rules, not concern for a particular result, other than to win support for himself and his family. The rules which gradually developed, because they made this game most effective, were essentially those of the law of property and contract. These rules in turn made possible the progressive division of labour, and that mutual adjustment of independent efforts, which a functioning division of labour demands.

V

The full significance of this division of labour is often not appreciated, because most people think of it — partly because of the classical illustration given by Adam Smith — as a designed intra-mural arrangement in which different individuals contribute the successive steps in a planned process for shaping certain products. In fact, however, *co-ordination by the market of the endeavours of different enterprises* in supplying the raw materials, tools and semi-finished products which the turning out of the final commodity requires, is probably much more important than the organised collaboration of numerous specialist workers.

It is in a great measure this inter-firm division of labour, or specialisation, on which the achievement of the competitive market depends, and which that market makes possible. Prices the producer finds on the market at once tell him what to produce and what means to use in producing it. From such market signals he knows that he can expect to sell at prices covering his outlays, and that he will not use up more resources than are necessary for the purpose. His selfish striving for gain makes him do, and enables him to do, precisely what he ought to do in order to improve the chances of any member of his society, taken at random, as much as possible — *but only if* the prices he can get are determined solely by market forces, and not by the coercive powers of government. Only prices determined on the free market will bring it about that demand equals supply. Not only this. Free market prices also ensure that all of a society's dispersed knowledge will be taken into account and used.

The game of the market led to the growth and prosperity of communities who played it, because it improved the chances for all. This was made possible because remuneration for the services of individual persons depended on objective facts, all of which no one could know, and not on someone's opinions about what they ought to have. But it also meant that, while skill and industry would improve each individual's chances, they could not guarantee him a specified income; and that the impersonal process which used all that dispersed knowledge set the signals of prices so as to tell people *what to do*, but without regard to needs or merits.

Yet the ordering and productivity-enhancing function of prices, and particularly the prices of services, depends on their informing people where they will find their most effective place in the overall pattern of activities — the place in which they are likely to make the greatest contribution to ag-

gregate output. If, therefore, we regard *that* rule of remuneration as just which contributes as much as possible to increasing the chances of any member of the community picked out at random, we ought to regard the remunerations determined by a free market as the just ones.

VI

However, they are inevitably very different from the relative remunerations which assisted the organisation of the different type of society in which our species lived so much longer, and which therefore still governs the feelings that guide us. This point has become exceedingly important since prices ceased to be accepted as due to unknown circumstances, and governments came to believe they could determine prices with beneficial effects.

When governments started to falsify the market-price signals, whose appropriateness they had no means of judging (governments as little as anyone else possessing all information precipitated in prices), in the hope of thereby giving benefits to groups claimed to be particularly deserving, things inevitably started to go wrong. Not only the efficient use of resources, but, what is worse, also the prospects of being able to buy or sell as expected — through demand equalling supply — were thereby greatly diminished.

It may be difficult to understand, but I believe there can be no doubt about it, that we are led to utilise more relevant information when our remuneration is made to depend indirectly on circumstances we do not know. It is thus that, in the language of modern cybernetics, the feed-back mechanism secures the maintenance of a self-generating order. It was this which already Adam Smith saw and described as the operation of the "invisible hand" — to be ridiculed for 200 years by uncomprehending scoffers. It is indeed *because* the game of catallaxy disregards human conceptions of what is due to each, and rewards according to success in playing the game under the same formal rules, that it produces a more efficient allocation of resources than any design could achieve.

I feel that in any game that is played because it improves the prospects of all beyond those which we know how to provide by any other arrangements, the results must be accepted as fair, so long as all obey the same rules, and no one cheats. If they accept their winnings from the game, it is cheating for individuals or groups to invoke the powers of government to divert the flow of good things in their favour — whatever we may do outside this game of the market to provide a decent minimum for those for whom the game does not supply it.

It is not a valid objection to such a game, the outcome of which depends partly on skill and particular individual circumstances and partly on pure chance, that the initial prospects for different individuals, although they are all improved by playing that game, are very far from being the same.

The answer to such an objection is precisely that one of the purposes of the game is to make the full possible use of the inevitably different skills, knowledge and environment of different persons. Among the greatest assets which a society can use in this manner for increasing the pool from which individual earnings are drawn, are the different moral, intellectual and material gifts parents can pass on to their children — and often will acquire, create or preserve only in order to be able to pass them on to their children.

VII

The result of this game of catallaxy, therefore, will necessarily be that many have much more than their fellows think they deserve, and even more will have much less than their fellows think they ought to have. It is not surprising that many people should wish to correct this by some authoritarian act of re-distribution. The trouble is that the aggregate product which they think is available for distribution exists only *because* returns for the different efforts are held out by the market with little regard to deserts or needs, and are required to attract the owners of particular information, material means and personal skills to the points where at each moment they can make the greatest contribution. Those who prefer the quiet of an assured contractual income to the necessity of taking risks to exploit ever-changing opportunities feel at a disadvantage compared with possessors of

large incomes which result from continual re-disposition of resources.

High actual gains of the successful ones, whether this success is deserved or accidental, are an essential element for guiding resources to where they will make the largest contribution to the pool from which all draw their shares. We should not have as much to share if *that* income of an individual were not treated as *just*, the prospects of which induced him to make the largest contribution to the pool. Incredibly high incomes may thus sometimes be just. What is even more important, scope for achieving such incomes may be the necessary condition for the less enterprising, lucky, or clever to get the regular income on which they count.

The inequality that so many people resent, however, has not only been the underlying condition for producing the relatively high incomes which most people in the West now enjoy. Some people seem to believe that a lowering of this general level of incomes — or at least a slowing down of its rate of increase — would not be too high a price for what they feel would be a juster distribution.

There is an even greater obstacle to such ambitions today. As a result of playing the game of catallaxy, which pays so little attention to imagined "social" justice but does so much to increase output, the population of the world has been able to increase so much, without the real incomes of most of the people increasing very much. We can maintain it and the further increases in population which are irrevocably on the way, only if we make the fullest possible use of that game which elicits the highest contributions to productivity.

VIII

If people in general do not appreciate what they owe to catallaxy and how far they are even dependent on it for their very existence, and if they often bitterly resent what they regard as its injustice, this is so because they have never designed it, and therefore do not understand it. The game rests on a method of providing benefits for others in which the individual will accomplish most if, within the conventional rules, he pursues solely his own interests — which need not be selfish in the ordinary sense of the word, but are in any case his own.

The moral attitude which this order demands not only of the entrepreneur but of all those, curiously called "self-employed", who have constantly to choose the directions of their efforts if they are to confer the greatest benefit on their fellows, is that they compete honestly according to the rules of the game, guided only by the abstract signals of prices and giving no preferences because of their sympathies or views on the merits or needs of those with whom they deal. It would mean not merely a personal loss, but a failure in their duty to the public, to employ a less efficient instead of a more efficient person, to spare an incompetent competitor, or to favour particular users of their products.

The gradually spreading new liberal morals, which the Open or Great Society demanded, required above all that the same rules of conduct should apply to one's relationship to all other members of society — except for natural ties to the members of one's family. This extension of old moral rules to wider circles most people, and particularly the intellectuals, welcome as moral progress. But they apparently did not realise, and violently resented when they discovered it, that the equality of rules applicable to one's relationship to all other men necessarily implied not only that new obligations were extended to people who formerly had no such claims, but also that old obligations which were recognised to some people, but could not be extended to all others, had to disappear.

It was this unavoidable attenuation of the content of our obligations, which necessarily accompanied their extension, that people with strongly ingrained moral emotions resented. Yet these are kinds of obligations which are essential to the cohesion of the small group, but which are irreconcilable with the order, the productivity, and the peace of a great society of free men. They are all those demands which under the name of "social justice" assert a moral claim on government that it gives us what it can take by force from those who in the game of catallaxy have been more successful than we have been. Such an artificial alteration of the relative attractiveness of

the different directions of productive efforts can only be counter-productive.

If expected remunerations no longer tell people where their endeavours will make the greatest contribution to the total product, an efficient use of resources becomes impossible. Where size of the social product, and no longer their contributions to it, gives individuals and groups a moral claim to a certain share of that product, the claims of those who really deserve to be described as "free riders" become an unbearable drag on the economic system.

IX

I am told there are still communities in Africa in which able young men, anxious to adopt modern commercial methods, find it impossible thereby to improve their position, because tribal customs demand that they share the products of their greater industry, skill or luck with all their kin. An increased income of such a man would merely mean that he had to share it with an ever-increasig number of claimants. He can, therefore, never rise substantially above the average level of his tribe.

Similarly, the chief adverse effect of so-call "social justice" measures in our society is that they prevent individuals from achieving what they could achieve — through the means for further investment being taken from them. It is also the application of an incongruous principle to a civilisation whose productivity is high *because* incomes are very unequal, and thereby the use of scarce resources is directed and limited to where they bring the highest return. Thanks to this unequal distribution, the poor get in a competitive market economy more than they would get in a centrally-directed system.

All this is the outcome of the — as yet merely imperfect — victory of the obligatory abstract rule of individual conduct over the common particular end as the method of social co-ordination — the development which has made both the Open Society and individual freedom possible, but which the socialists now want to reverse. Socialists have the support of inherited instincts, while maintenance of the comparatively

recent wealth which creates the new ambitions requires an acquired discipline which the non-domesticated barbarians in our midst, who call themselves "alienated", refuse to accept although they still claim all its benefits.

X

Let me before I conclude briefly meet an objection that is bound to be raised because it rests on a very widespread misunderstanding. My argument that in an evolving process of cultural selection we have built better than we understood, and that what we call our intelligence has been shaped concurrently with our institutions by a process of trial and error, is certain to be met by an outcry of "social Darwinism". But such a cheap way of disposing of my argument by labelling it would rest on an error.

It is true that during the latter part of the last century some social scientists, under the influence of Darwin, placed an excessive stress on the importance of natural selection of the most able individuals in free competition. I do not wish to under-rate the importance of this, but it is not the main benefit we derive from competitive selection. This is the competitive selection of cultural institutions.

For the discovery of this we did not need Darwin, since the growing understanding of it in fields like law and language tended to help Darwin to his biological theories. The problem under consideration is not genetic evolution of innate qualities, but cultural evolution through learning, which indeed leads sometimes to conflicts with near-animal natural instincts.

Nevertheless, it is still true that civilisation grew — not by the prevailing of that which man thought would be most successful — but by the growth of that which turned out to be so; and which, precisely because he did not understand it, led man beyond what he could ever have conceived.

NINE

'SOCIAL' OR DISTRIBUTIVE JUSTICE

> So great is the uncertainty of merit, both from its natural obscurity, and from the self-conceit of each individual, that no determinate rule of conduct could ever follow from it.
>
> David Hume*

> Welfare, however, has no principle, neither for him who receives it, nor for him who distributes it (one will place it here and another there); because it depends on the material content of the will, which is dependent upon particular facts and therefore incapable of a general rule.
>
> Immanuel Kant*

The concept of 'social justice'

While in the preceding chapter I had to defend the conception of justice as the indispensable foundation and limitation of all law, I must now turn against an abuse of the word which threatens to destroy the conception of law which made it the safeguard of individual freedom. It is perhaps not surprising that men should have applied to the joint effects of the actions of many people, even where these were never foreseen or intended, the conception of justice which they had developed with respect to the conduct of individuals towards each other. 'Social' justice (or sometimes 'economic' justice) came to be regarded as an attribute which the 'actions' of society, or the 'treatment' of individuals and groups by society, ought to possess. As primitive thinking usually does when first noticing some regular processes, the results of the spontaneous ordering of the market were interpreted as if some thinking being deliberately directed them, or as if the particular benefits or harm different persons derived from them were determined by deliberate acts of will, and could therefore be guided by moral rules. This conception of 'social' justice is thus a direct consequence of that anthropomorphism or personification by which naive thinking tries

to account for all self-ordering processes. It is a sign of the immaturity of our minds that we have not yet outgrown these primitive concepts and still demand from an impersonal process which brings about a greater satisfaction of human desires than any deliberate human organization could achieve, that it conform to the moral precepts men have evolved for the guidance of their individual actions.[1]

The use of the term 'social justice' in this sense is of comparatively recent date, apparently not much older than a hundred years. The expression was occasionally used earlier to describe the organized efforts to enforce the rules of just individual conduct,[2] and it is to the present day sometimes employed in learned discussion to evaluate the effects of the existing institutions of society.[3] But the sense in which it is now generally used and constantly appealed to in public discussion, and in which it will be examined in this chapter, is essentially the same as that in which the expression 'distributive justice' had long been employed. It seems to have become generally current in this sense at the time when (and perhaps partly because) John Stuart Mill explicitly treated the two terms as equivalent in such statements as that

> society should treat all equally well who have deserved equally well of it, that is, who have deserved equally well absolutely. This is the highest abstract standard of social and distributive justice; towards which all institutions, and the efforts of all virtuous citizens should be made in the utmost degree to converge[4]

or that

> it is universally considered just that each person should obtain that (whether good or evil) which he deserves; and unjust that he should obtain a good, or be made to undergo an evil, which he does not deserve. This is perhaps the clearest and most emphatic form in which the idea of justice is conceived by the general mind. As it involves the idea of desert, the question arises of what constitutes desert.[5]

It is significant that the first of these two passages occurs in the description of one of five meanings of justice which Mill distinguishes, of which four refer to rules of just individual conduct while this one defines a factual state of affairs which may but need

not have been brought about by deliberate human decision. Yet Mill appears to have been wholly unaware of the circumstance that in this meaning it refers to situations entirely different from those to which the four other meanings apply, or that this conception of 'social justice' leads straight to full-fledged socialism.

Such statements which explicitly connect 'social and distributive justice' with the 'treatment' by society of the individuals according to their 'deserts' bring out most clearly its difference from plain justice, and at the same time the cause of the vacuity of the concept: the demand for 'social justice' is addressed not to the individual but to society—yet society, in the strict sense in which it must be distinguished from the apparatus of government, is incapable of acting for a specific purpose, and the demand for 'social justice' therefore becomes a demand that the members of society should organize themselves in a manner which makes it possible to assign particular shares of the product of society to the different individuals or groups. The primary question then becomes whether there exists a moral duty to submit to a power which can co-ordinate the efforts of the members of society with the aim of achieving a particular pattern of distribution regarded as just.

If the existence of such a power is taken for granted, the question of how the available means for the satisfaction of needs ought to be shared out becomes indeed a question of justice—though not a question to which prevailing morals provide an answer. Even the assumption from which most of the modern theorists of 'social justice' start, namely that it would require equal shares for all in so far as special considerations do not demand a departure from this principle, would then appear to be justified.[6] But the prior question is whether it is moral that men be subjected to the powers of direction that would have to be exercised in order that the benefits derived by the individuals could be meaningfully described as just or unjust.

It has of course to be admitted that the manner in which the benefits and burdens are apportioned by the market mechanism would in many instances have to be regarded as very unjust *if* it were the result of a deliberate allocation to particular people. But this is not the case. Those shares are the outcome of a process the effect of which on particular people was neither intended nor foreseen by anyone when the institutions first appeared—institutions which were then permitted to continue because it was found that they improve for all or most the prospects of having their needs

satisfied. To demand justice from such a process is clearly absurd, and to single out some people in such a society as entitled to a particular share evidently unjust.

The conquest of public imagination by 'social justice'

The appeal to 'social justice' has nevertheless by now become the most widely used and most effective argument in political discussion. Almost every claim for government action on behalf of particular groups is advanced in its name, and if it can be made to appear that a certain measure is demanded by 'social justice', opposition to it will rapidly weaken. People may dispute whether or not the particular measure is required by 'social justice'. But that this is the standard which ought to guide political action, and that the expression has a definite meaning, is hardly ever questioned. In consequence, there are today probably no political movements or politicians who do not readily appeal to 'social justice' in support of the particular measures which they advocate.

It also can scarcely be denied that the demand for 'social justice' has already in a great measure transformed the social order and is continuing to transform it in a direction which those who called for it never foresaw. Though the phrase has undoubtedly helped occasionally to make the law more equal for all, whether the demand for justice in distribution has in any sense made society juster or reduced discontent must remain doubtful.

The expression of course described from the beginning the aspirations which were at the heart of socialism. Although classical socialism has usually been defined by its demand for the socialization of the means of production, this was for it chiefly a means thought to be essential in order to bring about a 'just' distribution of wealth; and since socialists have later discovered that this redistribution could in a great measure, and against less resistance, be brought about by taxation (and government services financed by it), and have in practice often shelved their earlier demands, the realization of 'social justice' has become their chief promise. It might indeed be said that the main difference between the order of society at which classical liberalism aimed and the sort of society into which it is now being transformed is that the former was governed by principles of just individual conduct while the new society is to satisfy the demands for 'social justice'—or, in other words, that the former demanded just action by the individuals while the latter

more and more places the duty of justice on authorities with power to command people what to do.

The phrase could exercise this effect because it has gradually been taken over from the socialist not only by all the other political movements but also by most teachers and preachers of morality. It seems in particular to have been embraced by a large section of the clergy of all Christian denominations, who, while increasingly losing their faith in a supernatural revelation, appear to have sought a refuge and consolation in a new 'social' religion which substitutes a temporal for a celestial promise of justice, and who hope that they can thus continue their striving to do good. The Roman Catholic church especially has made the aim of 'social justice' part of its official doctrine;[7] but the ministers of most Christian denominations appear to vie with each other with such offers of more mundane aims—which also seem to provide the chief foundation for renewed ecumenical efforts.

The various modern authoritarian or dictatorial governments have of course no less proclaimed 'social justice' as their chief aim. We have it on the authority of Mr Andrei Sakharov that millions of men in Russia are the victims of a terror that 'attempts to conceal itself behind the slogan of social justice'.

The commitment to 'social justice' has in fact become the chief outlet for moral emotion, the distinguishing attribute of the good man, and the recognized sign of the possession of a moral conscience. Though people may occasionally be perplexed to say which of the conflicting claims advanced in its name are valid, scarcely anyone doubts that the expression has a definite meaning, describes a high ideal, and points to grave defects of the existing social order which urgently call for correction. Even though until recently one would have vainly sought in the extensive literature for an intelligible definition of the term,[8] there still seems to exist little doubt, either among ordinary people or among the learned, that the expression has a definite and well understood sense.

But the near-universal acceptance of a belief does not prove that it is valid or even meaningful any more than the general belief in witches or ghosts proved the validity of these concepts. What we have to deal with in the case of 'social justice' is simply a quasi-religious superstition of the kind which we should respectfully leave in peace so long as it merely makes those happy who hold it, but which we must fight when it becomes the pretext of coercing other men. And the prevailing belief in 'social justice' is at present prob-

ably the gravest threat to most other values of a free civilization.

Whether Edward Gibbon was wrong or not, there can be no doubt that moral and religious beliefs can destroy a civilization and that, where such doctrines prevail, not only the most cherished beliefs but also the most revered moral leaders, sometimes saintly figures whose unselfishness is beyond question, may become grave dangers to the values which the same people regard as unshakeable. Against this threat we can protect ourselves only by subjecting even our dearest dreams of a better world to ruthless rational dissection.

It seems to be widely believed that 'social justice' is just a new moral value which we must add to those that were recognized in the past, and that it can be fitted within the existing framework of moral rules. What is not sufficiently recognized is that in order to give this phrase meaning a complete change of the whole character of the social order will have to be effected, and that some of the values which used to govern it will have to be sacrificed. It is such a transformation of society into one of a fundamentally different type which is currently occurring piecemeal and without awareness of the outcome to which it must lead. It was in the belief that something like 'social justice' could thereby be achieved, that people have placed in the hands of government powers which it can now not refuse to employ in order to satisfy the claims of the ever increasing number of special interests who have learnt to employ the open sesame of 'social justice'.

I believe that 'social justice' will ultimately be recognized as a will-o'-the-wisp which has lured men to abandon many of the values which in the past have inspired the development of civilization—an attempt to satisfy a craving inherited from the traditions of the small group but which is meaningless in the Great Society of free men. Unfortunately, this vague desire which has become one of the strongest bonds spurring people of good will to action, not only is bound to be disappointed. This would be sad enough. But, like most attempts to pursue an unattainable goal, the striving for it will also produce highly undesirable consequences, and in particular lead to the destruction of the indispensible environment in which the traditional moral values alone can flourish, namely personal freedom.

The inapplicability of the concept of justice to the results of a spontaneous process

It is now necessary clearly to distinguish between two wholly

different problems which the demand for 'social justice' raises in a market order.

The first is whether within an economic order based on the market the concept of 'social justice' has any meaning or content whatever.

The second is whether it is possible to preserve a market order while imposing upon it (in the name of 'social justice' or any other pretext) some pattern of remuneration based on the assessment of the performance or the needs of different individuals or groups by an authority possessing the power to enforce it.

The answer to each of these questions is a clear no.

Yet it is the general belief in the validity of the concept of 'social justice' which drives all contemporary societies into greater and greater efforts of the second kind and which has a peculiar self-accelerating tendency: the more dependent the position of the individuals or groups is seen to become on the actions of government, the more they will insist that the governments aim at some recognizable scheme of distributive justice; and the more governments try to realize some preconceived pattern of desirable distribution, the more they must subject the position of the different individuals and groups to their control. So long as the belief in 'social justice' governs political action, this process must progressively approach nearer and nearer to a totalitarian system.

We shall at first concentrate on the problem of the meaning, or rather lack of meaning, of the term 'social justice', and only later consider the effects which the efforts to impose *any* preconceived pattern of distribution must have on the structure of the society subjected to them.

The contention that in a society of free men (as distinct from any compulsory organization) the concept of social justice is strictly empty and meaningless will probably appear as quite unbelievable to most people. Are we not all constantly disquieted by watching how unjustly life treats different people and by seeing the deserving suffer and the unworthy prosper? And do we not all have a sense of fitness, and watch it with satisfaction, when we recognize a reward to be appropriate to effort or sacrifice?

The first insight which should shake this certainty is that we experience the same feelings also with respect to differences in human fates for which clearly no human agency is responsible and which it would therefore clearly be absurd to call injustice. Yet we do cry out against the injustice when a succession of calamities

befalls one family while another steadily prospers, when a meritorious effort is frustrated by some unforeseeable accident, and particularly if of many people whose endeavours seem equally great, some succeed brilliantly while others utterly fail. It is certainly tragic to see the failure of the most meritorious efforts of parents to bring up their children, of young men to build a career, or of an explorer or scientist pursuing a brilliant idea. And we will protest against such a fate although we do not know anyone who is to blame for it, or any way in which such disappointments can be prevented.

It is no different with regard to the general feeling of injustice about the distribution of material goods in a society of free men. Though we are in this case less ready to admit it, our complaints about the outcome of the market as unjust do not really assert that somebody has been unjust; and there is no answer to the question of *who* has been unjust. Society has simply become the new deity to which we complain and clamour for redress if it does not fulfil the expectations it has created. There is no individual and no co-operating group of people against which the sufferer would have a just complaint, and there are no conceivable rules of just individual conduct which would at the same time secure a functioning order and prevent such disappointments.

The only blame implicit in those complaints is that we tolerate a system in which each is allowed to choose his occupation and therefore nobody can have the power and the duty to see that the results correspond to our wishes. For in such a system in which each is allowed to use his knowledge for his own purposes[9] the concept of 'social justice' is necessarily empty and meaningless, because in it nobody's will can determine the relative incomes of the different people, or prevent that they be partly dependent on accident. 'Social justice' can be given a meaning only in a directed or 'command' economy (such as an army) in which the individuals are ordered what to do; and any particular conception of 'social justice' could be realized only in such a centrally directed system. It presupposes that people are guided by specific directions and not by rules of just individual conduct. Indeed, no system of rules of just individual conduct, and therefore no free action of the individuals, could produce results satisfying any principle of distributive justice.

We are of course not wrong in perceiving that the effects of the processes of a free society on the fates of the different individuals are not distributed according to some recognizable principle of

justice. Where we go wrong is in concluding from this that they are unjust and that somebody is to be blamed for this. In a free society in which the position of the different individuals and groups is not the result of anybody's design—or could, within such a society, be altered in accordance with a generally applicable principle—the differences in reward simply cannot meaningfully be described as just or unjust. There are, no doubt, many kinds of individual action which are aimed at affecting particular remunerations and which might be called just or unjust. But there are no principles of individual conduct which would produce a pattern of distribution which as such could be called just, and therefore also no possibility for the individual to know what he would have to do to secure a just remuneration of his fellows.

The rationale of the economic game in which only the conduct of the players but not the result can be just

We have seen earlier that justice is an attribute of human conduct which we have learnt to exact because a certain kind of conduct is required to secure the formation and maintenance of a beneficial order of actions. The attribute of justice may thus be predicated about the intended results of human action but not about circumstances which have not deliberately been brought about by men. Justice requires that in the 'treatment' of another person or persons, i.e. in the intentional actions affecting the well-being of other persons, certain uniform rules of conduct be observed. It clearly has no application to the manner in which the impersonal process of the market allocates command over goods and services to particular people: this can be neither just nor unjust, because the results are not intended or foreseen, and depend on a multitude of circumstances not known in their totality to anybody. The conduct of the individuals in that process may well be just or unjust; but since their wholly just actions will have consequences for others which were neither intended nor foreseen, these effects do not thereby become just or unjust.

The fact is simply that we consent to retain, and agree to enforce, uniform rules for a procedure which has greatly improved the chances of all to have their wants satisfied, but at the price of all individuals and groups incurring the risk of unmerited failure. With the acceptance of this procedure the recompense of different groups and individuals becomes exempt from deliberate control. It is the

only procedure yet discovered in which information widely dispersed among millions of men can be effectively utilized for the benefit of all—and used by assuring to all an individual liberty desirable for itself on ethical grounds. It is a procedure which of course has never been 'designed' but which we have learnt gradually to improve after we had discovered how it increased the efficiency of men in the groups who had evolved it.

It is a procedure which, as Adam Smith (and apparently before him the ancient Stoics) understood,[10] in all important respects (except that normally it is not pursued solely as a diversion) is wholly analogous to a game, namely a game partly of skill and partly of chance. We shall later describe it as the game of catallaxy. It proceeds, like all games, according to rules guiding the actions of individual participants whose aims, skills, and knowledge are different, with the consequence that the outcome will be unpredictable and that there will regularly be winners and losers. And while, as in a game, we are right in insisting that it be fair and that nobody cheat, it would be nonsensical to demand that the results for the different players be just. They will of necessity be determined partly by skill and partly by luck. Some of the circumstances which make the services of a person more or less valuable to his fellows, or which may make it desirable that he change the direction of his efforts, are not of human design or foreseeable by men.

We shall in the next chapter have to return to the rationale of the discovery procedure which the game of competition in a market in effect constitutes. Here we must content ourselves with emphasizing that the results for the different individuals and groups of a procedure for utilizing more information than any one person or agency can possess, must themselves be unpredictable, and must often be different from the hopes and intentions which determined the direction and intensity of their striving; and that we can make effective use of that dispersed knowledge only if (as Adam Smith was also one of the first to see clearly)[11] we allow the principle of negative feedback to operate, which means that some must suffer unmerited disappointment.

We shall also see later that the importance for the functioning of the market order of particular prices or wages, and therefore of the incomes of the different groups and individuals, is not due chiefly to the effects of the prices on all of those who receive them, but to the effects of the prices on those for whom they act as signals to change the direction of their efforts. Their function is not so much

to reward people for what they *have* done as to tell them what in their own as well as in general interest they *ought* to do. We shall then also see that, to hold out a sufficient incentive for those movements which are required to maintain a market order, it will often be necessary that the return of people's efforts do *not* correspond to recognizable merit, but should show that, in spite of the best efforts of which they were capable, and for reasons they could not have known, their efforts were either more or less successful than they had reason to expect. In a spontaneous order the question of whether or not someone has done the 'right' thing cannot always be a matter of merit, but must be determined independently of whether the persons concerned ought or could have known what was required.

The long and the short of it all is that men can be allowed to decide what work to do only if the remuneration they can expect to get for it corresponds to the value their services have to those of their fellows who receive them; and that *these values which their services will have to their fellows will often have no relations to their individual merits or needs.* Reward for merit earned and indication of what a person should do, both in his own and in his fellows' interest, are different things. It is not good intentions or needs but doing what in fact most benefits others, irrespective of motive, which will secure the best reward. Among those who try to climb Mount Everest or to reach the Moon, we also honour not those who made the greatest efforts, but those who got their first.

The general failure to see that in this connection we cannot meaningfully speak of the justice or injustice of the results is partly due to the misleading use of the term 'distribution' which inevitably suggests a personal distributing agent whose will or choice determines the relative position of the different persons or groups.[12] There is of course no such agent, and we use an impersonal process to determine the allocation of benefits precisely because through its operation we can bring about a structure of relative prices and remunerations that will determine a size and composition of the total output which assures that the real equivalent of each individual's share that accident or skill assigns to him will be as large as we know to make it.

It would serve little purpose to enquire here at greater length into the relative importance of skill and luck in actually determining relative incomes. This will clearly differ a great deal between different trades, localities and times, and in particular between highly

competitive and less enterprising societies. I am on the whole inclined to believe that within any one trade or profession the correspondence between individual ability and industry is higher than is commonly admitted, but that the relative position of all the members of a particular trade or profession compared with others will more often be affected by circumstances beyond their control and knowledge. (This may also be one reason why what is called 'social' injustice is generally regarded as a graver fault of the existing order than the corresponding misfortunes of individuals.)[13] But the decisive point is not that the price mechanism does on the whole bring it about that rewards are proportioned to skill and effort, but that even where it is clear to us that luck plays a great part, and we have no idea why some are regularly luckier in guessing than others, it is still in the general interest to proceed on the presumption that the past success of some people in picking winners makes it probable that they will also do so in the future, and that it is therefore worthwhile to induce them to continue their attempts.

The alleged necessity of a belief in the justice of rewards

It has been argued persuasively that people will tolerate major inequalities of the material positions only if they believe that the different individuals get on the whole what they deserve, that they did in fact support the market order only because (and so long as) they thought that the differences of remuneration corresponded roughly to differences of merit, and that in consequence the maintenance of a free society presupposes the belief that some sort of 'social justice' is being done.[14] The market order, however, does not in fact owe its origin to such beliefs, or was originally justified in this manner. This order could develop, after its earlier beginnings had decayed during the middle ages and to some extent been destroyed by the restrictions imposed by authority, when a thousand years of vain efforts to discover substantively just prices or wages were abandoned and the late schoolmen recognized them to be empty formulae and taught instead that the prices determined by just conduct of the parties in the market, i.e. the competitive prices arrived at without fraud, monopoly and violence, was all that justice required.[15] It was from this tradition that John Locke and his contemporaries derived the classical liberal conception of justice for which, as has been rightly said, it was only 'the way in which

competition was carried on, not its results',[16] that could be just or unjust.

It is unquestionably true that, particularly among those who were very successful in the market order, a belief in a much stronger moral justification of individual success developed, and that, long after the basic principles of such an order had been fully elaborated and approved by catholic moral philosophers, it had in the Anglo-Saxon world received strong support from Calvinist teaching. It certainly is important in the market order (or free enterprise society, misleadingly called 'capitalism') that the individuals believe that their well-being depends primarily on their own efforts and decisions. Indeed, few circumstances will do more to make a person energetic and efficient than the belief that it depends chiefly on him whether he will reach the goals he has set himself. For this reason this belief is often encouraged by education and governing opinion —it seems to me, generally much to the benefit of most of the members of the society in which it prevails, who will owe many important material and moral improvements to persons guided by it. But it leads no doubt also to an exaggerated confidence in the truth of this generalization which to those who regard themselves (and perhaps are) equally able but have failed must appear as a bitter irony and severe provocation.

It is probably a misfortune that, especially in the USA, popular writers like Samuel Smiles and Horatio Alger, and later the sociologist W. G. Sumner, have defended free enterprise on the ground that it regularly rewards the deserving, and it bodes ill for the future of the market order that this seems to have become the only defence of it which is understood by the general public. That it has largely become the basis of the self-esteem of the businessman often gives him an air of self-righteousness which does not make him more popular.

It is therefore a real dilemma to what extent we ought to encourage in the young the belief that when they really try they will succeed, or should rather emphasize that inevitably some unworthy will succeed and some worthy fail—whether we ought to allow the views of those groups to prevail with whom the over-confidence in the appropriate reward of the able and industrious is strong and who in consequence will do much that benefits the rest, and whether without such partly erroneous beliefs the large numbers will tolerate actual differences in rewards which will be based only partly on achievement and partly on mere chance.

There is no 'value to society'

The futile medieval search for the just price and just wage, finally abandoned when it was recognized that only that 'natural' price could be regarded as just which would be arrived at in a competitive market where it would be determined not by any human laws or decrees but would depend on so many circumstances that it could be known beforehand only by God,[17] was not the end of the search for that philosophers' stone. It was revived in modern times, not only by the general demand for 'social justice', but also by the long and equally abortive efforts to discover criteria of justice in connection with the procedures for reconciliation or arbitration in wage disputes. Nearly a century of endeavours by public spirited men and women in many parts of the world to discover principles by which just wage rates could be determined have, as more and more of them acknowledge, produced not a single rule which would do this.[18] It is somewhat surprising in view of this when we find an experienced arbitrator like Lady Wootton, after admitting that arbitrators are 'engaged in the impossible task of attempting to do justice in an ethical vacuum', because 'nobody knows in this context what justice is', drawing from it the conclusion that the criteria should be determined by legislation, and explicitly demand a political determination of all wages and incomes.[19] One can hardly carry any further the illusion that Parliament can determine what is just, and I don't suppose the writer would really wish to defend the atrocious principle implied that all rewards should be determined by political power.

Another source of the conception that the categories of just and unjust can be meaningfully applied to the remunerations determined by the market is the idea that the different services have a determined and ascertainable 'value to society', and that the actual remuneration frequently differs from the value. But though the conception of a 'value to society' is sometimes carelessly used even by economists, there is strictly no such thing and the expression implies the same sort of anthropomorphism or personification of society as the term 'social justice'. Services can have value only to particular people (or an organization), and any particular service will have very different values for different members of the same society. To regard them differently is to treat society not as a spontaneous order of free men but as an organization whose members are all made to serve a single hierarchy of ends. This would

necessarily be a totalitarian system in which personal freedom would be absent.

Although it is tempting to speak of a 'value to society' instead of a man's value to his fellows, it is in fact highly misleading if we say, e.g., that a man who supplies matches to millions and thereby earns $200,000 a year is worth more 'to society' than a man who supplies great wisdom or exquisite pleasure to a few thousand and thereby earns $20,000 a year. Even the performance of a Beethoven sonata, a painting by Leonardo or a play by Shakespeare have no 'value to society' but a value only to those who know and appreciate them. And it has little meaning to assert that a boxer or a crooner is worth more to society than a violin virtuoso or a ballet dancer if the former renders services to millions and the latter to a much smaller group. The point is not that the true values are different, but that the values attached to the different services by different groups of people are incommensurable; all that these expressions mean is merely that one in fact receives a larger aggregate sum from a larger number of people than the other.[20]

Incomes earned in the market by different persons will normally not correspond to the relative values of their services to any one person. Although, in so far as any one of a given group of different commodities is consumed by any one person, he or she will buy so much of each that the relative values to them of the last units bought will correspond to their relative prices, many pairs of commodities will never be consumed by the same person: the relative price of articles consumed only by men and of articles consumed only by women will not correspond to the relative values of these articles to anybody.

The remunerations which the individuals and groups receive in the market are thus determined by what these services are worth to those who receive them (or, strictly speaking, to the last pressing demand for them which can still be satisfied by the available supply) and not by some fictitious 'value to society'.

Another source of the complaint about the alleged injustice of this principle of remuneration is that the remuneration thus determined will often be much higher than would be necessary to induce the recipient to render those services. This is perfectly true but necessary if all who render the same service are to receive the same remuneration, if the kind of service in question is to be increased so long as the price still exceeds costs, and if anyone who wishes to buy or sell it at the current price is to be able to do so.

The consequence must be that all but the marginal sellers make a gain in excess of what was necessary to induce them to render the services in question—just as all but the marginal buyers will get what they buy for less than they were prepared to pay. The remuneration of the market will therefore hardly ever seem just in the sense in which somebody might endeavour justly to compensate others for the efforts and sacrifice incurred for his benefit.

The consideration of the different attitudes which different groups will take to the remuneration of different services incidentally also shows that the large numbers by no means grudge all the incomes higher than theirs, but generally only those earned by activities the functions of which they do not understand or which they even regard as harmful. I have never known ordinary people grudge the very high earnings of the boxer or torero, the football idol or the cinema star or the jazz king—they seem often even to revel vicariously in the display of extreme luxury and waste of such figures compared with which those of industrial magnates or financial tycoons pale. It is where most people do not comprehend the usefulness of an activity, and frequently because they erroneously regard it as harmful (the 'speculator'—often combined with the belief that only dishonest activities can bring so much money), and especially where the large earnings are used to accumulate a fortune (again out of the erroneous belief that it would be desirable that it should be spent rather than invested) that the outcry about the injustice of it arises. Yet the complex structure of the modern Great Society would clearly not work if the remunerations of all the different activities were determined by the opinion which the majority holds of their value—or indeed if they were dependent on any one person's understanding or knowledge of the importance of all the different activities required for the functioning of the system.

The main point is not that the masses have in most instances no idea of the values which a man's activities have to his fellows, and that it is necessarily their prejudices which would determine the use of the government's power. It is that nobody knows except in so far as the market tells him. It is true enough that our esteem of particular activities often differs from the value given to them by the market; and we express this feeling by an outcry about the injustice of it. But when we ask what ought to be the relative remunerations of a nurse and a butcher, of a coal miner and a judge at a high court, of the deep sea diver or the cleaner of sewers, of the organizer of a new industry and a jockey, of the

inspector of taxes and the inventor of a life-saving drug, of the jet pilot or the professor of mathematics, the appeal to 'social justice' does not give us the slightest help in deciding—and if we use it it is no more than an insinuation that the others ought to agree with our view without giving any reason for it.

It might be objected that, although we cannot give the term 'social justice' a precise meaning, this need not be a fatal objection because the position may be similar to that which I have earlier contended exists with regard to justice proper: we might not know what is 'socially just' yet know quite well what is 'socially unjust'; and by persistently eliminating 'social injustice' whenever we encounter it, gradually approach 'social justice'. This, however, does not provide a way out of the basic difficulty. There can be no test by which we can discover what is 'socially unjust' because there is no subject by which such an injustice can be committed, and there are no rules of individual conduct the observance of which in the market order would secure to the individuals and groups the position which as such (as distinguished from the procedure by which it is determined) would appear just to us.[21] It does not belong to the category of error but to that of nonsense, like the term 'a moral stone'.

The meaning of 'social'

One might hope to get some help in the search for the meaning of 'social justice' by examining the meaning of the attribute 'social'; but the attempt to do so soon leads into a quagmire of confusion nearly as bad as that which surrounds 'social justice' itself.[22] Originally 'social' had of course a clear meaning (analogous to formations like 'national', 'tribal', or 'organizational'), namely that of pertaining to, or characteristic of the structure and operations of society. In this sense justice clearly is a social phenomenon and the addition of 'social' to the noun a pleonasm[23] such as if we spoke of 'social language'—though in occasional early uses it might have been intended to distinguish the generally prevailing views of justice from that held by particular persons or groups.

But 'social justice' as used today is not 'social' in the sense of 'social norms', i.e. something which has developed as a practice of individual action in the course of social evolution, not a product of society or of a social process, but a conception to be imposed upon society. It was the reference of 'social' to the whole of society, or to

the interests of all its members, which led to its gradually acquiring a predominant meaning of moral approbation. When it came into general use during the third quarter of the last century it was meant to convey an appeal to the still ruling classes to concern themselves more with the welfare of the much more numerous poor whose interests had not received adequate consideration.[24] The 'social question' was posed as an appeal to the conscience of the upper classes to recognize their responsibility for the welfare of the neglected sections of society whose voices had till then carried little weight in the councils of government. 'Social policy' (or *Social-politik* in the language of the country then leading in the movement) became the order of the day, the chief concern of all progressive and good people, and 'social' came increasingly to displace such terms as 'ethical' or simply 'good'.

But from such an appeal to the conscience of the public to concern themselves with the unfortunate ones and recognize them as members of the same society, the conception gradually came to mean that 'society' ought to hold itself responsible for the particular material position of all its members, and for assuring that each received what was 'due' to him. It implied that the processes of society should be deliberately directed to particular results and, by personifying society, represented it as a subject endowed with a conscious mind, capable of being guided in its operation by moral principles.[25] 'Social' became more and more the description of the pre-eminent virtue, the attribute in which the good man excelled and the ideal by which communal action was to be guided.

But while this development indefinitely extended the field of application of the term 'social', it did not give it the required new meaning. It even so much deprived it of its original descriptive meaning that American sociologists have found it necessary to coin the new term 'societal' in its place. Indeed, it has produced a situation in which 'social' can be used to describe almost any action as publicly desirable and has at the same time the effect of depriving any terms with which it is combined of clear meaning. Not only 'social justice' but also 'social democracy', 'social market economy'[26] or the 'social state of law' (or rule of law—in German *sozialer Rechtsstaat*) are expressions which, though justice, democracy, the market economy or the *Rechtsstaat* have by themselves perfectly good meanings, the addition of the adjective 'social' makes them capable of meaning almost anything one likes. The word has indeed become one of the chief sources of confusion of political discourse

and can probably no longer be reclaimed for a useful purpose.

There is apparently no end to the violence that will be done to language to further some ideal and the example of 'social justice' has recently given rise to the expression 'global justice'! Its negative, 'global injustice', was defined by an ecumenical gathering of American religious leaders as 'characterized by a dimension of sin in the economic, political, social, sexual, and class structures and systems of global society'![27] It would seem as if the conviction that one is arguing in a good cause produced more sloppy thinking and even intellectual dishonesty than perhaps any other cause.

'Social justice' and equality

The most common attempts to give meaning to the concept of 'social justice' resort to egalitarian considerations and argue that every departure from equality of material benefits enjoyed has to be justified by some recognizable common interest which these differences serve.[28] This is based on a specious analogy with the situation in which some human agency has to distribute rewards, in which case indeed justice would require that these rewards be determined in accordance with some recognizable rule of general applicability. But earnings in a market system, though people tend to regard them as rewards, do not serve such a function. Their rationale (if one may use this term for a role which was not designed but developed because it assisted human endeavour without people understanding how), is rather to indicate to people what they ought to do if the order is to be maintained on which they all rely. The prices which must be paid in a market economy for different kinds of labour and other factors of production if individual efforts are to match, although they will be affected by effort, diligence, skill, need, etc., cannot conform to any one of these magnitudes; and considerations of justice just do not make sense[29] with respect to the determination of a magnitude which does not depend on anyone's will or desire, but on circumstances which nobody knows in their totality.

The contention that all differences in earnings must be justified by some corresponding difference in deserts is one which would certainly not have been thought to be obvious in a community of farmers or merchants or artisans, that is, in a society in which success or failure were clearly seen to depend only in part on skill and industry, and in part on pure accident which might hit any-

one—although even in such societies individuals were known to complain to God or fortune about the injustice of their fate. But, though people resent that their remuneration should in part depend on pure accident, that is in fact precisely what it must if the market order is to adjust itself promptly to the unavoidable and unforeseen changes in circumstances, and the individual is to be allowed to decide what to do. The now prevalent attitude could arise only in a society in which large numbers worked as members of organizations in which they were remunerated at stipulated rates for time worked. Such communities will not ascribe the different fortunes of its members to the operation of an impersonal mechanism which serves to guide the directions of efforts, but to some human power that ought to allocate shares according to merit.

The postulate of material equality would be a natural starting point only if it were a necessary circumstance that the shares of the different individuals or groups were in such a manner determined by deliberate human decision. In a society in which this were an unquestioned fact, justice would indeed demand that the allocation of the means for the satisfaction of human needs were effected according to some uniform principle such as merit or need (or some combination of these), and that, where the principle adopted did not justify a difference, the shares of the different individuals should be equal. The prevalent demand for material equality is probably often based on the belief that the existing inequalities are the effect of somebody's decision—a belief which would be wholly mistaken in a genuine market order and has still only very limited validity in the highly interventionist 'mixed' economy existing in most countries today. This now prevalent form of economic order has in fact attained its character largely as a result of governmental measures aiming at what was thought to be required by 'social justice'.

When the choice, however, is between a genuine market order, which does not and cannot achieve a distribution corresponding to any standard of material justice, and a system in which government uses its powers to put some such standard into effect, the question is not whether government ought to exercise, justly or unjustly, powers it must exercise in any case, but whether government should possess and exercise additional powers which can be used to determine the shares of the different members of society. The demand for 'social justice', in other words, does not merely require government to observe some principle of action according to

uniform rules in those actions which it must perform in any case, but demands that it undertake additional activities, and thereby assume new responsibilities—tasks which are not necessary for maintaining law and order and providing for certain collective needs which the market could not satisfy.

The great problem is whether this new demand for equality does not conflict with the equality of the rules of conduct which government must enforce on all in a free society. There is, of course, a great difference between government treating all citizens according to the same rules in all the activities it undertakes for other purposes, and government doing what is required in order to place the different citizens in equal (or less unequal) material positions. Indeed, there may arise a sharp conflict between these two aims. Since people will differ in many attributes which government cannot alter, to secure for them the same material position would require that government treat them very differently. Indeed, to assure the same material position to people who differ greatly in strength, intelligence, skill, knowledge and perseverance as well as in their physical and social environment, government would clearly have to treat them very differently to compensate for those disadvantages and deficiencies it could not directly alter. Strict equality of those benefits which government could provide for all, on the other hand, would clearly lead to inequality of the material positions.

This, however, is not the only and not even the chief reason why a government aiming to secure for its citizens equal material positions (or any determined pattern of material welfare) would have to treat them very unequally. It would have to do so because under such a system it would have to undertake to tell people what to do. Once the rewards the individual can expect are no longer an appropriate indication of how to direct their efforts to where they are most needed, because these rewards correspond not to the value which their services have for their fellows, but to the moral merit or desert the persons are deemed to have earned, they lose the guiding function they have in the market order and would have to be replaced by the commands of the directing authority. A central planning office would, however, have to decide on the tasks to be allotted to the different groups or individuals wholly on grounds of expediency or efficiency and, in order to achieve its ends, would have to impose upon them very different duties and burdens. The individuals might be treated according to uniform rules so far as

their rewards were concerned, but certainly not with respect to the different kinds of work they would have to be made to do. In assigning people to their different tasks, the central planning authority would have to be guided by considerations of efficiency and expediency and not by principles of justice or equality. No less than in the market order would the individuals in the common interest have to submit to great inequality—only these inequalities would be determined not by the interaction of individual skills in an impersonal process, but by the uncontradictable decision of authority.

As is becoming clear in ever increasing fields of welfare policy, an authority instructed to achieve particular results for the individuals must be given essentially arbitrary powers to make the individuals do what seems necessary to achieve the required result. Full equality for most cannot but mean the equal submission of the great masses under the command of some élite who manages their affairs. While an equality of rights under a limited government is possible and an essential condition of individual freedom, a claim for equality of material position can be met only by a government with totalitarian powers.[30]

We are of course not wrong when we perceive that the effects on the different individuals and groups of the economic processes of a free society are not distributed according to some recognizable principle of justice. Where we go wrong is in concluding from this that they are unjust and that somebody is responsible and to be blamed for this. In a free society in which the position of the different individuals and groups is not the result of anybody's design—or could within such a society not be altered in accordance with a principle of general applicability—the differences in rewards cannot meaningfully be described as just or unjust. There are, no doubt, many kinds of individual actions which are aimed at affecting particular remunerations and which might be regarded as unjust. But there are no principles of individual conduct which would produce a pattern of distribution which as such could be called just, and therefore also no possibility for the individual to know what he would have to do to secure a just remuneration of his fellows.

Our whole system of morals is a system of rules of individual conduct, and in a Great Society no conduct guided by such rules, or by decisions of the individuals guided by such rules, could produce for the individuals results which would appear to us as just

in the sense in which we regard designed rewards as just or unjust: simply because in such a society nobody has the power or the knowledge which would enable him to ensure that those affected by his actions will get what he thinks right for them to get. Nor could anyone who is assured remuneration according to some principle which is accepted as constituting 'social justice' be allowed to decide what he is to do: remuneration indicating how urgent it was that a certain work should be done could not be just in this sense, because the need for work of a particular kind would often depend on unforeseeable accidents and certainly not on the good intentions or efforts of those able to perform it. And an authority that fixed remunerations with the intention of thereby reducing the kind and number of people thought necessary in each occupation could not make these remunerations 'just', i.e. proportionate to desert, or need, or the merits of any other claim of the persons concerned, but would have to offer what was necessary to attract or retain the number of people wanted in each kind of activity.

'*Equality of opportunity*'

It is of course not to be denied that in the existing market order not only the results but also the initial chances of different individuals are often very different; they are affected by circumstances of their physical and social environment which are beyond their control but in many particular respects might be altered by some governmental action. The demand for equality of opportunity or equal starting conditions (*Startgerechtigkeit*) appeals to, and has been supported by, many who in general favour the free market order. So far as this refers to such facilities and opportunities as are of necessity affected by governmental decisions (such as appointments to public office and the like), the demand was indeed one of the central points of classical liberalism, usually expressed by the French phrase 'la carrière ouverte aux talents'. There is also much to be said in favour of the government providing on an equal basis the means for the schooling of minors who are not yet fully responsible citizens, even though there are grave doubts whether we ought to allow government to administer them.

But all this would still be very far from creating real equality of opportunity, even for persons possessing the same abilities. To achieve this government would have to control the whole physical

and human environment of all persons, and have to endeavour to provide at least equivalent chances for each; and the more government succeeded in these endeavours, the stronger would become the legitimate demand that, on the same principle, any still remaining handicaps must be removed—or compensated for by putting extra burden on the still relatively favoured. This would have to go on until government literally controlled every circumstance which could affect any person's well-being. Attractive as the phrase of equality of opportunity at first sounds, once the idea is extended beyond the facilities which for other reasons have to be provided by government, it becomes a wholly illusory ideal, and any attempt concretely to realize it apt to produce a nightmare.

'Social justice' and freedom under the law

The idea that men ought to be rewarded in accordance with the assessed merits or deserts of their services 'to society' presupposes an authority which not only distributes these rewards but also assigns to the individuals the tasks for the performance of which they will be rewarded. In other words, if 'social justice' is to be brought about, the individuals must be required to obey not merely general rules but specific demands directed to them only. The type of social order in which the individuals are directed to serve a single system of ends is the organization and not the spontaneous order of the market, that is, not a system in which the individual is free because bound only by general rules of just conduct, but a system in which all are subject to specific directions by authority.

It appears sometimes to be imagined that a mere alteration of the rules of individual conduct could bring about the realization of 'social justice'. But there can be no set of such rules, no principles by which the individuals could so govern their conduct that in a Great Society the joint effect of their activities would be a distribution of benefits which could be described as materially just, or any other specific and intended allocation of advantages and disadvantages among particular people or groups. In order to achieve *any* particular pattern of distribution through the market process, each producer would have to know, not only whom his efforts will benefit (or harm), but also how well off all the other people (actually or potentially) affected by his activities will be as the result of the services they are receiving from other members of the society. As we have seen earlier, appropriate rules of conduct can determine

only the formal character of the order of activities that will form itself, but not the specific advantages particular groups or individuals will derive from it.

This rather obvious fact still needs to be stressed since even eminent jurists have contended that the substitution of 'social' or distributive for individual or commutative justice need not destroy the freedom under the law of the individual. Thus the distinguished German legal philosopher Gustav Radbruch explicitly maintained that 'the socialist community would also be a *Rechtsstaat* [i.e., the Rule of Law would prevail there], although a *Rechtsstaat* governed not by commutative but by distributive justice.'[31] And of France it is reported that 'it has been suggested that some highly placed administrators should be given the permanent task of "pronouncing" on the distribution of national income, as judges pronounce on legal matters.'[32] Such beliefs, however, overlook the fact that no specific pattern of distribution can be achieved by making the individuals obey rules of conduct, but that the achievement of such particular pre-determined results requires deliberate co-ordination of all the different activities in accordance with the concrete circumstances of time and place. It precludes, in other words, that the several individuals act on the basis of their own knowledge and in the service of their own ends, which is the essence of freedom, but requires that they be made to act in the manner which according to the knowledge of the directing authority is required for the realization of the ends chosen by that authority.

The distributive justice at which socialism aims is thus irreconcilable with the rule of law, and with that freedom under the law which the rule of law is intended to secure. The rules of distributive justice cannot be rules for the conduct towards equals, but must be rules for the conduct of superiors towards their subordinates. Yet though some socialists have long ago themselves drawn the inevitable conclusion that 'the fundamental principles of formal law by which every case must be judged according to general rational principles . . . obtains only for the competitive phase of capitalism,'[33] and the communists, so long as they took socialism seriously, had even proclaimed that 'communism means not the victory of socialist law, but the victory of socialism over any law, since with the abolition of classes with antagonistic interests, law will disappear altogether',[34] when, more than thirty years ago, the present author made this the central point of a discussion of the political effects of socialist economic policies,[35] it evoked great

indignation and violent protests. But the crucial point is implied even in Radbruch's own emphasis on the fact that the transition from commutative to distributive justice means a progressive displacement of private by public law,[36] since public law consists not of rules of conduct for private citizens but of rules of organization for public officials. It is, as Radbruch himself stresses, a law that subordinates the citizens to authority.[37] Only if one understands by law not the general rules of just conduct only but any command issued by authority (or any authorization of such commands by a legislature), can the measures aimed at distributive justice be represented as compatible with the rule of law. But this concept is thereby made to mean mere legality and ceases to offer the protection of individual freedom which it was originally intended to serve.

There is no reason why in a free society government should not assure to all protection against severe deprivation in the form of an assured minimum income, or a floor below which nobody need to descend. To enter into such an insurance against extreme misfortune may well be in the interest of all; or it may be felt to be a clear moral duty of all to assist, within the organized community, those who cannot help themselves. So long as such a uniform minimum income is provided outside the market to all those who, for any reason, are unable to earn in the market an adequate maintenance, this need not lead to a restriction of freedom, or conflict with the Rule of Law. The problems with which we are here concerned arise only when the remuneration for services rendered is determined by authority, and the impersonal mechanism of the market which guides the direction of individual efforts is thus suspended.

Perhaps the acutest sense of grievance about injustice inflicted on one, not by particular persons but by the 'system', is that about being deprived of opportunities for developing one's abilities which others enjoy. For this any difference of environment, social or physical, may be responsible, and at least some of them may be unavoidable. The most important of these is clearly inseparable from the institution of the family. This not only satisfies a strong psychological need but in general serves as an instrument for the transmission of important cultural values. There can be no doubt that those who are either wholly deprived of this benefit, or grew up in unfavourable conditions, are gravely handicapped; and few will question that it would be desirable that some public institution so far as possible should assist such unfortunate children when

relatives and neighbours fail. Yet few will seriously believe (although Plato did) that we can fully make up for such a deficiency, and I trust even fewer that, because this benefit cannot be assured to all, it should, in the interest of equality, be taken from those who now enjoy it. Nor does it seem to me that even material equality could compensate for those differences in the capacity of enjoyment and of experiencing a lively interest in the cultural surroundings which a suitable upbringing confers.

There are of course many other irremediable inequalities which must seem as unreasonable as economic inequalities but which are less resented than the latter only because they do not appear to be man-made or the consequence of institutions which could be altered.

The spatial range of 'social justice'

There can be little doubt that the moral feelings which express themselves in the demand for 'social justice' derive from an attitude which in more primitive conditions the individual developed towards the fellow members of the small group to which he belonged. Towards the personally known member of one's own group it may well have been a recognized duty to assist him and to adjust one's actions to his needs. This is made possible by the knowledge of his person and his circumstances. The situation is wholly different in the Great or Open Society. Here the products and services of each benefit mostly persons he does not know. The greater productivity of such a society rests on a division of labour extending far beyond the range any one person can survey. This extension of the process of exchange beyond relatively small groups, and including large numbers of persons not known to each other, has been made possible by conceding to the stranger and even the foreigner the same protection of rules of just conduct which apply to the relations to the known members of one's own small group.

This application of the same rules of just conduct to the relations to all other men is rightly regarded as one of the great achievements of a liberal society. What is usually not understood is that this extension of the same rules to the relations to all other men (beyond the most intimate group such as the family and personal friends) requires an attenuation at least of some of the rules which are enforced in the relations to other members of the smaller group. If the legal duties towards strangers or foreigners are to be the same

as those towards the neighbours or inhabitants of the same village or town, the latter duties will have to be reduced to such as can also be applied to the stranger. No doubt men will always wish to belong also to smaller groups and be willing voluntarily to assume greater obligations towards self-chosen friends or companions. But such moral obligations towards some can never become enforced duties in a system of freedom under the law, because in such a system the selection of those towards whom a man wishes to assume special moral obligations must be left to him and cannot be determined by law. A system of rules intended for an Open Society and, at least in principle, meant to be applicable to all others, must have a somewhat smaller content than one to be applied in a small group.

Especially a common agreement on what is the due status or material position of the different members is likely to develop only in the relatively small group in which the members will be familiar with the character and importance of each other's activities. In such small communities the opinion about appropriate status will also still be associated with a feeling about what one self owes to the other, and not be merely a demand that somebody provide the appropriate reward. Demands for the realization of 'social justice' are usually as a matter of course, though often only tacitly, addressed to national governments as the agencies which possess the necessary powers. But it is doubtful whether in any but the smallest countries standards can be applied nationally which are derived from the condition of the particular locality with which the individual is familiar, and fairly certain that few men would be willing to concede to foreigners the same right to a particular income that they tend to recognize in their fellow citizens.

It is true that in recent years concern about the suffering of large numbers in the poor countries has induced the electorates of the wealthier nations to approve substantial material aid to the former; but it can hardly be said that in this considerations of justice played a significant role. It is indeed doubtful whether any substantial help would have been rendered if competing power groups had not striven to draw as many as possible of the developing countries into their orbit. And it deserves notice that the modern technology which has made such assistance possible could develop only because some countries were able to build up great wealth while most of the world saw little change.

Yet the chief point is that, if we look beyond the limits of our national states, and certainly if we go beyond the limits of what we

regard as our civilization, we no longer even deceive ourselves that we know what would be 'socially just', and that those very groups within the existing states which are loudest in their demands for 'social justice', such as the trade unions, are regularly the first to reject such claims raised on behalf of foreigners. Applied to the international sphere, the complete lack of a recognized standard of 'social justice', or of any known principles on which such a standard could be based, becomes at once obvious; while on a national scale most people still think that what on the level of the face-to-face society is to them a familiar idea must also have some validity for national politics or the use of the powers of government. In fact, it becomes on this level a humbug—the effectiveness of which with well-meaning people the agents of organized interests have learnt successfully to exploit.

There is in this respect a fundamental difference between what is possible in the small group and in the Great Society. In the small group the individual can know the effects of his actions on his several fellows, and the rules may effectively forbid him to harm them in any manner and even require him to assist them in specific ways. In the Great Society many of the effects of a person's actions on various fellows must be unknown to him. It can, therefore, not be the specific effects in the particular case, but only rules which define kinds of actions as prohibited or required, which must serve as guides to the individual. In particular, he will often not know who the individual people will be who will benefit by what he does, and therefore not know whether he is satisfying a great need or adding to abundance. He cannot aim at just results if he does not know who will be affected.

Indeed the transition from the small group to the Great or Open Society—and the treatment of every other person as a human being rather than as either a known friend or an enemy—requires a reduction of the range of duties we owe to all others.

If a person's legal duties are to be the same towards all, including the stranger and even the foreigner (and greater only where he has voluntarily entered into obligations, or is connected by physical ties as between parents and children), the legally enforceable duties to neighbour and friend must not be more than those towards the stranger. That is, all those duties which are based on personal acquaintance and familiarity with individual circumstances must cease to be enforceable. The extension of the obligation to obey certain rules of just conduct to wider circles and ultimately to all

men must thus lead to an attenuation of the obligation towards fellow members of the same small group. Our inherited or perhaps in part even innate moral emotions are in part inapplicable to Open Society (which is an abstract society), and the kind of 'moral socialism' that is possible in the small group and often satisfies a deeply ingrained instinct may well be impossible in the Great Society. Some altruistic conduct aimed at the benefit of some known friend that in the small group might be highly desirable, need not be so in the Open Society, and may there even be harmful (as e.g. the requirement that members of the same trade refrain from competing with each other).[38]

It may at first seem paradoxical that the advance of morals should lead to a reduction of specific obligations towards others: yet whoever believes that the principle of equal treatment of all men, which is probably the only chance for peace, is more important than special help to visible suffering, must wish it. It admittedly means that we make our rational insight dominate over our inherited instincts. But the great moral adventure on which modern man has embarked when he launched into the Open Society is threatened when he is required to apply to all his fellowmen rules which are appropriate only to the fellow members of a tribal group.

Claims for compensation for distasteful jobs

The reader will probably expect me now to examine in greater detail the particular claims usually justified by the appeal to 'social justice'. But this, as bitter experience has taught me, would be not only an endless but also a bootless task. After what has been said already, it should be obvious that there are no practicable standards of merit, deserts, or needs, on which in a market order the distribution of material benefits could be based, and still less any principle by which these different claims could be reconciled. I shall therefore confine myself to considering two arguments in which the appeal to 'social justice' is very commonly used. The first case is usually quoted in theoretical argument to illustrate the injustice of the distribution by the market process, though little is done about it in practice, while the second is probably the most frequent type of situation in which the appeal to social justice leads to government action.

The circumstance which is usually pointed out to demonstrate

the injustice of the existing market order is that the most unpleasant jobs are commonly also the worst paid. In a just society, it is contended, those who have to dig coal underground or to clean chimneys or sewers, or who perform other unclean or menial tasks, should be remunerated more highly than those whose work is pleasurable.

It is of course true that it would be unjust if persons, although equally able as others to perform other tasks, were without special compensation assigned by a superior to such distasteful duties. If, e.g., in such an organization as an army, two men of equal capacity were made to perform different tasks, one of which was attractive and the other very unpleasant, justice would clearly require that the one who had regularly to perform the unpleasant duty should in some way be specially compensated for it.

The situation is entirely different, however, where people earn their living by selling their services to whoever pays best for them. Here the sacrifice brought by a particular person in rendering the service is wholly irrelevant and all that counts is the (marginal) value the services have to those to whom they are rendered. The reason for this is not only that the sacrifices different people bring in rendering the same kind of service will often be very different, or that it will not be possible to take account of the reason why some will be capable of rendering only less valuable services than others. But those whose aptitudes, and therefore also remunerations, will be small in the more attractive occupations will often find that they can earn more than they could otherwise by undertaking unpleasant tasks that are scorned by their more fortunate fellows. The very fact that the more unpleasant occupations will be avoided by those who can render services that are valued more highly by the buyers, will open to those whose skills are little valued opportunities to earn more than they otherwise could.

That those who have to offer to their fellows little that is valuable may have to incur more pain and effort to earn even a pittance than others who perhaps actually enjoy rendering services for which they are well paid, is a necessary concomitant of any system in which remuneration is based on the values the services have to the user and not on an assessment of merit earned. It must therefore prevail in any social order in which the individual is free to choose whatever occupation he can find and is not assigned to one by authority.

The only assumption on which it could be represented as just that the miner working underground, or the scavenger, or slaughter-

house workers, should be paid more highly than those engaged in more pleasant occupations, would thus be that this was necessary to induce a sufficient number of persons to perform these tasks, or that they are by some human agency deliberately assigned to these tasks. But while in a market order it may be a misfortune to have been born and bred in a village where for most the only chance of making a living is fishing (or for the women the cleaning of fish), it does not make sense to describe this as unjust. Who is supposed to have been unjust?—especially when it is considered that, if these local opportunities had not existed, the people in question would probably never have been born at all, as most of the population of such a village will probably owe its existence to the opportunities which enabled their ancestors to produce and rear children.

The resentment of the loss of accustomed positions

The appeal to 'social justice' which in practice has probably had the greatest influence is not one which has been much considered in literary discussion. The considerations of a supposed 'social injustice' which have led to the most far-reaching interference with the functioning of the market order are based on the idea that people are to be protected against an unmerited descent from the material position to which they have become accustomed. No other consideration of 'social justice' has probably exercised as widespread an influence as the 'strong and almost universal belief that it is unjust to disappoint legitimate expectations of wealth. When differences of opinion arise, it is always on the question of what expectations are legitimate.' It is believed, as the same author says, 'that it is legitimate even for the largest classes to expect that no very great and sudden changes will be made to their detriment.'[39]

The opinion that long established positions create a just expectation that they will continue serves often as a substitute for more substantial criteria of 'social justice'. Where expectations are disappointed, and in consequence the rewards of effort often disproportionate to the sacrifice incurred, this will be regarded as an injustice without any attempt to show that those affected had a claim in justice to the particular income which they expected. At least when a large group of people find their income reduced as a result of circumstances which they could not have altered or foreseen, this is commonly regarded as unjust.

The frequent recurrence of such undeserved strokes of misfortune affecting some group is, however, an inseparable part of the steering mechanism of the market: it is the manner in which the cybernetic principle of negative feedback operates to maintain the order of the market. It is only through such changes which indicate that some activities ought to be reduced, that the efforts of all can be continuously adjusted to a greater variety of facts than can be known to any one person or agency, and that that utilization of dispersed knowledge is achieved on which the well-being of the Great Society rests. We cannot rely on a system in which the individuals are induced to respond to events of which they do not and cannot know without changes of the values of the services of different groups occurring which are wholly unrelated to the merits of their members. It is a necessary part of that process of constant adaptation to changing circumstances on which the mere maintenance of the existing level of wealth depends that some people should have to discover by bitter experience that they have misdirected their efforts and are forced to look elsewhere for a remunerative occupation. And the same applies to the resentment of the corresponding undeserved gains that will accrue to others for whom things have turned out better than they had reason to expect.

The sense of injury which people feel when an accustomed income is reduced or altogether lost is largely the result of a belief that they have morally deserved that income and that, therefore, so long as they work as industriously and honestly as they did before, they are in justice entitled to the continuance of that income. But the idea that we have morally deserved what we have honestly earned in the past is largely an illusion. What is true is only that it would have been unjust if anybody had taken from us what we have in fact acquired while observing the rules of the game.

It is precisely because in the cosmos of the market we all constantly receive benefits which we have not deserved in any moral sense that we are under an obligation also to accept equally undeserved diminutions of our incomes. Our only moral title to what the market gives us we have earned by submitting to those rules which makes the formation of the market order possible. These rules imply that nobody is under an obligation to supply us with a particular income unless he has specifically contracted to do so. If we were all to be consistently deprived, as the socialists propose to do, of all 'unearned benefits' which the market confers upon us, we would have to be deprived of most of the benefits of civilization.

It is clearly meaningless to reply, as is often done, that, since we owe these benefits to 'society', 'society' should also be entitled to allocate these benefits to those who in its opinion deserve them. Society, once more, is not an acting person but an orderly structure of actions resulting from the observation of certain abstract rules by its members. We all owe the benefits we receive from the operation of this structure not to anyone's intention to confer them on us, but to the members of society generally obeying certain rules in the pursuit of their interests, rules which include the rule that nobody is to coerce others in order to secure for himself (or for third persons) a particular income. This imposes upon us the obligation to abide by the results of the market also when it turns against us.

The chance which any individual in our society has of earning an income approximating that which he has now is the consequence of most individuals obeying the rules which secure the formation of that order. And though this order provides for most good prospects for the successful employment of their skills, this success must remain dependent also on what from the point of view of the individual must appear as mere luck. The magnitude of the chances open to him are not of his making but the result of others submitting to the same rules of the game. To ask for protection against being displaced from a position one has long enjoyed, by others who are now favoured by new circumstances, means to deny to them the chances to which one's own present position is due.

Any protection of an accustomed position is thus necessarily a privilege which cannot be granted to all and which, if it had always been recognized, would have prevented those who now claim it from ever reaching the position for which they now demand protection. There can, in particular, be no right to share equally in a general increase of incomes if this increase (or perhaps even their maintenance at the existing level) is dependent on the continuous adjustment of the whole structure of activities to new and unforeseen circumstances that will alter and often reduce the contributions some groups can make to the needs of their fellows. There can thus be in justice no such claims as, e.g., those of the American farmer for 'parity', or of any other group to the preservation of their relative or absolute position.

The satisfaction of such claims by particular groups would thus not be just but eminently unjust, because it would involve the denial to some of the chances to which those who make this claim owe their position. For this reason it has always been conceded only

to some powerfully organized groups who were in the position to enforce their demands. Much of what is today done in the name of 'social justice' is thus not only unjust but also highly unsocial in the true sense of the word: it amounts simply to the protection of entrenched interests. Though it has come to be regarded as a 'social problem' when sufficiently large numbers clamour for protection of their accustomed position, it becomes a serious problem chiefly because, camouflaged as a demand for 'social justice', it can engage the sympathy of the public. We shall see in volume 3 why, under the existing type of democratic institutions, it is in practice inevitable that legislatures with unlimited powers yield to such demands when made by sufficiently large groups. This does not alter the fact that to represent such measures as satisfying 'social justice' is little more than a pretext for making the interest of the particular groups prevail over the general interest of all. Though it is now usual to regard every claim of an organized group as a 'social problem', it would be more correct to say that, though the long run interests of the several individuals mostly agree with the general interest, the interests of the organized groups almost invariably are in conflict with it. Yet it is the latter which are commonly represented as 'social'.

Conclusions

The basic contention of this chapter, namely that in a society of free men whose members are allowed to use their own knowledge for their own purposes the term 'social justice' is wholly devoid of meaning or content, is one which by its very nature cannot be *proved*. A negative assertion never can. One may demonstrate for any number of particular instances that the appeal to 'social justice' in no way assists the choices we have to make. But the contention that in a society of free men the term has no meaning whatever can only be issued as a challenge which will make it necessary for others to reflect on the meaning of the words they use, and as an appeal not to use phrases the meaning of which they do not know.

So long as one assumes that a phrase so widely used must have some recognizable meaning one may endeavour to prove that attempts to enforce it in a society of free individuals must make that society unworkable. But such efforts become redundant once it is recognized that such a society lacks the fundamental precondition for the application of the concept of justice to the manner in which

material benefits are shared among its members, namely that this is determined by a human will—or that the determination of rewards by human will could produce a viable market order. One does not have to prove that something is impracticable which cannot exist.

What I hope to have made clear is that the phrase 'social justice' is not, as most people probably feel, an innocent expression of good will towards the less fortunate, but that it has become a dishonest insinuation that one ought to agree to a demand of some special interest which can give no real reason for it. If political discussion is to become honest it is necessary that people should recognize that the term is intellectually disreputable, the mark of demagogy or cheap journalism which responsible thinkers ought to be ashamed to use because, once its vacuity is recognized, its use is dishonest. I may, as a result of long endeavours to trace the destructive effect which the invocation of 'social justice' has had on our moral sensitivity, and of again and again finding even eminent thinkers thoughtlessly using the phrase,[40] have become unduly allergic to it, but I have come to feel strongly that the greatest service I can still render to my fellow men would be that I could make the speakers and writers among them thoroughly ashamed ever again to employ the term 'social justice'.

That in the present state of the discussion the continued use of the term is not only dishonest and the source of constant political confusion, but destructive of moral feeling, is shown by the fact that again and again thinkers, including distinguished philosophers,[41] after rightly recognizing that the term justice in its now predominant meaning of distributive (or retributive) justice is meaningless, draw from this the conclusion that the concept of justice itself is empty, and who in consequence jettison one of the basic moral conceptions on which the working of a society of free men rests. But it is justice in this sense which courts of justice administer and which is the original meaning of justice and must govern men's conduct if peaceful coexistence of free men is to be possible. While the appeal to 'social justice' is indeed merely an invitation to give moral approval to demands that have no moral justification, and which are in conflict with that basic rule of a free society that only such rules as can be applied equally to all should be enforced, justice in the sense of rules of just conduct is indispensable for the intercourse of free men.

We are touching here upon a problem which with all its ramifications is much too big to try to be examined here systematically, but

which must at least be mentioned briefly. It is that we can't have any morals we like or dream of. Morals, to be viable, must satisfy certain requirements, requirements which we may not be able to specify but may only be able to find out by trial and error. What is required is not merely consistency, or compatibility of the rules as well as the acts demanded by them. A system of morals also must produce a functioning order, capable of maintaining the apparatus of civilization which it presupposes.

We are not familiar with the concept of non-viable systems of morals and certainly cannot observe them anywhere in practice since societies which try them rapidly disappear. But they are being preached, often by widely revered saintly figures, and the societies in decay which we can observe are often societies which have been listening to the teaching of such moral reformers and still revere the destroyers of their society as good men. More often, however, the gospel of 'social justice' aims at much more sordid sentiments: the dislike of people who are better off than oneself, or simply envy, that 'most anti-social and evil of all passions' as John Stuart Mill called it,[42] that animosity towards great wealth which represents it as a 'scandal' that some should enjoy riches while others have basic needs unsatisfied, and camouflages under the name of justice what has nothing to do with justice. At least all those who wish to despoil the rich, not because they expect that some more deserving might enjoy that wealth, but because they regard the very existence of the rich as an outrage, not only cannot claim any moral justification for their demands, but indulge in a wholly irrational passion and in fact harm those to whose rapacious instincts they appeal.

There can be no moral claim to something that would not exist but for the decision of others to risk their resources on its creation. What those who attack great private wealth do not understand is that it is neither by physical effort nor by the mere act of saving and investing, but by directing resources to the most productive uses that wealth is chiefly created. And there can be no doubt that most of those who have built up great fortunes in the form of new industrial plants and the like have thereby benefited more people through creating opportunities for more rewarding employment than if they had given their superfluity away to the poor. The suggestion that in these cases those to whom in fact the workers are most indebted do wrong rather than greatly benefit them is an absurdity. Though there are undoubtedly also other and less meritorious ways of acquiring large fortunes (which we can hope to

control by improving the rules of the game), the most effective and important is by directing investment to points where they most enhance the productivity of labour—a task in which governments notoriously fail, for reasons inherent in non-competitive bureaucratic organizations.

But it is not only by encouraging malevolent and harmful prejudices that the cult of 'social justice' tends to destroy genuine moral feelings. It also comes, particularly in its more egalitarian forms, into constant conflict with some of the basic moral principles on which any community of free men must rest. This becomes evident when we reflect that the demand that we should equally esteem all our fellow men is irreconcilable with the fact that our whole moral code rests on the approval or disapproval of the conduct of others; and that similarly the traditional postulate that each capable adult is primarily responsible for his own and his dependants' welfare, meaning that he must not through his own fault become a charge to his friends or fellows, is incompatible with the idea that 'society' or government owes each person an appropriate income.

Though all these moral principles have also been seriously weakened by some pseudo-scientific fashions of our time which tend to destroy all morals—and with them the basis of individual freedom—the ubiquitous dependence on other people's power, which the enforcement of any image of 'social justice' creates, inevitably destroys that freedom of personal decisions on which all morals must rest.[43] In fact, that systematic pursuit of the *ignis fatuus* of 'social justice' which we call socialism is based throughout on the atrocious idea that political power ought to determine the material position of the different individuals and groups—an idea defended by the false assertion that this must always be so and socialism merely wishes to transfer this power from the privileged to the most numerous class. It was the great merit of the market order as it has spread during the last two centuries that it deprived everyone of such power which can be used only in arbitrary fashion. It had indeed brought about the greatest reduction of arbitrary power ever achieved. This greatest triumph of personal freedom the seduction of 'social justice' threatens again to take from us. And it will not be long before the holders of the power to enforce 'social justice' will entrench themselves in their position by awarding the benefits of 'social justice' as the remuneration for the conferment of that power and in order to secure to themselves the support of a praetorian

guard which will make it certain that their view of what is 'social justice' will prevail.

Before leaving the subject I want to point out once more that the recognition that in such combinations as 'social', 'economic', 'distributive' or 'retributive' justice the term 'justice' is wholly empty should not lead us to throw the baby out with the bath water. Not only as the basis of the legal rules of just conduct is the justice which the courts of justice administer exceedingly important; there unquestionably also exists a genuine problem of justice in connection with the deliberate design of political institutions, the problem to which Professor John Rawls has recently devoted an important book. The fact which I regret and regard as confusing is merely that in this connection he employs the term 'social justice'. But I have no basic quarrel with an author who, before he proceeds to that problem, acknowledges that the task of selecting specific systems or distributions of desired things as just must be 'abandoned as mistaken in principle, and it is, in any case, not capable of a definite answer. Rather, the principles of justice define the crucial constraints which institutions and joint activities must satisfy if persons engaging in them are to have no complaints against them. If these constraints are satisfied, the resulting distribution, whatever it is, may be accepted as just (or at least not unjust).'[44] This is more or less what I have been trying to argue in this chapter.

APPENDIX TO CHAPTER NINE

JUSTICE AND INDIVIDUAL RIGHTS

The transition from the negative conception of justice as defined by rules of individual conduct to a 'positive' conception which makes it a duty of 'society' to see that individuals have particular things, is often effected by stressing the *rights* of the individual. It seems that among the younger generation the welfare institutions into which they have been born have engendered a feeling that they have a claim in justice on 'society' for the provision of particular things which it is the duty of that society to provide. However strong this feeling may be, its existence does not prove that the claim has anything to do with justice, or that such claims can be satisfied in a free society.

There is a sense of the noun 'right' in which every rule of just individual conduct creates a corresponding right of individuals. So far as rules of conduct delimit individual domains, the individual will have a right to his domain, and in the defence of it will have the sympathy and the support of his fellows. And where men have formed organizations such as government for enforcing rules of conduct, the individual will have a claim in justice on government that his right be protected and infringements made good.

Such claims, however, can be claims in justice, or rights, only in so far as they are directed towards a person or organization (such as government) which can act, and which is bound in its actions by rules of just conduct. They will include claims on people who have voluntarily incurred obligations, or between people who are connected by special circumstances (such as the relations between parents and children). In such circumstances the rules of just conduct will confer on some persons rights and on others corresponding obligations. But rules as such, without the presence of the particular circumstances to which they refer, cannot confer on anyone a right to a particular sort of thing. A child has a right to be fed, clad, and housed because a corresponding duty is placed on the parents or guardians, or perhaps a particular authority. But there

can be no such right in the abstract determined by a rule of just conduct without the particular circumstances being stated which determine on whom the corresponding obligation rests. Nobody has a right to a particular state of affairs unless it is the duty of someone to secure it. We have no right that our houses do not burn down, nor a right that our products or services find a buyer, nor that any particular goods or services be provided for us. Justice does not impose on our fellows a general duty to provide for us; and a claim to such a provision can exist only to the extent that we are maintaining an organization for that purpose. It is meaningless to speak of a right to a condition which nobody has the duty, or perhaps even the power, to bring about. It is equally meaningless to speak of right in the sense of a claim on a spontaneous order, such as society, unless this is meant to imply that somebody has the duty of transforming that cosmos into an organization and thereby to assume the power of controlling its results.

Since we are all made to support the organization of government, we have by the principles determining that organization certain rights which are commonly called political rights. The existence of the compulsory organization of government and its rules of organization does create a claim in justice to shares in the services of government, and may even justify a claim for an equal share in determining what government shall do. But it does not provide a basis for a claim on what government does not, and perhaps could not, provide for all. We are not, in this sense, members of an organization called society, because the society which produces the means for the satisfaction of most of our needs is not an organization directed by a conscious will, and could not produce what it does if it were.

The time-honoured political and civil rights which have been embodied in formal Bills of Right constitute essentially a demand that so far as the power of government extends it ought to be used justly. As we shall see, they all amount to particular applications of, and might be effectively replaced by, the more comprehensive formula that no coercion must be used except in the enforcement of a generic rule applicable to an unknown number of future instances. It may well be desirable that these rights should become truly universal as a result of all governments submitting to them. But so long as the powers of the several governments are at all limited, these rights cannot produce a duty of the governments to bring about a particular state of affairs. What we can require is that so far as government acts it ought to act justly; but we cannot derive from

them any positive powers government ought to have. They leave wholly open the question whether the organization for coercion which we call government can and ought in justice be used to determine the particular material position of the several individuals or groups.

To the negative rights which are merely a complement of the rules protecting individual domains and which have been institutionalized in the charters of organization of governments, and to the positive rights of the citizens to participate in the direction of this organization, there have recently been added new positive 'social and economic' human rights for which an equal or even higher dignity is claimed.[1] These are claims to particular benefits to which every human being as such is presumed to be entitled without any indication as to who is to be under the obligation to provide those benefits or by what process they are to be provided.[2] Such positive rights, however, demand as their counterpart a decision that somebody (a person or organization) should have the duty of providing what the others are to have. It is, of course, meaningless to describe them as claims on 'society' because 'society' cannot think, act, value, or 'treat' anybody in a particular way. If such claims are to be met, the spontaneous order which we call society must be replaced by a deliberately directed organization: the cosmos of the market would have to be replaced by a taxis whose members would have to do what they are instructed to do. They could not be allowed to use their knowledge for their own purposes but would have to carry out the plan which their rulers have designed to meet the needs to be satisfied. From this it follows that the old civil rights and the new social and economic rights cannot be achieved at the same time but are in fact incompatible; the new rights could not be enforced by law without at the same time destroying that liberal order at which the old civil rights aim.

The new trend was given its chief impetus through the proclamation by President Franklin Roosevelt of his 'Four Freedoms' which included 'freedom *from* want' and 'freedom *from* fear' together with the old 'freedom *of* speech' and 'freedom *of* worship'. But it found its definite embodiment only in the *Universal Declaration of Human Rights* adopted by the General Assembly of the United Nations in 1948. This document is admittedly an attempt to fuse the rights of the Western liberal tradition with the altogether different conception deriving from the Marxist Russian Revolution.[3] It adds to the list of the classical civil rights enumerated in its first

twenty-one articles seven further guarantees intended to express the new 'social and economic rights'. In these additional clauses 'every one, as a member of society' is assured the satisfaction of positive claims to particular benefits without at the same time placing on anyone the duty or burden of providing them. The document also completely fails to define these rights in such a manner that a court could possibly determine what their contents are in a particular instance. What, for instance, can be the legal meaning of the statement that every one 'is entitled to the realization . . . of the economic, social, and cultural rights indispensible for his dignity and free development of his personality' (Art. 22)? Against whom is 'every one' to have a claim to 'just and favourable conditions of work' (Art. 23 (1)) and to 'just and favourable employment' (Art. 23 (3))? What are the consequences of the requirement that every one should have the right 'freely to participate in the cultural life of the community and to share in the scientific advances and its benefits' (Art. 27 (1))? 'Every one' is even said to be 'entitled to a social and international order in which the rights and freedoms set forth in this Declaration are fully realized' (Art. 28)—on the assumption apparently that not only is this possible but that there exists now a known method by which these claims can be satisfied for all men.

It is evident that all these 'rights' are based on the interpretation of society as a deliberately made organization by which everybody is employed. They could not be made universal within a system of rules of just conduct based on the conception of individual responsibility, and so require that the whole of society be converted into a single organization, that is, made totalitarian in the fullest sense of the word. We have seen that rules of just conduct which apply to everybody alike but subject nobody to the commands of a superior can never determine what particular things any person is to have. They can never take the form of 'everybody must have so and so.' In a free society what the individual will get must always depend in some measure on particular circumstances which nobody can foresee and nobody has the power to determine. Rules of just conduct can therefore never confer on any person as such (as distinct from the members of a particular organization) a claim to particular things; they can bring about only opportunities for the acquiring of such claims.

It apparently never occurred to the authors of the Declaration that not everybody is an employed member of an organization

whose right 'to just and favourable remuneration, including reasonable limitations of working hours and periodic holidays with pay' (Art. 24) can be guaranteed. The conception of a 'universal right' which assures to the peasant, to the Eskimo, and presumably to the Abominable Snowman, 'periodic holidays with pay' shows the absurdity of the whole thing. Even the slightest amount of ordinary common sense ought to have told the authors of the document that what they decreed as universal rights were for the present and for any foreseeable future utterly impossible of achievement, and that solemnly to proclaim them as rights was to play an irresponsible game with the concept of 'right' which could result only in destroying the respect for it.

The whole document is indeed couched in that jargon of organization thinking which one has learnt to expect in the pronouncement of trade union officials or the International Labour Organization and which reflects an attitude business employees share with civil servants and the organization men of the big corporations, but which is altogether inconsistent with the principles on which the order of a Great Society rests. If the document were merely the production of an international group of social philosophers (as in origin it is), it would constitute only somewhat disturbing evidence of the degree to which organization thinking has permeated the thinking of these social philosophers and how much they have become total strangers to the basic ideals of a free society. But its acceptance by a body of presumably responsible statesmen, seriously concerned with the creation of a peaceful international order, gives cause for much greater apprehension.

Organization thinking, largely as a result of the sway of the rationalist constructivism of Plato and his followers, has long been the besetting vice of social philosophers; perhaps it should therefore not surprise us that academic philosophers in their sheltered lives as members of organizations should have lost all understanding of the forces which hold the Great Society together and, imagining themselves to be Platonic philosopher-kings, should propose a re-organization of society on totalitarian lines. If it should be true, as we are told, that the social and economic rights of the Universal Declaration of Human Rights would today be 'accepted by the vast majority of American and British moralists,'[4] this would merely indicate a sorry lack of critical acumen on the part of these thinkers.

The spectacle, however, of the General Assembly of the United

Nations solemnly proclaiming that *every* individual (!), 'keeping this Declaration constantly in mind' (!), should strive to insure the universal observation of those human rights, would be merely comic if the illusions which this creates were not so profoundly tragic. To see the most comprehensive authority which man has yet created undermining the respect it ought to command by giving countenance to the naive prejudice that we can create any state of affairs which we think to be desirable by simply decreeing that it ought to exist, and indulging in the self-deception that we can benefit from the spontaneous order of society and at the same time mould it to our own will, is more than merely tragic.[5]

The fundamental fact which these illusions disregard is that the availability of all those benefits which we wish as many people as possible to have depends on these same people using for their production their own best knowledge. To establish enforceable rights to the benefits is not likely to produce them. If we wish everybody to be well off, we shall get closest to our goal, not by commanding by law that this should be achieved, or giving everybody a legal claim to what we think he ought to have, but by providing inducements for all to do as much as they can that will benefit others. To speak of rights where what are in question are merely aspirations which only a voluntary system can fulfil, not only misdirects attention from what are the effective determinants of the wealth which we wish for all, but also debases the word 'right', the strict meaning of which it is very important to preserve if we are to maintain a free society.

* The first quotation is taken from David Hume, *An Enquiry Concerning the Principles of Morals*, sect. III, part II, *Works* IV, p. 187, and ought to be given here in its context: the

> most obvious thought would be, to assign the largest possessions to the most extensive virtue, and give every one the power of doing good proportioned to his inclination. . . . But were mankind to execute such a law; so great is the uncertainty of merit, both from its natural obscurity, and from the self-conceit of each individual, that no determinate rule of conduct would ever follow from it; and the total dissolution of society must be the immediate consequence.

The second quotation is translated from Immanuel Kant (*Der Streit der Fakultäten* (1798), sect. 2, para. 6, note 2) and reads in the original: 'Wohlfahrt aber hat kein Prinzip, weder für den der sie empfängt, noch für den der sie austeilt (der eine setzt sie hierin, der andere darin); weil es dabei auf das *Materiale* des Willens ankommt, welches empirisch und so einer allgemeinen Regel unfähig ist.' An English translation of this essay in which the passage is rendered somewhat differently will be found in *Kant's Political Writings*, ed. H. Reiss, trs. H. B. Nisbett (Cambridge, 1970), p. 183, note.

1 Cf. P. H. Wicksteed, *The Common Sense of Political Economy* (London, 1910), p. 184: 'It is idle to assume that ethically desirable results will necessarily be produced by an ethically indifferent instrument.'

2 Cf. G. del Vecchio, *Justice* (Edinburgh, 1952), p. 37. In the eighteenth century the expression 'social justice' was occasionally used to describe the enforcement of rules of just conduct within a given society, so e.g. by Edward Gibbon, *Decline and Fall of the Roman Empire*, chapter 41 (World's Classics edn, vol. IV, p. 367).

3 E.g. by John Rawls, *A Theory of Justice* (Harvard, 1971).

4 John Stuart Mill, *Utilitarianism* (London, 1861), chapter 5, p. 92; in H. Plamenatz, ed., *The English Utilitarians* (Oxford, 1949), p. 225.

5 *Ibid.*, pp. 66 and 208 respectively. Cf. also J. S. Mill's review of F. W. Newman, *Lectures on Political Economy*, originally published in 1851 in the *Westminster Review* and republished in *Collected Works*, vol. v (Toronto and London, 1967), p. 444: 'the distinction between rich and poor, so slightly connected as it is with merit and demerit, or even with exertion and want of exertion, is obviously unjust.' Also *Principles of Political Economy*, book II, ch. 1, §, ed. W. J. Ashley (London, 1909), pp. 211ff.: 'The proportioning of remuneration to work done is really just only in so far as the more or less of the work is a matter of choice: when it depends on natural differences of strength and capacity, this principle of remuneration is itself an injustice, it gives to those who have.'

6 See e.g. A. M. Honoré, 'Social Justice' in *McGill Law Journal*, VIII, 1962 and revised version in R. S. Summers, ed., *Essays in Legal Philosophy* (Oxford, 1968), p. 62 of the reprint: 'The first [of the two propositions of which the principle of social justice consists] is the contention that *all men considered merely as men and apart from their conduct or choice have a claim to an equal share in all those things, here called advantages, which are generally desired and are in fact conducive to well-being.*' Also W. G. Runciman, *Relative Deprivation and Social Justice* (London, 1966), p. 261.

7 Cf. especially the encyclicals *Quadragesimo Anno* (1931) and *Divini Redemptoris* (1937) and Johannes Messner, 'Zum Begriff der sozialen Gerechtigkeit' in the volume *Die soziale Frage und der Katholizismus* (Paderborn, 1931) issued to commemorate the fortieth anniversary of the encyclical *Rerum Novarum.*

8 The term 'social justice' (or rather its Italian equivalent) seems to have been first used in its modern sense by Luigi Taparelli-d'Anzeglio, *Saggio teoretico di diritto naturale* (Palermo 1840) and to have been made more generally known by Antonio Rosmini-Serbati, *La costitutione secondo la giustizia sociale* (Milan, 1848). For more recent discussions cf. N. W. Willoughby, *Social Justice* (New York, 1909); Stephen Leacock, *The Unsolved Riddle of Social Justice* (London and New York, 1920); John A. Ryan, *Distributive Justice* (New York, 1916); L. T. Hobhouse, *The Elements of Social Justice* (London and New York, 1922); T. N. Carver, *Essays in Social Justice* (Harvard, 1922); W. Shields, *Social Justice, The History and Meaning of the Term* (Notre Dame Ind. 1941); Benevuto Donati 'Che cosa è giustizia sociale?', *Archivio giuridico*, vol. 134, 1947; C. de Pasquier, 'La notion de justice sociale', *Zeitschrift für Schweizerisches Recht*, 1952; P. Antoine, 'Qu-est-ce la justice sociale?', *Archives de Philosophie*, 24, 1961; For a more complete list of this literature see G. del Vecchio, *op. cit.*, pp. 37–9.

In spite of the abundance of writings on the subject, when about ten years ago I wrote the first draft of this chapter, I found it still very difficult to find any serious discussion of what people meant when they were using this term. But almost immediately afterwards a number of serious studies of the subject appeared, particularly the two works quoted in note 6 above as well as R. W. Baldwin, *Social Justice* (Oxford and London, 1966), and R. Rescher, *Distributive Justice* (Indianapolis, 1966). Much the most acute treatment of the subject is to be found in a German work by the Swiss economist Emil Küng, *Wirtschaft und Gerechtigkeit* (Tübingen, 1967) and many sensible comments in H. B. Acton, *The Morals of the Market* (London, 1971), particularly p. 71: 'Poverty and misfortune are evils but not injustices'. Very important is also Bertrand de Jouvenel, *The Ethics of Redistribution* (Cambridge, 1951) as well as certain passages in his *Sovereignty* (London, 1957), two of which may here be quoted. P. 140: 'The justice now recommended is a quality not of a man and a man's actions, but of a certain configuration of things in social geometry, no matter by what means it is brought about. Justice is now something which exists independently of just men.' P. 164: 'No proposition is likelier to scandalise our contemporaries than this one: it is impossible to establish a just social order. Yet it flows logically from the very idea of justice, on which we have, not without difficulty, thrown light. To do justice is to apply, when making a share-out, the relevant serial order. But it is impossible for the human intelligence to establish a relevant serial order for all resources in all respects. Men have needs to satisfy, merits to reward, possibilities to actualize; even if we consider these three aspects only and assume that—what is not the case—there are precise *indicia* which we can apply to these aspects, we still could not weight correctly among themselves the three sets of *indicia* adopted.'

The at one time very famous and influential essay by Gustav Schmoller on 'Die Gerechtigkeit in der Volkswirtschaft' in that author's *Jahrbuch für Volkswirtschaft etc.*, vol. v, 1895 is intellectually most disappointing—a pretentious statement of the characteristic muddle of the do-gooder foreshadowing some unpleasant later developments. We know now what it means if the great decisions are to be left to the 'jeweilige Volksbewusstsein nach der Ordnung der Zwecke, die im Augenblick als die richtige erscheint'!

9 Cf. note 7 to chapter VII above.

10 Cf. Adam Smith, *The Theory of Moral Sentiments* (London, 1801), vol. II, part VII, sect. ii, ch. 1, p. 198: 'Human life the Stoics appear to have considered as a game of great skill, in which, however, there was a mixture of chance or of what is vulgarly understood to be chance.' See also Adam Ferguson *Principles of Moral and Political Science* (Edinburgh 1792) vol. I p. 7: 'The Stoics conceived of

human life under the image of a Game, at which the entertainment and merit of the players consisted in playing attentively and well whether the stake was great or small.' In a note Ferguson refers to the *Discourses of Epictetus* preserved by Arrian, book II, ch. 5.

11 Cf. G. Hardin, *Nature and Man's Fate* (New York, 1961), p. 55: 'In a free market, says Smith in effect, prices are regulated by negative feedback.' The much ridiculed 'miracle' that the pursuit of self-interest serves the general interest reduces to the self-evident proposition that an order in which the action of the elements is to be guided by effects of which they cannot know can be achieved only if they are induced to respond to signals reflecting the effects of those events. What was familiar to Adam Smith has belatedly been rediscovered by scientific fashion under the name of 'self-organizing systems'.

12 See L. von Mises, *Human Action* (Yale, 1949), p. 255 note: 'There is in the operation of the market economy nothing which could properly be called distribution. Goods are not first produced and then distributed, as would be the case in a socialist state.' Cf. also M. R. Rothbard, 'Towards a Reconstruction of Utility and Welfare Economics' in M. Sennholz (ed.), *On Freedom and Free Enterprise* (New York, 1965), p. 231.

13 Cf. W. G. Runciman, *op. cit.*, p. 274: 'Claims for social justice are claims on behalf of a group, and the person relatively deprived within an individual category will, if he is the victim of an unjust inequality, be a victim only of individual injustice.'

14 See Irving Kristol, 'When Virtue Loses all Her Loveliness—Some Reflections on Capitalism and "The Free Society"', *The Public Interest*, no. 21 (1970), reprinted in the author's *On the Democratic Idea in America* (New York, 1972), as well as in Daniel Bell and Irving Kristol (eds), *Capitalism Today* (New York, 1970).

15 Cf. J. Höffner, *Wirtschaftsethik und Monopole im 15. und 16. Jahrhundert* (Jena, 1941) und 'Der Wettbewerb in der Scholastik', *Ordo*, V, 1953; also Max Weber, *On Law in Economy and Society*, ed. Max Rheinstein (Harvard, 1954) pp. 295ff., but on the latter also H. M. Robertson, *Aspects on the Rise of Economic Individualism* (Cambridge, 1933) and B. Groethuysen, *Origines de l'esprit bourgeois en France* (Paris, 1927). For the most important expositions of the conception of a just price by the late sixteenth century Spanish Jesuits see particularly L. Molina, *De iustitia et de iure*, vol. 2, *De Contractibus* (Cologne, 1594), disp. 347, no. 3 and especially disp. 348, no. 3, where the just price is defined as that which will form 'quando absque fraude, monopoliis, atque aliis versutiies, communiter res aliqua vendi consuevit pretio in aliqua regione, aut loco, it habendum est pro mensura et regula judicandi pretium iustum rei illius in ea regione.' About man's inability to determine beforehand what a just price would be see also particularly Johannes de Salas, *Commentarii in*

Secundum Secundae D. Thomas de Contractibus (Lyon, 1617), *Tr. de empt. et Vend.* IV, n. 6, p. 9: '. . . quas exacte comprehendere, et ponderare Dei est, not hominum'; and J. de Lugo, *Disputationes de Iustitia et Iure* (Lyon, 1643), vol. II, d. 26, s. 4, n. 40; 'pretium iustum matematicum, licet soli Deo notum.' See also L. Molina, *op. cit.*, disp. 365, no. 9: 'omnesque rei publicae partes ius habent conscendendi ad gradum superiorem, si cuiusque sors id tulerit, neque cuiquam certus quidam gradus debitur, qui descendere et conscendere possit.' It would seem that H. M. Robertson (*op. cit.*, p. 164) hardly exaggerates when he writes 'It would not be difficult to claim that the religion which favoured the spirit of capitalism was Jesuitry, not Calvinism.'

16 John W. Chapman, 'Justice and Fairness', *Nomos VI, Justice* (New York, 1963), p. 153. This Lockean conception has been preserved even by John Rawls, at least in his earlier work, 'Constitutional Liberty and the Concept of Justice', *Nomos VI, Justice* (New York, 1963), p. 117, note: 'If one assumes that law and government effectively act to keep markets competitive, resources fully employed, property and wealth widely distributed over time, and maintains a reasonable social minimum, then, if there is equality of opportunity, the resulting distribution will be just or at least not unjust. It will have resulted from the working of a just system . . . a social minimum is simply a form of rational insurance and prudence.'

17 See passages quoted in note 15 above.

18 See M. Fogarty, *The Just Wage* (London, 1961).

19 Barbara Wootton, *The Social Foundation of Wage Policy* (London, 1962), pp. 120 and 162, and now also her *Incomes Policy, An Inquest and a Proposal* (London, 1974).

20 Surely Samuel Butler (*Hudibras*, II,1) was right when he wrote

> For what is worth in any thing
> But so much money as 'twill bring.

21 On the general problem of remuneration according to merit, apart from the passages by David Hume and Immanuel Kant placed at the head of this chapter, see chapter VI of my book *The Constitution of Liberty* (London and Chicago, 1960) and cf. also Maffeo Pantaleoni, 'L'atto economico' in *Erotemi di Economia* (2 vols, Padua, 1963), vol. I, p. 101:

> E tre sono le proposizioni che conviene comprendere bene:
> La prima è che il merito è una parola vuota di senso.
> La seconda è che il concetto di giustizia è un polisenso che si presta a quanti paralogismi si vogliono ex amphibologia.
> La terza è che la remunerazione non può essere commisurata da una produttività (marginale) capace di determinazione isolamente,

cioè senza la simultanea determinazione della produttività degli altri fattori con i quali entra in una combinazione di complimentarità.

22 On the history of the term 'social' see Karl Wasserrab, *Sozialwissenschaft und soziale Frage* (Leipzig, 1903); Leopold von Wiese, *Der Liberalismus in Vergangenheit und Zukunft* (Berlin, 1917), and *Sozial, Geistig, Kulturell* (Cologne, 1936); Waldemar Zimmermann, 'Das "Soziale" im geschichtlichen Sinn- und Begriffswandel' in *Studien zur Soziologie, Festgabe für L. von Wiese* (Mainz, 1948); L. H. A. Geck, *Über das Eindringen des Wortes 'sozial' in die deutsche Sprache* (Göttingen, 1963); and Ruth Crummenerl, 'Zur Wortgeschichte von "sozial" bis zur englischen Aufklärung', unpublished essay for the State examination in philology (Bonn, 1963). Cf. also my essay 'What is "Social"? What does it Mean?' in a corrected English version in my *Studies in Philosophy, Politics and Economics* (London and Chicago, 1967).

23 Cf. G. del Vecchio, *op. cit.*, p. 37.

24 Very instructive on this is Leopold von Wiese, *Der Liberalismus in Vergangenheit und Zukunft* (Berlin, 1917) pp. 115ff.

25 Characteristic for many discussions of the issue by social philosophers is W. A. Frankena, 'The Concept of Social Justice', in *Social Justice*, ed. R. B. Brandt (New York, 1962), p. 4, whose argument rests on the assumption that 'society' *acts* which is a meaningless term if applied to a spontaneous order. Yet this anthropomorphic interpretation of society seems to be one to which utilitarians are particularly prone, although this is not often as naively admitted as by J. W. Chapman in the statement quoted before in note 21 to chapter VII.

26 I regret this usage though by means of it some of my friends in Germany (and more recently also in England) have apparently succeeded in making palatable to wider circles the sort of social order for which I am pleading.

27 Cf. the 'Statement of Conscience' received by the 'Aspen Consultation on Global Justice', an 'ecumenical gathering of American religious leaders' at Aspen, Colorado, 4–7 June 1974, which recognized that 'global injustice is characterised by a dimension of sin in the economic, political, social, racial, sexual and class structures and systems of global society.' *Aspen Institute Quarterly* (New York), no. 7, third quarter, 1974, p. 4.

28 See particularly A. M. Honoré, *op. cit.* The absurdity of the contention that in a Great Society it needs moral justification if *A* has more than *B*, as if this were the result of some human artifice, becomes obvious when we consider not only the elaborate and complex apparatus of government which would be required to prevent this, but also that this apparatus would have to possess power to direct the

efforts of all citizens and to claim the products of those efforts.

29 One of the few modern philosophers to see this clearly and speak out plainly was R. G. Collingwood. See his essay on 'Economics as a philosophical science,' *Ethics* 36, 1926, esp. p. 74: 'A just price, a just wage, a just rate of interest, is a contradiction in terms. The question of what a person ought to get in return for his goods and labour is a question absolutely devoid of meaning.'

30 If there is any one fact which all serious students of the claims for equality have recognized it is that material equality and liberty are irreconcilable. Cf. A. de Tocqueville, *Democracy in America*, book II, ch. I (New York, edn 1946, vol. II, p. 87): democratic communities 'call for equality in freedom, and if they cannot obtain that, they still call for equality in slavery'; William S. Sorley, *The Moral Life and the Moral Worth* (Cambridge, 1911), p. 110: 'Equality is gained only by constant interference with liberty'; or more recently Gerhard Leibholz, 'Die Bedrohung der Freiheit durch die Macht der Gesetzgeber', in *Freiheit der Persönlichkeit* (Stuttgart, 1958), p. 80: 'Freiheit erzeugt notwendig Ungleichheit und Gleichheit notwendig Unfreiheit', are merely a few instances which I readily find in my notes. Yet people who claim to be enthusiastic supporters of liberty still clamour constantly for material equality.

31 Gustav Radbruch, *Rechtsphilosophie* (Stuttgart, 1956), p. 87: 'Auch das sozialistische Gemeinwesen wird also ein Rechtsstaat sein, ein Rechtsstaat freilich, der statt von der ausgleichenden von der austeilenden Gerechtigkeit beherrscht wird.'

32 See M. Duverger, *The Idea of Politics* (Indianapolis, 1966), p. 201.

33 Karl Mannheim, *Man and Society in an Age of Reconstruction* (London, 1940), p. 180.

34 P. J. Stuchka (President of the Soviet Supreme Court) in *Encyclopedia of State and Law* (in Russian, Moscow, 1927), quoted by V. Gsovski, *Soviet Civil Law* (Ann Arbor, Michigan, 1948), I, p. 70. The work of E. Paschukanis the Soviet author who has most consistently developed the idea of the disappearance of law under socialism, has been described by Karl Korsch in *Archiv sozialistischer Literatur*, III, (Frankfurt, 1966) as the only consistent development of the teaching of Karl Marx.

35 *The Road to Serfdom* (London and Chicago, 1944), chapter IV. For discussions of the central thesis of that book by lawyers see W. Friedmann, *The Planned State and the Rule of Law* (Melbourne, 1948), reprinted in the same author's *Law and Social Change in Contemporary Britain* (London, 1951): Hans Kelsen, 'The Foundations of Democracy', *Ethics* 66, 1955; Roscoe Pound, 'The Rule of Law and the Modern Welfare State', *Vanderbilt Law Review*, 7, 1953; Harry W. Jones, 'The Rule of Law and the Modern Welfare State', *Columbia Law Review*, 58, 1958; A. L. Goodhart, 'The Rule

of Law and Absolute Sovereignty', *University of Pennsylvania Law Review*, 106, 1958.

36 G. Radbruch, *op. cit.*, p. 126.

37 Radbruch's conceptions of these matters are concisely summed up by Roscoe Pound (in his introduction to R. H. Graves, *Status in the Common Law*, London, 1953, p. XI): Radbruch

> starts with a distinction between commutative justice, a correcting justice which gives back to one what has been taken away from him or gives him a substantial substitute, and distributive justice, a distribution of the goods of existence not equally but according to a scheme of values. Thus there is a contrast between co-ordinating law, which secures interests by reparation and the like, treating all individuals as equal, and subordinating law, which prefers some or the interests of some according to its measure of value. Public law, he says, is a law of subordination, subordinating individual to public interests but not the interests of other individuals with those public interests.

38 Cf. Bertrand de Jouvenel, *Sovereignty* (Chicago, 1957), p. 136:

> The small society, as the milieu in which man is first found, retains for him an infinite attraction; he undoubtedly goes to it to renew his strength; but . . . any attempt to graft the same features on a large society is utopian and leads to tyranny. With that admitted, it is clear that as social relations become wider and more various, the common good conceived as reciprocal trustfulness cannot be sought in methods which the model of the small, closed society inspires; such a model is, in the contrary, entirely misleading.

39 Edwin Cannan, *The History of Local Rates in England*, 2nd edn (London, 1912), p. 162.

40 While one has become used to find the confused minds of social philosophers talking about 'social justice', it greatly pains me if I find a distinguished thinker like the historian Peter Geyl (*Encounters in History*, London, 1963, p. 358) thoughtlessly using the term. J. M. Keynes (*The Economic Consequences of Mr. Churchill*, London, 1925, *Collected Writings*, vol. IX, p. 223) also writes unhesitatingly that 'on grounds of social justice no case can be made for reducing the wages of the miners.'

41 Cf. e.g. Walter Kaufmann, *Without Guilt and Justice* (New York, 1973) who, after rightly rejecting the concepts of distributive and retributive justice, believes that this must lead him to reject the concept of justice altogether. But this is not surprising after even *The Times* (London) in a thoughtful leading article (1 March 1957) apropos the appearance of an English translation of Josef Pieper's

Justice (London, 1957) had observed that 'roughly, it may be said that in so far as the notion of justice continues to influence political thinking, it has been reduced to the meaning of the phrase "distributive justice" and that the idea of commutative justice has almost entirely ceased to influence our calculations except in so far it is embodied in laws and customs—in the maxims for instance of the Common Law—which are preserved from sheer conservatism.' Some contemporary social philosophers indeed beg the whole issue by so *defining* 'justice' that it includes *only* distributive justice. See e.g. Brian M. Barry, 'Justice and the Common Good', *Analysis*, 19, 1961, p. 80: 'although Hume uses the expression "rules of justice" to cover such things as property rules, *"justice" is now analytically tied to "desert" and "need"*, so that one could quite properly say that some of what Hume calls "rules of justice" were unjust' (italics added). Cf. *ibid.*, p. 89.

42 J. S. Mill, *On Liberty*, ed. McCallum (Oxford, 1946), p. 70.

43 On the destruction of moral values by scientific error see my discussion in my inaugural lecture as Visiting Professor at the University of Salzburg, *Die Irrtümer des Konstruktivismus und die Grundlagen legitimer Kritik gesellschaftlicher Gebilde* (Munich, 1970, now reprinted for the Walter Eucken Institute at Freiburg i.Brg. by J. C. B. Mohr, Tübingen, 1975).

44 John Rawls, 'Constitutional Liberty and the Concept of Justice', *Nomos IV, Justice* (New York, 1963), p. 102, where the passage quoted is preceded by the statement that 'It is the system of institutions which has to be judged and judged from a general point of view.' I am not aware that Professor Rawls' later more widely read work *A Theory of Justice* (Harvard, 1971) contains a comparatively clear statement of the main point, which may explain why this work seems often, but as it appears to me wrongly, to have been interpreted as lending support to socialist demands, e.g. by Daniel Bell, 'On Meritocracy and Equality', *Public Interest*, Autumn 1972, p. 72, who describes Rawls' theory as 'the most comprehensive effort in modern philosophy to justify a socialistic ethic.'

Ectopia, Tax Law and International Taxation*

JOHN PREBBLE†

Introduction

THE term "ectopia" is not in common use in the English language,[1] though its adjective is found in the expression "ectopic pregnancy", which describes a pregnancy that occurs in the wrong place. Just as an ectopic pregnancy is a pathological, serious, and incurable condition (in the sense that one cannot save the baby), so is the ectopia of income tax law pathological, serious, and incurable, though governments strive to alleviate the problems to which the condition gives rise.

"Ectopia" is used here as a label for a characteristic of income tax law that distinguishes it from most other forms of law. This characteristic is that income tax law is, in a fundamental sense, dislocated from the facts to which it relates. One result is that income tax law is and must always be fundamentally flawed. The flaws of income tax law are not always obvious at first sight and, when they are identified, they are not necessarily recognised as fundamental and pathological to the system.

There is a tendency to think that with goodwill, application, intelligence, industry, and the necessary resources, humans will be able to resolve the problem of being unable to create an unflawed income tax system. That thought is wrong, which is not to say that it is impossible to mitigate some of the problems of income tax law as they manifest themselves in some cases, nor that it is impossible to make some aspects of an income tax system work very well in some situations. The thesis of this article is that problems that result from the ectopia of income tax law are generally acute and particularly resistant to cure. This is particularly true of problems that are associated with the taxation of international trade and investment. The first part of this article introduces the reader to the elements of income taxation that bring about these problems in the international arena. The second part considers several specific aspects of the taxation of international transactions that are caused by ectopia. First, how is income tax law ectopic?

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[1] "Ectopia *Pathol.* Displacement; anomaly of situation or relation." *Oxford English Dictionary.* The use of "ectopia" to refer to the jurisprudential concept that is discussed in this article has attracted some support. Lord Cooke of Thorndon in "A Real Thing", Turning Points of the Common Law (The 1996 Hamlyn Lectures), 1996, Sweet & Maxwell, London) 1, 12. See also United Kingdom Inland Revenue Tax Rewrite Project Team, "The audience for tax legislation, is it different from that for other legislation? Should it be considered to be the same for all sections or Parts?", a paper presented to the New Zealand Inland Revenue Department Tax Drafting Conference, Auckland, November 1996, at p. 10, para. 33.

Symbiosis between law and its subject matter

The answer to the question can best be approached by first describing some relevant features of a paradigm of law. Comparison of income tax law with the paradigm can then show what is meant by the ectopia of income tax law, and how income tax law departs from the paradigm.

In the present context, the relevant feature of law in general is that there is a symbiosis between law and its subject matter. That is, there is a natural, almost organic, relationship between law and what law is about. This natural relationship is so sensible and expected that we take it for granted.

For example, if a sovereign decides to make a law to inhibit and to punish theft, it is no surprise that the product of the sovereign's labours are rules that describe theft and other larcenous activities in their various forms, and that prescribe penalties for actions that answer these descriptions. The better the words of the sovereign's laws accord with the facts of the actions that the sovereign wants to punish, the more efficiently will her objective be achieved. If the sovereign's will is clear from the text of her laws, judges will more efficiently give effect to that will. This is so even if the sovereign is a feared dictator with a dependent judiciary willing to bend to her wishes. If they can understand the sovereign's laws, dependent judges will not have to ask her what she means. In the more desirable case of an independent judiciary, careful drafting of laws is even more important because the sovereign cannot influence her judges in the exercise of their function.

The factors mentioned are so obvious that, doubtless, law-makers give them little thought as they go about their business. Nevertheless, these factors, together with such things as pride in their work, persuade law-makers to ensure that laws are as closely related to their subject matter as can be managed. The same influences act on law makers when they are drafting income tax laws as is the case with any other laws. But the results are inevitably different. The reason is that the ordinary symbiosis that exists between law and its subject matter is absent from the foundations of income tax law.

Concept of income

A convenient starting point for an explanation of the lack of symbiosis between income tax law and its subject matter is the question of the concept of income. Income tax is one of a group of taxes that tax *gains*. That is, income tax is not, for example, a transaction tax, such as a value added tax or a sales tax, nor is it a wealth tax, such as a death duty or the typical property tax (rates) levied by local governments. Income tax taxes gains, but not all gains. Typically, income tax does not tax capital gains and many income taxes do not tax gains in the form of lottery winnings or intra-family gifts. Most income taxes do not tax windfalls, such as finding someone's wallet and being allowed to keep it when the police cannot trace the owner.

The fact that income taxes by definition do not tax *all* gains means that it is fundamental to income tax law that there must be a concept of income. This concept is necessary so that people may know which gains are subject to the tax and which are not. Some income tax laws have more than one concept of income. In particular, schedular income tax laws such as are found in the United Kingdom and Hong Kong have different rules for different kinds of income (for example, salaries, business profits, farming profits, interest, and so on). Such laws contemplate more than one concept of income, but that consideration has no implications for the present discussion. It is the existence of, and the crucial role of,

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concepts of income that are important, whether a particular income tax system employs one or several concepts.

The ectopia of income tax law lies in the law's dependence on the existence of a concept of income. The problem is that the concept of income is not something that ultimately can be defined by law because it is not something that exists either as a physical fact or as an abstract thought. This characteristic distinguishes income from other subjects of law that, typically, can be defined by law because they are either physical facts (for example, a "blunt instrument" used in an "assault") or abstract thoughts (for example, "*mens rea*").

Of course, many subjects of law, particularly abstract thoughts, are difficult to define. There are, for example, many hundreds of thousands of words written on what the law means by *mens rea*. But there is no ultimate conceptual impossibility in defining what the law means by "guilty mind" in the sense that there is an ultimate conceptual impossibility in defining "income". The problem of defining *mens rea* is simply very difficult in some cases, but not impossible.

To say that it is conceptually impossible to define "income" does not mean that tax law can never recognise a particular receipt as income. Indeed it can. For example, rent, salaries, wages, and interest are usually recognisable as income without any doubt. Though, to make doubly sure, legislation that taxes "income" may specifically state that it extends to rent, salaries, wages, and interest, together with a long list of other receipts. What is meant by the impossibility of defining "income" is that one cannot identify the borders of the concept because, at its borders, income is a fiction, invented for the purposes of income tax legislation, that does not have independent existence in the world of physical fact or abstract thought. This fictional characteristic of income stems primarily from two factors: space and time.

Space

In this context, the term "space" refers to the consideration that all countries place geographical limits on the income that they tax. Some countries tax only income that finds its source within their own jurisdiction. Others tax foreign-source income as well if it is derived by a resident or, possibly, by a citizen. All countries that levy income tax assess income that is sourced within their boundaries and is derived by a resident.

These rules are self-imposed. There is no principle of international law that prevents a country from trying to tax foreign-source income that is derived by someone who is neither a resident nor a citizen. In fact, countries sometimes do tax income derivd by non-residents that has a foreign source according to general principles.

Take, for example, interest on money lent in Europe by one European company to another, that the borrower uses for purpose of a business that it carries on through a fixed establishment in New Zealand. Section OE4(1)(n)(ii) of the New Zealand Income Tax Act 1994 deems such interest to have a New Zealand source for tax purposes. However, in the absence of such a provision, the New Zealand Court of Appeal (to say nothing of courts in other jurisdictions) would hold that the interest finds its source in Europe.[2]

The example of this New Zealand source rule that applies to interest is far from isolated, but, ordinarily, countries do not try to tax income that is neither sourced within their borders nor is derived by a resident or citizen. One reason is comity: a reluctance to tax something in someone else's jurisdiction. A second is practicality: it is hard to collect tax on

[2] *Commissioner of Inland Revenue v. Philips Gloeilampenfabrieken N.V.* [1955] N.Z.L.R. 868.

income that has little or no connection with one's own jurisdiction. A third is, no doubt, a common understanding among law-makers of what income tax law is about, and a common understanding as to the reach of a nation's public law in general. Ordinarily, states do not purport to accord to their public law an ability to operate beyond its home jurisdiction and individual subjects.

Source

Once a state has decided that it will tax domestic-source income, and foreign-source income only when derived by a resident, the state must come to grips with the concepts of source and residence. Both of these present problems, but, probably, source is the most difficult.

Countries are defined primarily by reference to geography, a discipline that deals with physical phenomena. Certainly, countries are so defined for tax purposes. Income, on the other hand, is not a physical phenomenon. It may be represented by physical things, most notably by coins and bank notes, and it may be calculated and recorded on physical media, either paper or electronic. But income itself, like money, is an abstract concept.

Despite the abstract nature of income, the juridical system must treat income as if it has a physical source in a geographical location in the same manner as a river has a physical source in some place. As an Australian judge once said, for tax purposes the source of income is "a hard, practical, matter of fact".[3] In truth, however, income can no more have a physical source than can, say, patriotism or capitalism. And yet source rules, a crucial aspect of the juridical concept of income, are based on this contradiction.

The sort of problem to which this contradiction leads is readily demonstrated. Take interest on a loan from a German-resident creditor to a French-resident debtor pursuant to a contract negotiated and signed in England. Assume that the loan is secured over property in Canada and that the principal is used in a business that is carried on in the United States. The interest is paid by automatic transfer between accounts in the same Hong Kong bank. Such a loan would almost certainly never occur, if only because an alert adviser would point out the tax pitfalls (deemed source in several jurisdictions, leading to several imposts of tax on the same interest). However, the hypothetical loan illustrates the point made here: there is no logical or sensible way in which to accord a jurisdictional source to the interest, and yet for tax purposes that must be done. The answers (and there will be several answers as one moves from one jurisdiction to another) must be fictions.

Instructively, these fictions may be compared with the operation of other laws that may have an impact on the interest. None of the jurisdictions mentioned would have theoretical difficulty (and seldom any practical difficulty) in deciding whether the right to interest on the loan is enforceable, in giving judgment for debt in respect of unpaid interest, or in enforcing a foreign judgment to that effect. But note that these decisions relate to physical facts: whether the parties' actions amount to an enforceable loan contract; whether interest due has been noted as transferred from one account to another; and whether a foreign court has pronounced judgment.

In contrast, a judgment that the interest arises in one jurisdiction and not in the others must execute the action of fitting a metaphysical fact into a physical, geographical place, which is a logical impossibility. Law-makers are apt to respond in the only way possible: to pass laws that deem certain formal, physical facts that relate to a loan to determine the

[3] *Nathan v. Federal Commissioner of Taxation* (1918) 25 C.L.R. 183 at 189–190, *per* Isaacs J.

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source of the interest. In the case of section OE4(1) of the New Zealand Income Tax Act 1994 such facts include: place of contracting of loan, place of security, and residence of borrower.

Business profits

Business profits furnish a second example of the difficulty of ascribing a jurisdictional source to particular income. Take, for example, the profit made by an airline from a sector of an intercontinental flight that passes over international waters, as well as over several countries. The passengers will share among them a number of points of departure and destination. They will have bought their tickets in a wider range of jurisdictions, using agents and credit that are connected with even more jurisdictions. The question: "What is the source of the profit derived by the flight through the sector in question?" is almost meaningless in any sense that can have any connection with factual reality, and yet for tax purposes this question must be resolved.

Import-export contracts give rise to similar problems, though, ordinarily, fewer jurisdictions are involved. When a manufacturer in Taiwan sells goods to a customer in New Zealand, what is the source of the profit, assuming that there is a profit? Does it make any difference whether the sale is in response to an order placed direct by the New Zealand customer, or through a New Zealand branch that is maintained by the manufacturer, or through a New Zealand subsidiary? The answer to the first question is difficult. The answer to the second is yes, in that the structure of the transaction and the business vehicle employed by the manufacturer to make the sale will make a difference.

Jurisdictions as fictions

Like the interest in the earlier example, these business profits cannot logically be said to be sourced in one jurisdiction rather than another. The physical facts that have been mentioned are related to the interest or to the profits but cannot be connected with them in the sense that two physical facts can be connected, nor in the sense, for instance, that an abstract premise can be connected by logic with an abstract conclusion.

The logical separation of the world of physical facts and the world of abstract concepts is the fundamental reason for the difficulty of relating income to a particular jurisdiction. Previous work by the author has suggested another reason: that jurisdictions and their borders are fictions that are invented by people, not naturally occurring phenomena, whereas profit is something that occurs naturally. It is true that many national borders follow sea coasts, rivers, ranges, and other natural geographical features. But these incidents of topography are not necessarily borders: they are borders only because people say that they are borders. National borders form a matrix, created by humans, that lies over the natural world.

The natural world is formed, most obviously, by sea and land, but people occur in the natural world, and so does economic activity. Economic activity can occur without any law at all: for example, barter with immediate delivery between people who do not trust one another, or trade with credit between people who rely on trust but who know they have no remedy if the other party fails to perform. More so, economic activity has no need of national borders. Indeed, international borders are at best an irrelevancy and more commonly a hindrance to international trade and investment.

In previous articles it has been pointed out that profit from economic activity is a naturally occurring phenomenon, but national borders are not. From these facts, it has been argued that there is no connection between profits (or interest, for that matter) and jurisdictions that are surrounded by borders or, at least, no connection that helps to locate the source of profits in a particular jurisdiction.[4] The conclusion is correct, but the logic is wrong. The reason that prevents a connection being made between profit and jurisdiction is the reason that has already been explained: that is, profits are an abstraction, but jurisdictions are part of the world of physical facts. This is so, even though the borders of jurisdictions are not naturally occurring but are defined by people.

It is the ectopia between the physical and the abstract that is responsible for the phenomenon that the source of income cannot be located in a particular jurisdiction or, at least, it cannot be so located by dint of logical argument based on *a priori* principles. The phenomenon is not caused by the distinction between income being naturally occurring and borders being defined by humans.

This conclusion can be demonstrated by considering naturally occurring physical things. We can say that the source of the Seine is in France or that Kilimanjaro is in Tanzania and be certain that we are correct, at least at the time of speaking. That is because although France and Tanzania are defined by the actions and agreements of people, not by nature, the definitions that we employ are definitions (borders) that themselves are defined by reference to natural, physical features of the landscape. We can therefore make the required logical connection between a country and a mountain or a river in that country; the mountain and the river are physical facts, as are the features of the landscape that we use to define the borders of the country. Accordingly, if income, which is a naturally occurring phenomenon, were a physical thing its source could be located in a country, even though the country has been defined by humans, and not by nature.

Residence

As mentioned earlier, the question of space is, with time, one of the two factors that helps to explain the ectopia of income tax law. A sub-issue within the category of space is the question of source of income, which has been discussed. The second sub-issue within space is residence. If states rule, as many do, that their residents must pay tax on foreign-source income simply because they are resident in the jurisdiction, then states' laws must define "residence". Further, there must be definitions in respect of both individuals and corporations.

As far as humans are concerned, the problems of definition of residence are practical rather than conceptual. Individuals are physical facts, and the legal concept of residence relates them to another physical fact: a taxing jurisdiction. Making this relationship is conceptually a possible goal, because the two elements are both physical. This is in contrast to the object that the concept of source has as its goal, to relate jurisdiction, a physical thing, and income, which is at most an abstract fact.

Although the goal of rules of residence is conceptually a possible goal, it is difficult. People's habit of moving makes it more difficult to decide whether someone is resident in a

[4] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules in Income Tax Law" in W. Krawietz, N. MacCormick and G. H. von Wright (eds), *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers* (Duncker and Humblot, Berlin, 1994) p. 367, at 373–375; John Prebble, "Why is Tax Law Incomprehensible?" [1994] B.T.R. 380 at 384.

jurisdiction than, for example, whether a particular mountain is within the borders of that jurisdiction. Depending on the rules that jurisdictions may adopt, there are many facts that may be relevant to deciding where someone is resident: location of home, place where family lives, time spent within the borders, and so on. Depending on law-makers, residence rules may take account not only of physical facts like those just mentioned but also of metaphysical facts such as intention. Also, most, perhaps all, jurisdictions admit the possibility that people may have more than one fiscal residence. These difficulties lead some jurisdictions to pass laws that determine the bulk of residence questions by reference to formal, arbitrary criteria: typically, has the individual been present in the jurisdiction for at least a certain minimum number of days?

It is tempting to suggest that, like the rules of source, such arbitrary rules create an ectopia between tax law and its subject matter. The suggestion is correct, but only in the sense that in any particular case any formal rule is apt to create a gap between the rule and the facts to which it applies. Theoretically, a law-maker *could* pass a law that by one or more of hundreds of detailed, express provisions, without arbitrariness, would enable an individual to be connected with his or her appropriate jurisdiction or jurisdictions by rules that could be called the rules of residence. In practice, that cannot occur because of the multifarious variety of possible human behaviour. The arbitrariness of residence rules results, as stated, from practical difficulty, not from conceptual impossibility.

Corporate residence

The same cannot be said of rules that are calculated to determine corporate residence. A company is represented by physical facts (its documents of incorporation) but it is itself not even an abstract fact. It is a fiction. Nevertheless, for tax systems to operate companies must be accorded residences in jurisdictions just as humans are accorded residences in jurisdictions.

Countries often legislate to say that companies that are incorporated in their jurisdictions are resident there. This solution has the merit of certainty, but it is even more formalistic than a rule that says people remain forever resident for fiscal purposes where they were born. No jurisdiction is known to the present writer to adopt this test for people, yet the test has a slightly closer connection with reality than the common place-of-incorporation test that is employed for companies.

If, despite logic, it is possible for companies in law to have a substantive connection with a geographical locality, that connection can only be in terms of residence of shareholders, directors, or employees, or in terms of the place or places where directors or employees carry out their work for the company.

Humans must have spent at least *some* time in the jurisdictions where they were born, but (to the extent that companies are capable of having a substantive connection with any geographical place) companies may have no substantive connection at all with the place of their incorporation. The result is that the place-of-incorporation test of corporate residence for some companies reaches a result that is purely formal and devoid of any substance.

The solution is only a little happier when courts or legislatures try to compose substantive corporate residence rules. They employ expressions like, "Where the company's real business is carried on",[5] and "where what we should call the head office in

[5] *De Beers Consolidated Mines Ltd v. Howe* [1906] A.C. 455, H.L.

popular language is, and where the business of the company is really directed",[6] and "centre of management".[7] These expressions relate to the actions of people or, in the case of "head office", to the bricks and mortar that surround some of the people in question. At least the expressions relate current facts (of human action and place) to another fact (geographical jurisdiction). In this respect, the expressions are part of a law that more closely reflects reality than a law that turns on the location of a formal act of incorporation that may have occurred many years ago. But, nevertheless, the relationship of fact to fact is via an intermediate step that comprises a fiction: the corporation itself.

The question of corporate residence is compounded by another factor: because a company is a fiction, the statement that a company derives income is also a fiction. Nevertheless, parliaments are forced to draft income tax laws that assume that companies can derive income because so much of commercial life is organised on this very assumption. The assumption leads to a number of anomalies, the most obvious of which may be noted in passing: corporate profits are apt to be taxed twice, once in the hands of the company, and again as dividends derived by shareholders. Many countries enact imputation systems to overcome this difficulty. Be that as it may, the importance in the present context of the factor of fictional derivation of income by corporations is that income tax law in this area finds itself two steps away from reality: it must attribute income to a fictional entity that cannot in truth derive income (nor, indeed, do anything else), and this attribution must be done on the basis of the entity's connection with a fictional residence where the entity is assumed by law to live.

Where does this discussion lead? To a conclusion that the rules of corporate residence for fiscal purposes require the law to do two things that are conceptually impossible: to attribute a real, geographical residence to a fiction and to do so for the purpose and in the context of assuming that the fiction can derive income. This paragraph thus describes a second gap between tax law and its subject matter that may be classified as a problem of space.

Time

The second major factor that separates income tax law from its subject matter is time. On one hand, the paradigm of income is a stream that goes on more or less indefinitely. This is particularly true of the profits of a successful business. Considering business profits as a representative form of income, it follows that one cannot truly know whether a business has made an overall profit and, if so, how much, until the business comes to an end.

On the other hand, if income is to be taxed in any efficient manner governments cannot wait until businesses terminate. Income must be taxed in the meantime. To that end, income must be divided into segments. The only sensible method of segmentation in this context is by reference to time. Thus, for tax purposes we identify segments of income by reference to their starting and ending dates. Invariably, tax systems use a period of twelve months as the appropriate length for these segments, but there is no *a priori* reason why this should be so, particularly where the income in question is not affected by seasonal factors. Segments of six or sixteen months would be just as good, except that people are so used to employing the year to measure almost anything that lasts longer than months and that is quantified by reference to time that to use another duration would be confusing.

[6] *American Thread Co. v. Joyce* (1913) 6 T.C. 163, at 165.
[7] New Zealand Income Tax Act 1994, s.OE2(1)(c).

Dividing income into segments of time is an artificial, formal process that has no necessary connection with the way that gains and profits come about in the natural world. This consideration is further illuminated by an appreciation that the measurement system that we employ to divide income into taxable segments is itself artificial, in that the calendar is an invention of people, not something that (like profit) emerges naturally as soon as two people trade with one another. Nevertheless, this segmenting of income must be done if there is to be an income tax system.

Consequential rules

Ideally, an income tax system would look at individuals or companies over the duration of their existence and assess their total income to tax. That is not practical, so income tax law divides our existence into segments, as described. A consequence is that the rules of income tax law aim at only one segment of a taxpayer's income at a time, that is, income derived between the beginning and end of a particular financial year. It follows that if a taxpayer can defer the recognition of a receipt as income from one year to the next the taxpayer can defer tax on that income. Such deferral may be direct, by not recognising a gain, or indirect, by accelerating the recognition of an expense that must be subtracted from receipts in order to calculate assessable income. If taxpayers can go further, and continue to defer gains indefinitely, or can push gains backwards in time into past financial years, the gains may never be taxable.

Such strategies are fundamental to many tax avoidance techniques (though opportunities for the latter strategy are rare), but they would not work in the ideal tax system described at the beginning of the previous paragraph. Why would they not work? Because if profits throughout all financial years of a taxpayer's existence were assessed together on a single occasion, the taxpayer could not avoid tax by shifting gains from one year into another.

The need for the segmenting of income means that, in their nature, all income tax systems are vulnerable to avoidance strategies that rely on the exploitation of timing differences. The result is that tax laws contain increasing numbers of rules that inhibit the deferral of income or the acceleration of expenses. These rules are essential, but the very reason for their existence means that they are out of sympathy with the legal structure and legal effects of transactions that taxpayers enter: the whole point of the rules is to re-characterise transaction x as transaction y without changing the legal rights and duties that the parties to transaction x owe to each other. An important result is that transactions that the law taxes are not necessarily transactions that exist in the rest of the legal system. Succeeding paragraphs describe examples of this ectopia between the general law (which broadly reflects transactional realities) and income tax law.

Interest

First, take interest. Suppose Lender advances £100 to Borrower for two years at simple interest of eight per cent per annum. Suppose that the parties agree that the total interest, £16, will be due and payable at the end of the two years, when the principal is repaid. Alternatively, suppose that the interest is due on day one. In either case, and in respect of either party, when should the interest be recognised for tax purposes?

If Lender or Borrower were banks or similar financial organisations, in order to compute

their profits they would spread the interest according to a yield to maturity calculation over the two years of the loan. Less sophisticated parties might spread the interest on a straight line basis, attributing an equal fraction to each day of the loan. A third category of parties, people who do not understand the time value of money, might simply account for all the interest when paid or recived.

These different treatments will result in different profits. Income tax law as interpreted by judges in the absence of specific statutory provision, in at least some jurisdictions, would calculate profits in the manner adopted by the third category of people just mentioned. That is, receipts and expenditure would be recognised for tax purposes according to timing of obligations and facts specified in the contracts involved: for parties that are in the business of lending money, interest is ordinarily assessable when it becomes legally due for payment. For parties that are not in the business of lending money, interest may be assessable on a cash receipt basis.

These rules of income tax law invite avoidance. For example, for sophisticated taxpayers facing tax bills of dismaying proportions, it is not difficult to contrive loans with large sums of interest that are incurred on day one. Deducting the interest pro tanto eliminates assessable income. But, if carefully arranged, the loan and interest need not affect the true economic circumstances of the taxpayer.

Not surprisingly, law-makers react to this kind of tax planning by promulgating rules that are calculated to frustrate it. One possibility is a rule that requires taxpayers to spread interest deductions over the life of the loan to which they relate. Such a rule may reflect the economic reality of the taxpayer's circumstances but the rule means that tax law departs from the rest of law, and departs from actual transactions. A taxpayer may incur, or even pay, interest, both in fact and pursuant to a binding contract, but tax law treats the taxpayer as though the interest was not incurred, or incurred only in part. That is, there is a gap between tax law and transactions that in fact take place.

Farmers

Consider a farmer who is in business for 10 years. Suppose that over the 10 years taken as a whole the farmer breaks even and makes neither a profit nor a loss. Suppose, however, that the first five years were profitable, and the second five years yielded only losses. The result will be that the farmer will pay tax (albeit only in the first five years) although her farming business did not make a profit. Most tax systems do not permit taxpayers to carry assessable profits forward to set against losses that are incurred in future years. The result is that tax law will treat the farmer as having made a profit even though, over the long haul, she has not. The reverse is not true: if the farmer sustained the losses in the first five years most systems would allow her to carry the losses forward to reduce assessable income in the second five years.

Some tax systems try to mitigate this kind of problem by allowing agriculturalists, and possibly people in other industries where income tends to fluctuate from year to year, to spread their income evenly over several years by an averaging process. That approach is no doubt fair to the taxpayer. But, as with the spreading of interest that is described above, it means that an income tax law that contains averaging rules taxes people as if their transactions were different from what they actually were.

Capital and revenue

The factor of time throws up one problem that dwarfs all others in the income tax field: the distinction between capital and revenue. By definition, income tax law taxes income (or revenue) and not capital gains. Some countries do not tax capital gains, others bring them into the income tax system but at a reduced rate, and others have a separate tax for capital gains. However a jurisdiction deals with capital gains, it is almost inevitable that its income tax law will distinguish between capital items and revenue items.

There are many judicial and legislative attempts to explain the difference between capital and revenue but for present purposes it is sufficient to say that, broadly speaking, for tax purposes capital items are things that last a long time. For example, for a manufacturer, factory and machines are capital items while raw materials, work in progress, and staff remuneration are on revenue account.

In any tax system that purports to distinguish between capital and income the difference is vital. Capital gains are not taxed as income, and capital expenditure is not deductible in calculating assessable income profits. Accordingly, it is in the interests of taxpayers to do their best to characterise receipts as capital and expenditure as on revenue account. These endeavours can be successful. The reason is that, ultimately, gains are fungible; they are gains whether one calls them capital or income. Accordingly, recharacterisation of income as capital can often be achieved. Similar considerations apply to expenses, *mutatis mutandis*. These points may be illustrated by one or two examples of capital items and income items.

Example: business premises

Take business premises. A manufacturer needs a factory but the factory serves the same purpose whether the manufacturer owns it or rents it. However, the tax treatment varies enormously. Rent, being a regular, period-by-period expense, is deductible in calculating the manufacturer's assessable profits. The price of the factory, on the other hand, is not deductible. It is a capital item that relates to many years of occupation and to many years of carrying on business. Therefore, the price of the factory should not be taken into account in calculating annual profits.

Most tax systems mitigate the effect of the distinction between the treatment of rent and the treatment of the price of business premises by allowing taxpayers to subtract from their receipts notional expenses that reflect the depreciation in value of capital assets that are used in a business.

Depreciation or capital allowance regimes soften the economic effect of the difference between renting and buying, but they add to the ectopia of tax law. The reason is that for tax purposes they recognise sums that have not in fact been spent as deductible expenses. As the factory premises example illustrates, the capital/revenue distinction tends to ectopia, in that this fundamental premise of income tax law is not based in commercial reality.

Conversion of income to capital

The factory premises example illustrates that income tax law draws fundamental distinctions between expenditure (or receipts) that serve the same economic functions. Income tax law goes further. In principle, and in the absence of rules designed to frustrate

the practice, income tax law allows people to change income into capital gains, gains that, depending on the regime in question, may be assessable at a lower rate of tax, or that may be tax free.

Take rent, which, when received by a lessor, is assessable. But suppose that the lessor bargains with his tenant to receive a premium for granting the lease, followed by a reduced rate of rent. Premia are capital, and therefore not taxed as income. Thus, the lessor converts income to capital even though premia and rent are to a large extent substitutable for one another.

Take a shareholder, an ordinary investor, who owns shares that are pregnant with profits. If he derives a dividend from the shares it will ordinarily be subject to income tax. But, alternatively, the shareholder may sell the shares, for a price that reflects both their underlying value and the retained profits that have not yet been distibuted. The price received, including the part of the price that reflects retained profits, is a capital receipt, not assessable for tax as income.

Because of the ease with which some income gains can be converted to capital, most tax systems are replete with rules that frustrate such endeavours with more or less success. For example, one would expect an income tax statute to contain a rule that deems premia to be income, or something to the same effect. There are also likely to be rules about dividend stripping, to frustrate shareholders who sell shares *cum div* and buy them back *ex div*. But these rules do not catch shareholders who simply sell shares to liquidate their investment, as in the example described in the previous paragraph.

The need for the capital/revenue distinction

For all the irrationality of the capital/revenue distinction, and for all the legislative rules that are enacted to maintain a barrier between the two categories, the distinction is essential to the operation of a law that taxes income that is calculated on an annual basis. To understand why this is so, return to a point made earlier in this article: that our method of measuring income, a method which requires dividing income into segments that are delimited by time, is antipathetic to the very concept of income, which is a continuous stream that has no natural or necessary relationship with the calendar.

There is no natural relationship between income and the calendar, but an income tax system cannot operate without artificially creating this relationship. The alternative is to wait for taxpayers to expire and then to measure their lifetime profits, an impractical proposition for a state that wants to collect taxes now. A periodical system is therefore a practical imperative of an income tax regime. The period chosen is always a year, though there is no *a priori* reason why that should be so.

It is the annual nature of income taxation that requires a distinction between capital and revenue. Income is in essence a net concept: taxpayers take receipts and subtract expenses to calculate assessable profits. But take, for example, a manufacturer who buys a new machine that is estimated to last 10 years. The cost of the machine is certainly a cost of doing business but equally certainly, if the manufacturer deducts the total cost in the year of purchase he will under-compute his profits for that year. Only about one tenth of the cost should be attributable to that first year of use. (One tenth is a crude estimate that is sufficient to make the point at issue here. In fact, cost of money calculations would no doubt dictate a much refined fraction in any particular case.)

Many income tax systems have regimes that would allow the manufacturer to take

account of the cost of using the machine for producing assessable income, regimes that ordinarily take the form of schedules of deductible allowances that reflect annual depreciation of machinery. Such regimes are imprecise, in that they are based on estimates and on average costs and usage in different industries, but at least they permit capital costs of long-lasting plant and machinery to be integrated into an annual income tax system.

In contexts other than businesses, capital gains and capital expenditure are more intractable. How is a tax system to deal with the purchase and sale of income-producing investments, or of dwellings and other capital items that are acquired for private use? Again, in an income tax system that dealt with taxpayers one lifetime at a time these transactions would not present problems. But an annual system that brought major investment and private transactions to account in the year they occurred would be prey to unacceptable distortions. In this context, again, a distinction between capital items and revenue items is a practical imperative. To summarise:

- Income tax systems must operate on an annual basis in order to operate at all.
- Annual calculations of a standard income tax system lead inexorably to a distinction between capital and income, even though that distinction is artificial.
- The artificial distinction between capital and income (a) provides opportunities for minimisation of tax by converting income into capital, and (b) is itself responsible for distortions in the calculation of profits.
- In response to (a), law-makers promulgate rules of increasing complexity that are designed to close off tax planning opportunities.
- In response to (b), tax systems adopt regimes that are calculated to mitigate at least some of the distortions that are caused by the income/capital distinction in the first place, depreciation regimes being the example mentioned.

When these considerations are taken into account an income tax system can be viewed as a set of rules that can never exactly come to grips with assessable income, which is the subject matter of its attentions. Perceiving a problem, legislators respond by enacting a sub-set of rules, rules that give rise to another problem, which requires a further sub-set of rules, and so on. This pattern of tax legislation is familiar enough. People often describe tax reform as a never-ending process of closing one loophole only to reveal, or even to create, another. There is some truth in this description, but it tells less than the full story. It omits to mention that even as a theoretical hypothesis it is not possible to postulate the existence of a perfect income tax system, because one of the conceptual foundations of income tax, the distinction between capital and income, is fundamentally flawed.

Essence of ectopia

Starting from its introduction, this article has attempted to show how income tax law differs from most other areas of law. Ordinarily, there is a symbiotic relationship between law and its subject matter. That relationship can never properly exist between income tax law and taxable income for reasons that have been explained.

This quality of income tax law is not a result of income tax law's concern with taxation. Most other tax laws can be, and are, as closely related to their several subject matters as are laws that deal with things other than taxation. This assertion may be tested by considering first sales taxes, operating either directly or as value added taxes, and secondly wealth taxes.

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A sales tax attaches to transactions, simply taking a fraction of transaction prices by way of tax. That is so whether the original price is quoted as including or as excluding tax. Unlike income, a transaction is something that exists as an observable fact. Accordingly, the primary task of sales tax law is well able to be specified: to define the kinds of human action that are to be considered to be transactions for the purposes of attracting tax.

Similarly, a wealth tax attaches to something that exists as a fact, either tangible property or intangible rights to property (tangible or intellectual) or rights to money. The property in question is defined independently of the wealth tax itself. Physical property defines itself. Intangible property, for example, patent rights or rights under a debenture, is defined by law or by contract. Either way, the subject matter of a wealth tax exists independently, and the rules of a wealth tax simply prescribe that a fraction of the value of the property in question must be paid by way of tax at prescribed intervals. For this reason, litigation about wealth taxes tends to be conceptually simpler than litigation about income taxes.

These examples help to explain why some parts of income tax laws operate more readily than others. Take, for example, an income tax law that taxes wages and that allows no deduction in calculating the assessable component of wages. That is, wages are taxable in gross. In this event, the subject matter of the income tax law, gross wages, is identical to the same observable fact, again, gross wages. Accordingly, there is neither conceptual nor practical difficulty in assessing and collecting the tax, especially if it is exacted at source, collected from the employer. The contrast with a tax on business profits is extreme. For tax purposes, business profits must be defined by tax law itself, and, for the sorts of reasons that have been discussed in this article, tax law must establish rules and categories that exist only for its own purposes.

Consequences of ectopia

The ectopia of income tax law is all pervasive. It is the cause of most, if not all, of the characteristics of income tax law that are generally considered to be unsatisfactory. The author has considered some of these characteristics and their links with ectopia in other articles. An example is the excessive *formalism* of tax law: because income tax legislation cannot come directly to grips with income, it is typically the most formalistic of laws and, although it is above all an economic law, income tax cases frequently turn on form rather than on economic substance.[8] For similar reasons, income tax law is more often than most laws not readily *comprehensible*. It is often misleading to look for the substance or policy of an income tax rule in order to work out its meaning because the substance or policy may be separated from the rule by arbitrary demands of practicality.[9]

A third example comes about because of general anti-avoidance rules. Ectopia itself, the rigid formalism of income tax law that ectopia dictates, and the lacunae and avoidance possibilities that are one result, present difficulties for any tax system. One response, from both parliaments and courts, is to invent over-arching substance-over-form rules. At the cost of some *erosion of the rule of law*, such anti-avoidance rules may frustrate taxpayers' ability to exploit formalistic rules so as to avoid paying tax on economic gains.[10]

[8] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules", *supra* n. 4, pp. 380–383.
[9] John Prebble, "Why is Tax Law Incomprehensible?" *supra* n. 4, especially at 385–388.
[10] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules", *supra* n. 4, pp. 370–373.

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Ectopia and trans-national aspects of income tax law

Formalism, incomprehensibility, and erosion of the rule of law may manifest themselves in many aspects of an income tax system, both domestic and international, but ectopia has special and marked effects on tax law as it applies to international trade and investment. That is not surprising, considering that space, or geography, is one of the two major factors that lead to the ectopia of income tax law. The remainder of this article examines several features of international taxation that are sometimes or always brought about by ectopia.

Double taxation

The most pervasive tax-related problem of international trade and investment is double taxation, to the extent that the incidence of double taxation and measures to relieve it constitute the largest part of many university courses in international taxation. "Double taxation" is the term used when a single item or stream of income is taxed twice, once in each of two countries. The taxpayer may suffer because it is not fundamental to the computation of assessable income to make allowance for income tax that income has borne in another jurisdiction, subject to what is said in the next section of this article. In this respect, income tax may be contrasted with other taxes. For instance, most tax systems allow taxpayers who are computing their profits to deduct the expense of property taxes or sales taxes, along with other expenses of running a business, as part of the cost of deriving income.

The reason for the disallowance of a deduction for income tax is that income tax is held to be incurred after income has been derived: it is not a cost of earning income.[11]

The most common case of double taxation occurs where income with a source in one jurisdiction is derived by a taxpayer who is resident in another, and both jurisdictions assess the income. This example of double taxation is not in fact caused by ectopia. Rather, it is a result of jurisdictions using more than one connecting factor (here, both source and residence) to determine liability for tax. However, where double taxation comes about because two states both treat the taxpayer as resident for fiscal purposes, or where two states both say that certain income has a source within their respective jurisdictions, ectopia is at work.

As explained earlier in this article, there is a lack of logic in ascribing a geographical source to income at all. It is not surprising, therefore, that states' source rules sometimes overlap, and deem income to arise in more than one jurisdiction. There is a similar lack of logic in ascribing a geographical residence to a company, which in turn may lead to companies having more than one residence. The position is not so conceptually problematic in the case of individuals, who, logically, *can* have a geographical residence and, indeed, can have more than one.

Alleviation of double taxation

Double taxation is so clear a problem for international trade and investment that states commonly enact unilateral measures to relieve it. By statute, states may exempt all or certain kinds of foreign-source income from tax, or jurisdictions of residence may allow a

[11] *Ashton Gas Co. v. Attorney-General* [1906] A.C. 10, H.L.; *Inland Revenue Commissioners v. Dowdall O'Mahoney & Co. Ltd* [1952] A.C. 401; 33 T.C. 259, H.L.

credit for tax exacted at source, to be subtracted from tax payable in the jurisdiction of residence. Such unilateral measures are very helpful to international business, but they may not exist in a particular state, or, even if they do exist, they are seldom a complete solution.

One problem is that unilateral measures usually give credit only for tax deducted at source, with "source" defined according to the law of the jurisdiction of residence. Tax levied by a state that has a wider definition of "source" than the taxpayer's state of residence may remain unrelieved, because the state of residence does not recognise the income as having a source in the country that has taxed it. That will be especially likely to be so when the state of residence claims also that it is the state of source.

For these reasons, among others, it has become customary, particularly since about 1950, for states to conclude treaties for the relief of double taxation, usually on a bilateral basis, but occasionally multilaterally. Ordinarily, such treaties contain tie-breaker provisions that come into play when taxpayers are held to be resident in the jurisdictions of both treaty partners, or when the domestic law of each jurisdiction claims its state as the source of certain income.

Most of the world's double tax treaties follow models promulgated by the Organisation of Economic Co-operation and Development, the most recent being a loose-leaf version first published in 1992 that is subject to periodical updating.[12]

Credits for foreign tax

Whether a jurisdiction allows credits for foreign tax unilaterally or pursuant to a tax treaty there is one rule that is invariable in the author's experience: there is credit only in respect of foreign income that is the same income that is derived by the domestic taxpayer. However, such a rule can, in most circumstances, operate only imperfectly. The reason is that it is rare for any two income tax systems to treat the same economic profit in precisely the same manner. To say this another way, what one tax system means by "income" is not the same as what another tax system means by "income".

Take a relatively simple example. There are at least three ways of dealing with wages and salaries. A tax system may allow employees to deduct all income-related expenses, following a system-wide rule that applies to all kinds of income; or there may be a limited category of allowable deductions for employment-related income; or the system may allow no deductions. These three options mean that what is "income" varies according to which option jurisdictions adopt. But the author is reasonably confident that no state or treaty that provides for credit in respect of tax on foreign source employment income would deny a credit on the basis that the foreign state employs a different option from the state of residence.

This answer is practical and sensible, but where the issue relates to something other than employee deductions states' definitions of income may be so far apart that it is simply not possible to establish that what was taxed as "income" in state A is even recognised as a juridical concept by the tax laws of state B.

Credit for tax on underlying corporate profits

Dividends throw up a particular problem in the area of credits for foreign tax. Where a

[12] O.E.C.D., *Model Tax Convention on Income and Capital, Report of the Committee on Fiscal Affairs* (O.E.C.D., 1992, updated 1994, Paris).

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foreign dividend has suffered withholding tax in the state of source (ordinarily a flat rate tax imposed on the gross dividend with no allowance for deductions) the state of residence will have no difficulty in identifying the withholding tax with the dividend income that it wishes to assess. A credit for the withholding tax can be readily calculated and granted. But suppose that the state of residence also desires to allow credits for tax that was charged on the underlying corporate profits from which the dividend was paid. If the profits of the dividend-distributing company were derived from a range of sources, in a range of income years, and have borne a range of taxes, how is the crediting country to decide what foreign tax can be treated as relating to any particular dividend? There is no answer that can be wholly justified by principle or logic, which means that the rules that countries adopt to answer these questions must be arbitrary and ectopic to varying degrees.

Withholding taxes

Even the apparently conceptually simple institution of withholding taxes that countries levy at source on people who pay dividends, interest and royalties that flow out of the jurisdiction to foreign recipients illustrate the effect of ectopia, though in an unusual way. In one sense, these taxes are the least ectopic of income taxes. The reason is that flat-rate withholding taxes are levied on observable phenomena, namely payments of interest, dividends, and royalties. That is, there is no gap between the tax and the factual object that is taxed.

On the other hand, flat rate withholding taxes are a surrogate for ordinary income tax, which is a tax on net income. There are two reasons why countries employ such taxes to inflict tax on passive income that flows to non-residents. First, the recipients of the income are foreign. Therefore, to collect tax it is necessary to levy it at source, on the person who pays the tax. Secondly, because the recipient is foreign, it is not feasible to calculate the recipient's net profit from his or her gross receipts. The response by governments, to collect a flat rate of tax on gross payments, is understandable, but except in rare cases the result must be that a foreign taxpayer suffers a different rate of tax from a domestic taxpayer, sometimes more, sometimes less. Also, different foreigners suffer different rates of tax, being tax on net income, depending on the levels of expenses that they incur in order to earn the income in question.

Some of these variations are smoothed out by market forces: perhaps tax benefits are capitalised into the value of investments; perhaps foreigners increase the price that they charge for capital when investing in a jurisdiction that charges withholding taxes, thereby transferring the incidence of the tax to the domestic taxpayer (this transfer is particularly likely to happen in the case of withholding tax on interest); perhaps foreigners will organise their investments to avoid withholding taxes in one way or another. However, even when one takes factors such as these into account, the fact remains that withholding tax is a crude, pragmatic, arbitrary response to a realisation that income tax proper cannot be made to work in respect of outward flowing passive income. The public policy question becomes not, "How can the tax system be improved so that all forms of income and all taxpayers are taxed equally?" but, "How much withholding tax can the government impose without choking off inwards investment?"

Apportionment of profits

Some domestic tax laws and most double tax treaties recognise that certain business profits

may be attributable to more than one source, and provide for apportionment of such profits to the jurisdictions involved. An example is the profit on the manufacture and sale of an article that a taxpayer makes in one country and sells in another. Article 7 of the OECD model treaty, a version of which is customarily adopted in most bilateral treaties, resolves many such cases by providing that commercial and industrial profits are assessable only in the taxpayer's country of residence, unless the taxpayer carries on business in the other state through a "permanent establishment". Where there is a permanent establishment, Article 7 provides that it must be treated as if it were independent, and the taxpayer's assessable profit is split between the two jurisdictions as if the taxpayer were two persons.

A provision like Article 7 is quintessentially ectopic. That is, it requires taxpayers and tax authorities to calculate income, and therefore to assess tax, on the basis of the assumed fiction that one person is in fact two. The default rule in Article 7 (no tax without a permanent establishment) is also ectopic. Article 7, like all relevant articles in double tax treaties, assumes that business profits can sensibly be said to have a geographical source. *In fact* a manufacturing exporter derives profits that are related both to the state of manufacture and to the state of sale. But by Article 7 one of the sources is disregarded.

These are arbitrary rules that are necessary if tax systems are to operate with any sort of practical efficiency. But the income of an international business that these rules compute and tax is a measure of income that is different from the true measure of income in each of the two countries.

Transfer pricing

The problem just discussed, of apportioning business profits between two jurisdictions, is similar to the problem of dealing with transfer pricing. "Transfer pricing" refers to the practice of trading in goods or services between related persons (perhaps parent and subsidiary companies, perhaps sibling subsidiaries of the same parent company). Such business forms a large fraction of all world trade, as multinational groups export goods and services to their subsidiaries around the world.

Prices in such trade are by definition not set by parties who deal at arm's length. From the point of view of a multinational group that is wholly owned through a parent company, prices for goods that are bought and sold within the group have no economic importance. If a manufacturing company in the group charges too much to a sales subsidiary in another country the sales subsidiary's excessive expenditure and consequent loss will be balanced by the manufacturer's excessive receipts and consequent profit. From the point of view of tax, however, the situation is different. Other things being equal, it makes sense for the group to manipulate intra-group transfer prices, and thus to contrive to derive lower profits in higher-tax countries and higher profits in lower-tax countries.

Many jurisdictions legislate to try to frustrate such profit shifting, but the resulting rules are always difficult to apply and usually conceptually questionable. The most common approach is to deem goods and services that are transferred between related parties to have been sold at an arm's length price. That is, the solution is similar to certain apportionment of business profits rules that apply in the absence of a double tax agreement.

The problem of the arm's length rule is that it is fictional in several respects. First, the contracts that it attacks are not in fact arm's length contracts. Among other things, they

may contain enforceable and unenforceable terms that would not be found in an arm's length contract. Secondly, anti-transfer pricing rules take an entity that is essentially monolithic from the point of view of economics, and purport to divide it into separate, purportedly independent units. Thirdly, a rule that says that deemed intra-group prices should be calculated on an arm's length basis assumes that evidence of comparable uncontrolled prices exists. That is often not so, especially where the multinational group in question produces and sells a product for which there is no comparable counterpart.

For reasons such as these, transfer pricing regimes often have alternative tests, such as reference to the standard rate of profit in the industry in question. But whatever test is employed, the fact remains that it entails attributing profits to a company that are different from the profits that the company makes as a matter of non-tax law, and that are different from economic profits.

Economic double taxation

A by-product of the application of transfer pricing rules may be economic double taxation, which is to be distinguished from juridical double taxation. The latter, which has already been discussed, occurs when two jurisdictions expressly tax the same income.

Economic double taxation occurs in situations such as these: a parent company in country A sells widgets to a subsidiary in country B, at a price high enough to prevent the subsidiary from making a profit on the resale of the widgets. The tax authorities in country B recalculate the subsidiary's profits on the basis that the purchases were made at a cheaper, arm's length, price, and charge income tax on the result of this computation. Meantime, however, the authorities in country A have already taxed the parent company on the basis of the actual prices that the parent charged to its subsidiary. The group winds up paying tax twice on the same economic profit. However, there is no scope for mitigation of double taxation because, juridically, what is taxed is the separate incomes of the parent and the subsidiary. Only a few, relatively modern, double tax agreements provide for relief in these circumstances.

Controlled foreign companies

Income tax systems tend to have a love-hate relationship with companies. On the one hand, they generally recognise companies as taxable entities. On the other hand, they often provide for the corporate veil to be disregarded, in order to tax the economic reality that lies behind. One of the more dramatic examples of this kind of legislation is found in controlled foreign company regimes.

At the cost of some generalisation, controlled foreign company regimes may be described as sets of rules that are designed to frustrate people who try to divert part of their income to tax havens. There are many ways in which taxpayers may use controlled foreign companies. One example will suffice: reinvoicing by an importer. Suppose an importer establishes a wholly-owned subsidiary in a tax haven. Instead of buying from its foreign suppliers in the ordinary way, the importer causes the tax haven subsidiary to buy, and then to re-sell, to the importer. The subsidiary makes a profit on the transaction, perhaps large enough to eliminate the importer's profit in its own country, which is the object of the exercise.

Faced with this kind of international tax planning, controlled foreign company rules

take the profit of the foreign subsidiary and attribute it to the importer as if the profit were the importer's own income. Described simply like this, controlled foreign company rules may be seen as being calculated to reduce the ectopia of a taxation system. Without the rules, profit that belongs economically to the importer escapes the tax net. With the rules, the profit is caught and assessed to the taxpayer (the importer) who derives the economic benefit, albeit that the benefit is squirrelled away in a tax haven.

In complex cases analysis is more difficult. What does one do about foreign companies where the ownership changes during a tax year? Should controlled foreign company regimes apply to artificial, tax avoidance arrangements only, or should they apply in respect of all foreign companies that are owned by domestic taxpayers? Should they apply to tax haven companies only, or to companies resident in any foreign jurisdiction? These are only a sample of the questions that law-makers must answer before enacting a controlled foreign company regime and, at the margin, many of the answers must be formalistic and arbitrary, leaving an element of ectopia between the rules and the facts to which the rules relate.

Conclusion

The use of the concept of net income as a base for taxation is flawed. The flaws are much less obvious in some areas than in others. For example, in the context of a regime that collects tax on wages on a pay-as-you-earn basis there is very little gap between the law and the facts to which the law applies. For the wage worker who does not incur expenses in earning her income the wages that she receives are the same as the income on which she is taxed. The taxation occurs by withholding of tax from wages that she earns at the moment at which the employer pays the wages. Consequently, in respect of both computation and collection the tax regime is closely integrated with the observable, physical fact of the payment of wages.

The position is very different in respect of business profits, which are not physical facts that can be observed and reflected in a tax system in the same way that a payment of wages can be observed and reflected. This article uses the label "ectopia" to refer to the displacement between income tax law and the facts to which income tax law applies. As has been observed, ectopia varies in degree between one aspect of an income tax system and another.

The theme of this article is that where there is tax on income that arises from international transactions or investments the ectopia between the law and the subject matter of the tax system is apt to be very pronounced. A consequence of this pronounced ectopia is that it is probably impossible to construct an income tax system that is all at once principled, administratively efficient, comprehensible, and inexpensive to comply with. As a result, the income tax system is apt to distort the economic results of investment and trading decisions and may even distort judgment as to whether and how those decisions are made.

In modern times, and particularly since the mid-1980s, legislators have become increasingly aware of the desirability of neutrality in tax systems. This awareness has been reflected in at least some jurisdictions by such major measures as the repeal of fiscal preferences for one industry over another and by efforts to ensure that the form of a business does not dictate its tax status.

People have made similar efforts in the international area. For example, for domestic

taxpayers, controlled foreign company regimes may at least partly neutralise differences between investing at home and investing abroad; and for foreign-based taxpayers, transfer pricing rules help to neutralise tax planning advantages that they might enjoy over domestic enterprises. But there is no thoroughgoing solution. Income tax law must depend on concepts of time and place that are conceptually flawed in their application. The result is rules that mete out different treatment to taxpayers whose economic position is similar. Such discrepant treatment is particularly apt to occur if there is an international element involved.

It is hard, perhaps impossible, to measure the effects of states' income tax policies on international trade and investment. On the one hand, most large companies say their investment decisions are driven by commercial, not tax reasons.[13] On the other hand, one comes across cases where whole industries have shut down or begun as a result of tax changes. All that can be said for certain is that as long as governments continue to use income taxation as their major tool for raising revenue there will be distortions to international trade and investment and consequent efficiency costs.

[13] See, *e.g.*, John Prebble, "Costs of Compliance with the New Zealand Controlled Foreign Company Regime", in C. Sandford (ed.), *Tax Compliance Costs: Measurement and Policy* (Fiscal Publications in association with the Institute for Fiscal Studies, 1995, Bath and London) p. 321 at p. 340.

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REGENT OIL CO. LTD. APPELLANT H. L. (E) *

1965
June 15, 16, 17, 21, 22 23; *July* 27

AND

B STRICK (INSPECTOR OF TAXES) RESPONDENT

SAME APPELLANT

AND

INLAND REVENUE COMMISSIONERS RESPONDENTS

C

[CONSOLIDATED APPEALS]

[APPEAL FROM STRICK (INSPECTOR OF TAXES) *v.* REGENT OIL CO. LTD.]

Revenue—Income tax—Capital or revenue expenditure—Trading profits of oil company—Payments to secure exclusive sales stations
D *—Whether premiums for head leases deductible—Restrictive covenants by proprietors as sublessees—Payments for permanent assets—Income Tax Act*, 1952 (15 & 16 *Geo.* 6 & 1 *Eliz.* 2, *c.* 10), *s.* 137 (*f*).

A company made arrangements with a number of petrol retailers to secure exclusive sales of its products at their service stations. Under each arrangement the retailer leased his premises
E to the company for a term of years at a nominal rent in return for a lump sum, which was called a premium but was calculated on the basis of the estimated gallonage of petrol to be supplied to the retailer during the term of the lease. Simultaneously the company sublet the premises back to the retailer at a nominal rent for the same term less three days. The retailer covenanted, inter alia, to use the premises as a garage and petrol filling station, to
F take all his oil supplies from the company and not to assign except in favour of an assignee who undertook to enter into similar covenants. There was provision for forfeiture on breach of covenant by the retailer if he fell into financial difficulties. In each case the lease, sublease and supplemental documents, if any, formed a single transaction. The company paid a premium of £5,000 in one case in 1956, and in 1959 the premiums amounted
G in aggregate to £195,699.

For the assessment years 1957–58 and 1960–61 assessments under Case I of Schedule D of the Income Tax Act, 1952, were made on the company in the sums of £1,600 and £500,000, respectively, on the ground that the payments were premiums for leases by payment of which the company acquired an interest in land;

* *Present*: LORD REID, LORD MORRIS OF BORTH-Y-GEST, LORD PEARCE, LORD UPJOHN AND LORD WILBERFORCE.

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that as the company was a dealer in oil and not in land the payments were not of a revenue character, and, therefore, were not properly deductible in computing its profits for income tax purposes. There were also assessments on the company for profits tax on similar grounds. On appeal:— A

Held, dismissing the appeals, that the premiums or lump sums paid by the company in order to acquire the leases were lump sum payments for the acquisition of assets for the purpose of carrying on a trade thereon and were therefore capital payments. B

Dicta of Viscount Cave L.C. in *British Insulated and Helsby Cables* v. *Atherton* [1926] A.C. 205, 213; 42 T.L.R. 187; 10 T.C. 155, H.L. and Viscount Radcliffe in *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines Ltd.* [1964] A.C. 948, 959, 960; [1964] 2 W.L.R. 339; [1964] 1 All E.R. 208, P.C. considered.

Bolam v. *Regent Oil Co. Ltd.* (1956) 37 T.C. 56 distinguished. C

Per Lord Reid. Premiums for leases have always been regarded as capital, but we were not referred to any case where a premium had been paid for a very short lease—say two or three years, and I do not wish to decide whether in such a case a premium would necessarily be treated as a capital outlay. But I am satisfied that the weight of this factor in the present cases is sufficient to turn the scale if otherwise there were doubt (post, pp. 325F—326A). D

Per Lord Wilberforce. I prefer to treat a payment as made, not for a lease from five years to 21 years, i.e., for a legal estate in land, but as made for the granting of a lease which was (as part of the single bargain) to be subject to a sublease containing an exclusivity covenant by the sublessee with provisions making that covenant effective. So regarded, the payment was for a solid recognisable asset, evidently (to my mind) of a capital nature. It can be fairly described as a piece of fixed capital which is to be used in order to dispose of circulating capital (post, p. 350C–E). E

Decision of the Court of Appeal [1964] 1 W.L.R. 1166; [1964] 3 All E.R. 23, C.A. affirmed.

July 27, 1965. LORD REID. My Lords, two consolidated appeals are before your Lordships. It is admitted by all parties

[51] [1933] A.C. 368.
[52] 38 T.C. 216.
[53] 37 T.C. 56.
[54] 37 T.C. 56.
[55] 1926 S.C. 20.

A that any decision in the first must necessarily govern the second, so I do not propose to say anything about the second appeal. The first arises out of assessments to income tax for the years 1957–58 and 1960–61. The appellants import and refine oil and sell petrol and other oil products to garages and service stations for resale to motorists. During those years they made arrangements of various B kinds with those retailers under which they paid substantial lump sums to them. This case is only concerned with one such arrangement in the former year under which £5,000 was paid and with three in the latter year under which a total of £195,699 was paid. The question to be decided is whether these payments can be taken into account so as to diminish the appellants' profits for income C tax purposes. The special commissioners held that they could, but their decision was reversed by Pennycuick J. and the Court of Appeal dismissed the appellants' appeal.

It is necessary not only to consider the circumstances in which these payments were made but also to have regard to the manner in which the appellants had been and were conducting their D business. It appears that for some time past almost the whole of the petrol sold in this country has been the product of three oil companies, and the appellants' share of the market has generally been in the neighbourhood of 13 or 14 per cent. During the last war petrol was not sold under brand names but after 1945 the three companies began to prepare for resumption of selling under the E well-known brand names. It had been the custom for most garages to have pumps from which they supplied the petrol of more than one of these companies. But in 1950 one of the other companies started what has been called the exclusivity war. The appellants did not want to join in it, but they were forced to because within a few months a large proportion of garages had accepted a tie of F some kind.

There was intense competition between the oil companies, each trying to induce each garage or service station to sell its own products exclusively. At first they were able to obtain such ties at comparatively small cost. But soon garage owners found themG selves in a strong position so that they were able as time went on to obtain better and better terms for accepting ties. At first the appellants were able to obtain agreements of that character by offering a rebate of as little as ¼d. per gallon or offering to make small payments towards improvements of the service station, and the ties were then generally for a year or less. But soon garage owners were able to insist on lump sum payments in advance for

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longer ties—if one company would not pay another would. The appellants attach importance to the fact that they always calculated the lump sum which they were prepared to offer by estimating the gallonage likely to be sold during the period of the tie and multiplying by their current rate of rebate. But that rate continued to increase and had soon passed 1d. per gallon. The earlier history is set out in the case stated in *Bolam* v. *Regent Oil Co. Ltd.*,[1] and by agreement the relevant parts of that stated case are incorporated in the case stated in the present case. By the time that *Bolam's* case [1] was raised the ties then current varied in duration from a few months to five or six years.

Having succeeded in obtaining rather large lump sums for granting ties, garage owners naturally wished to ensure if they could that the lump sums were received by them as capital receipts so as not to attract income tax, and someone appears to have devised the form of tie which appears in the four instances in the present case. The appellants were unwilling to adopt it, but they had to yield because otherwise they would have lost these outlets for the sale of their petrol: some other oil company would have accepted the garage owners' demands, or at least so they feared.

The essence of this new form of tie is that the garage owner grants to the oil company a lease of his premises (or at least of that part containing the petrol pumps and storage tanks) for the agreed period of the tie. The consideration for this lease is the agreed lump sum payment plus a nominal rent of £1 per annum. On the same day the oil company then grants to the garage owner a sublease of the same premises for the period less three days, the consideration for the sublease being the same nominal rent of £1. But the sublease contains covenants or conditions whereby the garage owner is bound to buy the petrol which he needs for resale from that oil company and from no one else. The net result is that no money passes except the agreed lump sum and the oil company gets its tie. But this machinery is not a sham. There is no difference from the old form of a tie by agreement so long as all goes well: but if the garage owner defaults this new form of tie gives the oil company a better way of enforcing its rights by bringing the sublease to an end and standing on its rights under the lease. I should add that in two of these four cases the lump sums are expressly stated to be premiums while in the other two they are not, but I do not think that this makes any difference.

Whether a particular outlay by a trader can be set against

[1] (1956) 37 T.C. 56.

A income or must be regarded as a capital outlay has proved to be a difficult question. It may be possible to reconcile all the decisions but it is certainly not possible to reconcile all the reasons given for them. I think that much of the difficulty has arisen from taking too literally general statements made in earlier cases and seeking to apply them to a different kind of case which their authors almost B certainly did not have in mind—in seeking to treat expressions of judicial opinion as if they were words in an Act of Parliament. And a further source of difficulty has been a tendency in some cases to treat some one criterion as paramount and to press it to its logical conclusion without proper regard to other factors in the case. The true view appears to me to be that stated by Lord C Macmillan in *Van den Berghs Ltd.* v. *Clark* [2]:

> " While each case is found to turn upon its own facts, and no infallible criterion emerges, nevertheless the decisions are useful as illustrations and as affording indications of the kind of considerations which may relevantly be borne in mind in approaching the problem."

D One must, I think, always keep in mind the essential nature of the question. The Income Tax Act requires the balance of profits and gains to be found. So a profit and loss account must be prepared setting on one side income receipts and on the other expenses properly chargeable against them. In so far as the Act prohibits a particular kind of deduction it must receive effect. E But beyond that no one has to my knowledge questioned the opinion of Lord President Clyde in *Whimster & Co.* v. *Inland Revenue Commissioners*,[3] where, after stating that profit is the difference between receipts and expenditure, he said [4]:

> " the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently F with the ordinary principles of commercial accounting so far as applicable . . ."

So it is not surprising that no one test or principle or rule of thumb is paramount. The question is ultimately a question of law for the court, but it is a question which must be answered in light of all the circumstances which it is reasonable to take into account, G and the weight which must be given to a particular circumstance in a particular case must depend rather on common sense than on strict application of any single legal principle.

The purpose of any commercial account must be to give as fair and accurate a picture as possible of the trader's financial position.

[2] [1935] A.C. 431, 438, 439; 51 T.L.R. 393; 19 T.C. 390, H.L.

[3] 1926 S.C. 20; 12 T.C. 813.

[4] 1926 S.C. 20, 25.

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But the provisions of the Act as they have been interpreted make that difficult where a wasting asset has been acquired. As explained in *Kauri Timber Co. Ltd.* v. *Commissioner of Taxes*,[5] it had long been settled that if capital has been expended in acquiring or producing a wasting asset, it is not permissible to bring into the profit and loss account for tax purposes a part of that capital corresponding to the wasting or depreciation of the asset during the year; no part of the expenditure can be set against income in any year. These old cases were dealing with expenditure made to acquire or improve tangible assets and as regards a great many of them, such as machinery, plant, buildings and mines, the severity of this rule has been relaxed by statutory provision for annual and other allowances. But the rule still stands as regards matters not particularly dealt with by the Act.

If a trader acquires a rapidly wasting asset not covered by these statutory provisions he would not generally strike his balance of profits and gains without taking account of the annual wasting or diminution of value of that asset. But if his expenditure in acquiring it has to be regarded as capital expenditure he cannot do that for income tax purposes.

When one is dealing with tangible assets it is generally not very difficult to reach a decision. Things which the trader uses in his business to produce what he has to sell are part of his fixed capital and their cost is a capital outlay although their useful life may be short, as in *Hinton (Inspector of Taxes)* v. *Maden and Ireland Ltd.*[6] Things which he turns over in the course of his trade are circulating capital and their cost is a revenue expense. The things in respect of which the Act permits allowances are fixed capital. Difficulties can arise when a capital asset is improved, e.g., in distinguishing between repairs which are a revenue expense and renovation which is not, but I do not think that much assistance can be got in this case from cases dealing with tangible assets and I need only mention two. In *Vallambrosa Rubber Co. Ltd.* v. *Farmer*[7] the expense of maintaining a rubber plantation was allowed as a revenue expense although the trees would yield no rubber for some years to come. Lord Dunedin said[8]:

> "In a rough way I think it is not a bad criterion of what is capital expenditure—as against what is income expenditure—to say that capital expenditure is a thing that is going to be

[5] [1913] A.C. 771; 29 T.L.R. 671, P.C.

[6] [1959] 1 W.L.R. 875; [1959] 3 All E.R. 356, H.L.

[7] 1910 S.C. 519; 5 T.C. 529.

[8] 1910 S.C. 519, 525.

A spent once and for all, and income expenditure is a thing that is going to recur every year."

And in *Ounsworth* v. *Vickers Ltd.*[9] Rowlatt J. held that the expense of making what was in effect a new means of access was capital expenditure. With regard to the passage in Lord Dunedin's opinion which I have just quoted, he said[10]:

B "I take it, and indeed both sides agree, that no stress is there laid upon the words 'every year': the real test is between expenditure which is made to meet a continuous demand as opposed to an expenditure which is made once for all."

When one comes to intangible assets there is much more difficulty. To help the conduct of his business a trader obtains a right C to do something on someone else's property or an obligation by someone to do or refrain from doing something or makes a contract which affects the way in which he conducts his business. And the right or obligation or the effect of the contract may endure for a short or a long period of years. The question then arises whether D the sum which he has paid for that advantage is a capital or revenue expense. As long ago as 1914 it was settled in *Usher's Wiltshire Brewery Ltd.* v. *Bruce*[11] that in determining profit a deduction

E "is to be made or not to be made according as it is or is not, on the facts of the case, a proper debit item to be charged against incomings of the trade when computing the balance of profits of it" (*per* Lord Sumner[12]).

Where the wasting asset is a right to some benefit for a period of years and the consideration given for it is the payment of an annual sum during the continuance of the right there is generally no difficulty. Rent payable under a lease or under an agreement F for the hire of a machine is treated as a proper debit against incomings and the same must, I think, apply to an annual (or quarterly or monthly) payment for a tie. The difficulty begins to arise when a lump sum is paid to cover several years. If that is so, then it is not so much the nature of the right acquired as the nature of the payment for it that matters. It was argued that a rent and a G premium paid under a lease are paid for different things—that the premium is paid for the right but that the rent is paid for the use of the subjects during the year. I must confess that I have been unable to understand that argument. Payment of a premium gives just as much right to use the subjects as payment of a rent and an

[9] [1915] 3 K.B. 267; 31 T.L.R. 530; 6 T.C. 671.
[10] [1915] 3 K.B. 267, 273.
[11] [1915] A.C. 433; 31 T.L.R. 104; 6 T.C. 399, H.L.
[12] [1915] A.C. 433, 468.

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obligation to pay rent gives just as much right to the whole term of years as payment of a premium. A lessee who only pays rent has the same right to assign the rest of the term—perhaps for a large capital sum if values have gone up—as has the lessee who has paid a premium. But his right to assign is less valuable in so far as the amount of the rent to be paid in future is greater than it would be in a case where a premium has been paid. Both lessees are liable to have their rights terminated if they do not fulfil their obligations under the lease—but not otherwise.

One reason at least for refusing to allow a lump sum payment as a debit against incomings and therefore treating it as a capital outlay is that to allow it as a debit would distort the profit and loss account. Counsel agreed that a taxpayer is always permitted to bring the whole of any item of revenue expenditure into the profit and loss account of the year in which the money was spent. Counsel for the Inland Revenue suggested that the taxpayer might be permitted to spread it over more than one year, but certainly the Revenue cannot insist on that. So, if the whole of a payment made to cover several years is brought into one year's account, the profit for that year will be unduly diminished.

But the effect of that will be rather different according to the length of time covered by the lump sum payment. Suppose that in order to achieve a continuing advantage like a tie, the taxpayer makes a series of agreements each for three years and each for a lump sum. Then if the lump sum payments are allowed as revenue expenses the effect will be that in the first year of each agreement the profit will be too small but in the next two years it will be rather too large, and so on. So over each period of three years there will be a fair result. But on the other hand suppose that the taxpayer makes an agreement for a tie for 20 years or more then the lump sum will presumably be much larger, and the distortion in the first year much greater if the payment is allowed as a revenue expense; and, even if one could assume fairly constant conditions for so long a period, it would be only after 20 years that a fair result would be reached. That would seem to justify refusing to treat a payment covering so long a period as a revenue expense. And on more general grounds I must say that I would have great difficulty in regarding a payment to cover 20 years as anything other than a capital outlay. Ever since the *Vallambrosa* case [13] in 1910 recurrence as against a payment once and for all has been accepted as one of the criteria in a question of capital or income.

[13] 1910 S.C. 519.

I would regard a payment which has to be made every three years to retain an advantage as a recurrent payment, whereas for practical purposes I would not think that the fact that another payment will have to be made after 20 years if the situation does not change in that time would prevent the first payment from being regarded as made once and for all.

If the asset which is acquired is in its intrinsic nature a capital asset, then any sum paid to acquire it must surely be capital outlay. And I do not see how it could matter that the payment was made by sums paid annually. But it appears to me that an asset which is nothing more than a right to enjoy a certain advantage over a period is intrinsically of a different character from a thing which a person buys and can immediately use or consume in any way he chooses. If it were not so I can see no reasonable ground for allowing annual payments for such a right as revenue expenses.

I must now turn to the authorities. In *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines Ltd.*[14] Viscount Radcliffe said:

> "courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income—earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve."

Perhaps it is, but the illumination is very dim, and as Lord Radcliffe goes on to say,[15] it "leads to distinctions of some subtlety between profit that is made 'out of' assets and profit that is made 'upon' assets or 'with' assets." I must say that I distrust as a guide any criterion which leads to verbal distinctions of that kind, but fortunately it is not the only guide.

The "structure" of the profit-making apparatus was dealt with in *Van den Berghs'* case,[16] but the facts there were very strong, as explained by Lord Macmillan. This company and a Dutch company had long before bound themselves to "work in friendly alliance" by an elaborate scheme and on the cancellation of their agreement Van den Berghs received a sum of £450,000. This was held to be a capital receipt because

> "the three agreements which the appellants consented to cancel were not ordinary commercial contracts made in the

[14] [1964] A.C. 948, 960; [1964] 2 W.L.R. 339; [1964] 1 All E.R. 208, P.C.

[15] [1964] A.C. 948, 960.

[16] [1935] A.C. 431.

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course of carrying on their trade; they were not contracts for the disposal of their products, or for the engagement of agents or other employees necessary for the conduct of their business nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties. On the contrary the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business." [17]

I would think that the two most important of these considerations were that the contracts were not ordinary commercial contracts made in the course of carrying on the trade, and that, by defining what the company might do and might not do, they affected the whole conduct of the business. I think that in some later cases the metaphor of structure has been used with far less justification.

Van den Berghs' case [18] can be contrasted with *Anglo-Persian Oil Co. Ltd.* v. *Dale* [19] when the company paid a large sum to cancel an agency contract for a very wide area with the result that they were thereafter able to deal directly with their customers in that area. This certainly entailed an extensive change in the organisation of their business. But the payment was held to be a revenue expense because the cancellation of the agreement " merely effected a change in its business methods and internal organisation, leaving its fixed capital untouched " (*per* Lawrence L.J.[20]).

It was argued that these ties had become part of the profit-earning structure of the company. I do not think so. Let me take the matter stage by stage—almost as it in fact arose. First an oil company promises a rebate so long as the garage orders all its petrol from that company. Clearly there is no change in structure however many garages accept that arrangement. It is just an ordinary commercial contract. And there can be no difference if the arrangement is that £100 will be paid at the end of each quarter if the garage owner has bought all his petrol during that quarter from the company. Then suppose the parties agree to such a tie being binding for one year. That does not seem to make any relevant difference. Then suppose they agree to a three-year tie. As regards the profit-earning or capital structure of the company I do not see how it can matter how the tie is paid for—whether by lump sum or by periodical payments or by rebates. Either the tie is itself an addition to the capital structure or it is not. And I

[17] Ibid. 442.
[18] [1935] A.C. 431.
[19] [1932] 1 K.B. 124; 47 T.L.R. 487; 16 T.C. 253, C.A.
[20] [1932] 1 K.B. 124, 141.

A do not see how it can matter whether the company entered into such arrangements because it had to do so to keep its customers, or because it hoped thereby to attract new customers, or merely because the ties made distribution more economical. When we reach the stage that the greater part of the company's business is done with garages under long-term ties it could be said that the B company has altered its business methods perhaps with some internal reorganisation but that is not the same thing as altering its profit-making or capital structure. Nevertheless lump sum payments for these long-term ties may have to be treated as capital and not revenue expenses.

Reverting to the distinction to which Lord Radcliffe referred [21] C between profits made out of or upon or with the asset, that distinction is to my mind meaningless when applied to these ties. It was argued that when there is a tie the profits are not made out of the tie but out of orders given by reason of the existence of the tie, that the tie is used as part of the capital structure of the company in order to get the orders. I do not think that that is right. D When A is under a contractual obligation to B to do or refrain from doing a certain thing—here to give all his orders to B and give none to anyone else—B does not "use" his right under the contract when A does or refrains from doing that thing: he simply waits for A to fulfil his obligation. He might be said to use his right if A fails to fulfil his obligation and he then sues for damages E or seeks an injunction, but that is another matter. There may be many kinds of contract under which the company has taken an obligation that the other party shall do something or a series of things in a future year but that is no reason for saying that the company's chose in action is in addition to its capital structure. The distinction between a right and something done under it or in F exercise of it no doubt exists in other kinds of case and it may be of importance, but it does not seem to me to exist in cases like the present case.

The case which is generally cited and relied on, often by both sides, is *British Insulated and Helsby Cables* v. *Atherton*.[22] In order to understand the passage in Viscount Cave L.C.'s speech, G which is always quoted, it is essential to have the facts in mind. The company laid out a sum to assist in the setting up of a pension fund for its staff. It was intended that the fund would endure for the whole life of the company and it was not expected

[21] [1964] A.C. 948, 960.

[22] [1926] A.C. 205; 42 T.L.R. 187; 10 T.C. 155, H.L.

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that the company would have to lay out any further sum for this purpose. So when Lord Cave referred [23] to expenditure

> " made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade . . . ,"

he was dealing with a case where the payment was made literally once and for all and where the asset or advantage was to last as long as the company lasted. I can find nothing in his speech to indicate that he had in mind or intended to deal with a case where the asset or advantage would only last for a short period of years after which further money would have to be spent if a further corresponding asset or advantage was sought. And when in *Vallambrosa* [24] Lord Dunedin contrasted a thing going to be spent once and for all with a thing going to recur every year, I do not think that he had such a case in mind either.

But so much has been built on Lord Cave's words that I must try to see how they could be applied to a case like the present. In the first place what is the meaning of once and for all? Suppose that an advantage has been achieved by acquiring an asset which will only last for three years so that it will be necessary at the end of that time to acquire another similar asset if the advantage is to be retained. I would not think that a lump sum paid for that asset is paid once and for all, and I see nothing to indicate that either Lord Cave or Lord Dunedin would have thought so. If once and for all is merely to be related to the fact that only one payment, a lump sum, is made for the particular short-lived asset, then the only contrast is between paying a lump sum for it and making a periodical payment for it. Surely that cannot have been all that was meant. If a further payment to retain the advantage, in this case the outlet for sale of oil resulting from the tie of a particular garage, is necessary in the near future I would hold that the first payment was not once and for all.

There is a good deal of authority on the question of what kind of asset or advantage Lord Cave's words will cover. Broadly it seems to have been accepted that they will not extend to cover a payment to get rid of a handicap or disadvantage. But I do not think it necessary to explore this matter because I am satisfied that the words must cover a tie such as we are concerned with whether it is constituted by a simple obligation or by covenants in a sub-lease.

Lastly what is meant by " enduring "? I think that Lord Cave

[23] [1926] A.C. 205, 213.

[24] 1910 S.C. 519, 525.

A intended to link that with once and for all. He was thinking of a single payment for an advantage which would last for an indefinite time. I do not think he had in mind an advantage of limited duration, and I think that any decision about such an advantage must be reached without reference to or reliance on what Lord Cave said.

B But it was argued that "enduring" has come to be interpreted so as to include any benefit which lasts for more than one year and that this was recognised in the *Nchanga* case.[25] If this is an interpretation of Lord Cave's words where "once and for all" is coupled with "enduring" then the supposed rule must be that any lump sum paid for a benefit enduring for more than one year must C be treated as a capital outlay—not that any asset conferring an enduring benefit is intrinsically a capital asset. For if it were intrinsically a capital asset then any payment for it whether by a lump sum or by a series of periodic payments must be a capital outlay, and so far as I know it has not been suggested that, say, monthly payments for any asset the benefit of which endures for D more than a year must all be treated as capital outlays. Certainly that could not be spelled out from Lord Cave's words. I have searched in vain for any rational explanation of this supposed rule, so apparently it must just be an arbitrary rule. But, as I have already explained, arbitrary rules are quite out of place in this matter of capital or income.

E One argument has been put forward to justify the rule. When a trader's accounts come to be made up at the end of his financial year and the trader is then found to own an asset other than circulating capital or stock in trade, it is said, if I understand the argument, that that asset must go into the balance sheet as a capital asset and the price paid for it must therefore have been a capital F outlay. But even if correct that argument would not support this alleged rule. Let me suppose that in the first month of his financial year the trader acquired an asset conferring a benefit lasting for 15 months and that in the last month of that year he acquired a precisely similar asset conferring a benefit lasting for six months. Then at the end of the financial year he has two similar assets, the G first of which will last for a further four months and the second of which will last for a further five months. Why should they be treated differently? But if this supposed rule exists they must be treated differently. The first being "enduring"—bringing a benefit lasting more than a year—must go in the balance-sheet; but

[25] [1964] A.C. 948.

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the second not being "enduring" need not and the price paid for it can be treated as revenue expense. A variant of this argument is that a right which comes to an end during the financial year current when it is acquired is not enduring, but that any right which persists into the next financial year must be regarded as enduring. But that would mean that a right lasting for ten months would not be enduring if it was acquired during the first month of the financial year; whereas a similar right lasting for only three months must be held to be enduring if it was acquired in the last month of the financial year. But that would be absurd. These arguments, far from justifying the rule, merely go to show how arbitrary it is. I am satisfied that no such rule exists or could be supported.

In the *Nchanga* case [25] their Lordships sought to distinguish *John Smith & Son* v. *Moore*,[26] and some of Lord Radcliffe's observations are said to support the supposed rule. I do not think they do. *Smith's* case [26] was not relied on by the respondent in this appeal but I must try to show why it does not affect this matter. A son bought the whole assets of his father's business at a valuation and continued to carry on business as a coal merchant. Those assets included contracts by which he was entitled to buy coal in future at a fixed price. As the price of coal had risen since the contracts were made the rights under the contracts had become very valuable—they were valued at £30,000. The trader claimed that this sum had been spent to acquire stock in trade but that claim failed. Lord Cave held that there was a continuing business and his reasons are not material in this connection. But Lord Haldane and Lord Sumner appear to have regarded the son as setting up a new business. Their reasoning is not always easy to follow but on that basis the essence of the matter appears to me to be this. What a person spends to set up a business must be capital; there cannot be a revenue expense until trading commences, and the son did not claim this sum as a revenue expense. But the prospective merchant buys two things, stock in trade which he intends to sell—circulating capital—and other property or assets which must be regarded as fixed capital. The sum he spends on buying stock in trade goes into his first profit and loss account as the value of stock in trade at the beginning of his first year. But the rest can only go into his balance-sheet. So the former sum is taken into account in determining his first year's

[25] [1964] A.C. 948.

[26] [1921] 2 A.C. 13; 37 T.L.R. 613; 12 T.C. 266, H.L.

A profit but the latter is not. All that the case [26] decided was that, if a new trader acquires goods which he intends to resell, those goods are stock in trade; but if he acquires rights to buy such goods those rights cannot be treated as part of the stock in trade with which he begins trading. That seems to me to be perfectly sound.

B In my view the decision in *Smith's* case [26] has no application to what a trader does once he has started trading. Suppose that a merchant, instead of buying goods direct from the manufacturer, takes from another merchant an assignment of his contract to buy such goods. The goods may be for delivery next week (or next year). It would be ridiculous to say that the sum which he pays to C the other merchant is a capital outlay and not a revenue expense, and I can find nothing in the speeches in *Smith's* case to indicate that anyone thought otherwise. Lord Sumner indeed indicated that it would be different from a going business. He said,[27] dealing with an earlier similar case:

> D "The court held that this sum was paid with the rest of the aggregate price to acquire the business and thereafter profits were made in the business; the sum was not paid as an outlay in a business already acquired, in order to carry it on and earn a profit out of this expense as an expense of carrying it on."

It must be observed that the contracts purchased by the son in *Smith's* case [28] were all very short term contracts. As Lord Finlay E said,[29] "the contracts purchased all expired by the end of the current year." So *Smith's* case [30] is no authority for drawing a distinction between assets which last less than a year or which come to an end during the current accounting period and assets which last longer. On the contrary if *Smith's* case [30] had any application to the acquisition of short lived assets by a going business it would F require us to hold that even the cost of acquiring assets which cease to exist before the end of the current year is a capital outlay.

I do not think it necessary to survey all the cases cited in argument. Many deal with matters in no respect analogous to this case. There is, for example, the group of cases where payments to obviate competition were held to be capital outlays. If you buy a G business either to operate it or to close it down, if you pay a competitor to close down, or if you buy off a potential competitor the cost may well be a capital outlay. And so may certain preliminary expenses which you must incur before you can begin

[26] [1921] 2 A.C. 13.
[27] Ibid. 39.
[28] [1921] 2 A.C. 13.
[29] Ibid. 27.
[30] [1921] 2 A.C. 13.

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trading. In these and other cases cited I can find no established doctrine contradicting the observations which I have already made. But there are some cases on which I must comment.

Both sides in this case argued that *Bolam* v. *Regent Oil Co. Ltd.*[31] was rightly decided but they drew entirely different conclusions from it. The appellants used it to support an argument that any payment for any tie, however long, is a revenue payment. The respondents argued from it that any payment for a tie in the form of rebate—even a lump sum paid in advance for a long period of years—is a revenue payment but that any other kind of lump sum payment must be a capital payment even if only paid for a tie for two or three years. I cannot agree with either argument. The respondents' argument appears to me to lead to an irrational result. It is true that form as well as substance is often important, but I cannot think that the way in which the price paid for an asset is calculated can make so much difference as their argument requires. And the appellants' argument totally ignores the practical differences between allowing as a revenue expense a lump sum to cover the next two years and a lump sum to cover the next 20.

The longest ties in *Bolam's* case[31] were for five or six years. A business cannot simply be managed on a day to day basis. There must be arrangements for future supplies and sales, and it may not be unreasonable to look five or six years ahead—one hears of five-year plans in various connections. So I would think that making arrangements for the next five or six years could generally be regarded as an ordinary incident of marketing and that the cost of making such arrangements would therefore be part of the ordinary running expenses of the business. Moreover, a payment which will have to be repeated after five years to retain the tie can, I *think*, be regarded as a recurring payment. And there is no serious distortion of the profit and loss account for that period if payment for a five-year advantage is made in a lump sum instead of being spread over the period. For these reasons I think that the decision in *Bolam's* case[31] was right.

It was argued that *Henriksen* v. *Grafton Hotels*[32] was authority for the proposition that a payment, which is made for an asset lasting three years and which will then have to be repeated to acquire a new asset for the same purpose, is not a recurring payment and must be treated as a capital outlay. But Lord Greene M.R. laid stress on the special features of that case[32] and I need

[31] (1956) 37 T.C. 56.

[32] [1942] 2 K.B. 184; 58 T.L.R. 271; [1942] 1 All E.R. 678; 24 T.C. 453, C.A.

A not consider whether they were sufficient to justify the decision. If and in so far as the ratio decidendi was based on any such general proposition I would not agree with it.

There was reference in the judgments below to *Rorke (H. J.) Ltd.* v. *Inland Revenue Commissioners* [33] and earlier similar cases. But as counsel did not found on them before your Lordships I shall B only say this. I think that the decision of my noble and learned friend Lord Upjohn in *Knight (Inspector of Taxes)* v. *Calder Grove Estates* [34] was right because there land was purchased. But there are expressions of opinion in other cases which appear to conflict to some extent with what I have already said. Again, I need not consider whether the decisions were right.

C In two of the four arrangements with which the present case is concerned (including much the largest transaction) the ties were for 21 years: in one the tie was for 10 years; and in the fourth it was for five years. I would have no doubt that the lump sums paid for the 21-year ties could not be treated as revenue outgoings even if there were no lease and sublease. These ties were not obtained D in order to facilitate planned marketing or because the appellants thought it desirable to have them. The lump sums paid for them were only paid because garage owners were in a strong bargaining position: they wanted and were able to get large sums paid immediately and they were willing to grant long ties in return.

But with regard to the other two cases I must consider what E difference it makes that the transaction took the form of a lease and sublease. This is not a mere matter of form, because this form of transaction gave to the appellants much better security for the performance by the garage owner of his obligation and it gave to them interests in land which afforded that security. So the quality of their asset is different from what it is under the older form of tie. F I have already said that all relevant factors must be considered in each particular case and I regard this as a highly relevant factor.

Premiums paid for leases have always been regarded as capital but we were not referred to any case where a premium had been paid for a very short lease—say two or three years, and I do not wish to decide whether even in such a case a premium would G necessarily be treated as a capital outlay. But I am satisfied that the weight of this factor in the present cases is sufficient to turn the scale if otherwise there were doubt, and I would therefore hold that in each of the four cases the lump sums paid by the appellants

[33] [1960] 1 W.L.R. 1132; [1960] 3 All E.R. 359; 39 T.C. 194.

[34] (1954) 35 T.C. 447.

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cannot be allowed as revenue outgoings. It follows that these appeals must be dismissed. A

5.1. Dias, RWM, "Fiction" from *Jurisprudence* (1985) 5th ed, Butterworths, London, 318 - 319.

Fiction

Maine defined this as 'any assumption which conceals or affects to conceal, the fact that a rule of law has undergone alteration, its letter remaining unchanged, its operation being modified'[17]. Fictions need to be distinguished from shifts in the meanings of words. For example, the word 'possession' was originally applied to physical control; then it came to be applied to situations where there was no physical control[18]. There was no pretence about the facts of either situation; there was simply the application of a word to a new situation. Adoption, on the other hand, is not a shift in meaning, but the name for a pretended fact, namely, that the adopted child was born into the family. A more difficult case is that of the corporate person. One application of the word 'person' is to a human being, and it was submitted in Chapter 12 that its application to a corporation is best treated as a shift in meaning. Supporters of the 'fiction theory', however, seek to explain it on the ground that a corporation is treated 'as if' it is a human being.

Are fictions something to be ashamed of? In the opinion of Bentham the answer was yes, and he repeatedly attacked them in various parts of his many writings. Vaihinger, on the other hand, contended that they are indispensable to the working of the human mind[19]. In the workings of the law there is an additional reason behind the use of fictions, namely, to introduce change behind the façade of adherence to existing law. It is thus a manifestation from early times of how the law can be adaptable and also stable. Both adaptability and stability are responses to different calls of justice. In the words of Coke *'in fictione juris semper aequitas existit'*.

Professor Fuller detected the following motivations behind the use of fictions[20].

14 See chs 5 and 17. For the Marxist 'philosophy of revolution', see ch 18.
15 Maine *Ancient Law* (ed Pollock) p 31.
16 Eg Diamond *Primitive Law* (2nd edn) p 346. Kahn-Freund 'Recent Legislation on Matrimonial Property' (1970) 33 MLR 601, 630, points out that in matrimonial property the courts appear to have moved from equity to fiction.
17 *Maine* pp 32–33.
18 See p 272 ante.
19 Vaihinger *The Philosophy of 'As If'* (trans Ogden); Fuller *Legal Fictions* ch 3.
20 *Fuller* pp 57 et seq.

POLICY. Bentham believed that judges resorted to fictions in order to conceal something from others, and pointed to the fiction that judges do not make law, but only declare what has always been law. Maine himself thought that this fiction may have had some justification in the past, but was now so threadbare that everyone could see through it[1]. The point that most fictions in fact deceive no one weakens the charge of concealment. Besides, there are other reasons of policy behind fictions, eg the rule that husband and wife are one. Even the old rule that a wife was deemed to have committed a crime under her husband's compulsion was not originally introduced in order to deceive anyone, although the absurdity of it did wring from Mr Bumble the comment 'If the law says that, the law is an ass'.

EMOTIONAL CONSERVATISM. Fuller said this is the judge's way of satisfying his own craving for certainty and stability. If there is any deceit, it is not intended to deceive anyone but himself; it is at most a process of self-deception.

CONVENIENCE. This consists of making use of existing legal institutions by pretending that certain facts exists. Ihering gave the example of the Roman *hereditatis petitio*, the action by which an heir claimed the estate. When later it became necessary to enable the purchaser of a bankrupt's estate (*bonorum emptor*) to claim the estate, the same action was made available, but with the pretence that the *bonorum emptor* was heir[2]. Adaptation of existing institutions reflects at bottom the need to preserve respect for the law; open innovations are unsettling, while novel applications of established institutions are not.

INTELLECTUAL CONSERVATISM. 'A judge', said Fuller, 'may adopt a fiction, not simply to avoid discommoding current notions, or for the purpose of concealing from himself or others the fact that he is legislating, but merely because he does not know how else to state and explain the new principle he is applying'[3].

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Ectopia, the Root Cause of the Ineliminable Fictions of Income Tax[1]

John Prebble[2]

This is a working paper, not for quotation or other publication. The author would be most grateful for responses and comments.

Contents

Ectopia

Income tax law generally taxes the results of legal transactions rather than their underlying economic effect. The courts often tell us that tax law does not tax on the basis of economic equivalence.[3] 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 becomes removed from the facts of the case.

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[1] This paper has been developed from a theme introduced in "Income Taxation: a Structure Built on Sand", the inaugural Ross Parsons Memorial Lecture, delivered by the author at Sydney University in June 2001. It repeats some material, particularly introductory passages, from that lecture.

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

I have written several articles on this phenomenon,[4] which I call "ectopia". "Ectopia" means "displacement" or "dislocation".

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. Tax law's concept of income is not the fact of income itself but a legal 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. Income tax law cannot tax economic transactions directly. Rather, it taxes the legal forms that we use to represent economic transactions.[5]

People may challenge this analysis by saying that, apart from the wholly exceptional case of honour clauses,[6] business profits are in fact always derived within legal frameworks. Business people may talk mostly about prices, goods, and services, but their transactions are in fact able to be analysed in terms of contracts, leases, trusts, companies, and so on. Moreover, that picture is not a matter of chance. Business people generally ensure that they pay attention to the legal implications of their transactions, if only in case things go wrong.

All this is true, but history demonstrates that profits are independent of the law. In Anglo-Saxon times, it was impossible

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[4] "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) BTR 380-393.

[5] 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).

[6] See, eg, *Rose & Frank Ltd v Crompton Bros* [1923] 2 KB 261, reversed [1925] AC 445.

to enforce any contracts at all, except contracts of betrothal. Even in the case of betrothal, if a man reneged on his engagement the bride's family did not turn to the courts for help. To mark the engagement, the family had confirmed the promise by taking from the groom a wed, which was a valuable object, handed over as a pledge. Grooms who failed to appear at their weddings forfeited their weds.

The position did not change much for hundreds of years. It was not until 1602 in *Slade's*[7] case that the common law began to enforce executory contracts. But throughout this entire time people continued to make business profits,[8] profits that in principle could have been subject to income tax. That is, history reveals the obvious point that profits, the subject matter of income taxation, arise from transactions, not from the law. Nevertheless, it is the legal substance of transactions that the law taxes, not the underlying economic substance. Often, perhaps even usually, these two substances coincide. Nevertheless, they are different. The legal substance of a transaction is a simulacrum of its economic substance, a likeness that often diverges from its original.

This is the first reason for the dislocation between income tax law and the economic profits that are its substance. Other reasons include the problem of place and the problem 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"[9]. 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

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[7] 4 Co Rep 91a.

[8] This paragraph slightly overstates the case, but not in a way that detracts from its basic thesis. In Anglo-Saxon times, apart from betrothals it was also possible to enforce a promise to appear at court to answer the claims of a plaintiff, achieved as with betrothals by taking security. For some periods of history people could enforce mercantile contracts in the courts of fairs and boroughs or "piepowder" courts. Many standard texts on the law of contract, such as the various editions of Cheshire & Fifoot, *Law of Contract*, begin with an historical introduction that includes references works on the history of contract in the common law.

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

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.

Problems of residence are just as bad as problems of source. That is especially true of problems of corporate residence. For tax systems to work, companies must be made to reside somewhere, but the whole concept of corporate residence is artificial. We can think of a company in a number of ways: as a pile of papers in a filing cabinet; as a collection of people who are shareholders, albeit often living in different countries; as a congeries of contracts that is reduced to a constitution or memorandum and articles; or as an inchoate legal person through which shareholders interact with third parties. But whichever way we look at it, to say that a company resides anywhere involves a metaphor.

These problems of source and residence are endemic in a world where taxing jurisdictions are defined by reference to geographical facts, that is, by reference to national borders on a map. To cope with companies one must operate as if the fiction of corporate residence were a fact. To cope with profits, one must attribute a fictional physical source to income. That is the problem of place in a nutshell.

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 that long; so, like accountants, tax authorities require businesses to divide their lives into periods delimited by dates. We 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. Another result is that, to reduce tax, people try to accelerate expenses and to defer receipts. In response, Parliament treats receipts and expenses as if they arose at times different from when they arose in law. For instance, for tax purposes, the law may spread interest paid on day one of a long-term loan over the duration of the loan. The policy of such a rule is to reflect the true economic position, but the result is that tax law treats interest as paid at times that are different from the times when it was paid in fact and in law.

These problems of timing show how tax law must distort facts and law in order to operate. 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 accelerate income 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. The 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 three criticisms or questions, which are directed to suggesting that income tax law is not so very unusual. The questions are first, are not the rules of accountancy similar in character to the rules of income taxation? Secondly, is the apparent uniqueness of income tax law not just a matter of requiring more detail, in the sense that legislators could make rules for all the different possibilities of income taxation if they wished? That is, one might argue that if there is a difference between tax law and other law it is essentially a matter of degree rather than kind. More densely woven legislation would demonstrate the point should legislators choose to go down that path. Thirdly, the law is well used to fictions. Are not the assumptions that give us our concept of income just examples of legal fictions? Dr Alex Frame suggests that the concept of ectopia appears to be essentially the same as that of the fiction understood sufficiently widely.[10] Is he correct? I shall attempt to answer these questions first generally and then individually.

Regarding the matter in general, I have made the point a number of times that 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 transactions are credit sales. Section FC 10 of the New Zealand Income Tax Act 1994 is such a provision.

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[10] Alex Frame "Fictions in the Thought of Sir John Salmond" (1990) 30 VUWLR 159, 168 n 26.

Factually, such a law does not involve pretence at all. Hire purchase transactions are indeed fundamentally credit sales. Retailers construct their sales as hire purchases not to change the basic nature of the transactions but in order to keep title to their goods against the possibility of buyer default. All section FC 10 does is to tax such transactions according to their economic effect rather than according to their legal form. Take another example. A sovereign that wants to tax the world-wide income of a resident may pass controlled foreign company legislation that says that income of a company in another country is the income of the resident.[11] To some people, such a rule is a jurisprudential anathema; to a tax economist it seems an obvious measure.

Accountancy

I turn to the three questions or criticisms. First, it is true that accountancy must grapple with exactly the same problems of timing as must income tax. Should receipts or expenses be recognised all at once, or should they be spread? Should we have a concept of capital to deal with matters of a particularly long-term nature? On the face of it, accountancy seems to respond to these sorts of questions in the same manner as tax law. For instance, like law, accountancy must divide the life of a business into artificial intervals and must force receipts and expenses into those intervals whether they fit well or not. Secondly, law and accountancy share the same basic policy: to measure profits.

Nevertheless, the response of accountancy is different from the response of income tax law. Despite its apparent formality, accountancy has an overriding requirement to reach the factual substance of things, whereas for income taxation the goal is legal substance. If generally accepted principles of accountancy lead to a picture that is incorrect in substance, then, at least in principle, accountants who are trying to calculate the profits of an enterprise either should follow different rules or should add explanatory notes to their accounts. That is, at least in principle the rules of accountancy are flexible enough to accommodate all the different varieties of business experience that accountants may be asked to record. Income tax law is different, in that it allows only one correct answer, and only one route to that answer. Further, the answer is the answer that emerges from taxing a legal simulacrum, which may not be the answer that financial economics would reach.

Let me illustrate by an example. Suppose a shipping company starts business under-capitalised. It copes with the problem by chartering its ships on balloon leases, that is, leases where the rent starts low and increases from year to year. The result will be that in year one profits will be higher than they would have been

[11] Eg Income Tax Act 1994 (NZ) s CG 1.

had the leases provided for flat rate payments. Accurate accounts for the company should note that part of the cost of the first year has been deferred to future years, and should make provision for that cost; but income tax will simply assess the apparent profit, and that will be that. My point is that at least in principle accountancy endeavours to record the true substance of business, whereas income tax assesses an apparent profit that may be some distance removed from the true profit.

This difference between tax law and accountancy is sometimes masked by apparent over-formality on the part of accountants. This over-formality occasionally emerges as an entertaining by-product of judgments in tax cases. For instance, both *FCT v Myer Emporium Ltd*[12] and *AA Finance Ltd v CIR*[13] had their origins in stratagems designed to circumvent limits on borrowing powers that earlier lenders had imposed on the companies in question. Clever accountants had devised schemes of a circumventing nature that, in each case, involved the taxpayer selling financial assets. Tax people are interested in the cases because the courts held the sales to be on revenue account, but in the present context one's interest in the schemes is different. It arises from the fact that the companies were able to persuade auditors who represented the interests of the earlier lenders that these schemes (which had no obvious substantive effect) did in fact allow the companies to circumvent borrowing limitations.

Despite the story of the *Myer* and *AA Finance* cases, to conclude that accountancy is as formalistic as tax law is to be misled. Accountancy aims to reflect substance, but sometimes allows accountants to follow rules that lead to a formalistic rather than substantive result. That is, accountancy sometimes follows *permissive* rules that permit accounts to diverge from economic truth. Tax law, on the other hand, is obliged to operate according to *mandatory* rules that sometimes require accounts to diverge from economic truth. The irony is the tax law took the accounting legerdemain in both the *Myer* and *AA Finance* cases seriously and, in each case, taxed a profit that did not exist in economic terms.

General and specific rules

Secondly, is the apparent problem of ectopia simply a result of the rules of tax law being too general? Could enacting increasingly detailed rules that would reflect all of the many facets of modern business solve the problem? The answer is no, for two reasons. First, some aspects of income tax law are truly irrational. It would not be possible to enact detailed rules that

[12] (1987)18 ATR 693 HC.
[13] (1994) 19 TRNZ 133 CA.

would be both comprehensive in coverage and consistent with one another. Take, for instance, the simple example of private investors who own portfolios of corporate shares that are pregnant with profits. If the investors sell the shares the receipt is capital; if they take the dividend the receipt is income. Modern income tax laws mitigate the irrationality with imputation systems and capital gains taxes, but they cannot dispel it.

My second response to the argument that the dislocation of income tax law could be remedied by greater detail in legislation is an analogy with science. These days, most of the great problems of science are solved, or, at least, people are well on the way to solving them. It is only a matter of time before someone reaches a unified theory for the forces of physics, and since the discovery of DNA biology has been transformed once and for all. The last great-uncharted field in science is human consciousness. We know very little about it, and there is no major breakthrough on the horizon.[14]

In my analogy, law corresponds with science in general, and income tax law with the science of human consciousness. Law in general is rooted in the objective facts to which it relates, as physics and biology are nowadays rooted in proven fact. In contrast, income tax law hovers around the facts to which it relates, as the study of consciousness hovers around the brain. The novelist, David Lodge, has described the problem of consciousness in words that fit the problem of income tax law with remarkable aptness. Lodge says that the problem of consciousness is "How to give an objective, third-person, account of a subjective, first-person, phenomenon."[15] Income tax law relates to profits that emerge from transactions conducted between two or more individuals. How can income tax law give an objective account of these transactions to the state, which as a third person is independent of the transactions, but which as a taxing power is vitally interested in them? If my analogy is good, Lodge's further elaboration of the problems of studying human consciousness offers little encouragement to people who might hope to bring income tax law closer to the reality of the tax base. Lodge explains that there are about one hundred billion neurones in the human brain, and there are more possible connections between them than there are atoms in the universe.[16] The problems of income tax law can form only a small sub-set of these many inter-neurone connections, but they are certainly a subjective sub-set, in the sense that citizens are for the most part free to organise their commercial relationships how they choose,

[14] Explanation from Lodge, David, *Thinks* ..., (2001) London, Secker & Warburg, 35.
[15] Id 42.
[16] Id 52.

and free to construct the legal record of those relationships in whatever manner they like. There is a gap between these subjective relationships and the objective appraisal of the relationships that tax law must undertake.

Fictions

I'll turn now to the third critical question, relating to legal fictions. 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.[17]

That is a fiction from Roman Law. Two fictions from the common law are the doctrines of trover and of attractive nuisance. When you sued someone for the return of your goods you pleaded that he 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.[18] The courts well knew 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

[17] 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.

[18] Blackstone III *Private Wrongs* 152.

to come in and play on those articles; so the maimed children were not trespassers, and the occupiers were liable.[19]

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 it did many years later.[20] That these things did not happen, at least when they were first needed, and that the legal systems in question remedied the injustices by fictions, were functions of conservatism and of a wish to advance law reform slowly. They were not a result of any inherent difficulty in direct reform of the laws in question.

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 vehicle to provide transport on the road to a just result, but the duplicity of a taxation fiction is part of the result itself. 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. Rules that attribute the income of foreign trustees or of foreign companies to Australian residents assume impliedly that the Australian residents in question indeed derive the income.

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*[21] on one hand and *Heavy Minerals Pty Ltd v Federal Commissioner of Taxation*[22] on the other. In both cases, the business of the taxpayer was destroyed. Both taxpayers received compensation for the loss; but Californian Oil Products' 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

[19] See *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.
[20] Occupiers' Liability Act 1957.
[21] (1934) 52 CLR 28.
[22] (1966) 115 CLR 512.

view of a tax lawyer, but a tax payer could be forgiven for finding it unpersuasive.

Californian's problem was that its American principal, Union Oil Company, decided not to sell it any more oil, terminated Californian's purchasing contract, and paid compensation. Heavy Minerals's difficulty was that the world price of rutile fell below its 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, Windyer J told Heavy Minerals that it could ignore these facts and proceed to mine rutile if it wanted to do so. There was no legal impediment.

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 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 Union Oil. 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 transactions 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.

Income tax law achieves its policy of taxing business profits by defining a surrogate of business profits in legal terms as best it can. 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.

This is not to say that law and economics never coincide. They often do. One occasion was in the *Californian Oil Products*

case. In reality, the business of the company was destroyed. The legal position exactly reflected that reality, because it was the cancellation of the contract with Union Oil that wrought the destruction. Thus, the legal position in *Californian Oil Products* was not a fiction. The problem for Heavy Minerals was that in its case factual reality and legal context parted company, leaving an ectopia between them. The point that I emphasise here is that this ectopia was not an occasional incident but an example of a fiction that is fundamental to income tax law (that is, the fiction that income tax law does in fact relate to the reality of its subject matter). This fiction is different from an ordinary legal fiction in that if we are to have a concept of income, and if we are to have a tax that operates on an annual basis, the tax must assume that the fiction is true.

If it chooses, tort law can redraft itself so as to operate without the fiction of inviting children to enter premises and play on dangerous turntables. Indeed, it did so in several Occupiers' Liability Acts in the 1950s and '60s.[23] But income tax law cannot abandon the fiction of a logical and factual boundary between capital and revenue.

History

The courts have grappled with the distinction between capital and revenue for decades, and will no doubt continue to do so. Early cases attempted to assess tax on the basis of economic fact rather than of legal fact. Viscount Haldane said in *Sun Insurance Office v Clark*:[24] "[I]t is plain that the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business". In *Riches v The Westminster Bank Ltd*,[25] Lord Wright said, "The distinction [between capital and income] depends on substance, not on mere name." In context, it is clear that his Lordship was referring to economic substance, not to legal substance.

In the same case, Lord Simmonds, said, "But the real question is still what is [a receipt's] intrinsic character, and in the consideration of this question a description due to the authority under which it is paid may well mislead".[26] That is, Lord Simmonds distinguished factual, or intrinsic, reality from legal reality in holding that the question of whether a payer is authorised to pay does not necessarily determine whether what is paid is "interest".

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[23] Eg Occupiers' Liability Act 1957 (England), Occupiers' Liability (Scotland) Act 1960, Occupiers' Liability Act 1962 (New Zealand).
[24] [1912] AC 443, 455 HL.
[25] [1947[AC 390, 403, [1947] 1 All ER 469, 474 HL.
[26] Id 406, 476.

Nowadays, this sort of reasoning is consigned to history. In *Europa Oil (NZ) Ltd v CIR*,[27] Lord Diplock explained that in this context, "reality" is "directed only to the legal character of the payment and not to its economic consequences".

Lord Diplock's words are undoubtedly good law, but they are not calculated to achieve precision in executing the policy of income taxation, to tax business profits. As has been explained, there is a gap between legal reality and economic reality. To tax legal reality rather than economic reality may perhaps be thought of as taxing by fiction, but the fiction is different in kind from what is usually meant by a legal fiction.

Theory of fictions

Lon Fuller, the great American jurist of the mid-20th century, identified several characteristics of legal fictions.[28] He said that fictions are like scaffolding. As the law develops we can abandon them without injuring the policy or vested interests that they are designed to sustain.[29] In contrast, it is my thesis that the fictions of income tax law an integral part of the law's *modus operandi*.

Tourtoulon argued that "judicial theory is all the more objective when it presents itself as fictions, and all the more delusive when it claims to do without fictions".[30] Fuller agreed. He said, "A doctrine that is plainly fictitious must seek its justification in considerations of social and economic policy; a doctrine that is nonfictitious often has a spurious self-evidence about it".[31] That insight hardly applies to the fictions of income tax. For a start, judges often deny them. I have already mentioned Isaacs J's remarks, which are an express denial that the concept of the source of income is a fiction.[32] Windeyer J's reasoning in *Heavy Minerals* is an implied denial that the company had gone out of business. In Fuller's words, the whole doctrine of the capital/revenue boundary has a spurious self-evidence about it. For instance, the identifiable asset test saved the taxpayer in *Inland Revenue Commissioners v Carron Co*,[33] where the House of Lords held that expenditure on a company's constitution, the single item that stays with it from incorporation to liquidation, was a matter of revenue. The same test sank the

[27] [1976] 1 NZLR 546, 553 PC.
[28] *Legal Fictions* (Stanford, 1967).
[29] Id 70.
[30] Cited at idem, from Tourtoulon, *Philosophy in the Development of Law* (1922) 295.
[31] *Legal Fictions* (Stanford 1967) 71. I thank Dr Alex Frame, of Wellington, for drawing this monograph to my attention.
[32] *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, 189–190.
[33] 1968 SC (HL) 47, 45 Tax Cas 18.

taxpayer in *Tucker v Granada Motorway Services Ltd,*[34] where Lord Wilberforce denied a deduction for a payment to reduce the taxpayer's rent because the payment was consideration for an alteration in a lease. These results are hardly dictated by considerations of economic and social policy, apart from the consideration that income tax law must operate somehow, and that this "somehow" necessarily entails a distinction between capital and revenue.

The German philosopher, Vaihinger, posed a similar question to those of Tourtoulon and Fuller. He asked in his book, *The Philosophy of As If*, "How does it come about that with consciously false ideas we are yet able to reach conclusions that are right?"[35] Vaihinger was referring to thinking in general rather than to law. For instance, most of the modern developments in atomic physics stem from people making calculations *as if* atoms were comprised of a number of particles with varying qualities. As it turns out, they probably are, but people did not know this at the beginning. Fuller points out that Vaihinger's question is equally applicable to legal fictions because they help the law to develop towards the truth.[36] On the other hand, as we have seen, the fundamental fictions of the concept of income are apt to lead us away from truth.

Vaihinger explained that "The greatest and most important human errors originate through thought-processes being taken for copies of reality itself".[37] If we distinguish between law and fact, law, being a collection of norms, is a "thought-process" while facts are reality. Business profits are an aspect of economic reality, but a legal simulacrum of business profits is not an exact copy of the underlying facts of those profits. Fuller expanded:[38]

> [T]hese constructs must be used as instruments of thought only; we must treat them as servants to be discharged as soon as they have fulfilled their functions. They are foreign elements which may be inserted into the equation provisionally to render the computation simpler, but which must be dropped from the final reckoning.

Income tax law's problem is that in the context of business profits it is itself a "foreign element". We cannot drop it from the reckoning once it has fulfilled its function because it is the means of fulfilment. Income tax's fictions are fictions, but not fictions as they are known in other parts of the law.

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[34] [1979] 2 All ER 801 HL.

[35] *Die Philosophie des Asl Ob* (1911), quoted in L Fuller, *Legal Fictions* (Stanford 1967) 103.

[36] Idem.

[37] Quoted by Alex Frame in "Fictions in the Thought of Sir John Salmond" (1990) 30 VUWLR 159, 167 from Hans Vaihinger *The Philosophy of As-if*, trans C.K. Ogden (London 1924) 8.

[38] Lon Fuller, *Legal Fictions* (Stanford 1967) 121, quoted by Frame, id, 166.

Analeptic fictions

It is useful to call such fundamental fictions of the concept of income "inherent fictions", in that they are inherent in that concept. Fictions about source, residence, capital, revenue, and time in general are inherent fictions. As well as inherent fictions, income tax law is replete with what may be called analeptic, or remedial fictions. Most analeptic fictions in tax law are statutory. They are legislative efforts to take charging provisions closer to the subject matter of income taxation. Examples include rules to treat hire purchase transactions as credit sales or to attribute the income of a controlled foreign company to its shareholders who are resident in the jurisdiction. The *Ralph Report's* recommendation of rollover relief for people affected by take-overs is a recommendation for an analeptic fiction. In effect, the report says that where there is a take-over there is only a legal realisation, not an economic realisation and tax should not bite at that point. That is, the report says that tax treatment should be brought more closely into line with economic reality. The fiction is that the legal realisation is ignored.

On the face of it, these analeptic fictions of income tax law look very much like some classic fictions of general law. For instance, the *fictio Lex Corneliae* told Romans to treat a living captive as a dead citizen for purposes of testamentary succession. In an apparent parallel, for purposes of taxation section FC 6 of the New Zealand Income Tax Act 1994 treats finance leases as if they were sales accompanied by loans.

On closer examination, the parallel is not exact. The Romans had an alternative to the *fictio Lex Corneliae*. They could have simply enacted that the wills of people who lost their citizenship because of captivity remained valid. But there is no obvious parallel in respect of the tax consequences of a finance lease. If the government wants to tax the lease according to economic reality it has to tax it as a sale accompanied by a loan. The Act achieves that result by preferring economic substance to legal substance. Section FC 6 takes the taxing power of the Act closer to economic reality at the cost of employing a fiction in respect of the legal relationships that are involved. In contrast, the hypothetical alternative to the *fictio Lex Corneliae* achieves a valid testament without resorting to fictions of either law or fact.

One reason for the difference is that the *fictio Lex Corneliae* was concerned with the law of succession alone, whereas section FC 6 is concerned with both tax law and the law of leases. Economic reality for tax law is not necessarily the same as legal reality for leasing law. It is a characteristic of tax law that this kind of problem is always potentially present. That is, there are always two different laws potentially applicable to any one transaction, namely the law of the transaction itself and tax law.

The comparison of inherent and analeptic fictions within tax law prompts two observations. First, I conclude that the fictions of income tax are of two kinds, inherent, which relate to fictions of fact, and analeptic, which relate to fictions of law. The first arise as a result of the need to have a concept of income. The second make tax law work better as an economic instrument, but only at the cost of distorting non-tax law.

The second observation is that it is at first sight curious that modern tax legislation uses analeptic fictions to the extent that it does, or even at all. After all, fictions are a fairly crude and old-fashioned way of reforming the law. Fictions were very numerous in Roman law because of the need to appease sensitivities of citizens who believed fundamental legal precepts were god-given. If a fiction did the job, Roman reformers thought it better to work round a fundamental precept than to attack it head on and to buy a fight. Fictions were very numerous in the common law for another reason: because of the need to circumvent the dead hand of the forms of action. But nowadays we give superstition short shrift and elevate substance above form, with the result that legislative drafting favours a plain, transparent, direct style. Fictions seem out of place. The reason that fictions remain so entrenched in tax law is the reason that I have mentioned so often, that tax law is different from other law, and tax law reform requires different tools.

Apologetic, deeming, and expository fictions

I have considered fictions inherent in tax law and analeptic fictions that are employed to improve tax law. I have tried to demonstrate that both kinds of fiction are symptoms of the underlying malaise of tax law that I have called "ectopia". Nevertheless, some people may point to certain fictions in tax law and see that they appear to function much as similar fictions function in other areas of law.

The simplest examples are apologetic fictions, that is, explanations for elements in the law that people might consider harsh. Examples include, "everyone is presumed to know the law" and "the King can do no wrong".[39] Apologetic fictions work in the same manner in tax law as anywhere else.

A second example is the deeming fiction. Drafters use deeming fictions for convenience. Suppose that there is already a set of rules that deals with the taxation of salaries, and suppose that the legislature wants employer-provided accommodation to be taxed in the same way. A drafting short cut is to deem employer-provided accommodation to be salary.[40] Deeming

[39] Id 83 – 85. "Apologetic fiction" is Fuller's label.

[40] See, eg, the definition of "monetary remuneration" in the New Zealand Income Tax Act 1994, s OB 1.

fictions are simply a drafting technique and tell us nothing about the character of the subject matter to which they are applied.

A third category is the expository fiction.[41] An expository fiction is ambitious shorthand. The best example is "company". The company is a fiction in the sense that it is not a real person, and yet it is a legal person. In another sense, "company" is shorthand for a congeries of contracts and state-created rights and duties that result from investors banding together in a manner that complies with relevant legislation. Analytically, a company comprises truth rather than fiction, in that, given time, one can trace back from the company itself through all the formalities that have endowed the company with a personality separate from the personalities of its shareholders. Nevertheless, it is sometimes more convenient to think of a company simply as a disembodied being that is fictionally, but effectively, endowed with a legal personality. However one cares to look at it, the word, "company", and other expository fictions perform the same role in income tax law as they do in the general law.

I have just described three categories of fiction: apologetic, deeming, and expository. It is convenient to call them "fictions" in ordinary discourse. But for purposes of the present argument I must distinguish them from the pure legal fictions that I have been discussing, that is, inherent and analeptic fictions; so I'll call them "quasi fictions". Strictly speaking, what I can call a pure legal fiction is a statement that is truly false, whereas these quasi fictions contain within themselves their own explanations, so they only appear to be false until one examines them closely. Quasi fictions do not illuminate the difference between income tax law and general law.

Fictions show tax law is different

In contrast, pure fictions do illustrate the difference between income tax law and other law. As I explained, where there is a true legal fiction in the general law, the law can be reformed and can operate directly, without using the fiction. As Fuller explained, legal fictions justify themselves by reference to social and economic policy. Neither explanation is true of the fictions of income tax law. Tax law can operate *only* by using fictions; and these fictions are based not in policy but in the pragmatic need to make income tax work.

Some tax fictions say something false about the underlying facts; others say something false about the legal simulacrum that lies over the facts. Fuller had some useful observations on this phenomenon, also, though he did not think of the particular case of income tax. Fuller said that:

[41] Id 53 – 55. Likewise, Fuller coined "expository fiction".

> A fiction is either (1) a statement propounded with a complete or partial consciousness of its falsity, or (2) a false statement recognised as having validity.[42] [But] ...
>
> A fiction taken seriously, that is 'believed' becomes dangerous and loses its utility. It ceases to be a fiction under either alternative of the definitions given above.[43] ...
>
> [T]he danger of a fiction varies inversely with the acuteness of [the] awareness [of its falsity]. A fiction becomes wholly safe only when it is used with complete awareness of its falsity.[44]

Fuller's words have an almost uncanny resonance when we apply them to income tax law. Windeyer J really did seem to think that it made some sort of sense to say that Heavy Minerals Pty Ltd was free to go on mining rutile even though it could not carry on that business at a profit. To take another example, for Lord Wilberforce, *Tucker v Granada Motorway Services Ltd*[45] turned on the existence of a lease that was so onerous that it could not even be shown as a balance sheet asset. As Fuller puts it, the courts "believed" the fiction, yet we would all agree that both judgments were right in law.

Lord Wilberforce put his finger on it when the said that there "may not be much commercial difference between a payment [to free a taxpayer of a long-term agency agreement, which is deductible] and a payment to get rid of an onerous lease" which is not.[46] He agreed that the test is "to some extent arbitrary" but he defended the test on the basis that it provides a means which the courts can understand for distinguishing capital and income expenditure". He thought the courts "would be wise to maintain it".[47]

If we apply Fuller's words to the present debate, the courts "believe" the fiction of a logically defensible boundary between revenue and capital. Fuller would say that the fiction is unsafe because the courts employ it with only a partial awareness of its falsity. To put words into Fuller's mouth, the fiction is therefore dangerous and has lost its utility. This conclusion that I have put into Fuller's mouth is only partially correct. It is correct that the fiction is dangerous, but it is wrong to say that it lacks utility. The fiction is dangerous in the sense that it leads to decisions that cannot be justified by reference to any criterion outside the law. The law can defend these decisions only by bootstraps, self-referential arguments. Lord Denning MR put it well in *Heather v P-E Consulting Group* when he said:[48]

> The question–revenue expenditure or capital expenditure–is a question which is being repeatedly asked by men of business, by

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[42] Id 9.
[43] Idem.
[44] Id 10.
[45] [1979] 2 All ER 801, HL.
[46] *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 HL.
[47] Idem.
[48] [1973] 1 All ER 8, 17h-18a CA.

> accountants and by lawyers. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other; but this is simply not possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night or the border between red and orange. .... In this area, at least, where no decision can be said to be right or wrong the only safe rule is to go by precedent.

This is an unpropitious verdict. It seems to vindicate the conclusion that Fuller would draw, that the capital/revenue fiction lacks utility. But that conclusion is not correct. The problem is that Fuller assumed that law by its nature has a close relationship with its subject matter. That is a reasonable assumption in general, but it is not true of large areas of income tax law. Because income tax law is based on a number of false assumptions, it can operate only by using fictions that assume that those assumptions are true. Here, oddly enough, two wrongs do make a right. This is not to say that income tax law is law of high quality as compared to law in general. It certainly is not. But if people are to tax income they must make shift with whatever law they can construct.

Let me return to where I started on the discussion of fictions. For some years, I have argued that income tax law is different from other law in that it is separated from its subject matter in a way in which other law is not. One symptom is that income tax law employs many fictions. People have responded to my thesis by saying that fictions are nothing new; law often uses fictions. My rejoinder is that the fictions of tax law are different in kind from ordinary legal fictions. They are essential to tax law in a way in which ordinary fictions are not essential to the general law. Far from showing that tax law is similar to the rest of law the fictions of tax law vindicate my argument that it is different.

Consequences of fictions: general anti-avoidance rules

In a number of articles I have tried to identify various consequences that flow from the separation between tax law and its subject matter. First, that separation helps to explain why tax law is unduly complex.[49] Secondly, it means that there is limited scope for simplifying tax laws by re-drafting them as principled codes, despite people's optimism in that direction.[50] Rowlatt J was right when he said that there is no "intendment"[51] about a

[49] "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.

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

[51] *Cape Brandy Syndicate v IRC* [1921] 1 KB 64, (1920) 12 TC 358.

tax; income tax, in particular, is structurally not capable of following a logical, thematic principle.

Thirdly, there are some areas of law where ectopia is particularly marked. Parliaments typically respond with increasingly complex analeptic fictions that are calculated to bring tax law and its subject matter closer together. Take, for example, rules about source and residence; transfer pricing; controlled foreign companies; foreign tax credits; and conduit taxation , from the international field.[52]

Fourthly, tax law is forever undergoing reform, as parliaments try to remedy the results of the fundamental defects that this paper has tried to describe. The inexorable flow of tax Bills in almost all jurisdictions is too familiar to need elaboration.

Fifthly, the ectopia of tax law leads to the enactment of open-ended general anti-avoidance rules like Part IVA of the Australian Income Tax Assessment Act 1936 and section BG 1 of the New Zealand Income Tax Act 1994.[53] Dr Frame has very perceptively explained the relationship between cause and effect in this context. He focuses on what this article has called analeptic fictions, that is, in the context of taxation, fictions that tell taxpayers that their transaction X (not taxable) will be treated as if it is transaction Y (taxable). But Dr Frame's words apply equally to the inherent fictions of tax law. He says:[54]

> I should note here two dangers of the fiction as a device for preventing the exploitation of legal forms to frustrate the intent of legal policy. First, use of the device *strengthens* the legitimacy and likely success of such exploitation in respect of those legal forms [that] are *not* specifically targeted – thus, if legal facts A, B, and C are specifically treated as if they were legal fact T (Taxable), then by implication legal fact X, which has not been designated, is not to be so treated, however artificial its existence may appear to be. Secondly, an ever-widening net of fictions may end in frustration and a despairing lunge towards legislation of the Danzig Decree type promulgated by the Nazi regime in the 1930s:
>
> "Any person who commits an act which this law deems to be punishable or which is deserving of penalty according to the fundamental conceptions of penal law and sound popular feeling, shall be punished. If there is no penal law directly covering an act, it shall be punished under the law of which the fundamental conception applies most nearly to the said act."

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[52] "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.

[53] 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.

[54] Alex Frame "Fictions in the Thought of Sir John Salmond" (1990) 30 VUWLR 159, 168.

The current version of the New Zealand anti-avoidance rule, which reads, in effect, "An arrangement that has the effect of avoiding tax is void against the Commissioner for income tax purposes",[55] is an uncanny echo of the Danzig Decree's "Any ... act which is deserving of penalty ... shall be punished".

It is for this sort of reason that 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. The concept of income is imprecise; so the rules that buttress income taxation must share that imprecision.

The gap between tax law and fact that is the subject of this article 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.

In an income tax statute, a general anti-avoidance rule may be defended *in spite of* its parallel with the Danzig Decree. There is a distinction between criminal law (the context of the Decree) and income tax law. Criminal law both can and should be drafted in direct, transparent terms, without fictions. Indeed that characteristic of drafting is a quality to be desired of all law. But income tax law is constitutionally incapable of attaining the desideratum of fictionless transparency. As this article has explained, income tax law is based on inherent fictions.

Income tax presents society with the Siberian dilemma: if you go fishing in Siberia and the ice breaks and you fall in you have twenty seconds to decide whether you want to drown or you prefer to freeze to death when you manage to climb out.[56] If society decides to have an income tax it has two choices. It can allow people to exploit the law's inherent imperfections and avoid tax; or it can minimise exploitation by the biggest tax law fiction of them all, a general anti-avoidance rule. I call such a rule the "biggest fiction" because a general anti-avoidance rule treats unspecified, non-taxable, transactions as if they were other unspecified, but taxable, transactions. Some anti-avoidance rules even give the Commissioner specific powers to reconstruct non-

[55] This formulation is a concatenation of the general anti-avoidance provision, section BG 1 of the Income Tax Act 1994, and the definition of "tax avoidance arrangement" in section OB 1 of the same Act.

[56] Analogy borrowed from Peter Munz "The Progression of Values, or Mankind's Siberian Dilemma" paper presented at the conference of the New Zealand Historical Association, Christchurch, 2 December 2001.

taxable arrangement X as if it were arrangement Y, and then to tax arrangement Y.[57]

For people brought up to respect the rule of law and to despise the rule of the Nazis the very idea of a general anti-avoidance rule is anathema. But logic leads us to accept it. Society has chosen a tax base that is inherently flawed by fictions, a base that the law cannot describe accurately. Parliament does its best to repair these defects by enacting one analeptic fiction after another, but the task is never complete. Moreover, to rephrase Dr Frame's perceptive generalisation, enacting a fiction about one transaction inferentially invites taxpayers to switch their attention to a surrogate. Parliament may be forgiven for taking the rough with the rough: an income tax law without a general anti-avoidance rule is a law that is not only crippled but that lacks crutches.

These 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. 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.

[57] Eg, Income Tax Act 1994, s GB 1 (NZ).

Fuller, Lon L, extract from "What motives give rise to the legal fiction?" from *Legal Fictions* (1967) Stanford University Press, Stanford 56 - 63.

of the persuasive fiction this linguistic change ordinarily does not take place,[15] because when it has occurred, the reason for the fiction ceases to exist.

Historical and Nonhistorical Fictions

A given fiction may or may not have had for its original purpose the introduction of a change into the law. Many of our fictions—probably most of the fictions of the English common law—had this purpose in the beginning. As to many of them, we know, or can discover, the details of their creation, what rule they were designed to escape, what specific change resulted from their application, "who devised them and how the exigencies of meeting a special case where existing legal materials were inadequate moved him to do so."[16] These are the historical fictions dealt with so penetratingly by Maine.[17]

But not all of our fictions have a historic or "creative" function. Many of them, as will be shown later, are intended merely as expositions of the law "as it is"; some few may perhaps be intended as apologies for rules of law that have existed from the beginning of our legal system.

The Motives for the Historical Fiction

We turn now to a more particular examination of the motives back of the historical fiction. Why do courts so frequently introduce new law in the guise of old? What impulses have produced this habit of mind? Speaking in general terms, one may say, of course, that the impulse is one of conservatism. But "conservatism," after all, is only a description of a tendency, not an explanation for it. What is

[15] But there are important exceptions, as in the case of "constructive possession," "constructive fraud," "implied malice," etc. See pp. 18–19, 22–23.

[16] Pound, *Interpretations of Legal History* (1923), p. 130.

[17] *Ancient Law* (1861; Beacon Press ed., 1963), ch. II.

back of this conservatism? A closer examination of the problem will reveal that a number of distinct motives may be segregated. In the discussion that follows, an attempt is made to distinguish the *conservatism of policy, emotional conservatism,* the *conservatism of convenience,* and, last, what will be called for want of a better term *intellectual conservatism.* We shall begin with the least worthy of these.

The motive of policy. There was no doubt in Bentham's mind about the purpose of the historical fiction. It was "a wilful falsehood, having for its object the stealing of legislative power, by and for hands which could not, or durst not, openly claim it, and but for the delusion thus produced could not exercise it."[18] Austin recognizes that the motive may be "a wish to conciliate (as far as possible) the friends or lovers of the law which they [the judges] really annulled. If a praetor, or other subordinate judge, had said openly and avowedly, 'I abrogate such a law,' or 'I make such a law,' he might have given offence to the lovers of things ancient, by his direct and arrogant assumption of legislative power. By covering the innovation with a decent lie, he treated the abrogated law with all seemly respect, whilst he knocked it on the head."[19] In short, a judge, fully conscious that he is changing the law, chooses, for reasons of policy, to deceive others into believing that he is merely applying existing law.

It cannot be positively affirmed that Bentham and Austin were wrong; it cannot be proved that courts may not, in some instances, have employed fictions with a deliberate intention of deceiving the public. But most of us would feel that this interpretation is somewhat uncharitable to the courts. In the first place, it is a little difficult to see how the supposed deceit could actually succeed. Bentham and Austin were not fooled

[18] *Works* (J. Bowring's ed., 1843), p. 243. Cf. "The fiction is frequently resorted to in the attempt to conceal the fact that the law is undergoing alteration at the hands of the judges." J. Smith, "Surviving Fictions," 27 *Yale L. Jour.* (1917), 147, 150.

[19] *Lectures on Jurisprudence* (5th ed., 1885), II, 610.

by it. Is it likely that anyone who knew the facts, i.e., what the preexisting law was and what the fiction accomplished, could be deluded?

It is true that the fiction may *obscure* the process of legislating. Without deceiving anyone into the belief that no change has occurred in the law, it may serve to create the impression that the change is no greater than that involved in the ordinary case where legal principles are extended by way of analogy. It may temper the boldness of the change. But inasmuch as it does this, the fiction probably has as much effect on the judge employing it as on his audience. And this brings us to a consideration of emotional conservatism.

Emotional conservatism. A judge may state new law in the guise of old, not for the purpose of deceiving others, but because this form of statement satisfies his own longing for a feeling of conservatism and certainty. As a famous judge himself has said, speaking on behalf of his profession, "We may think the law is the same if we refuse to change the formulas."[20] And presumably this feeling that the law "is the same" and that existing law determines the case at hand is a comforting one for the man whose business consists in a regular intervention in the affairs of his fellow citizens.

I call this the motive of emotional conservatism because it proceeds, not from any clearly formulated theory of the process of law making, but from an emotional and obscurely felt judgment that stability is so precious a thing that even the *form* of stability, its empty shadow, has a value.

The conservatism of policy, discussed in the last section, proceeds presumably from a conscious intent to deceive *others;* it involves an external deception. Emotional conservatism, on the other hand, involves a process of *internal* deception, of self-deception.

This is the motive commonly attributed to the courts that

[20] Cardozo, *The Paradoxes of Legal Science* (1928), p. 11.

developed the fictions of the English common law, and to the praetor in Rome. Austin recognizes it when he says that the fiction may be produced by "a respect on the part of the innovating judges for the law which they virtually changed."[21] Strangely enough, this motive is not recognized by the two most famous Romanists, Savigny and Ihering. They apparently recognize only the motive of convenience.

The motive of convenience. Ihering regarded the following brief account of the legal fiction by Savigny as "exhausting its true nature":

> When a new juridical form arises it is joined directly on to an old and existing institution and in this way the certainty and development of the old is procured for the new. This is the notion of the Fiction, which was of the greatest importance in the development of the Roman Law and which has often been laughably misunderstood by moderns . . . And because in this way legal thinking progresses from simplicity to the most variegated development, steadily and without external disturbance or interruption, the Roman jurists were able to attain, even in later times, that complete mastery of their subject which we admire in them.[22]

Ihering's own discussion of the fiction begins with a reference to the passage from Savigny quoted above and then proceeds:

> To be sure the fiction presents a certain temptation to this "laughable misunderstanding." It is one of the phenomena of legal technique by means of which it is easy to make Roman jurisprudence seem ridiculous to the uninitiated . . . How puerile it is, one may say, simply to *imagine away* a legal difficulty one cannot solve; to sweep aside the prejudicial effects of an emancipation by declaring it not to have

[21] *Lectures on Jurisprudence,* II, 609.

[22] Savigny, *Vom Beruf unserer Zeit für Gesetzgebung und Rechtswissenschaft* (2d ed., 1828), pp. 32–33.

happened; to make the daughter of the patron a son, the foreigner a citizen; and even to confer children on the chaste Diana in order to procure for her the capacity for inheritance attached to the jus liberorum. How indeed lawyers could let themselves be deceived by the whimsical device of the fiction is hard to understand, and yet literary history presents a striking example in one of the most renowned of the jurists of the last century [Heineccius].

And yet the thing is so remarkably simple! I may perhaps be allowed to use as an illustration an example from modern life. The administration of a railway or a taxing board has had schedules printed in which, through inadvertence or because the article was not at the time known, a column or heading for an article—which, let us say, in the interim has become common—is lacking. In order to avoid the necessity of reprinting the whole schedule they provide that the article shall be brought under one of the existing columns; that lignite, for example, shall be regarded as hard coal. Did the praetor do anything different when he extended actions to new situations and preserved the old formulas unchanged, simply adding the remark for the judex that he should treat the new situation as if it fell in the category of the old? It was, in fact, nothing but a peculiar form of the analogical extension of the law.

This and no other purpose has the fiction. It is intended to save the praetor the trouble of altering the formulation of the action, and legal theory the trouble of altering the concept. "Only an heir can bring the hereditatis petitio"—thus ran the provision of the old law. But later the necessity arose to grant the action to other persons; for example, to the purchaser of a bankrupt estate and to the bonorum possessor. In consequence of that it would have been necessary to change, not simply the wording of the *action* (which spoke in terms of the heres or hereditas), but also the formulation of the above *rule*. This last was not easy. It meant, in place of the current, familiar notion of the hereditas, substituting a new, more general notion, that of universal succession, which would have to be clearly conceived and formulated. Should life wait until legal theory had succeeded in this? A way was chosen which was theoretically less correct but which in practice reached the goal more

quickly; those two persons [the bonorum emptor and the bonorum possessor] are regarded as heredes. They are not heredes of course, but are feigned, i.e., treated, as such; in this particular situation they are placed on an equality with heredes. In this way the form of the existing law was saved. The praetor still issued the same formula as before, with the addition only of the remark [for the judex] mentioned above; the teacher of law expounded the same rule as before and answered the objection of the student (that these persons were after all not heredes) in the same way that the praetor answered the possible doubt of the judex—although in fact these persons were not heredes, they were with respect to the capacity for bringing an action placed on an equality with heredes; the right of action of the heres had been carried over to them.

"The testament is the last will of a Roman citizen; whoever lacks this status at the time of his death can leave no valid testament." This was the principle of the old law. As a consequence of this the testament of a citizen who died in the captivity of the enemy had no validity [since captivity involved a loss of citizenship]. The lex Cornelia abrogated this consequence insofar as it applied to a testament made before captivity. This might have been done in the way in which we would do it today; i.e., this reform might have been openly declared. It probably would have been done in that way, too, had not the Roman lawyers taken part in the deliberations and preserved the interests of their discipline by devising an expedient that preserved the external form of the above-mentioned principle—the well-known fictio legis Corneliae. The statute declared that the case should be regarded as if the testator had died at the instant he was taken prisoner, while he was still a free man and a Roman citizen.

These two illustrations will be sufficient to show the peculiar mechanism and the technical purpose of the fiction.

The purpose of the fiction consists in making lighter the difficulties connected with the assimilation and elaboration of new, more or less revolutionary, legal principles; in making it possible to leave the traditional learning in its old form, yet without hindering thereby the practical efficiency

> of the new in any way . . . It is therefore not accident, but a sound instinct, that bids Science in her infancy take up these crutches; and once again the example of the English law (which has made a most extended application of this expedient) can teach us that we are dealing here, not with a device that is peculiarly Roman, but with something that, at a certain stage of legal development, crops out of an inner compulsion. And even when Science has outgrown her swaddling clothes and centuries of mental discipline have matured in her that certainty and dexterity in abstract thought which the reorganization of the foundations of a system demands, still the fiction can have a certain justification as the first step toward the mastery of a new thought, in a situation of theoretic necessity. Better order and easy mobility with the fiction, than disorder and stagnation without it![28]

Despite the fact that Ihering begins with the assertion that the matter is extremely simple, his own point of view seems to undergo a discernible alteration in the course of his discussion. The statement toward the end of this quotation, that the fiction is often the "first step toward the mastery of a new thought," is a long way from his simile of the railway board. Certainly no railway board ever found it necessary to think of lignite as hard coal in order to conceive of its being subject to the same tariff as hard coal!

But let us, for the moment, concentrate our attention on the point of view expressed in the first parts of this discussion. Here Ihering seems to contemplate a judge or legislator who wishes to change the law and who knows exactly *why* he wishes to change it and precisely *what* reform he desires to achieve. He could, if he chose, state the new rule accurately and completely in nonfictitious language. But he chooses to employ a fiction that brings the reform within the linguistic cover of existing law. Why? Simply because this will avoid discommoding current notions. Change always carries with it

[28] Ihering, *Geist des römischen Rechts* (6th ed., 1923), III[1], 301–6.

troublesome adjustments to the new situation. Let us, therefore, restrict the reform to as narrow limits as possible; let it affect the substance but not the form of existing law. In this way existing treatises will not have to be rewritten—if one reads judiciously between the lines, everything now stated in them remains true. Lawyers will not have to change their concepts—they need only change the content of these concepts. This seems to be the point of view expressed in the first part of Ihering's discussion.

Is it really ever convenient to cover a reform with a pretense where the judge is able to state it in nonfictitious terms? Did the Roman jurists really "preserve the interests of their discipline" by making a statute (which could have provided simply that captivity did not abrogate a will) take the awkward form of stating that the testator should be deemed to have died at the moment of his captivity?[24] Is it true, as Savigny says, that the Roman lawyers were able to "attain that complete mastery of their subject which we admire in them" because the Roman law was honeycombed with fictions? With all deference to such eminent authority, it seems exceedingly questionable whether it is ever truly convenient to employ a fiction where the judge introducing the reform can state the new rule in nonfictitious terms.

But suppose the judge finds that he *cannot* state the reform in nonfictitious terms? This brings us to the other point of view expressed by Ihering when he speaks of the difficulty of "altering the concept," and particularly when, in the latter part of his discussion, he refers to the fiction as the "first step toward the mastery of a new thought."

Intellectual conservatism. A judge may adopt a fiction, not simply to avoid discommoding current notions, or for the

[24] There is some question whether the statute actually contained this fiction. Some take the view it was a later invention. See Buckland, *A Text-Book of Roman Law* (1921), p. 288.

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Legalist Fictions and the Problem of Scientific Legitimation

JIŘÍ PŘIBÁŇ

Abstract. The author analyzes fictions of legal positivist philosophy and their role in the scientific legitimation of modern law and political domination. The original function of legalist fictions was the establishment of legal science, which would be autonomous and independent of other social sciences and public morality. In the second half of the 20th century, legal positivist philosophy has nevertheless adopted the fiction of the just law as its scientific legitimation fiction and incorporated moral and political discourse into legal science, again.

Legal positivism and its critiques within the discourse of the sociology of law and critical legal science keep the image of a hierarchical and centralized legitimation of law. Paradoxically, current legal philosophy and theory searching for a universally valid legitimation scheme is full of many different legitimations and reveals their growing plurality and the impossibility of establishing one sovereign legitimation scheme in the current social, theoretical and political condition.

I. Legal Positivism and the Scientific Legitimation of Law

A system of positive law establishes itself in the process of social and systemic differentiation of modern society and legal positivism is its reflexion (Luhmann 1985). Consequently, modern positive law must look for its own sources of legitimacy and cease to understand legitimacy as a matter of political procedures superior to a legal system. Modern legal positivist science formulates *the problem of legitimacy as a matter of validity* and legitimation questions are marginalized within the legalist scholarship. A question of validity is more general than the fiction of a democratic general will of the people. The German philosopher of law, Gustav Radbruch, perceived legitimacy just from this perspective. According to him, the question of legitimacy is always a question of how law persists and remains law: "[T]he juridical doctrine of validity turns into the principle of legitimacy, the postulate that each new legal order must have evolved from its predecessor in a legal way" (Radbruch 1950,

125). The topic of legitimacy thus becomes entirely a part of legal framework. What is illegal becomes automatically illegitimate. Discontinuity and fractures between two legal orders mean an illegitimate change of law. The reason is that it is impossible to conceptualize such a change by means of a previous legal order. Revolution becomes a favourite jurisprudential example of the illegitimate change of law (Kelsen 1945, 117), in spite of the fact that it is exactly revolutions that blame old political regimes for the loss of their legitimacy.

The difference between the political and legal positivist concept of legitimacy emerges here. It is a consequence of paradigmatic changes in modern legal science. Jurisprudence limits its focus to the field of positive law and deliberately excludes all non-legal elements outside the borders of legal discourse. Legitimacy, if it is to be examined by legal science at all, must be reduced to matters of legal normativity and its own inner laws and regularities.

It is highly important to explain how modern positivist jurisprudence comes to such a scientific perspective. In order to examine law as an independent normative order of modern society, it must *create fictions* about law's nature, origin and functions. The fundamental function of these fictions is that they make it possible to speak about law as an autonomous and independent order of modern society. They make it possible to examine law independently mainly of two external spheres—morality and politics. To create such *legalist fictions* is an important task of any legal positivist theory.

If legitimacy is only a technical question of inner functions and structures of law, it is a plain fact that those fictions will play a crucial role in setting up the conditions of legitimate law. The role of jurisprudence thus grows enormously in modern society in the process of construction of a legitimate system of positive law. Jurisprudence seeks to explain why and how law functions in modern society. Analyses of a system of positive law become a way to provide it with *scientific jurisprudential legitimation*. Legal theory is to support the inner demands of law and legality for rational legitimacy (Van de Kerchove and Ost 1994, 8).

This scientific legimacy, which modern positivist legal theory claims to provide, coincides with the disappearance of traditional legitimacy and fundamental integrity of law and social morals. The legitimation strategy of modern jurisprudence coincides with the time when law begins to be structured into codifications, the number of legal regulations systematically grows and purposive rationality begins to play a more important role within the system of positive law.

Fictions of modern legal positivism are closely linked to the attempt to separate law from discourses of political and moral science. They are a consequence of a conviction that neither democracy nor any other political regime can be a sufficient reason for the validity of law. Law's legitimacy cannot be secured by political conditions.

Fictions are also a consequence of legal positivist denials of moral legitimacy of law and fundamental refusals to understand the problem of legitimacy as

a problem of moral principles and values existing in the system of modern political domination. Positivism explores the inner reasons of validity and reflects upon the fact that law is valid also in political societies, which have nothing in common for instance with liberal democratic political regimes and their moral foundations. The question of legitimacy thus forms a part of a more general question concerning the very nature of law and its functions.

II. Different Kinds of Legalist Fictions

Historically, the first fiction significantly influencing modern legalist thinking is *the fiction of social contract* in the form designed by Thomas Hobbes in his *Leviathan*. Although it is inappropriate to call Thomas Hobbes a modern legal positivist, his whole work involves an extraordinarily strong emphasis on positive law as an instrument of regulation of existing political institutions. The social contract therefore represents a fiction, which explains the origin of political community with its positive laws, but which also sets up the principles and content of its legislation. Hobbes defines these principles "naturally" in the language of natural law.

The idea of contract being the foundation of "the eternal peace" among nations and within a nation is closely tied to the concept of civil society. It played an important role in Alex Fergusson's political project. The contractualist approach pervades Immanuel Kant's political writings and had a strong impact on modern political theory. According to Kant, the ideals of republicanism, civil society and freedom form the fiction of political contract.

The contract between a government and people as a primary condition of acceptance of the political and legal order of society is deeply entrenched in modern legal theory and sociology. The founding fathers of sociology understood the contractualist concept of society as a sign of modernity and analyzed a growing importance of social relations based on contracts. The contract as a fabric of social order is examined by Karl Marx in his *Capital* (Marx 1976). George Herbert Spencer (1969) adopts Henry Maine's legal historical scheme of social progress being conceived as a transition from status to contract. According to Emile Durkheim (1964), the contract represents modern organic solidarity. Max Weber (1968) distinguishes between a purposive and status contract and understands both types as an example of the rationalization and disenchantment of modern society. According to Georg Simmel (1964), relations between the government and people have a reciprocal character and include a mutual obligation to subject their actions to the contracted rules. The concept of the rule of law itself is based on the notion that the relation between a legislator and citizens is ruled by a fictitious contract subjecting one's own behaviour to rules, which thus form political community. This contract can secure the political values of certainty and predictability.

The *fiction of a political sovereign*, elaborated by Jeremy Bentham and later John Austin and to a large extent presumed in the works of Thomas Hobbes

(Přibáň 1997), has the same paradigmatic importance for modern legal and social science as the fiction of social contract. The famous definition that "law is the command of a sovereign" immediately evokes the response that nobody has ever seen a political sovereign acting in the way designed by Bentham and Austin (Duguit 1970). However, the concept of a political sovereign is a theoretical construct and not a realistic description of a political system. It is therefore useless to criticize it for its inability to provide a "realistic picture" of modern politics and law. In spite of the proclaimed realism of analytical jurisprudence, which might be summarized in the metaphysical principle "to describe the world as it is," the concept of a sovereign is a pure fiction. This fiction is to separate law from other fields of social reality and form a kind of modern scientific research focusing exclusively on legal phenomena.

According to Bentham's and Austin's ideas, a political sovereign is to unite political community and rule independently of morals and values. The only criterion is the functioning of the political mechanism, which must also conform to the purposes of a legal system. The modern image of politics and law as a kind of machine with a complicated inner structure and architecture, but also with a clearly defined centre causing its motion, finds one of its finest expressions here.

Jeremy Bentham answers the question of who is the sovereign in a much more democratic spirit than John Austin. According to Bentham, a political sovereign is the people (Rosen 1983). It is only democratically elected assemblies which have the power to protect the government against political criminals and bandits (Hart 1983, 185). The political sovereign must have the form of a democratically elected body, which represents the will of the people in the whole political community. The political sovereign is established by democratic procedures, which also support an important function of the sovereign's power—the avoidance of anarchy and obsequious quietism. Anarchy means a danger that people will not respect laws, while quietism means a danger that people will think that they should obey laws on moral grounds (Postema 1986).

According to Jeremy Bentham, the political sovereign represents impersonal power, and law is a sovereign technique of such a performance. Unlike Bentham, John Austin did not seek to classify the political sovereign in political categories such as democracy or the people and simply assumes any sovereign power in the given territory to be the foundation of the existence of valid law. Its function is the same in all political systems. It is to unite political society into a totality of political subjects who obey the laws.

The fiction of a political sovereign is to clarify the origin and reason of the validity and binding force of positive law. It requires political subjects who are addressees of the sovereign's will. If the reason for legal validity is determined by law being the manifestation of a sovereign political will, it is unnecessary to carefully examine the conditions under which an addressee of this will accepts commands in the form of law.

The "Benthamite" version of legalism ignores a *belief* in the legitimacy of political domination and law as a central problem of the legitimation fiction of political sovereign. It is enough when subjects behave with discipline and accept law because of their *habit of obedience*. The psychologically unsatisfactory argument of the habit of obedience is, according to analytical jurisprudence, an anthropological truism making it possible to found the validity and legitimacy of every law just on the fact that law is issued by a sovereign, which can enforce obedience by the threat of violence.

The fiction of a political sovereign was subject to many criticisms. One of the most persuasive critiques can be found in the works of Hans Kelsen. Kelsen's main argument is that no law can look for the ground of its validity in the world of social and political facts, such as a political will, habit of obedience and sovereignty. Law must look for the ground of its own validity in the world of norms. The foundations of law must always be normative. In Kelsen's words, "law regulates its own creation" (Kelsen 1971, 278–9).

Hans Kelsen severely criticizes the sociological approach to law with its emphasis on the facticity of law and analysis of law as it is performed in society. According to Kelsen, there is no scientific justification for the sociological perspective worked out by Max Weber. It radically differs from the juristic perspective because it examines the condition of validity of legal norms in individual actions and analyzes the meaning of legal norms attributed to them by individuals (Kelsen 1945, 175). The sociological perspective is scientifically unacceptable because law, in Kelsen's view, must not be examined in the famous *de iure/de facto* duality. Law must be examined in its normative unity and the only scientifically justifiable analysis of law must be concentrated, therefore, on law's normativity, its *de iure* nature.

According to Kelsen's pure theory of law, law is law because it is law. The normative binding force of law cannot be derived from social facts. Law thus can never be reduced to some command of a political sovereign because such a command and expression of will does not belong to the normative world. According to Kelsen, the democratic fiction that a parliament represents the people's general will, and therefore can claim that its legislation is legitimate, is also misleading (Kelsen 1945, 292). It is not disturbing that political institutions of representative democracy claim to express the will of the people. What is disturbing for the pure theory of law is a possibility that an entirely volitive act could be the foundation of the whole body of law. The decision-making process of parliaments and any other political sovereigns are factual exercises of political power, which establish a legal normative order. In contrast to this speculation, Kelsen says that normativity is an *a priori* phenomenon, which cannot be determined by political and social facts.

But where is the normative foundation of law? Hans Kelsen comes with his famous solution—the concept of the *basic norm*. This concept sharply separates, entirely in the style of neo-Kantianism, the world of "is" (*Sein*) from the world of "ought to" (*Sollen*) and refers the validity and effectiveness

of every legal order to its normativity. Categories of validity and effectiveness, according to the paradigm of pure theory of law, have no sociological meaning and the sociology of law thus cannot resolve the problems of legal validity and efectiveness. These problems can be resolved only within the pure theory of law, which finds the very identity of a legal system in the concept of basic norm (Raz 1970, 100ff.).

The basic norm is a ground of existence of legal systems and ultimate reason of the validity of legal norms. All legal norms in positive legal systems derive their existence from it. The basic norm is the answer to the question of whether and under what conditions legal statements concerning legal norms, duties and rights are possible (Kelsen 1945, 116–7). In this sense, *the basic norm performs the role of a legitimation fiction of positive law* and represents a highly important and original construct of modern legal science. It is a unique attempt to supply positive law with scientific legitimacy.

Joseph Raz even concludes that the basic norm concept is intended to replace the concept of political sovereignty, but that, when examined against the background of the principle of law's origins and identity, there is no really important difference between these two concepts (Raz 1970, 95). Even for Kelsen, law represents a specific order and organization of power and behind all legal norms there must be an act of enforcement. This means that, together with its normative character, sanctions and rules of positive law derive their existence from an expression of will of political authority (Kelsen 1945, 45, 121, 392).

The basic norm determines the validity of positive law and enforcement, which human political authority has at its disposal for the implementation of legal norms. Behind validity, there is no morality. The basic norm cannot be measured in terms of morals. Like Austin, Kelsen says that even when legal and moral norms occasionally overlap, it is impossible to speak about some minimum content of morality in law or moral foundations of law. In those cases, morality simply becomes law because it is possible to enforce its rules by political violence (Kelsen 1945, 410).

The basic norm is not a constitution in the sense of positive law. It is a transcendental logical foundation of law and *construct of legal logics*. It is not a positive legal norm (Kelsen 1965, 1130–41). It is a theoretical fiction. Kelsen uses Vaihinger's concept of philosophy "as if" (Vaihinger 1924) and says that the basic norm as a kind of fiction helps to conceptualize the problem of foundations and origins of the validity of norms, be they legal or moral norms (Stewart 1980). The basic norm is not a hypothesis, which might be proved true. Instead, it is a fiction making it possible to establish a juridical discourse about the validity of norms and relation between a volitive act of political authority and normative expression of such an act. The relation between "ought to" (*Sollen*) and "volition" (*Wollen*) is resolved by founding the meaning of the volitive act of political authority on the concept of the basic norm.

Here, the complexity of the basic norm becomes even more complicated because Kelsen must connect his theoretical construct with volitive acts of the sovereign authority. If sanctions and enforcement are the substance of legal norms, it is necessary to analyze their binding force in relation to the will of authority standing behind such enforcement. Kelsen then retreats to the similar *fiction of a historically first lawgiver*, who had drafted a historically first constitution. It can be a political assembly, or a tyrant. This lawgiver (as it were) transforms the transcendent basic norm into the constitution, which already belongs entirely to the sphere of positive law.

However, this transformative lawgiver's fiction, translating the basic norm into legal norms of a positive legal order, has a damaging effect on the image of pure normativity which is to be the ground of validity of all norms. Due to the factual volitive act of a political sovereign, the pure normativity is somehow "polluted." Kelsen's sovereign *de iure* world becomes mixed with *de facto* elements of social and political power, in spite of the fact that those elements have a purely fictional character and must be perceived as an intellectual tool for the analysis of the nature of modern law.

Kelsen conceives legitimacy as a problem of the persistence of validity of legal norms and legal order as a whole. A change of law is legitimate if it happens according to the inner rules of a legal order. Legitimacy of a norm means that this norm is effective and valid within a framework of law. Together with the conditions of validity, the principle of legitimacy thus also contains the *principle of effectiveness* (Kelsen 1945, 117–19).

In the pure theory of law and modern legal positivism in general, *legitimacy is a matter of legality*. It is not a matter of some moral order or an act of political will. According to Kelsen, Radbruch (in his pre-war legal philosophical views) and others, legitimacy becomes a problem of succession of law's authority in situations when one legal order replaces another one, or when new legal norms replace old ones. If this change occurs according to legal rules and procedures, which are built into the old legal order, it is considered legitimate. If this change happens irrespective of those rules, it is illegal and therefore illegitimate. A revolution or coup d'état are typical examples of the illegitimate birth of a new legal order. In these historical situations, the original basic norm creating the old legal order is broken and it is necessary to create the new basic norm (Kelsen 1945, 117–18). The basic norm is absolutely essential from the perspective of law's legitimacy. The limits of legitimacy of a legal order are the limits of coherence of the basic norm.

III. Prospective Positivism and the Return of Ethics into Legal Positivist Science

The function of all these legitimation fictions in legal positivism is clear—to define law as a completely independent phenomenon existing in modern society and set up the paradigm of modern legal science, which would focus

on such law. Legitimation fictions were to separate law from morality and, in the most ambitious project of the basic norm, normativity from facticity. *Legal science was to be the sovereign source of the legitimation of law.*

In spite of all these efforts, the rigid legalist approach failed. The statement "law is law," originally intended as a liberal protection against the legal naturalist traditionalism and conservatism, became the worst nightmare and intellectual "kitsch" of the late Europe, which witnessed the horrors of Gulags and Nazi concentration and extermination camps. All fictions legitimating law in purely legalist concepts originally sought to establish a pure juridical discourse and legal theory freed from any other normative structures of modern society and external judgments about law. However, any command of the political sovereign or any behaviour pattern can consequently become contents of a legal norm. Even a crime can become and achieve the force of law, as happened in totalitarian systems. The legitimation fictions of a political sovereign and the basic norm did not satisfactorily address this problem.

Jeremy Bentham reflected upon this danger when he required the democratic foundations of politically sovereign bodies, in order to protect the government against criminals. In Bentham's work, it is possible to recognize a concern about possible consequences of the definition of law being the command of a political sovereign and the need to address the political question of the sovereign's nature (Bentham 1983). It is as if Bentham was afraid of possible consequences of his own legal theory. This concern can hardly be discerned in John Austin's concept of sovereignty. Jürgen Habermas then rightly criticizes the paradigmatic foundations of legal positivism for the restrictive view, which recognizes only legal institutions without questioning the origin of legitimacy of those institutions (Habermas 1988, 535–6).

Consequently, contemporary legal positivism has significantly changed the whole framework of the problem of validity and legitimacy of legal norms. In the legal theory of Joseph Raz, taking its inspiration from critical examinations of Hart's and Kelsen's theories, but also in the works of Ota Weinberger, Neil MacCormick and others, the reflexions of liberal democratic principles and their entrenchment in a legal system form an essential part of legal theoretical thinking. While the problem of validity remains predominantly a problem of enforcement and obedience, a broader problem of the legitimacy of law becomes a political topic for the democratic legislation and protection of human rights and freedoms. It also becomes a problem of ethics of obedience of rules, which is common to law and morality and thus extends beyond a common legalist separation of law and morals. Validity and effectiveness of legal norms are different from their legitimacy. Legitimacy is determined by what is usually marked as the principle of the rule of law. The main function of the rule of law then consists of subjecting the sovereign political power to legal procedures and limitation of that power by a complete catalogue of civil and political rights (Neumann 1986, 45).

This development of current legal positivism means that the whole paradigm retreats from its founding fictions that used to keep the whole legal theoretical discourse together. Legal positivists talk about the "soft" version of positivism instead of the "hard" version represented by Bentham's or Kelsen's theories (Campbell 1996). It is also significant that the current legal theoretical literature constantly oscillates between the problems of normative logic on the one hand and political philosophy on the other. Neil MacCormick (1989, 184), distinguishes in modern legal systems what he calls "the ethics of legalism". Tom D. Campbell (1996) similarly elaborates his own theory of "ethical positivism". By ethical positivism, he means complex ethics, which is common to both law and morality and builds on the autonomous logic of creation and observance of rules of human conduct. This logic then forms the inherent part of the life of democratic political society. The topics which cannot be grasped by the legalist approach have thus returned to legal positivism. Franz Neumann's comment that the law based state/rule of law must always recall the transcendent ideals (Neumann 1986, 256–7), achieved its concrete shape in the legal positivist science of the last two or three decades.

Taken from the perspective of the problem of the legitimacy of law, legal positivist science did not come with anything interesting or new. Instead of the original fiction of the basic norm, it is possible to see a kind of eclecticism, which is to help legal science to overcome the impossibility of legitimating law and political domination exclusively on the basis of inner principles of legality. The democratic legitimacy of law-making bodies is taken as an automatic condition of legitimation process (Raz 1979). The main problem is seemingly the legitimacy of judicial decision-making and the extent of discretion in the process of the application of law (Posner 1990; Dworkin 1986; Dyzenhaus 1991).

Contemporary legal positivism adopted the theory of judicial discretion and stands in opposition to the original positivist theories of Bentham and Austin, which assumed the subjection of judicial bodies to the sovereign parliament (Shiner 1994, 41). Legal positivists recognize the presence of extra-legal elements in positive law, mainly the influence of moral political judgements, provided that they do not infringe upon the consistency of legality.

Together with the acknowledgement of the role of moral political judgments in the process of judicial decision-making, legal positivism had to come up with new attitudes to the legal normativity itself, to its context and foundations. Neil MacCormick thus says that every positive law involves the duties of justice, which belong to the sphere of morality. Law must regulate this sphere of morality, although it must not regulate and enforce morality as such (MacCormick 1982, 35).

MacCormick's adoption of the concept of duties of justice from the moral theory of Adam Smith resembles very much what H. L. A. Hart (1994)

described as the minimum content of natural law in positive law. In this context, MacCormick (1989, 184) also speaks about the ethics of legalism and opposes it to legal moralism. He refuses to accept any sort of moral subordination of legality. At the same time, he attributes a strong ethical contribution to the legalism for its subjection of a government to the system of rules. Legalism diminishes the arbitrary use of political force and all this enhances the security of citizens and predictability of actions of government. Pragmatic technique finds its ethical meaning here.

MacCormick attributes to legalism a similar function to Hobbes and, according to him, the ethics of legality consists of its ability to protect the Leviathan from becoming an unbound and destructive Frankenstein. Legal reasoning is a specific, highly institutionalized and formalized type of moral reasoning. This, nevertheless, does not mean that law would have to establish itself against the moral background. It means that behind both types of argumentation there are normative structures of practical reason and reasoning (MacCormick 1978, 272f.).

MacCormick is well aware of all the deficits of legality and the chances of its political abuse and he still asserts: "[T]he independence or autonomy in the face of public action which bourgeois legality secures to people is a fundamental political and human good." (MacCormick 1989, 191). Such legality can exist because we believe in it and in concrete laws and are convinced about the rightness of acting in accordance with legal rules (ibid.). The legitimacy of law and all institutions of a legal system such as courts is derived from a larger political community and its definition of what is accepted as binding (MacCormick 1978, 55f.).

MacCormick takes the habit of obedience (in Bentham's or Hart's theoretical meaning) as the foundation of legitimacy and understands it entirely in the sense of political sociology as a consequence of the transformation of a political will into the general conviction about the rightness of legal norms and institutions. In MacCormick's legal theory, the Hobbesian relation between will and reason, which is typical for the whole modern legal and political science, shifts partly back to the sphere of will. MacCormick also recalls Hume's philosophy and normative scepticism, which might be illustrated by the following statement: "My belief that I ought to strive to be rational is not a belief which I can justify by reasoning" (MacCormick 1978, 268). Rational arguments are absolutely essential, but the belief in them extends the very framework of rationality. MacCormick rejects the irrationalism and voluntarism of legal realists, just as he rejects the unreasonable trust in law as a rationally organised and practised system of rules. Law is understood as a normative order performed in a constant tension between the will and belief on the one hand and rational arguments on the other.

MacCormick reads and changes Kelsen's concept of legitimacy as effectiveness in the following way: Instead of taking it as a part of the normative sphere of validity, he perceives the effectiveness as a *sphere of belief* about the

binding force of legal norms, which dominates in a political community and therefore is closer to will than to reason. The problem of legality and legitimacy returns to the world of collective political beliefs and moral judgements. It returns to exactly those spheres, which Hans Kelsen sought to exclude from legal science by his fiction of the basic norm and strong criticism of Max Weber's sociological theory.

Legal positivism thus comes with a much delayed *project of an extralegal legitimation of law and political domination*. This project is founded on the liberal theory of civil and political rights and freedoms and on the theory of the democratic rule of law. "The iron cage" of modernity, represented by the concept of legality here, caused a panic and, consequently, legal philosophers now seek to fill it with the values and norms of liberal democratic politics, morality and practical reason. Nevertheless, at the same time they pretend that the cage functions perfectly and is a kind of morality itself. People only have to trust in it and justify it by practical reasons. *The duality legitimacy/legality is thus impoverished and reduced to the duality morality/law or political principles/law*. Morality and certain political virtues such as the principles of practical reason must be introduced and incorporated into law.

The mutual relation between morality, practical reason and political virtues is often complicated and controversial. Another legal philosopher, Ronald Dworkin, also rejects a classical moralist argument that the legitimate coercive power would have to be justified by moral reasons. According to him, a state becomes legitimate when its constitutional structure and practices have such a nature that citizens have a general obligation to observe its political decisions, which formulate concrete civil duties.

Legitimacy is then acquired by practical reasons, which justify this general condition. This however does not mean that the government could demand anything from its citizens and citizens would have to observe all of its decisions irrespective of their contents. In the principle of generality, there is included the founding political ideal and virtue—the *integrity of political community*. This virtue must be followed and protected by a legal system. State and law become legitimate only when they support the political ideal of integrity (Dworkin 1986, 191ff.). Legitimacy is a particular quality of political community searching for its integrity.

In Dworkin's theory, practical reason must finally meet with a political virtue and therefore with a particular version of political morality (although rejecting the moral argument as a foundation of politics), in order to fulfil the demand of legitimacy of state and law. Law must express certain principles, which we commonly designate as the rule of law. These principles must use their own legal language and formulate the general nature of political obligations and obedience, which subsequently makes it possible to integrate all citizens into the state. This general character of political obedience can be achieved by the universal definition of humanity, such as is present in the concept of human rights.

Practical arguments for the legitimacy of the state and law finally cannot escape a moral version of the world, humanity and politics established on the modern concept of political universalism. The rule of law, as suggested by David Dyzenhaus, is a moral concept, which must be entrenched in the liberal traditions of civil and political rights, an independent judiciary and democratic legislation in a parliament. The discourse theory of Habermas, mixing the liberal values with democratic techniques of government, could then seemingly be reconciled with legal positivism and form an important part of the theory of the democratic and legitimate rule of law (Dyzenhaus 1991, 267).

According to Dyzenhaus (1994, 80–94), the legitimacy of law is a matter of standards already implicit in law which are best revealed in adjudication. These standards, completely corresponding to Dworkin's views, are derived from the liberal democratic political culture and moral beliefs and convictions of this political community. Legalism, if it is filled with these moralist impulses, can be criticized and legitimated from inside.

Joseph Raz, although his theory of legitimacy builds on the critique of moral normative apriorism in the form represented for instance by the theory and culture of human rights, came to similar conclusions. He criticizes legitimacy through the mediation of rights and opposes to it legitimacy by reasons, established on practical rational arguments (Raz 1979, 12). Political authority is legitimate if its commands have the nature of exclusionary reasons (ibid., 27). Raz takes legitimacy into the exclusionary sphere of rational normative demands, which have a *de iure* nature and the condition of which is not effectiveness or *de facto* practiced power.

Legitimacy is normative and its foundation is in practical reason. Nevertheless, even in Joseph Raz's theory this normativity has finally a moral nature. Raz says about legitimacy that:

> No system is a system of law unless it includes a claim of legitimacy, of moral authority. That means that it claims that legal requirements are morally binding, that is that legal obligations are real (moral) obligations arising out of the law. (Raz 1984, 131)

Legitimacy finds itself outside the legality circle and is a result of practical reasons of political rationality and morality. Raz, Dworkin and other legal and political philosophers turn legitimacy into the exclusive concept of theory of practical reason and morality. The meaning of legitimacy is derived from a particular kind of moral philosophical speculation. The functioning of legitimate authority is determined by normative claims of practical reason. *Legitimacy is a matter of scientific speculation*, which finally sets up binding reasons for practical actions. This speculation and arguments of practical reason also found the political morality of modern democratic and liberal political communities.

Because the concept of legitimacy has no sociological meaning here and it is therefore impossible to relate it to *de facto* existing social institutions, the definition of legitimacy must be *exclusive*. Political authority, which would not derive its structures from the normativity of practical reason, cannot be

treated as legitimate. Legitimacy becomes a very narrow and speculative concept in both the philosophical and political sense. Legality must incorporate normative claims of legitimacy into its structure. Legal philosophers demand that the formal rationality of legal rules and procedures must also include the substantive rationality of values and principles.

The positivist critique of legalism and its legitimation fictions of a moral law can either emphasize the democratic aspect, or the liberal aspect. It can be either more normativist in the sense of supporting a priori *de iure* principles, or more realistic in the sense of respecting *de facto* existing institutions of the rule of law/law-based state. Conditions of the legitimacy of law can be defined differently in respect to the relation between human and political rationality and will. Under all circumstances, the legitimation of law must nevertheless be founded on the knowledge and ethics of a specific political community of liberal democracies.

The basic norm as a fiction constituting the legality must be buried, in order to save legality as a legitimation technique of political domination existing in liberal democratic communities. When the principles of liberal democratic politics and practical reason are encoded into legality, it seems that legality can consequently provide political domination with legitimacy.

The rule of law and legality must be declared to achieve the status of universal morality, or at least a political value and virtue (Cotterrell 1996, 463f.). Nevertheless, the reason why Kelsen created his fiction has never disappeared. As if current legal positivists just want to hide the problem of the existence of law in societies which are radically different from liberal democracies—the problem which helped to form legal positivism as a project of objective value-free science about law.

The original legitimation fictions of legal positivism were substituted by a paradigmatic inconsistency and legitimation moralism, which builds on liberal democratic foundations. The only real difference seems to be in the classifications of these foundations, because they can be treated either as a cultural product, or as a consequence of universal practical reason disclosed by modern humans.

IV. Scientific Legitimation and the Centralized Models of Legal Science

All fictions of modern legal philosophy had a double function. The first function consisted in the description of law, its normative structures, socio-political roles, and logics of creation and application of legal norms. The second function was the legitimation of law by the language of legal science. Scientific reasons and intellectural constructions were to provide prescriptive claims of positive law and secure the obedience of subjects of law. The seemingly value-free scientific language of legal theory was to explain the legitimacy of law from the inner logic of legal system and exclude "uncertain" illogical moments of trust, beliefs and convictions of law's subjects, concerning the rightness of their subjection and obedience to law.

In modern legal theory, the legitimacy of law loses its transcendent metaphysical character. Scientific discussions are concerned only with the relative legitimacy of different systems of positive law (Radbruch 1950, 125; Ward 1992, 191).

Legal positivist theory could not defend this prescriptive and at the same time relativistic claim and, faced with the development of legal systems in 20th century, retreated from the idea of a moral law that is legitimated exclusively from the legal conditions of validity. Contemporary legal positivist theory abandoned the attempt to create a universal fiction of law and its paradigm is restricted to the analysis of legal systems of western liberal democracies. Legal theory and philosophy have lost their general character and become a philosophy and theory of the western rule of law.

The cultural and political contextualization of legal science and legal systems themselves are a consequence of this paradigmatic change. Nevertheless, behind such a change there is an ancient construction, according to which the ultimate purpose of every positive law is the representation of the rightness and justice. Legal positivism had to acknowledge the failure in its attempt to create a moral legitimation science about positive law. Rudolf Stammler's *de iure fiction of the just law* (*richtiges Recht*) (Stammler 1925, 40f.) returns to legal science and constitutes a normative claim and criterion of the right functioning of the liberal democratic rule of law and even-handed justice (Larenz 1979). Stammler's original neo-Kantian position and concept of the just law,[1] suggesting that law is just when it is guided by its own intrinsic values and distinct social and logical forms, is transformed into the ethics of positivism, which builds on more general ethics of social rules containing both "the empires" of law and morality.

The fiction of the just law legitimates the existing system of positive law and operates within it in the form of constitutive principles and procedures of the rule of law, for instance in the famous principle "Treat like cases alike and different cases differently!" The concept of the just law can also be detected, to a large extent, within the famous "Radbruch's rule," which helped the post-war German judiciary to distinguish between the justifiable and unjustifiable duties imposed by the Nazi positive law and which is one of the most important contributions to the post-war development of the ethics of justice and positive law. This rule states that:

> Where the injustice of positive law reaches such measures that the legal certainty guaranteed by positive law no longer functions as the counter-balance of his injustice, unjust positive law must make way for justice. (Radbruch 1959, 33)[2]

[1] The problem here is that the English translation of *richtiges Recht* suggests its direct links to the notion of justice. The concept, however, is rather indicating the idea of "rightness" or "correctness" and refers to the intrinsic nature of positive law, not to the more general concept of justice. Any reference to the concept of "the just law" should be, therefore, read more appropriately as "the right law."

[2] This translation quoted from Minkkinen 1999, 41.

The fiction of the just law is a result of the eclectic combination of ethical claims of liberal democratic political communities and technical claims to establish the sovereign political power on the principle of legality and even-handed justice. Positive law must be operating as an autonomous normative system, but all its operations are subject to the supervision and corrections of the "supra-positive" law.

Behind the fiction of the just law as a condition of the legitimacy of political domination and system of positive law, there is the idea that it is not only force and violence, but also a more general normative order and principles, that is the reason for the law's validity and obligatory nature. The legitimacy of law cannot be derived from the conditions of validity defined by the system of law itself. It can be derived only from a comparison of the legal conditions of validity with a broader moral political context of law or transcendental rules of "correct" thinking.

Legal positivist concepts of legal legitimacy and their fictions are a reflection of the modern process of positivisation of law and the image of society as a unit organized and managed from one centre. The centralized, hierarchical and self-concentrating model of society was one of many reflections of the concept of modernity as a rational break with historically and geographically limited moral traditions. This model required universal validity on the ground of rational thinking, the ultimate stage of which should be science.

Within the framework of legal science, these legitimation attempts were formulated in the fictions of the political sovereign and basic norm. These fictions were a product of scientific rational speculation and their function was to describe law as a united, centralized and hierarchical system. *The fictions were to play a role of the centre.*

This attempt to create the scientific legitimacy of positive law failed and current legal positivism uses again commonly the concepts of morality and ethics. These concepts are treated as an inherent part of the logic of positive law. Normative structures of legality operate both as an impersonal technique and ethical claim. This dual character of legality and the operative role of the idea of justice in legal argumentation is analyzed for instance by Chaim Perelman (1963) in his interpretive legal theory.

In contemporary legal theory, the centralized and hierarchical structure of the problem of legitimacy still survives. Instead of the fiction of the political sovereign and basic norm, legitimation discourse concentrates on the legal principles in their dual role of technique and ethics. Acceptance and application of these principles are conditions of the existence of the just law and subsequently the legitimacy of the system of positive law and political domination. Legal science, if it is to survive as a legitimation narrative about law and political domination, must incorporate ethics into its inner structures and translate it into the language of legality.

The function of the fiction of the just law is clear: to reconcile ethical and legal discourse in contemporary liberal democracies and keep law operating

independently of the moral normative system. The internal unity of law, which was conceived by Kelsen as the technique of social organization, must become the ethical demand and respect ethics of political community. This function, however, includes a strange and, especially among lawyers, popular idea that law is the main and ultimate integrative mechanism of modern society. Legality then legitimates modern political domination and integrates society, but only when it ceases to be "the iron cage" and becomes also a reflexion of the substantive morality and practical reason of society.

V. Critiques of Legal Science, their Centres and Hierarchies

The dual concept of legality as a technique and ethics and its legitimation function are subject to many criticisms. Legal positivist fictions include both descriptive and prescriptive aspects. Their purpose is the establishment of legal science which would analyze and describe structures and functions of the system of positive law, its normativity and logic operations. However, these fictions also have an important integrative role because they determine the images of law as it ought to be and work.

Contemporary mainstream legal philosophy represents a grand attempt at the legitimation of the rule of law idea in the condition of liberal democratic political communities. For instance, Ronald Dworkin does not consider his theory to be general. According to him, his legal theory concentrates and analyzes only one specific kind of legal system, the one which has emerged in modern liberal democracies. Legality is legitimate only when it corresponds to the principles of democratic political regime and enforces the catalogue of human rights. Such legality is an exclusive matter of one legal and political culture. Other legal systems cannot claim to be legal in the real sense of the word. The main task of legal philosophy and legal science in general is to provide such legality with the scientific explanations and scientific legitimacy.

Such a concept of legality and legal legitimacy has always been castigated by critical legal theory and some theoretical schools within the sociology of law. Critical legal theory questions law's self-legitimation by legal science. This is one of the main purposes of critical jurisprudence. For instance, according to Austin Sarat and Thomas R. Kearnes (1991, 253), "'critical story' calls into question law's legitimating narratives."

Conventional legal philosophy and jurisprudence is depicted as just one of many legitimating narratives about law. Critical legal science must disclose the falsity and real power mechanisms behind this narrative. Legality and the idea of formal justice before the law produce new injustices. Legality and liberal democratic ethics expressed through the law are nothing but a mask, power instrument and strategy of social control (Goodrich 1990).

According to critical legal scholars, the modern image of legality helps to mythologize law and constitute fictions supporting the image of law as an exclusive product of technical rationality (Fitzpatrick 1992). Law is politics in the disguise of normative universalism and image of an autonomously functioning system. This is the way to blur the instability and contingency of our political world. Law is to strengthen the image of stability and order. It appears therefore crucial to analyze these fictions of modern law and point to the factual dependence of legal normative structures on the contingent world of politics.

According to critical legal scholars, it is important to lead the theoretical struggle against the ideology and political discourse of analytical jurisprudence. The modern concept of legality threatens to suppress the contingent and heterogeneous nature of law, dismantle the richness of law's images and differences in its various forms. It is therefore considered very important to deconstruct the grammar of modern legality and manifest the plurality of discourses hidden behind the seemingly homogeneous facade of law (Douzinas, Warrington, and McVeigh 1991, 145ff.).

Sociologists of law very often approach modern legality with similar consequences. Socio-legal criticisms of analytical jurisprudence and legalism are entrenched in the texts of Eugen Ehrlich (1975), who wanted to establish the sociological method as the most general method of legal science. A similar treatment of jurisprudence is also present in the sociology of law as defined by Jean Carbonnier. Traditional jurisprudence deforms the reality of law and is a source of pathological law, not real and normal law (Carbonnier 1988, 20ff.). Sociology of law therefore has a crucial task to deliver a truly scientific view and understanding of law.

Roger Cotterrell, one of the most important figures of contemporary British sociology of law, also believes that the role of the sociological interpretation of law is to disclose and demystify the legal doctrine, discourse and law's understanding of itself. The basic function of every scientific discipline is the advancement of knowledge. The sociology of law advances our knowledge about law's and legal doctrines' social foundations (Cotterrell 1995, 49). Legal science and sociology, according to Cotterrell, are two disciplines, the intellectual confrontations of which stimulate the establishment of new knowledge about law. Sociological interpretation is an inherent part of legal scholarship and the field of sociology of law cannot be limited to a sub-field of sociology. Knowledge about the nature of law and legal doctrine is unthinkable without the sociological study of law (ibid., 71).

The sociology of law achieves a special status consisting in the "realistic" perspective (Tamanaha 1997) on law and chance to disclose the true social nature of law, power and ideological mechanisms behind the legal field. It helps to abandon the ideological nature of legal scholarship. The role of sociological methodology is to understand law better and subsequently to contribute to the improvement of legal reality (Cotterrell 1998). "Realistic"

sociology of law is contrasted to "ideological" jurisprudence. The sociological perspective must consequently claim epistemological supremacy.

Cotterrell, Tamanaha and others use words such as "must" and "moral vision," when defining the paradigm of their discipline. The sociological perspective is automatically connected with the concept of truth and its political consequences. Sociologists of law have normative commitments to the whole political community and use their theory and empirical research to improve our social reality. The legal realism project takes the form of the pragmatic use of the sociology of law as a moral vehicle.

The social determination of law is overestimated and the sociological perspective becomes the realistic perspective. Sociology not only maintains the status of a realistic science, but also of a moralist attitude, which, due to its own methodology, can reveal pathological elements in the life of society and thus contribute to the improvement of social reality.

Within the context of the sociology of law, this social reality is the reality of positive law. Normative commitments of the sociology of law indicate that sociologists of law, although criticising the concept of state law, diminishing the significance of legal regulations for everyday social reality and pointing to the facts of legal pluralism, still claim or tacitly assume that law has an enormous power and important role in modern societies. Otherwise, they would not be bothered studying it and move rather to some other knowledge and scholarship, which would more likely change our reality and make our world a better place. The social and political importance of law requires then a grand theoretical project. In this sociological project, Theory, Law and Politics make up the common triangle of the modern scientific legitimation of law.

Critical legal theory and some schools of the sociology of law seek to make up a scientific framework or discourse, which would prove the false nature of modern legality at the theoretical level. The "realistic" theory ought to replace legalism and its fictions.

The unity of descriptivity and prescriptivity, common to legal positivism and legalist fictions, is reproduced in critical legal theory and the sociology of law. Realism and scientific legitimacy remain untouched. The domination and exclusiveness of legalism, which are the first targets of critical legal science and sociology of law, achieve their new forms in these fields of legal studies. The hierarchical and asymmetrical model of legal science, favouring one discourse/system and subjecting other discourses/systems to it, remains untouched.

Critical legal theory proclaims law to be a part of politics and explains the law's functioning by political concepts and strategies. On the other hand, the sociology of law starts from the realistic notion of one united common sense, which is detectable by sociological methods and helps us to construct a better and much more reflexive law. The sociological perspective, it is said, can represent such common sense and its normativity, pragmatics and value structure. Sociology can thus serve as a moral vehicle.

The project of delegitimation of legal institutions by political language has its roots in the belief that theoretical thinking has strong social power and the role of law in contemporary society is also exceptional. *Law is taken too seriously and its limits are ignored.* Legality is finally translated into politics and, moreover, everything becomes politics. Law becomes everything and nothing at the same time in the discourse of critical jurisprudence. Although putting the emphasis on heterogeneity, critical legal theory finally constructs a strongly hierarchical model of legal discourse. As if critical theory were only the dark side of analytical jurisprudence and could not be conceived without its legalism and positivism.

The sociological perspective can also have a romantic mask of the fight for better and just law, which will conform better to the common space of social reality, defined by structures of common sense. The juxtaposition of the concept of common sense and expert legal knowledge does not involve only the truth/falsity distinction, but also represents the need to define the foundations of our social reality, its hierarchy and symmetrical nature.

Critical legal science and the sociology of law often castigate legal positivism in that it comes with exclusive definitions of law and delivers a false picture of law by the discourse of legality and legal legitimacy. Nevertheless, this critique itself often represents a foundationalist model of *scientific* thinking and *legitimation*, the primary task of which is to construct a 'realistic' picture of law beyond legality.

VI. Scientific Legitimation and Its Dissolution

Legal science offers many different definitions of law and legitimation strategies, when analyzing contemporary legal systems. A German legal philosopher, Adolf Reinach (1953), said that a legal theory was in the end always a science about justice. He correctly noticed the general character of legal theoretical thinking—a constitution of scientific strategy, which serves as an ethical programme and becomes a final goal of legal science. The scientific subjects the ethical and attempts to get it under control by means of objective language. Moral obligations are to have a scientific background. In Reinach's statement, modernity achieves its pure form. Scientific definitions contain and express moral and political goals. Modes of defining legality determine a moral version of the world, which is favoured by legal philosophers and theorists.

The statement that the final goal of legal theory is justice, is only a different manifestation of the "legitimacy by legality" question. Together with the task to define justice, legal science involves a banal question "What is law?", to which there is obviously no satisfactory answer. All answers, even when they are veiled by a highly symmetrical fabric of objective concepts and scientific definitions, mix up theses about what law and legality "are" and what they "ought to be" in order to conform the criteria of just . *Legal theories always*

constitute legitimate legality. In this sense, H. L. A. Hart's *The Concept of Law* is nothing but an attempt to address the problem of law's legitimacy (Hart 1994, 6–17). Legal realists' critique of legalism also represents such an attempt, although it is structured as a critique of a legal paradigm.

Legalist attempts for a clear distinction between "Is" (*Sein*) and "Ought to Be" (*Sollen*) and building the legal science as a science of "Ought to Be" finally ended up in the reunification of both worlds within the scientific discourse, again. Legalism can survive as a science only when it is contradictory to its own original claims and demands for a sharp separation of law and morals. *Pure legal science is founded by a "dirty" ethical search for justice and legitimate law.*

It is no surprise that legal science can never be constituted as a purified discourse, which was a primary goal of the founding fathers of modern legal positivism. Legal theory translates a real and genuine problem of modern society into its scientific language. It is a problem of legitimacy of a political domination and any social order and system, which is deeply entrenched in all modern societies. For modern political systems, legality with its seemingly impersonal and formal rational foundations seemed to be the only way to political integration and legitimation. Searching for definitions of legality, legal theory in fact elaborates a set of classifications, which are to understand modern legal systems, but also to justify and legitimate them.

A chain of connections between science and legality is typical for the problem of legitimacy and legitimation in modern society. Scientific knowledge searches for its own inner grounds of legitimacy and, subsequently, these grounds become the grounds of the legitimacy of legality and political order. The example of legal theory and its fictions proves how science itself "suffers" from disunity of its own genre and cannot offer a sovereign narrative to contemporary societies. A growing plurality of definitions, theoretical constructs and fictions is a reflection of a growing plurality of legitimations and the impossibility of supplying a simple answer to the question of legitimacy.

Any vocabulary constituted on such distinctions as truth/falsity or fact/fiction turns out to be insufficient for understanding the current problem of legitimacy and legitimation of law. Legal science constantly produces new definitions and scientific legitimating narratives about law and legality, although it can never conform to the universalistic demands of scientific definitions. Conversely, a growing number of definitions and plurality of legal theories manifests a decline of a universal legitimacy of law by the scientific discourse of jurisprudence and legal philosophy. Scientific legitimation and its universalistic claims bring to mind a man from a story of the good soldier Švejk, who pretended that inside the planet Earth there is another one, yet much bigger (Hašek 1990, 46). Legal science also seeks to press its own scientific legitimation into a smaller body of legality.

Faced with this legitimation plurality of the scientific genre itself, it is not then useful to ask what is truth and falsity, when one wants to analyze and legitimate law. It will to make up and constitute legitimation schemes and

narratives about law, included in different theories, is interesting in itself. It is not important whether those narratives about legality are true or false. The most important fact is that there is a need in contemporary societies and science to constitute certain constructs, which are to legitimate legality and political orders.

Legalist fictions have an entirely *functional meaning* because they attempt to understand, explain and accept law in its systematicity, often incomprehensible structures and language. At the scientific level, these fictions function in a very similar way to various "lay" explanations and interpretations of law, which occur in everyday reality and help subjects of the law to conform their behaviour to the rules and regulations of positive law, or, on the contrary, fight the unjust and illegitimate laws.

The purpose of legalist fictions is to provide a general picture and explanation of law and therefore generate its general acceptance and consequently a better functioning. In other words, legalist fictions are to support and prove the founding thesis of a modern state and society that "law is the only legitimate violence and force which everybody is obliged to accept."

Legitimating fictions of legalism and legal science in general has failed in their attempt to support modern law and legality with a scientific legitimacy. This is also the reason why contemporary legal positivism resigned for a scientific framework, which would be able both to describe structures and functions of all existing and past legal systems and legitimate the modern concept of legality. The scientific legitimacy of the liberal democratic system of law in the works of Ronald Dworkin or Joseph Raz represent only a small fragment of the original legal positivist project. The "realism" of the critical jurisprudence and sociology of law also cannot offer a generally valid legitimation framework and the main value of this "realistic" view is that it discloses a relative validity and external limits of the current discourse of legal science and all its definitions. Legal science only reproduces a growing social, ideological and cultural plurality.

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JURISPRUDENCE

OR

THE THEORY OF THE LAW

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§ 7. Law logically subsequent to the Administration of Justice.

We have defined law as the body of principles observed and acted on by the state in the administration of justice. To this definition the following objection may be made. It may be said: "In defining law by reference to the administration of justice, you have reversed the proper order of ideas, for law is the first in logical order, and the administration of justice second. The latter, therefore, must be defined by reference to the former, and not *vice versâ*. Courts of justice are essentially courts of law, justice in this usage being merely another name for law. The administration of justice is essentially the enforcement of the law. The laws are the commands laid by the state upon its subjects, and the law courts are the organs through which these commands are enforced. Legislation, direct or indirect, must precede adjudication. Your definition

[1] The term sanction is derived from Roman law. The *sanctio* was originally that part of a statute which established a penalty, or made other provision in respect of the disregard of its injunctions. D. 48. 19. 41. By an easy transition it has come to mean the penalty itself.

of law is therefore inadequate, for it runs in a circle. It is not permissible to say that the law is the body of rules observed in the administration of justice, since this function of the state must itself be defined as the application and enforcement of the law."

This objection is based on an erroneous conception of the essential nature of the administration of justice. The primary purpose of this function of the state is that which its name implies—to maintain right, to uphold justice, to protect rights, to redress wrongs. Law is secondary and unessential. It consists of the fixed principles in accordance with which this function is exercised. It consists of the pre-established and authoritative rules which judges apply in the administration of justice, to the exclusion of their own free will and discretion. For good and sufficient reasons the courts which administer justice are constrained to walk in predetermined paths. They are not at liberty to do that which seems right and just in their own eyes. They are bound hand and foot in the bonds of an authoritative creed which they must accept and act on without demur. This creed of the courts of justice constitutes the law, and so far as it extends, it excludes all right of private judgment. The law is the wisdom and justice of the organized commonwealth, formulated for the authoritative direction of those to whom the commonwealth has delegated its judicial functions. What a litigant obtains in the tribunals of a modern and civilized state is doubtless justice according to law, but it is essentially and primarily justice and not law. Judges are appointed, in the words of the judicial oath, "to do right to all manner of people, after the laws and usages of this realm." Justice is the end, law is merely the instrument and the means; and the instrument must be defined by reference to its end.

It is essential to a clear understanding of this matter to remember that the administration of justice is perfectly possible without law at all. Howsoever expedient it may be, howsoever usual it may be, it is not necessary that the courts of the state should, in maintaining right and redressing wrong, act according to those fixed and predetermined principles

which are called the law. A tribunal in which right is done to all manner of people in such fashion as commends itself to the unfettered discretion of the judge, in which equity and good conscience and natural justice are excluded by no rigid and artificial rules, in which the judge does that which he deems just in the particular case, regardless of general principles, may not be an efficient or trustworthy tribunal, but is a perfectly possible one. It is a court of justice, which is not also a court of law.

Moreover, even when a system of law exists, the extent of it may vary indefinitely. The degree in which the free discretion of a judge in doing right is excluded by predetermined rules of law, is capable of indefinite increase or diminution. The total exclusion of judicial discretion by legal principle is impossible in any system. However great is the encroachment of the law, there must remain some residuum of justice which is not according to law—some activities in respect of which the administration of justice cannot be defined or regarded as the enforcement of the law. Law is a gradual growth from small beginnings. The development of a legal system consists in the progressive substitution of rigid pre-established principles for individual judgment, and to a very large extent these principles grow up spontaneously within the tribunals themselves. That great aggregate of rules which constitutes a developed legal system is not a condition precedent of the administration of justice, but a product of it. Gradually from various sources —precedent, custom, statute—there is collected a body of fixed principles which the Courts apply to the exclusion of their private judgment. The question at issue in the administration of justice more and more ceases to be, "What is the right and justice of this case?" and more and more assumes the alternative form, "What is the general principle already established and accepted, as applicable to such a case as this?" Justice becomes increasingly justice according to law, and courts of justice become increasingly courts of law.

§ 10. The Defects of the Law.

These then are the chief advantages to be derived from the exclusion of individual judgment by fixed principles of law. Nevertheless these benefits are not obtained save at a heavy cost. The law is without doubt a remedy for greater evils, yet it brings with it evils of its own. Some of them are inherent in its very nature, others are the outcome of tendencies which, however natural, are not beyond the reach of effective control.

The first defect of a legal system is its rigidity. A general principle of a law is the product of a process of abstraction. It results from the elimination and disregard of the less material circumstances in the particular cases falling within its scope, and the concentration of attention upon the more essential elements which these cases have in common. We cannot be sure that in applying a rule so obtained, the elements so disregarded may not be material in the particular instance; and if they are so, and we make no allowance for them, the result is error and injustice. This possibility is fully recognised in departments of practice other than the law. The principles of political economy are obtained by the elimination of every motive save the desire for wealth; but we do not apply them blindfold to individual cases, without first taking account of the possibly disturbing influence of the eliminated elements. In law it is otherwise, for here a principle is not a mere guide to the due exercise of a rational discretion, but a substitute for it. It is to be applied without any allowance for special circumstances, and without turning to the right hand or to the left. The result of this inflexibility is that, however carefully and cunningly a legal rule may be framed, there will in all probability be some special instances in which it will work hardship and injustice, and prove a source of error instead of a guide to truth. So infinitely various are the affairs of men, that it is impossible to lay down general principles which will be true and just in every case. If we are to have general rules at all, we must be content to pay this price.

The time-honoured maxim, *Summum jus est summa injuria*, is an expression of the fact that few legal principles are so founded in truth that they can be pushed to their extremest logical conclusions without leading to injustice. The more general the principle, the greater is that elimination of immaterial elements of which it is the result, and the greater therefore is the chance that in its rigid application it may be found false. On the other hand, the more carefully the rule is qualified and limited, and the greater the number of exceptions and distinctions to which it is subject, the greater is the difficulty and uncertainty of its application. In attempting to escape from the evils which flow from the rigidity of the law, we incur those due to its complexity, and we do wisely if we discover the golden mean between the two extremes.

Analogous to the vice of rigidity is that of conservatism. The former is the failure of the law to conform itself to the requirements of special instances and unforeseen classes of cases. The latter is its failure to conform itself to those changes in circumstances and in men's views of truth and justice, which are inevitably brought about by the lapse of time. In the absence of law, the administration of justice would automatically adapt itself to the circumstances and opinions of the time; but fettered by rules of law, courts of justice do the bidding, not of the present, but of the times past in which those rules were fashioned. That which is true to-day may become false to-morrow by change of circumstances, and that which is taken to-day for wisdom may to-morrow be recognised as folly by the advance of knowledge. This being so, some method is requisite whereby the law, which is by nature stationary, may be kept in harmony with the circumstances and opinions of the time. If the law is to be a living organism, and not a mere petrification, it is necessary to adopt and to use with vigilance some effective instrument of legal development, and the quality of any legal system will depend on the efficiency of the means so taken to secure it against a fatal conservatism. Legislation—the substitution of new principles for old by the express declara-

tion of the state—is the instrument approved by all civilised and progressive races, none other having been found comparable to this in point of efficiency. Even this, however, is incapable of completely counteracting the evil of legal conservatism. However perfect we may make our legislative machinery, the law will lag behind public opinion, and public opinion behind the truth.

Another vice of the law is formalism. By this is meant the tendency to attribute undue importance to form as opposed to substance, and to exalt the immaterial to the level of the material. It is incumbent on a perfect legal system to exercise a sound judgment as to the relative importance of the matters which come within its cognisance; and a system is infected with formalism in so far as it fails to meet this requirement, and raises to the rank of the material and essential that which is in truth unessential and accidental. Whenever the importance of a thing in law is greater than its importance in fact, we have a legal formality. The formalism of ancient law is too notorious to require illustration, but we are scarcely yet in a position to boast ourselves as above reproach in this matter. Much legal reform is requisite if the maxim *De minimis non curat lex* is to be accounted anything but irony.

The last defect that we shall consider is undue and needless complexity. It is not possible, indeed, for any fully developed body of law to be such that he who runs may read it. Being, as it is, the reflection within courts of justice of the complex facts of civilised existence, a very considerable degree of elaboration is inevitable. Nevertheless the gigantic bulk and bewildering difficulties of our own labyrinthine system are far beyond anything that is called for by the necessities of the case. Partly through the methods of its historical development, and partly through the influence of that love of subtilty which has always been the besetting sin of the legal mind, our law is filled with needless distinctions, which add enormously to its bulk and nothing to its value, while they render great part of it unintelligible to any but

the expert. This tendency to excessive subtilty and elaboration is one that specially affects a system which, like our own, has been largely developed by way of judicial decisions. It is not, however, an unavoidable defect, and the codes which have in modern times been enacted in European countries prove the possibility of reducing the law to a system of moderate size and intelligible simplicity.

From the foregoing considerations as to the advantages and disadvantages which are inherent in the administration of justice according to law, it becomes clear that we must guard against the excessive development of the legal system. If the benefits of law are great, the evils of too much law are not small. The growth of a legal system consists in the progressive encroachment of the sphere of law upon that of fact, the gradual exclusion of judicial discretion by predetermined legal principles. All systems do to some extent, and those which recognise precedent as a chief source of law do more especially, show a tendency to carry this process of development too far. Under the influence of the spirit of authority the growth of law goes on unchecked by any effective control, and in course of time the domain of legal principle comes to include much that would be better left to the *arbitrium* of courts of justice. At a certain stage of legal development, varying according to the particular subject-matter, the benefits of law begin to be outweighed by those elements of evil which are inherent in it.

Bacon has said, after Aristotle:[1] *Optima est lex quae minimum relinquit arbitriô judicis.* However true this may be in general, there are many departments of judicial practice to which no such principle is applicable. Much has been done in recent times to prune the law of morbid growths. In many departments judicial discretion has been freed from the bonds of legal principle. Forms of action have been abolished; rules of pleading have been relaxed; the credibility of witnesses has become a matter of fact, instead of as formerly one of law; a discretionary power of punishment

[1] Bacon, De Augmentis, Lib. 8, Aph. 46; Aristotle's Rhetoric, I. 1.

has been substituted for the terrible legal uniformity which once disgraced the administration of criminal justice; and the future will see further reforms in the same direction.

We have hitherto taken it for granted that legal principles are necessarily inflexible—that they are essentially peremptory rules excluding judicial discretion so far as they extend—that they must of necessity be followed blindly by courts of justice even against their better judgment. There seems no reason, however, in the nature of things why the law should not, to a considerable extent, be flexible instead of rigid—should not aid, guide, and inform judicial discretion, instead of excluding it—should not be subject to such exceptions and qualifications as in special circumstances the courts of justice shall deem reasonable or requisite. There is no apparent reason why the law should say to the judicature: "Do this in all cases, whether you consider it reasonable or not," instead of: "Do this except in those cases in which you consider that there are special reasons for doing otherwise." Such flexible principles are not unknown even at the present day, and it seems probable that in the more perfect system of the future much law that is now rigid and peremptory will lapse into the category of the conditional. It will always, indeed, be found needful to maintain great part of it on the higher level, but we have not yet realised to what an extent flexible principles are sufficient to attain all the good purposes of the law, while avoiding much of its attendant evil. It is probable, for instance, that the great bulk of the law of evidence should be of this nature. These rules should for the most part guide judicial discretion, instead of excluding it. In the former capacity, being in general founded on experience and good sense, they would be valuable aids to the discovery of truth; in the latter, they are too often the instruments of error.

[14]

REVIEW

Musings on Form and Substance in Taxation

Joseph Isenbergh†

Federal Taxation of Income, Estates and Gifts. BORIS I. BITTKER. Warren, Gorham & Lamont, Boston, 1981. 4 volumes. $295.00.

One must spend some time with this work for Professor Bittker's accomplishment to sink in. It is staggering to have compressed so much learning into the space of four volumes. Now that this work has appeared, it is impossible to imagine engaging in a tax practice without it. Indeed, it is nearly possible to imagine engaging in tax practice with nothing else. A treatise can earn its keep if it steers us even occasionally to a sorely needed answer. Professor Bittker's new treatise will do so often, and will also provide some undiscounted intellectual pleasure along the way.

In his preface, Professor Bittker tells us that he has aimed to lay bare "structure" and "principal effects" rather than turn over every stone littering the tax terrain.[1] The treatise never gives us less than this promise, and often more. There are, of course, aspects of the income tax system—a few entire segments and many more details—that escape Professor Bittker's scrutiny. This was inevitable since the income tax provisions of the Internal Revenue Code now contain as many words as any one of Professor Bittker's four volumes. Add the Treasury Regulations to the scales, and the entire treatise is comfortably exceeded in length by the law it expounds.

Despite the inevitable limitations imposed by space, however, the eighty-two chapters already published[2] provide an overview of nearly all the areas of income tax that lawyers in general practice

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[1] 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS vii (1981).

[2] The outline of the work now allows for 119 chapters. Thirty-seven have been reserved. *Id.* at xv-xix. A fifth volume, on estate and gift taxation, is forthcoming.

II

Among the tax perennials, one especially persistent question is how the tax laws should be applied to transactions that appear designed to defeat them. Most major statutes raise problems of interpretation, of course, but the quest for "substance" through the distracting haze of "form" has attracted a particularly intense scrutiny in tax matters.[15]

As a starting point, there is almost universal assent among tax lawyers and theorists that the revenues should not be defeated by certain entirely artificial maneuvers. We are assured—and it would be hard to demur—that the "substance" of events should determine their tax consequences and that any other principle would expose the Treasury to obvious manipulations. Certain presumptions, generally favoring the Treasury, are thought to flow from the order of things. Both on matters of fact and interpretation, a taxpayer must sustain a position once challenged by the tax authorities, and that burden is entirely reasonable.[16]

The harder question, however, is the nature of the defense the taxpayer must produce. From a clean slate, it might be thought sufficient for the taxpayer to show that a transaction, fairly characterized, is encompassed by the statute and that the statute, by its terms, yields the desired result. Things are not so simple, though, and much has been made to turn on the nature of the taxpayer's desire. There has developed a welter of rules and extrastatutory standards that impose particular scrutiny on transactions with results unfavorable to the Treasury. These standards are enshrined in celebrated cases—*Gregory*,[17] *Court Holding*,[18] *Bazley*,[19] *Earl*,[20] *Goldstein*[21]—that stand as bulwarks against overreaching by taxpayers. It is from these cases that the basic weapons in the Com-

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[15] One man's tax shelter being everyone else's budget deficit, all taxpayers *ultimately* have an interest in the reasonable interpretation of the tax laws.

[16] *See, e.g.*, Welch v. Helvering, 290 U.S. 111, 115 (1933).

[17] Gregory v. Helvering, 293 U.S. 465 (1935). *See infra* notes 33-49 and accompanying text.

[18] Commissioner v. Court Holding Co., 324 U.S. 331 (1945). *See infra* notes 50-65 and accompanying text.

[19] Bazley v. Commissioner, 331 U.S. 737 (1947).

[20] Lucas v. Earl, 281 U.S. 111 (1930).

[21] Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). *See infra* notes 65-79 and accompanying text.

missioner's arsenal are derived—the business purpose doctrine, the step transaction doctrine, "substance over form," and others. The effect of these doctrines is the existence alongside the Internal Revenue Code of an additional (and somewhat autonomous) set of principles for deciding tax disputes.

Professor Bittker is a faithful reporter of these doctrines. He recognizes that a number of principles extrinsic to the Code (narrowly conceived) now govern its application.[23] There remains the question of the intellectual force of these principles in their present sway. On this question—perhaps *the* question among tax perennials—Bittker takes a restrained position, a posture fully justified, however, by the stated object of his work.

Professor Bittker starts from the readily accepted limitations of pure literalism: words shorn of all context are not always self-construing.[23] From there he proceeds to a description of the prevalent doctrines. He describes the judicial search for "substance" in tax matters with a caution bordering on detachment.[24] If one had to infer Bittker's own views on the issue, however, one might be able to extract from the pages of his treatise a lukewarm endorsement of the general approach taken by the courts in this area. But perhaps I find this so only because Professor Bittker describes in mild tones doctrines and cases at which I balk. Certainly nothing in Professor Bittker's goal of being "concise, lucid, and accurate"[25] required him to betray any intellectual uneasiness aroused by the doctrines he relates.

To Professor Bittker's dispassionate summary of the law I cannot resist adding my own view that several of the touchstone cases on form and substance in taxation are flawed in principle and serve neither taxpayers nor the Treasury. What follows here, in support of this view, is an excursion—dotted with a few generalizations—through a handful of cases widely regarded as embodying important glosses on the Internal Revenue Code.

III

The source of the problem is that the tax laws necessarily have a limited number of terms, but must be applied to a nearly unlimited range of transactions. Many of the basic terms of the Code are therefore imported into it with their contours already set. For ex-

[23] 1 B. Bittker, *supra* note 1, at 4-18 to 4-25.
[24] *Id.* at 4-2.
[25] *Id.* at 4-18 to 4-56.
[26] *Id.* at vii.

ample, the Code taxes a "sale" without defining what a sale is;[26] business and commercial experience supply that knowledge. In the terms of *Welch v. Helvering*,[27] life tells us what a sale is. It follows that someone who has engaged in a transaction more reasonably characterized as a license or a lease cannot make it a "sale" simply by writing that word at the top of an agreement. The point is simple enough: where the Code follows life, life is determinative. The underlying idea—that it does not matter what things are called—is common to all law. No label can make a diamond of a rhinestone. This principle is more than sufficient to defeat transactions that are simply shams.[28]

In addition to reflecting the world, statutes are also creatures of art that impose their own form on the world. The Internal Revenue Code tells us that a "dividend" is a distribution by a corporation out of the profits of the current taxable year.[29] That being so, it makes no difference that the corporation may have lost money from its operations overall and that an economist might assure us that a distribution in such circumstances was a return of capital. A distribution out of current profits is a dividend because the statute says so.

In almost all statutes one finds an amalgam of references to the world and relations created by the statute itself; a mixture, if you will, of life and art. Finding and isolating these two elements is much of what the problem of form and substance is about. The normal process of applying a statute to a transaction consists in determining first, where the statute responds to the transaction, and second, what this response does to the transaction itself.

Things become difficult when life imitates art, as it often does. When someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means. It may also happen that rich people who would not otherwise have cows buy them to gain cow subsidies. Here, when people say (as they do) that this is not what the statute means, they are in fact saying something quite different.

Many of the difficulties that bedevil the pursuit of "substance" and "form" in taxation stem from the assimilation of these

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[26] I.R.C. § 1001 (1976).

[27] 290 U.S. 111, 115 (1933).

[28] The "sham transaction" doctrine means nothing more than that labels are not determinative. The term itself is used loosely, though, and in some cases is invoked in connection with doctrines of broader reach. *E.g.*, Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *see infra* notes 33, 48.

[29] I.R.C. § 316 (1976).

two patterns. From the beginning of taxation people have sought advantage in calling one thing another. To avoid a tax imposed on compensation, for example, people would call it a gift.[30] The principle of following "substance" rather than "form" has always meant sweeping aside pretenses of this sort.

In another class of cases what was done apparently falls within the statute, but results in a bad thing.[31] Although they differ among themselves on what constitute "bad things," people dislike them enough to strain to suppress them when possible. Many bad things, however, are precisely what they purport to be, and therefore cannot be swept aside as shams. Here the inclination of one who feels strongly is to invoke some more general feature of the law, for example the "intent" (or perhaps nowadays the "deep structure"[32]) of the statute, to conclude that the bad thing ought not to be.

The Treasury, naturally enough, regards the reduction of tax obligations as a ubiquitous bad thing. Because there are many different ways of engaging in transactions with roughly similar ends, some more heavily taxed than others, the world in the Treasury's view is a mosaic of bad things. None of this is at all surprising. More surprising, however, is the success the Treasury has had in litigation in establishing that the problem of distinguishing between transactions fairly characterized and impostors is the same sort of intellectual problem as the difference between good and bad things generally, and that both fall within the general rubric of form and substance.

IV

One of the cases that opened this path for the Treasury, and also perhaps the case most widely invoked as a source of first principles on form and substance, is *Helvering v. Gregory*.[33] In *Greg-*

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[30] *See, e.g.*, Commissioner v. Duberstein, 363 U.S. 278, 281-82 (1960); Noel v. Parrott, 15 F.2d 669, 669 (4th Cir. 1926).

[31] *See, e.g.*, Goldstein v. Commissioner, 364 F.2d 734, 741 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); *see infra* notes 65-79 and accompanying text.

[32] *See* Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861 (1976); *infra* note 89.

[33] 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). *Gregory* was by no means the first case to attempt a standard for wresting substance from the jaws of form. Earlier Supreme Court opinions from the pen of Justice Holmes had asserted that tax disputes should not turn on "technicalities," "attenuated subtleties," or "the refinements of title," but on the "import and reasonable construction of the taxing act" or "actual command over the property taxed." Corliss v. Bowers, 281 U.S. 376, 378 (1930); Lucas v. Earl, 281 U.S. 111, 114 (1930); Irwin v. Gavit, 268 U.S. 161, 165 (1925). In these cases, however, Holmes simply

ory, assets had been separated from a corporation by the creation and distribution of shares of a second corporation, a transaction ostensibly meeting the requirements of a "reorganization" under the Revenue Act of 1928.[34] As such, the separation of assets would be tax-free, and the subsequent liquidation of the second corporation would give rise to capital gains in the hands of the shareholder who had received the distribution of shares. The result of the transaction, however, was the same as a simple dividend distribution, and the Commissioner sought to tax it as such.

For the Board of Tax Appeals, the problem in *Gregory* was whether this transaction should be measured by life or by art.[35] The distribution of shares fitted precisely within the definition of a tax-free "reorganization" in the 1928 Act. The statute did more than merely attach tax consequences to the occurrence of a "reorganization"; it purported to say what the term "reorganization" *meant*. The Board of Tax Appeals thought it inescapable to regard the notion of "reorganization" as a creature of the statute itself, and concluded that a reorganization was precisely what had occurred.[36] Judge Sternhagen's opinion rested on the principle that "a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy and leaves only the small interstices for judicial consideration."[37] The Second Circuit, with Learned Hand writing for a panel of judges of great intellectual prestige,[38] reversed in a decision that has left echoes in every corner of the tax law.[39]

A difficulty with *Gregory* is that these echoes reflect an opinion of greater literary power than sharpness of doctrine. There are two strands in *Gregory*, corresponding roughly to the two different views of form and substance sketched above. At the outset, *Greg-*

found in broader principles of interpretation confirmation of a technical analysis already unfavorable to the taxpayer. At least as a matter of tone, though, the Holmes opinions leave open the possibility that the terms of the statute (narrowly conceived) might in a proper case give way to other considerations.

[34] Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 791, 818 (repealed 1934); *id.* § 112(i), 45 Stat. at 818 (current version at I.R.C. § 368(a)(1) (Supp. IV 1980)). The question might well have been asked whether the overall transaction arose under a "plan" of "reorganization" as required by section 112(g) of the Act, the requirement of a "plan" being arguably in addition to the requirement that a transaction qualify as a "reorganization," but the point was apparently not made.

[35] Gregory v. Commissioner, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[36] *Id.* at 225-26.

[37] *Id.* at 225.

[38] Judges Thomas W. Swan and Augustus N. Hand sat with Hand.

[39] 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

ory raises the question whether the notion of a "reorganization" in the 1928 Act is simply a creature of the statute or whether it imports something from life—life in this case being the world of business in which "reorganizations" occur. Within the terms of the statute, the taxpayer had a winning case because she had done everything the statute required. If, however, we view the statute not as an exhaustive definition of reorganizations but as incorporating something from the world of business, the government had a strong case. Certainly what happened in *Gregory* did not much look like the sort of adjustment of a business that the notion of a "reorganization" would bring to mind if derived from the business world and not solely from the statute.

If the question in *Gregory* is so framed, the case is a close one. Having said that the case was close, though, I also think the Board of Tax Appeals decided it correctly. The 1928 Act clearly purported to *define* reorganizations.[40] The contrast with the Revenue Act of 1921, which purported only to enumerate certain transactions *included* within the term "reorganization,"[41] cuts against any suggestion that the language of the 1928 Act was accidental and not entitled to full effect.[42] Certainly the IRS would not have acknowledged as a "reorganization" any transaction falling outside the statutory range but similar in business effect. The definition of a "reorganization" in the statute happened to be broad enough to include transactions similar in pattern to the reorganizations conducted in the world, even though they aimed at different ends.

Seen as a case on the scope of the term "reorganization" in the 1928 Act, *Gregory*, whether rightly or wrongly decided, is not doctrinally startling. The term "reorganization" had already been found, in earlier cases on continuity of shareholder interest, to be bounded to some extent by its antecedents in the world.[43] Judge Hand's oft-cited metaphor that "a melody is more than the notes"[44] essentially reasserts this and might have been sufficient to set aside Mrs. Gregory's transaction as too sterile to amount to a

[40] Revenue Act of 1928, ch. 852, § 112(i)(1), 45 Stat. 791, 818 (current version at I.R.C. § 368(a)(1) (1976)).

[41] Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230 (current version at I.R.C. § 368(a)(1) (1976)).

[42] The legislative history is not particularly helpful, beyond suggesting that a definition of *reorganizations* is indeed what Congress intended.

[43] *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 469-70 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

[44] *Gregory*, 69 F.2d at 811.

reorganization in the business sense.

There are, however, two sentences in the case that enlarge its reach: "But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.' "[45] These sentences contain in germ a theory of business purpose and tax avoidance. Although the boundaries of these notions do not emerge fully drawn, the intentions underlying the two are obviously linked in this passage, the latter becoming more sinister in the absence of the former. The "venture in hand" must be the conduct of the underlying business of the corporation from which the distribution was made.[46]

As an abstract proposition, it is not immediately obvious why a division of corporate assets would have to be germane to the conduct of the remaining business or even what it means to be germane. Businesses might well be perfectly indifferent whether other assets were held in corporate solution along with them, and will hardly be affected whether a separation of assets occurs by reorganization or by dividend. The second sentence, of course, largely clarifies what is meant by "germane" in its suggestion that the end of a reorganization as such cannot be tax avoidance.

This also is far from self-evident, however, for the whole point of the reorganization provisions in the Code is to make certain transactions tax-free. To be sure, the range of dividend taxation is cut back as a result; but it was in response to patterns otherwise taxed as dividends that the reorganization provisions came into being in the first place.

The transaction in *Gregory* was doubtless economically equivalent to a dividend distribution, and to that extent the reorganization served principally to avoid the more onerous dividend tax. As a basis for resolving matters of form and substance, however, economic equivalence is untenable. The Code creates numerous tax differences between economically equivalent transactions.[47] The very decision to incorporate a business often entails a choice between two economically equivalent ways of pursuing a profit.

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[45] *Id.*

[46] To treat the "venture in hand" as the reorganization itself makes Hand's statement meaningless.

[47] *E.g.*, I.R.C. §§ 302, 305 (1976) (same result achieved by stock redemption or by stock dividend taxed respectively as capital gain or dividend).

Whatever its precise boundaries, the inquiry of the court in *Gregory* remained whether the thing done fell within the statute. In resolving that question, Judge Hand apparently found in the tax laws a generalized requirement that a reorganization be free of certain bad features. This can be restated more broadly as a principle that where the character of a corporate transaction is ambiguous, the Code somehow "prefers" a dividend to a capital gain, the latter being a matter of grace. So viewed, *Gregory* can be treated as a fairly traditional exercise in statutory interpretation. The opinion itself concluded squarely that Mrs. Gregory's transaction did not fall within the statutory term "reorganization" and was therefore a "sham."[48] The Supreme Court's affirmance seized particularly on this aspect of the case and, by repeatedly characterizing the underlying transaction as a "device," a "masquerad[e]," or an "artifice," tended to bring *Gregory* back within the range of "sham" cases.[49]

On balance, however, it is hard to view *Gregory* as simply a sham transaction case. Even though Judge Hand ostensibly operated entirely within the statute, the specific definitions of the 1928 Act ultimately surrendered to an almost open-ended statement of statutory purpose as the basis for decision.

V

Subsequent decisions have found in *Gregory* a broad mandate to attack perceived "bad" features of transactions, however firmly anchored within the terms of the Code. Reflecting perhaps the two strands within *Gregory*, a pattern common to many of the important later cases on "form" and "substance" is the coexistence within them of a narrow and a broad holding. The narrow holding is usually the ferreting out of some sham or other that justifies a recasting of a transaction. The broad holding is typically the assertion of some overriding principle of taxation that denies the taxpayer the wanted result, even assuming a transaction perfectly fitted within the terms of the statute.

Generalizing about these cases, one can say that in their nar-

[48] 69 F.2d at 811. Judge Hand, in later pronouncements about *Gregory*, was often at pains to construe it as a simple "sham" case. *See* Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935) (question in the Supreme Court's opinion in *Gregory* was whether transaction was in fact what it appeared to be in form). In other places, however, he treated the case as containing the entire "business purpose" doctrine. Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949) (*Gregory* requires business purpose for transaction to be effective for tax purposes).

[49] 293 U.S. at 465, 470, 471.

row holdings they are often wrong. Courts have been too quick to recast transactions that in fact deserved the character assigned them by the taxpayers. This in itself is not a serious problem, except for the taxpayers. A bad result in any given case is correctable later as transactions become better understood and more carefully managed. But there are also errors of principle in these cases, more troublesome in their permanent effect.

A case that epitomizes this pattern is *Commissioner v. Court Holding Co.*[50] In that case, negotiations for the sale of a piece of property by a corporation culminated in an oral agreement.[51] When the parties met to reduce the agreement to writing, however, the corporation's attorney advised the buyers that the sale could not go through because of adverse tax consequences. Instead, the corporation was liquidated the next day and its properties were distributed to its shareholders in exchange for their stock; the shareholders then sold the properties to the buyers on terms essentially the same as those previously negotiated with the corporation. If the transaction could properly be regarded as a liquidation of the corporation, followed by a sale of its properties by the shareholders, the corporate-level tax would be avoided. The Commissioner, however, insisted that the corporate-level tax be paid as though the corporation had sold the property before the liquidation and had distributed the cash proceeds to the shareholders in liquidation.[52] The Supreme Court upheld the Commissioner.[53]

One can find in *Court Holding* a narrow decision, largely factual, sounding in the sham transaction doctrine. So conceived, the Court's opinion merely asserts that, based on the overall record, no actual liquidation of the company occurred before the sale and that the sale was actually made by the corporation itself.[54] As such, there is nothing sinister about the *Court Holding* case. It is merely

[50] 324 U.S. 331 (1945).

[51] *Id.* at 333.

[52] 2 T.C. 531, 535 (1943), *rev'd*, 143 F.2d 823 (5th Cir. 1944), *rev'd*, 324 U.S. 331 (1945). Under the tax laws then in effect, *see* I.R.C. § 115(c) (1939), the pattern insisted upon by the Commissioner gave rise to taxable gain both for the corporation and the shareholders. *See* 2 T.C. at 541.

[53] 324 U.S. at 333-34.

[54] *Id. Court Holding* can be read even more narrowly as a case on the scope of appellate review of facts found by the Tax Court. The Tax Court "found" that the property had been sold by the corporation, 2 T.C. at 537, an implausible finding on the record, but not beyond belief. The Supreme Court might have concluded that the Tax Court's findings should be disturbed only if patently wrong. *See, e.g.*, Dobson v. Commissioner, 320 U.S. 489, 501-02 (1943) (Tax Court's findings of fact stand on review as long as there is a "rational basis" for them in the record). So conceived, *Court Holding* might be correctly decided, although having nothing to do with form versus substance.

wrong. On the facts as summarized by the Supreme Court (and apparently found by the Tax Court) it is fairly plain that a liquidation really did occur.[55] The conclusion would be different if, for example, the corporation had in fact sold the property and the taxpayers, as an afterthought, had attempted to trump up a liquidation. The Court was apparently misled by the rapid succession of events into thinking that a liquidation that briefly precedes a sale is somehow less a liquidation than one that precedes it by a long period, a notion readily dispelled upon reflection.[56]

The Court was not satisfied with a narrow and wrong decision, however. There is a larger aspect of *Court Holding*, far more difficult to state and limit. Starting from the proposition that "[t]he incidence of taxation depends on the substance of a transaction,"[57] the opinion asserted that the "means employed to transfer a legal title" cannot by themselves govern the tax consequences of a sale.[58] The liquidation of the corporation, in the Court's view, did nothing more than set up the shareholders as a "conduit" for the passage of title to the buyers, and as such could be disregarded as a "mere formalism[]."[59]

These propositions must have substantial superficial appeal, because they are accepted by an overwhelming majority of tax lawyers. But they are not tenable. All that the liquidation of a corporation ever entails is a transfer of title in its assets. When an artifi-

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[55] Whether such an erroneous inference from the facts would require reversal is another matter.

[56] Even here the Supreme Court's holding can be justified on the narrower ground that findings of fact by the Tax Court should be respected as long as they are warranted by the record, even though the conclusion the Tax Court drew can be shown to be wrong as a practical matter. The Supreme Court has held that any latitude in resolving factual issues in tax cases belongs to the Tax Court in its greater expertise, and that deference to those findings is therefore due. Dobson v. Commissioner, 320 U.S. 489, 501-02 (1943). This interpretation of *Court Holding*, of course, goes only to the scope of appellate review. *See supra* note 54.

It is an essential aspect of *Court Holding* that because the agreement was oral, there was no contract, enforceable against the corporation, to sell the property. There was thus no assignment of a contract already in force from a corporation to its shareholders, who might then be regarded as doing nothing more than fulfilling the corporation's obligations. Even in such a case it would not be obvious that the corporation was the seller; however, this hypothesis has no bearing on *Court Holding*, in which the only enforceable sale was made by the shareholders after liquidation.

On its narrow, factual basis, *Court Holding* was corrected in a later case, United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950), where the Supreme Court found, on essentially indistinguishable facts, that liquidation and sale had occurred in the order urged by the taxpayer.

[57] 324 U.S. at 334.

[58] *Id.*

[59] *Id.*

cial entity disappears, there results a change in the form of ownership of property. Indeed, it is hard to think of what else happens in a liquidation other than a change in the formal indicia of ownership.[60] This central fact—that liquidations of corporations are purely formal creatures of law—was apparently misunderstood by the Supreme Court. There is no specific physical event to which liquidations correspond. The same people may remain in control of the same property both before and after. To describe the passage of title pursuant to a liquidation as a "mere formalism" is to deny in effect that there can ever be a "real" liquidation.

In order to avoid the *reductio* implicit in *Court Holding*, later decisions[61] and commentators[62] have derived a somewhat different principle from the case. *Court Holding* is read to mean that the "substance" of a transaction can be found in the negotiations leading up to it, that from these negotiations the essential character of the transaction can be determined, and that once determined, it can override both the formal mechanics and purported effect of the transaction as structured by the parties. This is how the IRS[63] and most tax lawyers now understand *Court Holding*.[64] Lawyers routinely advise clients, once a corporation has taken a step or two toward a transaction with another party, that any form of the same transaction between the corporation's shareholders and the same party may be imputed back to the corporation. If it turns out that a transaction with the shareholders would bring better tax consequences, lawyers will frequently advise negotiating an entirely new transaction, with a different party, for fear of the penumbras of *Court Holding*. The lawyers may also stress how much difficulty the client would have saved by consulting them earlier.

The notion that negotiations are somehow part of the "substance" of a transaction is baffling. Negotiations can go on interminably and lead to a transaction or none, as the case may be. At the

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[60] In most states no conveyance is necessary; title to properties automatically vests in shareholders upon liquidation. *See* 16A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8134 (rev. perm. ed. 1979).

[61] *See, e.g.*, Waltham Netoco Theatres, Inc. v. Commissioner, 49 T.C. 399, 404-05, *aff'd*, 401 F.2d 333 (1st Cir. 1968).

[62] *See, e.g.*, Mintz, *Recent Developments Under Court Holding and Cumberland Public Service Co. Cases—Sale of Assets or Stock*, 11 INST. ON FED. TAX'N 873, 876-84 (1953).

[63] *See* Rev. Rul. 69-172, 1969-1 C.B. 99.

[64] Applied to the facts of *Court Holding*, this principle would no longer defeat the taxpayer. Section 337 eliminates recognition of gain by a liquidating corporation, regardless of the order of liquidating and sale. I.R.C. § 337 (West Supp. 1982). The principle of *Court Holding* is still applied to recast transactions other than complete liquidations. *E.g.*, Rev. Rul. 69-172, 1969-1 C.B. 99.

last minute the parties can storm out and war can ensue. In fact, *Court Holding* could be invoked to show that the Trojan War never was, or at least could be set aside as a sham, because it followed a series of negotiations tending to peace. However long the negotiations, the parties can change their minds in an instant and make a deal never before contemplated. Indeed, the longer the negotiations, the more likely the transaction actually consummated will be different from any one previously canvassed by the parties.

On close scrutiny, the reasoning in *Court Holding* simply collapses. The case does hardly more than proceed directly from the proposition that substance must prevail over form to the conclusion that the taxpayer's transaction cannot stand.

Although couched in the language of "form" and "substance," *Court Holding* has little to do with either of these things. Rather, it requires that the Treasury not be deprived of the benefit of an error that a taxpayer was about to make and corrected too late. Although it is not immediately obvious what the Court meant by "substance," in practice *Court Holding* called up a new set of forms to replace those less appealing to the Court. If the negotiators of a transaction are careful to assert from the start on whose behalf they negotiate, *Court Holding* can be tamed. Such an assertion is itself a formality and can be regarded as a Miranda warning of sorts, necessary to make certain transactions operative under subchapter C.

VI

Gregory and *Court Holding* encapsulate in the end an essentially aesthetic response to attempts by taxpayers thought unworthy of success. Both cases are, however, couched in the language, at least, of traditional statutory interpretation. *Gregory* purports to be striving for the *meaning* of the tax statute. *Court Holding* purports to lay bare what "really happened" in a transaction. A later case, *Goldstein v. Commissioner*,[65] took a large step in severing the question of form and substance altogether from one of dissecting transactions and the Internal Revenue Code.

Tillie Goldstein won $140,000 in the Irish Sweepstakes in 1958.[66] Shortly thereafter she borrowed somewhat less than one million dollars at four percent from banks, prepaying several years'

[65] 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).
[66] *Id.* at 736.

interest of $81,000 in cash.[67] With the loan proceeds she bought at a discount one million dollars' worth of 1.5% United States treasury notes, with maturities of three and four years.[68] The notes were pledged as security for the bank loans. Mrs. Goldstein hoped that the large interest prepayment would provide a deduction to offset her sweepstakes winnings, while the interest she received on the treasury notes would be reported annually. There was also the possibility of a capital gain upon retirement of the notes. What Mrs. Goldstein attempted in effect was home-made income averaging and deferral, but the plan would succeed only if the $81,000 in prepaid interest was deductible.

To the Tax Court the interest payments were a sham.[69] It reasoned that the bank had, in fact, invested directly in the treasury notes and had received from Mrs. Goldstein a fee for the service of donning the facade of a lender.[70] The Tax Court was almost surely wrong on this point, and the Court of Appeals so found.[71] Interest on the bank loans really had been paid, the bank had no rights in the treasury notes except as collateral, and it was nearly impossible not to treat the indebtedness of Mrs. Goldstein as genuine.

Having restored the character of interest to the amount paid by Mrs. Goldstein, the Court of Appeals was still not satisfied to let her win the case. The overall borrowing and purchase of treasury notes held out quite slender prospects of an economic profit for Mrs. Goldstein. The tax advantage of an interest deduction in the year of the sweepstakes win obviously was the motivating force in the transaction. Following the language of *Gregory*, the court could conceivably have said that it was intrinsic to the concept of "interest" that its payment have some object other than reducing taxes, and therefore that no "interest" had been paid. That would have been somewhat hard to say, however, considering what came before, and given that nothing in the statute indicates that the term "interest" is taken with a special meaning. Instead, the court said simply that this interest was not deductible.[72] The court held that interest could be deducted only if the underlying borrowing arose from activity that could be called "purposive."[73] The adjective is somewhat startling, and one might have thought it entirely

[67] *Id.* at 736, 739.
[68] *Id.* at 736.
[69] Goldstein v. Commissioner, 44 T.C. 284, 298 (1965).
[70] *Id.* at 299.
[71] 364 F.2d at 737-38.
[72] *Id.* at 740.
[73] *Id.* at 741.

applicable to Mrs. Goldstein's desire to reduce taxes. But the court explained that obtaining a tax deduction is not in itself purposive.[74] More is required, and whatever that is, Mrs. Goldstein did not have it.

Goldstein has been understood (somewhat charitably) in later cases[75] and commentaries[76] as embodying a specific refinement of the business purpose doctrine. Starting from the suggestion in *Gregory* that reducing taxes is not in itself a business purpose,[77] the doctrine posits that a transaction must have the inherent possibility of making a profit, entirely aside from tax effects, in order to fall within Code provisions ostensibly applicable to it. For this purpose, one imagines (although it is never stated), that the imputed income from consumption or ownership of property must be deemed an aspect of "profit," or the interest deduction for all consumer borrowing would be struck down.

But even passing this problem, the difficulties with the doctrine are insuperable. Whole classes of transactions could be shown to be uneconomical absent the effect of particular tax allowances. For example, one of the principal advantages of home ownership is the tax benefit of deductible mortgage interest coupled with the exclusion of the imputed rental income from taxation.[78] In many cases the purchase of a house with borrowed money is demonstrably uneconomical without this tax benefit, a benefit often fully discounted in the price of housing. Consistently applied, therefore, the *Goldstein* doctrine would wipe out the deductibility of much home mortgage interest—not such a bad result as a matter of policy, but not one commonly thought to be within the province of the courts to bring on unilaterally. The particular ferocity of the outcome in *Goldstein* embodies no consistently applicable general principle but, once again, an aesthetic response to a transaction thought unappealing.[79]

VII

The cases on form and substance have come some distance

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[74] *Id.* at 741-42.

[75] *E.g.*, Roemer v. Commissioner, 69 T.C. 440, 463 (1977).

[76] *E.g.*, Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985, 986-91 (1981).

[77] 364 F.2d at 741-42.

[78] I.R.C. § 163 (1976).

[79] I am, happily, spared the need to say more to demonstrate the doctrinal infirmities of *Goldstein* and its progeny because precisely such a demonstration has recently been made in an excellent article. *See* Warren, *supra* note 76.

past the simple attempt to distinguish genuine transactions from shams. So uncertain are the broader doctrines drawn by the courts, however, that the pattern of two-level holdings, adumbrated in *Gregory* and *Court Holding*, has persisted. Where possible, courts still try to cast transactions in disfavor as shams, before burying them under pronouncements of more sweeping import.

The much-vexed case of *Waterman Steamship Corp. v. Commissioner*[80] is an example. In that case the taxpayer (a corporation) sold the shares of a wholly owned subsidiary, in which its tax basis was $700,000. The buyer originally offered $3,500,000 for the shares. Not wanting a large capital gain of $2,800,000, the parent corporation rejected the offer but countered with its own offer of a sale for $700,000, to be preceded by a dividend distribution of $2,800,000. The buyer accepted this proposal.[81] The subsidiary distributed a $2,800,000 note to its parent as a "dividend" shortly before the sale of its shares. Shortly after the sale, the buyer lent the (now former) subsidiary of the taxpayer $2,800,000, which was used to pay off the note.[82]

Dividends from a wholly owned subsidiary are normally tax-free to its parent.[83] This explains the dividend distribution *before* sale of the subsidiary's shares. The subsidiary, however, almost surely had insufficient liquid assets actually to pay a $2,800,000 dividend in cash, which explains the distribution of a note. The Tax Court found that a dividend had in fact been paid by the subsidiary to its parent before the sale of shares.[84] The Court of Appeals reversed in an opinion laced with the language of form and substance.[85]

The narrow holding of the court was apparently that in "substance" no dividend had been paid and that the overall transaction was a sale of the subsidiary's stock for $3,500,000. At this level the opinion is unremarkable but, again, wrong. To be sure, the transaction was economically equivalent to a sale of shares for $3,500,000 before the dividend, but sales of shares are always at a price that reflects the previous payment of dividends. It is true also that the

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[80] 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971).

[81] *Id.* at 1187-90.

[82] *Id.* at 1189-90.

[83] I.R.C. § 243 (West Supp. 1982).

[84] Waterman S.S. Corp. v. Commissioner, 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971).

[85] *E.g.*, 430 F.2d at 1185, 1192 ("attempt by a taxpayer to ward off tax blows with paper armor"; "economic substance"; "courts will look beyond the superficial formalities of a transaction to determine the proper tax treatment").

subsidiary probably did not have the ready cash to pay a $2,800,000 dividend. But the creation of claims against corporate assets in the form of debt instruments distributed to shareholders has normally been treated by the IRS and the courts as a dividend.[86] The succession of events was rapid rather than drawn out, but that was hardly a reason for the individual steps to change their character.

To its dissection of the taxpayer's specific transaction, the court added a statement of general principle. To allow a tax-free dividend would open "a new horizon of tax avoidance" by the circumvention of capital gains treatment "through a pre-sale extraction of earnings and profits."[87] The inevitable implication of this principle is that there can never be a dividend distribution in close proximity to a sale of shares.

The court's notion of what is necessary to prevent tax avoidance, assuming this to be a legitimate standard, is remarkable. The profits of the subsidiary in *Waterman Steamship* had already been taxed at the regular corporate tax rate for business profits. When the parent was taxed on gain from the "sale" of its subsidiary's shares, these profits were in effect taxed again in corporate solution. And the profits of the subsidiary could still be taxed as dividends upon their ultimate distribution to individual shareholders. Thus a regime of potential triple taxation of the same profits was found necessary by the court to prevent a "new horizon of tax avoidance."

Curiously, the result sought by the taxpayer in *Waterman Steamship* (and decried as a potential "new horizon" of abuse) was unilaterally adopted by the IRS, four years before *Waterman Steamship* was decided, in its 1966 revision of the regulations governing consolidated returns of parent and subsidiary corporations.[88] To have respected the dividend distribution in *Waterman Steamship* would have given the taxpayer the result now routinely obtained under IRS regulations by parent corporations that sell subsidiaries, a result denounced by no one as "tax avoidance."[89]

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[86] *See, e.g.*, Bazley v. Commissioner, 331 U.S. 737, 742-43 (1947).

[87] 430 F.2d at 1195.

[88] *Compare* Treas. Reg. § 1.1502-34A (1955) (generally no adjustment of parent's basis for subsidiary's earnings and profits) *with* Treas. Reg. § 1.1502-32, T.D. 7637, 1979-2 C.B. 311, 315 (parent's basis in stock of consolidated subsidiary increased by subsidiary's earnings and profits).

[89] Many of the difficulties inherent in the Fifth Circuit's handling of *Waterman Steamship* are analyzed in Kingson, *supra* note 32. Kingson offers a powerful critique of the case, but then appears to conclude that the true substance of the transaction should be found in

VIII

It is easy enough to criticize, I suppose, and someone having read this far might well ask how the courts could have done better in unravelling form and substance in taxation. For one, they could have paid less attention to the whole idea. More parsing of the statute and specific transactions and less concern with how to save the world from manipulative taxpayers would have led to sounder holdings in all these cases.

The most important inquiry at the threshold is whether a statutory provision draws its meaning from the terms of the statute itself or (and to what extent) from outside. When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. "Substance" can only be derived from forms created by the statute itself. Here substance *is* form and little else; there is no natural law of reverse triangular mergers. The IRS should no more be required to concede a near miss than a taxpayer to be denied the benefit of a formally perfect transaction for want of moral purity.

The harder problem is measuring transactions against statutory provisions that draw their content from life. The ultimate question here is what it is that taxpayers have actually done. This is a difficult sort of inquiry, which requires a grasp of transactions in their complete setting.

Hard grappling with the facts of a case and the inner workings of a statute, although both difficult and intellectually admirable, is frequently passed off as a trivial or excessively "formal" exercise. For one who has gotten that far, the slogan of "substance over form" is as good a means as any to clear the intellectual landscape for an inquiry about the "larger" nature of the statute itself. The latter exercise is in fact quite easy, requiring only the assertion of a statutory purpose that encapsulates one's own tastes, either generally or regarding the transaction under scrutiny.

As Professor Bittker points out, the enshrinement of substance over form has come to serve in the discourse of tax lawyers and judges as a "maxim" of statutory construction.[90] As with its older relatives—or perhaps like a proto-language after generations of etymological transformation—it is harder and harder to know which way it will cut when it surfaces. Learned Hand himself once

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the underlying negotiations, on the principle of *Court Holding*. *Id.* at 883-84. It seems to me that Kingson replaces the approach taken by the court in *Waterman Steamship* with one conceptually even less tenable. *See supra* note 64 and accompanying text.

[90] 1 B. BITTKER, *supra* note 1, at 4-35 to 4-44.

described "form" and "substance" as "anodynes for the pains of reasoning."[91] In its recent manifestations in decided cases, the slogan has become as much a means of blunting the thrust of the statute as promoting it.

A justification frequently offered for extrastatutory or remedial forays by the courts in tax cases is that the tax laws cannot possibly reach all the artful forms of transaction used by taxpayers to reduce taxes and, therefore, that the courts have an important function in filling gaps left open by an imperfectly expressed congressional intent.[92] Few myths so persistent are as easily dispelled. It is hard to think of a single case that has ever permanently staunched any fissure in the congressional dyke.

None of the cases reviewed here forestalled the necessity to change the law. Some even required specific corrective responses against their own holdings from Congress and the IRS. Neither the IRS nor the courts need rely on the highly metaphorical language of *Gregory* to prevent dividend distributions from taking on the guise of corporate separations, because the Code has been specifically amended to require first, that the shares received by would-be Mrs. Gregorys represent ownership of an active business undertaking with a five-year history,[93] and second, that the overall transaction not be a "device" for the distribution of profits.[94] The result in *Court Holding* so little comported with desirable tax policy that the outcome of the case in its original setting was reversed by Congress in the 1954 Code.[95] The IRS was forced to repudiate the principle underlying its victory in *Waterman Steamship* when it became apparent that it favored the taxpayer in cases where individuals rather than parent corporations received distributions from corporations before the sale of their shares.[96] The IRS has retreated to the position that *Waterman Steamship* is a pure sham transaction case, which it certainly is not.[97]

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[91] Commissioner v. Sansome, 60 F.2d 931, 933 (2d Cir.), *cert. denied*, 287 U.S. 667 (1932).

[92] *E.g.*, Davant v. Commissioner, 366 F.2d 874, 887 n.27 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

[93] I.R.C. § 335(a)(1)(b) & (c) (West Supp. 1982).

[94] *Id.* § 355(a)(1)(B).

[95] Internal Revenue Code of 1954, ch. 736, § 337, 68A Stat. 1, 106 (1954) (codified as amended at I.R.C. § 337 (West Supp. 1982)).

[96] *See* Casner v. Commissioner, 450 F.2d 379, 395, 398 (5th Cir. 1971) (*Waterman Steamship* applied to distributions received by individual shareholders); Rev. Rul. 75-493, 1975-2 C.B. 109 (IRS will not follow *Casner*; *Waterman Steamship* distinguished as "sham" case).

[97] *See supra* text accompanying note 86.

The *Goldstein* case best illustrates the fecklessness of judicial attempts to make the law "better" by designing it in response to the affairs of a single taxpayer. The perceived abuse in *Goldstein* stemmed principally from two causes. The first was the deduction claimed for prepaid interest, at that time not barred by the Internal Revenue Code. Certainly, the prepayment of several years' interest could be regarded conceptually as a capital expenditure, being the cost of producing the right to use borrowed funds for a period of years. Arguably, then, a deduction should be only ratably allowed. Offsetting this is the fact that the taxpayer has actually parted with the interest and that the lender must recognize income immediately.[98] The other major problem with the *Goldstein* transaction was the creation of a current interest deduction against ordinary income for the cost of holding an asset that, by virtue of accruing unrealized appreciation, would produce gains both deferred and partly taxed at lower capital gains rates.

Quite possibly these two problems were defects in the tax system. But it certainly was not within the reach of a single decision like *Goldstein* to cure them. The tax result sought by Tillie Goldstein has been prevented independently by at least two subsequent statutory changes. One is a limitation on the deduction of interest on borrowings used to carry investment assets.[99] The other is a requirement that prepaid interest be deducted ratably over the full period of a borrowing.[100] Either rule alone would have stopped Tillie Goldstein. It is inconceivable that Congress could have been spared the trouble of amending the law by the generalized requirement of a "purposive" transaction asserted in *Goldstein*. The net effect of *Goldstein* was therefore not to improve the law in a way that voided the need for further statutory overlays, but simply to penalize one Tillie Goldstein for having thought that she could rely on a clearly stated Code provision allowing a deduction for "interest,"[101] which no one denied that she paid.

The sort of "creative" jurisprudence found in the cases on form and substance cannot, in the end, be justified by any demonstrable needs of sound tax administration. It has, however, become the norm, and one wonders why.

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[98] Indeed, objections to prepaid interest might also invalidate the allocation of large amounts of interest to the early payments of a mortgage.

[99] Tax Reform Act of 1969, Pub. L. No. 91-172, § 227, 83 Stat. 487, 574 (current version at I.R.C. § 163(d) (West Supp. 1982)).

[100] Tax Reform Act of 1976, Pub. L. No. 94-455, § 208, 90 Stat. 1520, 1541-42 (codified at I.R.C. § 461(g) (1976)).

[101] I.R.C. § 163(a) (1976).

One reason is that judges have aspirations. Little attention is drawn to those who hew narrowly to technical rules. The painstaking process of examining transactions and statutes to determine whether they concord promises little glory. In a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through, rather than unravel, the Gordian knot. A simpler variant of this attitude is the desire not to look naive, to understand what is "really going on." Many of the judges who have written opinions in this area display the tone of one who wants very much not to be taken in.

A recent Tax Court case, *Carriage Square, Inc. v. Commissioner*,[102] is both amusing and unnerving in its surrender to this tendency. The underlying issues are unimportant, because it little matters whether the court was right or wrong. A concurring opinion contains the following thoughts:

> All the members of the Court recognize that the tax avoidance scheme of Arthur Condiotti and his accountant-tax adviser, William P. Barlow, cannot be allowed to stand. It is an obvious attempt, and a somewhat crude attempt, lacking in legitimate business purposes, to spread large anticipated sums of ordinary income among several taxpayer[s] . . . . The only disagreement among the members of the Court is how best to set aside the tax avoidance scheme.[103]

The opinion then goes on to scourge the taxpayer with a variety of epithets.[104] Six judges agreed with this concurrence. To be sure, neither Learned Hand nor Hugo Black would ever have written such words into an opinion, but it is also hard to imagine that any judge would feel licensed to follow a pure gut response in deciding a tax dispute if *Gregory* and *Court Holding* had gone the other way.

On the whole, law professors do not help much either. It is their wont to decry "formalism" and glorify the ends of "policy" in the resolution of disputes. It is not uncommon for professors to regard—and teach—the process of legal interpretation as a vehicle for their own aesthetic preferences, which cover the range from allocative efficiency to distributive justice. Whatever the merits of this style of legal analysis in general, in tax matters it is a fertile

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[102] 69 T.C. 119 (1977).

[103] *Id.* at 130-31 (Goffe, J., concurring).

[104] *Id.* at 133 ("not acquired in a bona fide transaction"; "scheme to avoid tax"); *id.* at 134 ("reek with suspicion"); *id.* at 137 ("flunked all of the tests").

source of bad law.

If not the taxpaying public or the fisc, who ultimately benefits from this approach? The only unequivocal beneficiary is the tax bar. The heavier the layers of judicial divination superimposed on the Internal Revenue Code, the richer tax lawyers are apt to get. The development of an exquisite set of intuitions about what kinds of transactions the courts "like" and "don't like" has become a large part of what tax lawyers sell.

After *Court Holding*, a lawyer could with a certain smug veracity tell a client who had thought it a good idea to save taxes by liquidating a company before a sale, "You should have called me months ago—now you're in trouble." Indeed, it would not take too many cases like *Court Holding* to justify the injunction not to take a deep breath without calling a tax lawyer.

Some of this is inevitable. Clients will rarely read the tax laws or the decided cases as accurately as their counsel and will always have some reason to fear that they may have missed something. To the extent that every transaction has to run the gauntlet of an array of extrastatutory standards, however, tax lawyers' contribution to the GNP deflator will be all the greater.

To be sure, all of this matters less than war or famine, and we shall all manage to lurch along even with this additional dead weight on our tax system. Still, I believe that if *Gregory* had gone the other way (and all that that entails had ensued), we would now have a more readily fathomable demarcation between the respective spheres of statutory provisions and judicial intuition.

IX

Remembering my starting point, I should add that it was not—nor should it have been—Professor Bittker's mandate to scour the tax cases for unsound pronouncements. The most important function of a tax treatise is to aid in giving advice. And there is no denying that tax lawyers must, in advising their clients, heed every one of the cases examined here, notwithstanding the sort of misgivings an academic reviewer might muster.

Overall, *Federal Taxation of Income, Estates and Gifts* serves the ends of tax lawyers so well that with it Professor Bittker has cemented his already immense reputation. Another actor in this story, however, now mostly forgotten, also deserves a word of praise—a word necessarily directed to his heirs. It was Judge Sternhagen of the Board of Tax Appeals who, in the original opinion in *Gregory*, made the clearest and most defensible statement I

have yet encountered on the subject of form and substance in taxation.[105]

[105] *See supra* notes 35-37 and accompanying text.

A

[PRIVY COUNCIL]

P. C.* 1965 *May* 17, 18, 19, 20, 24, 25, 26, 27 *July* 27

B.P. AUSTRALIA LTD. APPELLANT

AND

COMMISSIONER OF TAXATION OF THE COMMONWEALTH OF AUSTRALIA RESPONDENT

B

ON APPEAL FROM THE HIGH COURT OF AUSTRALIA

Australia—Revenue—Income tax—Capital or income expenditure—Payments by oil company to secure exclusive sales stations—"Solo site service station system"—Lump sum paid to retailer in return for tie for a period of years—Retailer to sell only approved brands of motor spirit—Oil company's ultimate object—Character of the advantage sought—Lasting qualities—Recurrence—Manner in which the advantage to be used, relied upon or enjoyed—Means adopted to obtain the advantage—Enduring benefit—Capital structure—"Once and for all" payments—Whether allowable deductions for tax purposes—Income Tax and Social Services Contribution Assessment Act, 1936–1952 *(Commonwealth), s.* 51.

C

D

Revenue—Income tax—Capital or revenue expenditure—Trading profits of oil company—Payments by oil company to secure exclusive sale stations.

E

Until 1951 the usual method of retailing motor spirit in Australia was that operators conducted service stations at which the pumps and tanks of competing oil companies were installed and their products were bought and sold in competition with one another. Each operator offered to the public a choice of a number of different brands of motor spirit. The pumps and tanks remained the property of the oil companies concerned and were subject to the right of the service station operator to give notice (one month) for them to be removed. In practice, the tanks were not removed, as there was in existence a trade convention by which a company which had received notice of removal would make its existing tanks on a particular site available to its successor.

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In 1951 one of the oil companies, the Shell company, announced that it had decided to introduce a dealer plan with

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[Reported by S. P. KHAMBATTA, Esq., Q.C.]

* *Present*: LORD REID, LORD MORRIS OF BORTH-Y-GEST, LORD PEARCE, LORD UPJOHN and LORD WILBERFORCE.

A the object of confining its trade to stations which were prepared to become solo outlets. When the announcement was made the Shell company had already been promised the co-operation of a number of service station proprietors. The introduction of the Shell company's plan made it imperative for every other oil company to take steps to secure the co-operation of some service station proprietors if it was to retain a share of the trade through B selling outlets of this description. One of the courses adopted by the appellant company ("B.P.") to reorganise marketing and distribution in this section of the trade was to join with three other oil companies in order to secure sites where their products might, in common, be resold to the public. In pursuance of this plan B.P. promised to pay a sum of money (in the agreement called "development allowance") as part of the consideration for the C undertaking by the service station proprietor to deal exclusively in the brands of motor spirit approved by the appellant company for a fixed number of years. The gallonage factor was a matter for consideration in deciding what sum should, prima facie, be regarded as the maximum amount which might in the particular case be laid out, but it was not the determining factor in the amount actually paid.

D On appeal from the disallowance by the Commissioner of Taxation of the "development allowance" payments as income tax deductions under section 51 (1) of the Income Tax and Social Services Contribution Assessment Act, 1936–1952,[1] the High Court of Australia (Taylor J.) held that it was implicit in the agreement that B.P.'s pumps and tanks would remain on the subject premises for the period, and B.P.'s products would be sold on the premises for the period, and B.P. also secured substan- E tial freedom from competition on the site for the period and this constituted an advantage for the enduring benefit of its trade, that the lump sums paid to the service station proprietors were not paid either in form or substance as the equivalent of trade rebates or discounts, and that, accordingly the payments were not of a revenue character and were not deductible in computing its assessable income.

F On appeal to the Full High Court of Australia, the majority (McTiernan, Windeyer and Owen JJ.) affirmed the judgment of Taylor J.; the minority (Dixon C.J. and Kitto J.) held that the advantage for which B.P. made the expenditure was not the acquisition of a new market, nor a new framework within which to carry on trade for the future, nor an extension of B.P.'s selling organisation to include a regiment of resellers, nor such an ex- G clusion of competition as would add to goodwill a negative right

[1] Income Tax and Social Services Contribution Assessment Act, 1936–1952, of the Commonwealth of Australia, s. 51: "(1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

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and thus increase the value of goodwill; that it consisted simply of the practical assurance of receiving bundles of orders for motor spirit, the circumstances being such that for the foreseeable future it would be only by getting similar bundles of orders that a trade such as B.P. could be carried on, and that the ultimate question for B.P. was whether, bearing in mind the probable amount of the trade which would result from obtaining an agreement with the operator, it was worth while paying a particular sum as the price of the agreement. On B.P.'s appeal:—

Held, (1) that the solution to the problem was not to be found by any rigid test or description, but had to be derived from many aspects of the whole set of circumstances some of which might point in one direction, some in the other; that one consideration might point so clearly that it dominated other and vaguer indications in the contrary direction and the ultimate answer came from a common sense appreciation of all the guiding features; that, in border line cases, it turned on questions of emphasis and degree and depended on what the expenditure was calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process (post, p. 264E–G).

Dictum of Dixon J. in *Hallstroms Pty. Ltd.* v. *Federal Commissioner of Taxation* (1946) 72 C.L.R. 634, 648 applied.

(2) That the guiding features were (a) the character of the advantage sought, i.e., its lasting qualities, the fact of recurrence and the nature of the need or occasion which called for the expenditure; (b) the manner in which the advantage was to be used, relied upon or enjoyed, and in which recurrence might play a part; and (c) the means adopted to obtain the advantage, i.e., by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment: that a common sense appreciation of those guiding features made the expenditure of a revenue nature if its purpose brought it within the very wide class of things which in the aggregate formed the constant demand which had to be answered out of the returns of a trade or its circulating capital (post, p. 261D–F).

Dicta of Dixon J. in *Sun Newspapers Ltd.* v. *Federal Commissioner of Taxation* (1938) 61 C.L.R. 337, 362, 363 and in *Hallstroms Pty. Ltd.* v. *Federal Commissioner of Taxation* (1946) 72 C.L.R. 634 and Viscount Radcliffe in *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines Ltd.* [1964] A.C. 948, 959; [1964] 2 W.L.R. 339; [1964] 1 All E.R. 208, P.C. applied.

Mitchell v. *B. W. Noble Ltd.* [1927] 1 K.B. 719; 43 T.L.R. 245, C.A. and *British Insulated and Helsby Cables* v. *Atherton* [1926] A.C. 205; 42 T.L.R. 187; 10 T.C. 155, H.L. considered.

(3) That, in considering the character of the advantage sought, the indicia were (a) that the advantage which B.P. sought was to

promote sales and obtain orders for petrol by up-to-date marketing methods, and since orders could be obtainable only from tied retailers, B.P. had to be tied with retailers, though its real object was not the tie but the orders flowing from the tie (post, p. 265D–E); (b) that, applying the test of whether the payments were out of fixed or circulating capital, the sums in question were sums which had to come back penny by penny with every order during the period in order to reimburse and justify the particular outlay, and therefore the lump sums were circulating capital which was turned over and in the process of being turned over yielded a profit or loss and part of the constant demand which must be answered out of the returns of the trade (post, pp. 265G—266C) (*John Smith & Son* v. *Moore* [1921] 2 A.C. 13; 37 T.L.R. 613; 12 T.C. 266, H.L.(Sc.) considered); (c) that, taking a broad view of the general operation under which the expenditure was incurred, it was made to meet a continuous demand in the trade, and fresh sums were paid each year to fresh retailers, so that, if regard was had to the whole picture, the expenditure was of a "recurrent" and not a "once for all" nature (post, p. 267C–D); (d) that, considering the many aspects of the whole set of circumstances dealing with payments made to particular customers to secure their particular custom, the nature of the benefit sought and obtained by B.P. pointed to the expenditure being revenue rather than capital (post, p. 273C).

Anglo-Persian Oil Co. Ltd. v. *Dale* [1932] 1 K.B. 124; 47 T.L.R. 487; 16 T.C. 253, C.A. and *Van den Berghs Ltd.* v. *Clark* [1935] A.C. 431; 51 5.L.R. 393; 19 T.C. 390, H.L. considered.

Bolam v. *Regent Oil Co. Ltd.* (1956) 37 T.C. 56 approved.

(4) That in considering the manner in which the advantage was to be used, relied upon or enjoyed, the benefit was to be used in the continuous and recurrent struggle to get orders and sell petrol; that the agreements were the basis of the orders and made the orders inevitable and merged in and became part of the ordinary process of selling, so that that consideration pointed to the expenditure being of a revenue nature (post, p. 273D–F).

(5) That, therefore, on a balance of all the relevant considerations the scales inclined in favour of the expenditure being of a revenue and not a capital nature.

Judgment of the Full Court of Australia (1964) 37 A.L.J.R. 365 and of Taylor J. (1962) 35 A.L.J.R. 77 set aside.

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July 27. The judgment of their Lordships was delivered by LORD PEARCE, who observed that the result depended not so much on fact as on the weight and emphasis that one gave to indisputable facts and the overall inference which one drew from the situation as a whole, said that their Lordships were indebted to counsel on both sides for their careful, fair and vigorous arguments, stated the facts as set out above and continued. There was considerable argument as to the findings of Taylor J. concerning the relation of the sums paid to gallonage and how far they were affected by competition, but these do not conclude the matter one way or the other.

B.P.'s ultimate object was to sell petrol and to maintain or increase its turnover. There can be no doubt that the only ultimate reason for any lump sum payment was to maintain or increase gallonage. If B.P. paid a higher lump sum to A than B it was because (1) A then was selling at a higher rate than B, or (2) A was likely to sell at a higher rate in the future than B, either since he was a better salesman or had a better strategic site, or (3) A was a better bargainer and therefore obtained from B.P. the highest price which it was prepared to pay instead of the lower price which it had induced B to accept, or (4) A had a particularly good site which must not go by default because that would allow rivals to encroach and so decrease B.P.'s overall gallonage. All these reasons are founded on gallonage whether immediate or ultimate. The fourth reason which is founded on the company's overall gallonage as opposed to A's personal gallonage was no doubt infrequent; and it does not alter the general relation of the sums paid to the estimated efficacy of the recipient retailer in selling B.P.'s petrol and to the impact of his efforts on the overall gallonage. The fact that the amounts of the lump sums were influenced or even decided by competition does not greatly affect the matter. Every price or rebate is influenced and largely decided by competition. The trader offers the rebate that competition renders necessary or desirable. So too with lump sums paid to retailers. The more they were based on the particular retailer's gallonage the more closely they were tied to the immediate costs of selling to an individual customer. But even where the overall gallonage rather than the immediate gallonage influenced the sum paid it could still be one of the revenue expenses of marketing.

Considerable emphasis has been put on the fact that B.P.'s whole existence was threatened by the new situation which had occurred. But this is not a decisive factor. Whenever a business finds that its trade rivals are getting ahead of it, its existence is threatened. The seriousness of the situation has, however, this much relevance, that it provided ample justification for capital expenditure in the reorganisation of its business structure if that should be necessary or desirable. It demolishes any argument that the occasion was too trivial or too ordinary to enable counter-measures in the means of marketing to assume the structural quality of capital expenditure. But it still leaves unanswered the question whether the steps which were taken to meet the crisis were in fact of a capital or of a revenue nature.

A valuable guide to the traveller in these regions is to be found in the well-known judgment of Dixon J. in *Sun Newspapers Ltd.* v. *Federal Commissioner of Taxation*,[1] where he discussed the nature of certain sums spent in buying up the competition of a rival and concluded that they were capital. "There are, I think," he said,[2]

> "three matters to be considered, (*a*) the character of the advantage sought, and in this its lasting qualities may play a part, (*b*) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (*c*) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

And he said [3]:

> "the expenditure is to be considered of a revenue nature if its purpose brings it within the very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital and that actual recurrence of the specific thing need not take place or be expected as likely."

To this one may add the general observation of Viscount Radcliffe in *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines* [4]:

> "Nevertheless, it has to be remembered that all these phrases, as, for instance, 'enduring benefit' or 'capital structure' are essentially descriptive rather than definitive, and, as each new case arises for adjudication and it is sought to

[1] (1938) 61 C.L.R. 337.
[2] Ibid. 363.
[3] Ibid. 362.
[4] [1964] A.C. 948, 959; [1964] 2 W.L.R. 339; [1964] 1 All E.R. 208, P.C.

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reason by analogy from its facts to those of one previously decided, a court's primary duty is to inquire how far a description that was both relevant and significant in one set of circumstances is either significant or relevant in those which are presently before it." A

and [5]:

"Again, courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income-earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve, but the reality of the distinction, it must be admitted, does not become the easier to maintain as tax systems in different countries allow more and more kinds of capital expenditure to be charged against profits by way of allowances for depreciation, and by so doing recognise that at any rate the exhaustion of fixed capital is an operating cost. Even so, the functions of business are capable of great complexity and the line of demarcation is sometimes difficult indeed to draw and leads to distinctions of some subtlety between profit that is made 'out of' assets and profit that is made 'upon' assets or 'with' assets." B C D

Many cases have been cited to their Lordships and careful arguments have been based on the decisions either by analogy or on the actual language used in illuminating those decisions.

Some of the cases on which the revenue rely deal with the buying off of competition. Instances of these are the *Sun Newspaper Case* [6]; *United Steel Cos. Ltd.* v. *Cullington* [7]; and *Collins* v. *Joseph Adamson & Co.*[8] *Associated Portland Cement Manufacturers Ltd.* v. *Kerr* [9] also comes in this category. And *Van den Berghs Ltd.* v. *Clark* [10] has an element of this although it comes into another category. E F

Where a trader buys out a rival in order to secure his goodwill or to suppress it and so provide or maintain a clear field for his own enterprise over a substantial period, there is a definite prima facie pointer towards a capital payment. But in the present case B.P. was not achieving a monopoly nor buying off competition nor obtaining any substantial area for its own domain. Although one retailer was tied to B.P., the retailer next door could still buy G

[5] [1964] A.C. 948, 960.
[6] 61 C.L.R. 337.
[7] [1940] A.C. 812; 56 T.L.R. 550; [1940] 2 All E.R. 170; 23 T.C. 91, H.L.
[8] [1938] 1 K.B. 477; 54 T.L.R. 64; 21 T.C. 400; [1937] 4 All E.R. 236.
[9] [1946] 1 All E.R. 68; 62 T.L.R. 115; 27 T.C. 103, C.A.
[10] [1935] A.C. 431; 51 T.L.R. 393; 19 T.C. 390, H.L.

[illegible] passing motorist could do likewise. When a shop agrees to deal only in the goods of a certain manufacturer, it may be said loosely that the manufacturer has a monopoly in that shop. But the word is misleading when all the other shops in the row are available to competitors. It may be that a particular shop is in a site so superior to the others, that securing its trade is a matter of great local importance. But looked at over a broad front, as one should look at dealings which are so widely spread as those in the present case and are common to the whole of a vast and universal trade, the particularly good site should be balanced against the particularly bad site. It is the acquisition of the sole trade of a retailer sited at an average service station which should be regarded. The wholesaler would in practice achieve the same result by entering into a forward instalment contract for the supply to a particular retailer of an amount of goods which equalled his anticipated capacity to sell. As to the advantage to the wholesaler of being able to paint the service station in his own colours, or advertise in any other way, it is a misuse of the word to describe it as an advertising monopoly. In practice a retailer welcomes (or demands) advertising matter from his wholesaler, and the advertising advantage is no more than a natural by-product of the wholesaler having tied a dealer to take his goods.

For those reasons the cases where competition had been stifled for a substantial period or a monopoly has been acquired have little direct bearing.

Some of the cases on which B.P. relies deal with the removal of unsatisfactory personnel. An instance of these is *Mitchell* v. *B. W. Noble Ltd.*[11] in which a lump sum paid to get rid of a bad director was held to be a revenue payment. In that case Hanworth M.R. said [12] that the payment was made

> "not in order to secure an actual asset to the company but to enable the company to continue to carry on, as it had done in the past, unimperilled by the presence of one who . . . might have caused difficulty."

Again in *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* [13] a lump sum paid to get rid of an unnecessary director was held to be a revenue payment since "The purpose was transient and, although not itself recurrent, it was connected with the ever-recurring question of personnel" (*per* Dixon J.[14]). A gratuity of

[11] [1927] 1 K.B. 719; 43 T.L.R. 245.
[12] Ibid. 737.
[13] (1936) 56 C.L.R. 290.
[14] Ibid. 306.

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£1,500 paid to a reporter on his retirement (*Smith* v. *Incorporated Council of Law Reporting for England and Wales* [15]) and £4,994 spent in buying an annuity for an actuary who had retired (*Hancock* v. *General Reversionary and Investment Co.*[16]) were held to be revenue payments. But the facts of these cases which deal with the recurrent problems of personnel do not provide an analogy to the present case. Nor on the other hand can any useful comparison be made with *British Insulated and Helsby Cables* v. *Atherton.*[17] There a company's contribution of over £30,000 to form the nucleus of a fund and provide the amount then necessary to provide pensions for its staff was held to be a capital payment on the ground that [18]:

> " when an expenditure is made, not only once and for all but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade . . . there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

Those words are useful as an expression of general principle on prima facie indications, but the benefit in the particular case was the foundation of a fund that would endure for the whole life of the company and provides no analogy to the present case.

The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

> " depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process ":

per Dixon J. in *Hallstroms Pty. Ltd.* v. *Federal Commissioner of*

[15] [1914] 3 K.B. 674; 30 T.L.R. 588; 6 T.C. 477.
[16] [1919] 1 K.B. 25; 35 T.L.R. 11.
[17] [1926] A.C. 205; 42 T.L.R. 187; 10 T.C. 155, H.L.
[18] [1926] A.C. 205, 213.

A *Taxation.*[19] As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.

B One may approach the problem by considering the first of the matters mentioned by Dixon J. above, namely the character of the advantage sought, and in this both its lasting qualities and the fact of recurrence may play their parts. Under this head one might also take account of the nature of the need or occasion which calls for the expenditure: Dixon J. in *Hallstrom's* [19] case.

C The need or the occasion came from the fact that marketing in the petrol trade in 1951 changed its nature suddenly but for sound commercial reasons. This change was in accord with modern tendencies in commerce. Instead of being a short term trade it became a long term trade. The producers' output no longer flowed unimpeded, intermingled, and haphazard over the whole area of
D consumption. It was diverted into separate specialised and individual channels. Henceforth the customer gave his whole loyalty or none at all. The producer in accordance with the new market fashion needed to have his own tied retailers, fewer in number but individually better customers, if he was to compete with his rivals. The advantage which B.P. sought was to promote
E sales and obtain orders for petrol by up-to-date marketing methods, the only methods which could now prevail. Since orders were now and would in future be only obtainable from tied retailers, it must obtain ties with retailers. Its real object, however, was not the tie but the orders which would flow from the tie. To obtain ties it had to satisfy the appetite of the retailers by pay-
F ing out sums for a period of years, whose amount was dependent on the estimated value of the retailer as a customer and the length of the period. The payment of such sums became part of the regular conduct of the business. It became one of the current necessities of the trade.

G The test of whether these sums were payable out of fixed or circulating capital, referred to for example in *John Smith & Son* v. *Moore* [20] tends in the present case in favour of regarding these payments as revenue expenditure. Fixed capital is prima facie that on which you look to get a return by your trading operations.

[19] (1946) 72 C.L.R. 634, 648.

[20] [1921] 2 A.C. 13, 19; 37 T.L.R. 613; 12 T.C. 266, H.L.(Sc.).

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Circulating capital is that which comes back in your trading operations. The sums in question were sums which had to come back penny by penny with every order during the period in order to reimburse and justify the particular outlay. If one imagines a B.P. agent justifying the price of petrol to a retailer or discussing whether price reduction was possible, it is hard to imagine him omitting the lump sum so paid (divided by the estimated gallonage) as an item in the cost per gallon. It is doubtful if he would even relegate it to overheads since it was in the forefront of the wholesaler's selling costs. Nor can one imagine the retailer demurring at such a calculation. Prima facie therefore the lump sums were circulating capital which is turned over and in the process of being turned over yields a profit or loss; they were part of the constant demand which must be answered out of the returns of the trade. This, however, is merely one indication and by no means concludes the matter.

Mr. Menhennit forcibly contends that these were payments of a "once and for all" nature producing assets or advantages which are an enduring benefit and which should therefore go into capital account: see *per* Lord Cave in *British Insulated and Helsby Cables Ltd.* v. *Atherton.*[21] Further he argues that the benefit was to the structure of B.P. within which its profits were earned and not to the process of earning them. These are admittedly valid tests to apply and he contends that each points in favour of a capital expenditure.

The first point involves the question of recurrence. The Lord President in *Vallambrosa Rubber Co. Ltd.* v. *Farmer*[22] said, as a rough criterion,[23] "capital expenditure is a thing that is going to be spent once for all, and income expenditure is a thing that is going to recur every year." But as Rowlatt J. pointed out in *Ounsworth* v. *Vickers Ltd.*[24] the words "every year" are not to be taken literally but mean pursuant to a continuous demand.

It is argued that here there is nothing to show that the retailers would or could insist on fresh payments for a renewal at the end of the periods. But the reasonable inference is that they would and could do so. Unless the demand for petrol exceeds the supply (which on a balance of probabilities seems quite unlikely) the retailers would at the end of the period be in a position as good as or better than their original position. The fact that B.P. did not

[21] [1926] A.C. 205, 213.
[22] 1910 S.C. 519; (1910) 5 T.C. 529.
[23] 1910 S.C. 519, 525; 5 T.C. 529, 536.
[24] [1915] 3 K.B. 267, 273; 31 T.L.R. 530; 6 T.C. 671.

regard the lump sum payments as a permanent solution but considered that some other method should be found does not prevent their being of a recurrent nature. A temporary ad hoc solution is none the less of a recurrent nature because it is recognised that when the problem recurs it may have to be met in some other or more permanent fashion. Nor does the fact that in some cases B.P. dealt with the problem by an admittedly capital solution (e.g., by buying the service station itself and letting it to a customer) affect the question whether the method here in issue was a capital or income solution. Moreover there were fresh sums being paid each year to fresh retailers, a fact which cannot be wholly disregarded in considering whether there is a recurrent demand.

Their Lordships agree with Owen J. in thinking that if regard was had to "the whole picture" the expenditure was recurrent. To find whether expenditure is of a recurrent nature one must take a broad view of the general operation under which the expenditure was incurred. Here it was made to meet a continuous demand in the trade. Prima facie matters connected with the ever-recurring question of marketing and customers, though not themselves recurrent in an identical form, share the same quality of recurrence possessed by matters "connected with the ever-recurring question of personnel."

What additional indication is given by the actual length of the agreements? That must be a question of degree. Had the agreements been only for two or three year periods that fact would have pointed to recurrent revenue expenditure. Had they been for 20 years, that fact would have pointed to a non-recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought. In this case the periods varied between three and 15 years, but the average appears to be something just under five years and the predominant number of agreements was for a five-year period. The case was argued before their Lordships as in the courts below on the footing that five years was the length of the tie and neither side sought to make any differentiation because a few of the ties were very much longer. That length of time appears to be neutral, and in itself indicates neither capital expenditure nor revenue by its mere length. It therefore does not add effectively to the argument either way. The question must be decided by other weights in the balance.

In support of his argument that this was an enduring benefit

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Mr. Menhennit stresses the fact that B.P. secured a valuable chose in action, namely, the contractual obligation of the retailer to order from B.P. and to allow them to advertise at his station. Once an asset outlives its year of acquisition, its proper place, he contends, must be in the balance sheet as a capital asset. He relies inter alia on the observations of Lord Reid in *Hinton* v. *Maden and Ireland Ltd.*,[25] where expenditure on knives which were used in machinery and had an average life of three years (but sometimes a life of only one year) was held to be a capital expenditure. But the observations were directed to tangible tools and such assets do not form a safe analogy when dealing with choses in action. The plant and machinery and tools of a factory and other tangible assets are prima facie durable objects and part of the structure within which the profit-yielding process is carried out. By convention and practice they are placed in the balance sheet and their diminution in value is acknowledged and accommodated by a system of capital depreciation for revenue purposes. No such clear practice or convention exists with respect to choses in action and their Lordships cannot accept the contention that a chose in action must be a capital benefit if its value outlives the year of accounting.

Much reliance is placed on *John Smith & Co.* v. *Moore*,[26] as showing that the contractual right to buy goods is a capital expense which must be distinguished from the actual purchase which is a revenue expense. Therefore, it is said, in the present case one cannot (as did Kitto J.) equate the tie to obtaining the mere "practical assurance of receiving bundles of orders" but one must treat it as a separate asset of enduring capital benefit. But that case dealt with special facts. The son had bought the father's business of a coal exporter for an overall sum on a valuation. An item in the valuation consisted of forward contracts with collieries for the delivery of coal at a very low price. The father had paid nothing for the contracts but owing to the rise in the price of coal, the forward contracts were valued at £30,000. The son made a large profit on the coal, and sought to set against them £30,000 as expenditure in the profit and loss account for the purposes of excess profits duty. The expenditure was disallowed. Lord Cave held that the change of ownership must be disregarded since the duty was a tax on a continuous business, which was the chief point there urged on behalf of the Crown. His opinion therefore has no relevance to the present case. Lord Haldane held that as

[25] [1959] 1 W.L.R. 875, 884; [1959] 3 All E.R. 356; 38 T.C. 391.

[26] [1921] 2 A.C. 13.

A the son had acquired the contracts among other assets of the business as part of the capital of the business they became his fixed capital.[27] "It was not by selling these contracts . ... but by retaining them, that he was able to employ his circulating capital by buying under them." Lord Sumner held that the case was covered by *City of London Contract Corporation* v. *Styles* [28] where B the purchaser of a business of contractors which had some construction contracts uncompleted, sought to set against the profits of the contracts when completed such part of the purchase price for the business as was attributable to their value. The court had there held that that sum was paid with the rest of the aggregate price to acquire the business, and not as an outlay in a business C already acquired. Neither of their Lordships indicated that, had there been no change of ownership and purchase of the business assets, and had the son himself paid £30,000 to the collieries for the benefit of the contracts, the sum so paid would have been a capital expenditure. Lord Finlay, however, who dissented, did deal with "the distinction" between "goods" and "choses in D action," such as contracts for coal. "This distinction," he said,[29]

> "seems to me to be for this purpose untenable. The contracts gave the means of getting coal, and there is no difference for this purpose between having coal stored in your yard and having a contract which enables you to get it from time to time as you want it. This, indeed, was admitted by the Lord Advocate in argument when he was asked the question E specifically by Lord Haldane."

It is clear that this board found difficulty with that case in *Nchanga's* case.[30] Lord Radcliffe observed that it decided nothing that could govern *Nchanga's* case [30] and pointed out that Lord Haldane's and Lord Sumner's opinions had been determined by a combination of two elements namely that no sum of £30,000 F had ever been paid and that in paying something in respect of the benefit of the contracts the son had not acquired stock-in-trade or anything like stock. In the present case likewise their Lordships do not derive help from *John Smith & Son* v. *Moore*.[31] One certainly cannot deduce that the result would have been the same if the son had paid £30,000 to the collieries for the contracts.

G Nor do their Lordships obtain help from *Kauri Timber Co., Ltd.* v. *Commissioner of Taxes*.[32] There the company in order to carry out its business of cutting and selling timber had bought 20 years previously (and in some instances thereafter) land with

[27] [1921] 2 A.C. 13, 20.
[28] (1887) 2 T.C. 239, C.A.
[29] [1921] 2 A.C. 13, 28.
[30] [1964] A.C. 948.
[31] [1921] 2 A.C. 13.
[32] [1913] A.C. 771, P.C.

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timber on it, or had bought timber with the right to cut and remove it during a stated time which in most instances was 99 years. It subsequently claimed to set off the value of the timber against revenue but this claim was rejected. The case was decided on the wording of the New Zealand Act and the references to the general principles of mining law with regard to capital and income do not help in the present case.

Their Lordships do not find *Stow Bardolph Gravel Co.* v. *Poole* [33] or *H. J. Rorke Ltd.* v. *Inland Revenue Comrs.* [34] helpful. In the former case Jenkins L.J. expressly mentioned that the distinction on which the court decided that the right to get gravel differed from the getting of gravel and was a capital expenditure might not be satisfying to some minds. Both are within the difficult area of mining cases; and principles governing extraction industries have little relation to the present case.

It is of commercial importance that profits should not be inflated for tax purposes by the artificial withdrawal from the profit and loss account of expenditure directly incurred in earning them unless it is of a truly capital nature. There is force in the observation of the Lord President in the *Vallambrosa* case [35]

> "the Crown will not really be prejudiced by this, because when the tree comes to bear, the whole produce will go to the credit side . . . the only deduction will be the amount which has been spent on the tree in that year; they will not be allowed to deduct what has been deducted before."

In the present case one is dealing with payments made to particular customers to secure their particular custom. The only case cited which deals with that problem is *Bolam* v. *Regent Oil Co. Ltd.* [36] which in their Lordships' view was rightly decided. But that case (as Taylor J. found) does not necessarily decide this case. For in that case the payments were simply calculated as an advance rebate which was repayable pro tanto if the actual gallonage fell below the estimated gallonage. *Usher's Wiltshire Breweries Ltd.* v. *Bruce* [37] decided that where a landlord brewer pays or allows moneys to the tenant of a tied house as a necessary incident of the profitable working of a brewery business, the landlord brewer may deduct those moneys in the balance of profit and loss for the purposes of income tax, in spite of the fact that they enure also for the benefit of the tenant's separate trade in the tied house. But the question whether the outgoings were

[33] [1954] 1 W.L.R. 1503; [1954] 3 All E.R. 637; 35 T.C. 459, C.A.
[34] [1960] 1 W.L.R. 1132; [1960] 3 All E.R. 359; 39 T.C. 194.
[35] 1910 S.C. 519, 524; 5 T.C. 529, 535.
[36] (1956) 37 T.C. 56.
[37] [1915] A.C. 433; 31 T.L.R. 104, H.L.

A of a capital or revenue nature was not raised and it was assumed that they were revenue payments.

One of the matters to be considered is how the sum in question should be treated on the ordinary principles of commercial accounting: see *Whimster & Co.* v. *Inland Revenue Commissioners*.[38] The sums paid to the retailers in the present case were B put by B.P.'s accountants in the profit and loss account. Had they been put in the balance sheet together with the choses in action for which they had been paid, the latter would have been inappropriate capital assets. They would necessarily have to be written down in the first and every succeeding year by one third or one fifth (or whatever was the figure appropriate to the C length of the tie) if the balance sheet was to be honest. And they would have to be written down out of money which had borne tax although the depreciation had gone directly to earn the taxable profits during the period. On the other hand it may be fairly said that to put the whole sum into one year's expenses is also misleading. But at least it evens out fairly over a period of years as D do major repairs or renewals (e.g., *Rhodesia Railways Ltd.* v. *Collector of Income Tax*[39]) or other intermittently recurring revenue expenditures.

The most apt way of dealing with these sums might seem to be to debit the profit and loss account with the whole payments and credit it with their unexpired value, thus treating them as a revenue E item; but this is not the practice of accountants. If, therefore, one must allocate these payments either wholly to one year's revenue or to capital it would seem that either course presents difficulties but that an allocation to revenue is slightly preferable.

Finally, were these sums expended on the structure within which the profits were to be earned or were they part of the F money-earning process? In *Hallstrom's* case,[40] where by a majority the court held that the cost of fighting a patent was a revenue expenditure, Dixon J.[41] described the difference between capital and income expenditure as lying

> "between the acquisition of the means of production and the use of them; between establishing or extending a business G organisation and carrying on the business; between the implements employed in work and the regular performance of the work; . . . between an enterprise itself and the sustained effort of those engaged in it."

On this aspect of the matter two cases point the contrast. In

[38] (1925) 12 T.C. 813.
[39] [1933] A.C. 368.
[40] 72 C.L.R. 634.
[41] Ibid. 647.

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Van den Berghs Ltd. v. *Clark* [42] £450,000 was received by one company from another as damages on the rescission of a 20-year agreement with 13 years unexpired by which the companies agreed to share profits of trading in margarine instead of competing with one another. The case therefore had certain similarities to the cases of buying off competition, and to that extent the argument in favour of a capital payment was strengthened. It was held that this sum was a capital receipt, since

> "the agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself. They provided the means of making profits, but they themselves did not yield profits."

A contrary conclusion was reached in *Anglo-Persian Oil Co. Ltd.* v. *Dale.*[43] The oil company employed an agent company to manage its business in Persia and the East, and to carry out the oil company's sales there for 10 years, renewable for a further period of 10 years. Eight years later it decided that it would be cheaper to dispense with its agent and to employ the agent's staff and organisation direct. It paid the agent company £300,000 cash in consideration of the agency agreement being terminated. It was held by Rowlatt J. that this was a revenue payment since there was no purchase of goodwill or start of a business, but simply the putting to an end of an expensive method of carrying on the business which remained the same, whether the distributive side was in the hands of the oil company itself or its agents. The Court of Appeal affirmed this decision. Lawrence L.J. concluded that [44]:

> "The contract to employ an agent to manage the company's business in Persia, however, in no sense forms part of the fixed capital of the company, but is a contract relating entirely to the working of the company's business, the method of managing which may be changed from time to time. Neither the contract itself nor a payment to cancel it would, in my opinion, find any place in the capital accounts of the company."

That case goes some way in support of B.P.'s contentions. Although it does not provide any compelling analogy, it is nearer to the present case than is *Van den Berghs Ltd.* v. *Clark.*[45] It justifies the argument that expenditure incurred in making a radical change in the marketing arrangements of a company's

[42] [1935] A.C. 431.
[43] [1932] 1 K.B. 124; 47 T.L.R. 487; 16 T.C. 253, C.A.
[44] [1932] 1 K.B. 124, 144.
[45] [1935] A.C. 431.

A organisation need not be a capital payment. It refutes any argument and the bigness of the amounts and the widespread area involved and the finality and extent of the change point automatically to a capital outlay.

Henriksen v. *Grafton Hotel Ltd.*[46] was a special case dealing with the payment for a license. Without the license the business B could not be carried on. There was also an element of monopoly. On those grounds it was held to be a capital payment. In *Inland Revenue Commissioners* v. *Adam*[47] the sums in question were spent on a dumping ground which the company had to have in order to carry on its business. These cases do not provide any safe analogy with sums paid to customers to secure their custom.

C Thus a consideration of the nature of the benefit sought and obtained by B.P. would on the various tests suggested by the authorities seem to point to the expenditure being revenue rather than capital.

The second of the considerations suggested by Sir Owen Dixon above, mainly the manner in which the benefit was to be used, D relied on and enjoyed by B.P., points in a similar direction. The benefit was to be used in the continuous and recurrent struggle to get orders and sell petrol. The agreements were not strictly "bundles of orders" but they were the basis of them and made orders inevitable. The retailer was bound to sell none but B.P.'s petrol and to increase the sale of its products to the best of his E ability. This means that in practice he was bound to give orders for petrol which B.P. was bound to supply. Although the price and time of delivery were not specified these would be implied by law as reasonable. No fresh consensus between the parties was necessary. All that was needed was that the retailer should specify from time to time what quantity he required. Thus the F agreements merged in and became part of the ordinary process of selling. These facts point to the expenditure being a revenue item.

The third consideration suggested by Sir Owen Dixon, namely the method of payment, does not point very clearly in either direction. An advance payment for a period is not unusual in G many revenue matters (e.g., purchase of stock). These payments were not current payments made annually over the period of benefit but on the other hand it was clear that they would have to be made again at intervals of a few years. In a durable company

[46] [1942] 2 K.B. 184; 58 T.L.R. 271; [1942] 1 All E.R. 678; 24 T.C. 453, C.A.

[47] (1928) 14 T.C. 34.

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of this nature recurrent five yearly payments certainly cannot be said to have a "once for all" quality. Had the payments been for one or two years they would point towards revenue; had they been for 20 years they would point towards capital. But the actual period of time for which these particular payments were made, as in the consideration of the nature of the advantage (above), gives no indication which could outweigh the indications given by other considerations.

The case is not easy to decide. But on a balance of all the relevant considerations the scales appear to incline in favour of the expenditure being revenue and not capital outgoings.

Mr. Menhennit raised an alternative argument that this expenditure could not come within the words of section 51 (1) of the Act since it was not incurred in gaining the assessable income. B.P. made the payments, he argues, to put itself into a position from which to make income; it simply entered into arrangements favourable to the making of income and the payments are too indirect to fall within section 51 (1). He relies on the observations of Menzies J. in *John Fairfax and Sons, Ltd.* v. *Federal Commissioner of Taxation.*[48]

Their Lordships do not feel able to accept this narrow view of the matter in the light of their conclusions on the broader issue. The alternative argument stands or falls with the main argument. For the reasons given they hold that the expenditure was incurred in gaining the assessable income.

Their Lordships will therefore humbly advise Her Majesty that the appeal should be allowed, the orders of the full court and of Taylor J. set aside with costs and the amended assessment for income tax and social services contribution for the year ending June 30, 1952, remitted to the respondent for him to allow the appellant's objections thereto. The respondents must pay the costs of the appeal.

Solicitors: *Linklaters & Paines*; *Coward Chance & Co.*

[48] (1959) 101 C.L.R. 30, 48.

HIGH COURT OF JUSTICE (CHANCERY DIVISION)—8TH, 9TH AND 10TH DECEMBER 1971

COURT OF APPEAL—12TH, 13TH AND 14TH JULY 1972

Heather (H.M. Inspector of Taxes) *v.* P-E Consulting Group Ltd.[1]
Commissioners of Inland Revenue *v.* P-E Consulting Group Ltd.

Income tax, Schedule D—Profits of trade—Deduction—Expenses—Payments to trustees of scheme to buy shares in paying company for benefit of employees—Capital or revenue—Statements of accountancy witnesses not conclusive—Income Tax Act 1952 (15 & 16 *Geo.* 6 & 1 *Eliz.* 2, *c.* 10), *s.* 137(*a*) *and* (*f*).

The Respondent Company carried on the business of management consultants It was a subsidiary of H Ltd. Following the death in 1957 *of one of the principal shareholders in H Ltd. the senior professional staff became concerned at the prospect of control being exercised by outside shareholders with no professional qualifications. They had in fact been upset on two occasions by drastic changes in management made by the outside shareholders. In September* 1963 *a scheme was set up with the objects broadly of* (a) *giving staff an opportunity to purchase a stake in the Company, thereby providing an incentive to greater effort on their part, and* (b) *removing the possibility of outside interference with the business of the Company. The articles of the Company and of H Ltd. were amended to provide that any shares available for transfer should be offered in the first place to the trustees hereinafter mentioned; and a trust deed was executed whereby the Company undertook to pay from time to time to the trustees* 10 *per cent. of its consolidated gross profits for each financial year (subject to a minimum of* £5,000) *to be held on trust for the purchase of such shares. The trustees were empowered to sell shares to employees and to apply the income from their shares in making discretionary grants to employees. The Company's obligation to the trustees was to cease when they had acquired* 40 *per cent. of the share capital of H Ltd.* (41 *per cent. being already held by the group's pension fund*), *or earlier on notice being given by the Company. At the winding up of the trust the proceeds of the net balance of the trust fund were to be distributed among the employees as the trustees should determine.*

The Special Commissioners accepted the evidence of an accountant that the cost to a company in securing and retaining the services of employees was usually treated as revenue expenditure, and that as " employee goodwill " could not be evaluated expenditure for that purpose was normally written off.

On appeal against assessments to income tax under Schedule D for the years 1963–64 *to* 1965–66, *profits tax for the chargeable accounting periods ending* 31*st December* 1962 *to* 1964 *and corporation tax for the accounting periods ending* 31*st December* 1965 *and* 1966, *the Company contended that the payments to the trustees (including an advance payment made to a stakeholder in* 1962) *should be deducted in computing its profits. For the Crown it was contended* (inter alia) *that the scheme was outside s.* 137(*a*), *Income Tax Act* 1952, *because its purposes were not solely for the Company's benefit but provided an extended market for the shares, and also that the payments were instalments of capital within the*

[1] Reported (Ch. D.) [1972] 2 W.L.R. 918; 116 S.J. 125; [1972] 2 All E.R. 107; (C.A.) [1972] 3 W.L.R. 833; 116 S.J. 824; [1973] 1 All E.R. 8.

meaning of s. 137(f). The Special Commissioners held that the payments did not secure a permanent asset for the Company, within the principle in Atherton v. British Insulated and Helsby Cables Ltd. 10 T.C. 155, *at page* 192, *and were of a revenue nature.*

Held, (1) *that the question of capital or revenue is a question of law, and it is for the court to decide whether an accountancy witness's evidence exemplifies sound accountancy principles;* (2) *that the payments in question were revenue expenditure, being annual payments made to provide an incentive for the staff, and not instalments of any predictable capital sum;* (3) *that, in view of the special character of the Company's business, the acquisition of the shares by the professional staff from outside shareholders was for the purposes of the trade.*

Commissioners of Inland Revenue *v.* Carron Company 45 T.C. 18; 1968 S.C. (H.L.) 47 *applied;* Atherton *v.* British Insulated & Helsby Cables Ltd. 10 T.C. 155; [1926] A.C. 205 *distinguished*; Odeon Associated Theatres Ltd. *v.* Jones page 257 *ante*; [1972] 2 W.L.R. 331 *explained.*

Lord Denning M.R.—The facts of this case are fully set out in the report of it in the Court below, [1972] 2 W.L.R. 918. I need therefore only set out the salient points.

The taxpayer Company, P-E Consulting Group Ltd., are management consultants. In 1962 they had a professional staff of 310, all of whom held university degrees or professional qualifications. The shares in the taxpayer Company were all owned by a holding company, P-E Holdings Ltd. The shares in the holding company were owned in 1962 as to 41 per cent. by the group's pension fund and as to 59 per cent. by outside shareholders with no professional qualifications. On two occasions drastic changes in management had been made by the outside shareholders. This upset the senior professional staff. In consequence a scheme was introduced to enable the employees to obtain control. The scheme was designed to take advantage of s. 54(1)(*b*) of the Companies Act 1948. This enables a company to provide moneys for a trust fund under which the trustees can purchase the company's own shares or the shares of a holding company—provided always that the shares are held by or for the benefit of employees of the company. Under the scheme the taxpayer Company was to pay to the trustees 10 per cent. of the consolidated profits of the group (with a minimum of £5,000 a year). The trustees were to use that fund to acquire shares in the taxpayer Company and the holding company so as to gain control. The trustees were to hold the shares for the benefit of the employees. They would offer them for sale to the employees: but arrangements were made whereby on death or retirement the shares were bought back by the trustees or other employees. If the trust came to an end, the whole fund would be divided amongst the employees. The Special Commissioners found that the objects of the scheme were broadly to be (*a*) to give staff an opportunity to purchase a stake in the taxpayer Company, and (*b*) to remove the possibility of outside interference with the business of the Company.

In pursuance of the scheme the taxpayer Company paid these sums to the trustees: £5,000 for the year 1962; £5,000 for 1963; £16,412 for 1964; £25,119 for

A 1965; £23,426 for 1966. The taxpayer Company contended that these payments were revenue expenditure and were proper deductions to be made in computing the Company's tax. The Crown contended that they were instalments of capital and could not be deducted. The Commissioners held they were revenue expenditure and Goulding J. upheld them. The Crown appeal.

The question—revenue expenditure or capital expenditure—is a question B which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy: but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other: but this is simply not possible. Some cases lie on the border between the two: and this border is not a line clearly marked out; it is a blurred and undefined area in C which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in the marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners—be they accountants or lawyers—must of necessity put them into one category or the other. And then, by custom D or by law, by practice or by precept, the border is staked out with more certainty. In this area at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is to search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find.

One of the nearest cases to this one is *British Insulated and Helsby Cables* E *Ltd.* v. *Atherton*(1) [1926] A.C. 205, where a large sum was provided by a company to form the nucleus of a pension fund for employees. Each year thereafter the company made annual contributions to the fund. That was a marginal case. Different minds could, and did, come to different conclusions with equal propriety. The reasoning in the House of Lords shows it. The majority (3 to 2) held that the large initial contribution was capital and not revenue expenditure: F but all agreed that the annual contribution thereafter was revenue expenditure. Viscount Cave L.C., for the majority, used a sentence which has been repeatedly quoted since(2):

> " When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of G special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

In applying that case to the present, there are different views. Each can be held with equal propriety. The Commissioners thought that this case did not fall within the *Atherton* decision: but the Judge thought it did, or at any rate that it fell within the language of Lord Cave L.C. I must say that I agree with H the Commissioners. It seems to me that the purpose of these payments was to provide an incentive for the staff, to make them more contented and ready to remain in the service of the Company, and also to help in the recruitment of new staff—they were annual payments too—all of which makes them more like the annual payments in *Atherton's* case than the nucleus fund. They were like the Company's contributions to a cash profit-sharing scheme and to the pension I fund. They were all regarded by the taxpayer Company as rewards to staff for the profits they had helped to make. There is this difference, however, from

(1) 10 T.C. 155. (2) *Ibid.*, at pp. 192–3.

(Lord Denning M.R.)

Atherton's case(1). One of the objects here was to remove the possibility of outside interference with the business of the Company. Does this alter the nature of the payments? I think not. Here we have guidance from another case in the House of Lords, but it was not cited to the Judge. It is *Commissioners of Inland Revenue* v. *Carron Company*(2) 45 T.C. 18. It came from Scotland. A company had a charter and constitution which was out of date, so much so that it was inimical to the good running of the company. They could not get good managers or staff. The company paid considerable sums to amend the charter and to get rid of dissentient shareholders. Those payments were held to be revenue expenditure and not capital expenditure.

On the cases, therefore, it seems to me that the payments to the trust were revenue, and not capital expenditure. In addition, I have no doubt that the Commissioners were influenced considerably by the evidence of a distinguished accountant, Mr. Bailey of Price Waterhouse:

> " Mr. Bailey gave evidence (which we accepted) to the effect that the cost to a company in securing and retaining the services of employees was usually treated as revenue expenditure, and that as it was impossible to evaluate ' employee goodwill ' it was the normal practice to write off expenditure for that purpose."

The Commissioners were entitled to give weight to that evidence of Mr. Bailey, but the Judge went further. He seems to have thought that, as a result of the decision of this Court in *Odeon Associated Theatres Ltd.* v. *Jones*(3) [1972] 2 W.L.R. 331, the evidence of accountants should be treated as conclusive and that all the Commissioners or the Court would have to do would be to evaluate their evidence. And Mr. Bates submitted to us that the *Odeon* case had upgraded the evidence of accountants so that the Commissioners and the Courts were bound by their evidence to a greater degree than they had been in the past. I cannot agree with that for a moment. It seems to me that that case does not add to or detract from the value of accountancy evidence. The Courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the Courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the Courts. They are not to be deflected from their true course by the evidence of accountants, however eminent. However, in the end the Judge agreed with the Commissioners—as I agree with them—that the payments here were revenue and not capital expenditure.

The other question is whether these payments were made wholly and exclusively for the purposes of the Company's trade within s. 137(*a*) of the Income Tax Act 1952. The Crown relied particularly on an observation by Lord Reid in *Morgan* v. *Tate & Lyle Ltd.*(4) 35 T.C. 367, at page 421, in which he says:

> " a change of shareholders does not interest the company as a trader, and expenditure to prevent a change of shareholders can hardly be expenditure for the purposes of the trade."

That may in some circumstances be correct; but not in this case. This Company is dependent on a large number of graduates and professional men. The object of the scheme is to keep their goodwill and to secure that the control will remain in their hands. Both the Commissioners and the Judge found that the moneys were wholly and exclusively for the purposes of the Company's trade.

(1) 10 T.C. 155. (2) 1968 S.C. (H.L.) 47. (3) Page 257 *ante*. (4) [1955] A.C. 21.

A I think the decisions of the Commissioners and the Judge are right, and I would accordingly dismiss the appeal.

Buckley L.J.—The question with which we are concerned in this case is whether the payments which were made by the Company under clause 3 of the trust deed, which is set out *in extenso* in the Case Stated, are deductible in calculating the profits of the Company in the several years in which those B payments were made for tax purposes. The Crown submits that the question should be answered in the negative, on two grounds: first, because the expenditure was not, it is submitted, revenue expenditure but was expenditure of a capital nature; secondly, because the expenditure was not, it is submitted, made wholly and exclusively for the purposes of the Company's trade: s. 137(*a*) of the Income Tax Act 1952.

C It is common ground that the first of these questions is a question of law. In this connection there has been a good deal of discussion about the effect of the evidence of Mr. Bailey to which my Lord has already referred. The Judge was much affected by this, as he says in the passage in his judgment to which again my Lord has already referred. I think that, if that passage is read in its literal sense, it puts the effect of an accountant's evidence on such a matter too D high. It must be axiomatic that the evidence of no witness can be conclusive on a question of law. It is well established that the question whether a particular payment is a payment of a capital nature or of a revenue nature must be answered in accordance with sound accountancy principles. Skilled accountants may well be much better qualified than most Judges to formulate and explain such principles; but nevertheless in every case of this kind it is the Judge and not the E witness who must decide whether a witness's evidence in fact exemplifies sound accountancy principles. A Judge may, as Lord Wilberforce did in *Strick* v. *Regent Oil Co. Ltd.* [1966] A.C. 295; 43 T.C. 1, reject the accountant's evidence, or he may accept it. I endeavoured to state this position in *Odeon Associated Theatres Ltd.* v. *Jones*(1) [1972] 2 W.L.R. 331, at page 340, and this I think precisely accords with what was said by Pennycuick V.-C. in that case at first F instance(2), [1971] 1 W.L.R., at page 454. It also, I think, accords with what was said by Salmon L.J. in the Court of Appeal(3) [1972] 2 W.L.R. 331, at page 337, where the learned Lord Justice said this:

> " Where, however, there is evidence which is accepted by the court as establishing a sound commercial accounting practice conflicting with no Statute, that normally is the end of the matter. The court adopts the G practice, applies it and decides the case accordingly."

I emphasise the words " which is accepted by the Court as establishing a sound commercial accounting practice ". If Goulding J. in the present case meant to attribute any more binding character than this to Mr. Bailey's evidence, I would respectfully think that he went too far; but I doubt if he really intended to do so. I think he may well have meant no more than that, in the state of the H evidence in this case, he saw no reason to reject Mr. Bailey's evidence, which consequently should be accepted as exemplifying sound principles of commercial accountancy.

The Crown has claimed in the present case that it is governed by the decision in *Atherton* v. *British Insulated and Helsby Cables Ltd.* 10 T.C. 155. It has been emphasised in many cases of high authority that cases concerned I with this particular problem must all be considered in the light of their particular

(1) *See* pp. 285–6 *ante*. (2) *See* p. 273 *ante*. (3) *See* p. 283 *ante*.

(Buckley L.J.)

facts. I would refer to *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines Ltd.* [1964] A.C. 948; *B.P. Australia Ltd.* v. *Commissioner of Taxation of the Commonwealth of Australia* [1966] A.C. 224, *per* Lord Pearce, at page 263; and *Strick* v. *Regent Oil Co. Ltd.*(1) 43 T.C. 1, *per* Lord Reid, at pages 29–30. The decision in *Atherton's* case(2) must have turned on the character of the payments there in question as being the nucleus of a new pension fund. The annual contributions which the company was thereafter to make under the pension fund scheme were conceded to be deductible. I confess to sympathy with the views expressed by Lord Blanesburgh, who dissented in that case. He could see no difference in principle between the initial payment and the annual payments. The majority of the House of Lords, however, thought that there was such a difference, though I do not find it very easy to put a finger on any passage in any of the speeches which clearly states what the difference was. The fact that the payment was a single payment and not one of a series of recurrent payments is no doubt a circumstance to be taken into account, but cannot have been conclusive, any more than the circumstance that a payment is made by instalments or is a periodic payment of some other kind as the price of a capital asset could establish that those payments were not properly to be regarded as capital expenditure. It seems to me that the majority view in the House of Lords in *Atherton's* case must have been founded on some such consideration as this. The company was anxious to establish a contributory pension scheme for its employees to which the company would itself contribute in circumstances which would allow a deduction of its own contribution for tax purposes. It could not, however, establish such a scheme which would be solvent in respect of its existing senior employees unless a fund were initially provided to cover actuarial liabilities in respect of those employees. The establishment of such a fund was a condition precedent to the establishment of the contributory scheme. In order to open the way to the establishment of the scheme, the company itself provided the fund. That is what is called the nucleus fund. As an expenditure distinct from the company's subsequent contributions, it was a once-for-all expenditure which made it possible for the company to embark upon a scheme which would benefit its commercial activity. It might perhaps in fanciful language be said to have prepared the ground, or provided the site, upon which the scheme itself should be erected. Seen in this light, this initial payment can perhaps justifiably be viewed as having a different character and being made with a different object from the company's subsequent annual contributions. In any case, I think it is worthy of note that judicial views differed as to what was the right interpretation of the position in *Atherton's* case; the decision was a majority decision.

In the present case it seems to me that the payments with which we are concerned are different in their character in several respects, which may be material, from the sort of payment which was under consideration in *Atherton's* case. In the first place, whereas the payment in question in *Atherton's* case was a single payment, we are here concerned with a series of payments being made annually under the covenant contained in the trust deed. No one of those payments was in itself sufficient to achieve the object of the scheme incorporated in the trust deed. The aggregate of those payments was unpredictable. The payments year by year were to be calculated by reference to the fair value for the time being of the shares in the Company, which might vary year by year, and so it would be impossible at any stage to say what moneys would have to be contributed by the Company in the future in order to achieve the objective of buying 40 per cent. of the shares of the Company at their fair value. Moreover,

(1) [1966] A.C. 295. (2) 10 T.C. 155.

A the Company could under the trust deed at any time have discontinued these contributions or brought the whole scheme to an end. It is not a case in which the payments can be regarded as instalments of a specified purchase price.

The purposes for which the scheme was established must, I think, be taken to have been those which the Commissioners found in the Case Stated to have been its purpose. They say:

B

> "The objects of the scheme were broadly to be: (*a*) to give staff an opportunity to purchase a stake in the Company, thereby providing an incentive to greater effort on their part; and (*b*) to remove the possibility of outside interference with the business of the Company."

The first of those two objectives is one intimately connected with the day-to-day operation of the Company's business, for the goodwill of the staff was something C which might change or fluctuate from day to day. The advantage to be obtained by giving the staff an incentive to greater effort is one which would depend upon the state of the Company's business from time to time and the state of the employer-employee relations between the Company and its employees from time to time. It was also an objective directly related to the profitability of the Company's business from time to time. The Company was one which in its D character depended for the efficient conduct of its trade upon the high qualifications and expertise of its employees. The Company's business was that of business management and industrial consultants, and the value of the services which it provided depended to a very great extent upon the quality and expertise of those whom it employed and, as I think it right to infer, upon these employees being permitted to carry out their functions as management and industrial E consultants uninterfered with or uninhibited by interference by any persons who were not as well qualified to deal with the problems which had to be dealt with as they were themselves. It was therefore a case in which the independence as well as the qualifications of the staff—independence, I mean, from inhibiting superior supervision—were very important to the welfare of the trade of the Company, and in that respect it appears to me that the second objective which F the Commissioners found to obtain in this case was one directly related to the conduct of the Company's trade.

It seems to me that the present case comes much closer in its nature to *Commissioners of Inland Revenue* v. *Carron Company* 45 T.C. 18 than it does to *Atherton's* case[1]. In the *Carron* case the company which was there under consideration had been established by a charter in 1773 which had become G archaic; so that the company was not able to operate within the terms of its charter advantageously in the field of its trade, and the company therefore sought a new charter. Costs were incurred in obtaining the new charter, but there was also a faction in the company among the shareholders which was anxious to resist this reform in the company's constitution; and eventually a settlement of litigation between the company and this minority faction was H compromised on terms which involved a payment by the company to the minority who objected to the reform. The House of Lords in that case came to the conclusion that the expenditure on obtaining the new charter and the expenditure on getting rid of the opposition to the charter was a revenue expenditure. I think the passages which are perhaps most helpful to refer to are passages in the speech of Lord Wilberforce, at page 75. At page 74, he had said that he I thought that the case then under consideration, the *Carron* case, was closer to the decision in *Anglo-Persian Oil Co. Ltd.* v. *Dale*[2] [1932] 1 K.B. 124 than to

(1) 10 T.C. 155. (2) 16 T.C. 253.

(Buckley L.J.)

another case, *Van den Berghs Ltd.* v. *Clark*(1). At the foot of page 74 Lord Wilberforce said this:

> "By contrast, in *Van den Berghs*' case the payment was made in consideration of the recipient company cancelling an agreement which regulated the division of trading activity as between it and the paying company. It was in this context that Lord Macmillan used the words invoked by the Solicitor-General—' the whole structure of the appellant's profit-making apparatus '(2)—and it is obvious that he used them in a sense quite different from any sense in which the Carron Company's ' profit-making apparatus ' may be said to have been affected here. In *Van den Berghs*' case the two companies traded in quite a different manner after the agreement from that in which they had traded before; the Carron Company's business was unaffected: it provided itself merely with the means of organising itself more effectively to trade more profitably."

Lord Wilberforce then went on to comment upon a submission which had been made by the Solicitor-General to the effect that for expenditure to take on the character of capital expenditure it was not necessary for it to produce any recognisable capital asset. Lord Wilberforce pointed out that there must be something which can be pointed to as in the nature of a permanent advantage to the company if it is to be treated as expenditure on a capital asset. And then, about half way down the page, he says(3):

> "Again, as was pointed out by Lord Morris of Borth-y-Gest in *Strick* v. *Regent Oil Co. Ltd.*(4) [1966] A.C. 295, at page 329, an asset may be of a capital nature whether it is of a tangible or of an intangible nature. I respectfully agree, but this does not assist the Solicitor-General's argument. Finally, the Solicitor-General relied for support in his contention upon *Mallett* v. *Staveley Coal & Iron Co. Ltd.*(5) [1928] 2 K.B. 405, but this only shows that the disposition of a source of liability may be equivalent to the acquisition of a source of profit—an extension perhaps, but not an exception, to the principle that in some sense or other an asset of a capital nature, tangible or intangible, positive or negative, must be shown to be acquired. If this is correct—and until a case arises which constitutes a true exception I shall continue to think that it is—the present expenditure cannot be brought within the capital class. It procured indeed an advantage—important and not of a transitory nature—but one essentially of a revenue character in that it enabled the management and conduct of the Company's business to be carried on more efficiently."

Now, I for my part would say that in the present case the objects of this scheme were to enable this Company's business to be carried on more efficiently; they were directed to improving and maintaining the trading potential of the Company and facilitating its trading to advantage. I would myself think that the present case fell much nearer to the *Carron* case(6) than to *Atherton's* case(7); but once again I would say the case must be considered on its own facts and not, I think, be decided by reference to other cases with similar but not identical facts as binding authority. On the facts of this particular case I have reached the conclusion that the learned Judge was right in upholding the Commissioners in the view that this was an expenditure of a revenue nature.

Finally, as regards s. 137(*a*) of the Income Tax Act 1952, I would say that, having regard to the particular character of this Company and of its business

(1) (1935) 19 T.C. 390. (2) *Ibid.*, at p. 431. (3) 45 T.C. 18, at p. 75.
(4) 43 T.C. 1, at p. 41. (5) 13 T.C. 772. (6) 45 T.C. 18. (7) 10 T.C. 155.

A and of the relation to that business of the qualifications and experience of the Company's employees, the expenditure here ought to be regarded as being expenditure incurred wholly and exclusively for the purposes of the Company's trade.

For these reasons I agree that this appeal should be dismissed.

Orr L.J.—In *Atherton* v. *British Insulated and Helsby Cables Ltd.*(1) the B respondent company established a pension fund by way of a trust deed for the benefit of its salaried staff, and contributed to that fund, first, a payment of some £31,000 calculated actuarially as the amount required in order that past years of service of the existing staff should rank for pension, and thereafter made successive yearly payments sufficient to raise the income from investments of the fund to a net 4 per cent. It was common ground that the latter payments C were properly deductible in computing the profits and gains of the company for income tax purposes; and the issue which arose was only as to the payment of £31,000 which was described in the trust deed as being made in order to form a nucleus of the pension fund. It was held by a majority of the House of Lords that that payment was in the nature of capital expenditure and not admissible as a deduction for tax purposes, and it was with reference to that payment that D Lord Cave L.C. made the statement which Lord Denning M.R. has quoted as to the characteristics of a capital expenditure. Lord Carson and Lord Blanesburgh, dissenting, found it difficult to see how the object with which the payment of £31,000 was made differed in any way from the object of the succeeding payments; but in my judgment the basis of the majority decision was that the £31,000 was a sum which had to be expended before the scheme could begin to operate, and E that the subsequent payments, on the other hand, merely represented annual servicing of the scheme after it had begun to operate.

In the present case we are concerned with the establishment by a company of a trust fund designed, like the pension fund in the *Atherton* case, to retain and attract employees and to improve the quality of their services, but in this case not by means of a pension fund but by enabling them to acquire shares in the F Company. The means by which the scheme was to operate were that the Company would annually make payments to the trustees so as to enable them, in accordance with directives given from time to time by the Company, to acquire shares in the Company or in the holding company, which they would then sell to employees on terms that after the employee's death, or on his leaving the Company or wishing to sell his shares, the Company would have a right to sell G them as his agent and would offer them either to the trustees of one of its schemes or to some other employee. The Company contracted to make these payments until the trustees should have acquired shares amounting to 40 per cent. of the shares of the holding company or until the expiry of a period of 21 years, whichever should be the earlier, but the Company also retained the right on six months' notice to discontinue or suspend or reduce the payments.

H It is not contended that any one of these payments differed at all in character from the others, the Respondents claiming that all of them were on revenue account, and the Crown that they were all on capital account, for tax purposes. It has been common ground that if in law they represent a capital expenditure that expenditure would not be deprived of its capital character by being paid in instalments, but that the fact that what is in question is a series of payments and I not a single payment is a consideration to be taken into account in determining their character. The main issue in the case is whether these payments in their total represent a capital expenditure comparable to that involved in the payment

(1) 10 T.C. 155.

(ORR L.J.)

of £31,000 in the *Atherton* case(1). The argument for the Crown is that they did, on the basis that it was essential for the operation of the scheme that this expenditure should be incurred and that the object of it was to produce, if not an asset, at least an advantage for the enduring benefit of the trade.

There are, however, in my judgment, important differences between the facts of the *Atherton* case and those of the present case. In the *Atherton* case the scheme could not begin to operate until the expenditure was incurred, whereas in the present case it could begin to operate as soon as the Company's first contribution was made, inasmuch as that contribution could be applied at once in the acquisition of shares and so on from year to year. The total of the contributions to be made was indeterminate for the reasons given by Buckley L.J. and also because the Company could at any time by six months' notice discontinue its contributions and the payments were from the outset to be made by annual contribution. I have not found the case at all an easy one, and have not reached a conclusion without some degree of doubt, but the conclusion I have come to is that the factors I have mentioned do materially differentiate this case from the *Atherton* case, and that the expenditure in question was for tax purposes incurred on revenue account. I also agree with the view expressed by both my Lords that the facts are closer in all the circumstances to those of *Commissioners of Inland Revenue* v. *Carron Company*(2) than to those of the *Atherton* case.

As to the second issue, whether the expenditure was incurred wholly and exclusively for the purposes of the trade, I agree with the views expressed by my Lords and do not wish to add anything.

I would add, because I was a party to the decision in the recent *Odeon* case(3), a few words with regard to the place of accountancy evidence in cases of this kind. The main issue in the *Odeon* case was whether it was governed by the earlier decision in *Law Shipping Co. Ltd.* v. *Commissioners of Inland Revenue*(4); and this Court found a number of differences between the two cases, of which only one was that accountancy evidence had been called in the *Odeon* case but not in the *Law Shipping* case. Nothing in any of the judgments in the *Odeon* case throws any doubt on the proposition, which was common ground in this appeal and is supported by a long line of authority, that the question whether an expenditure is for tax purposes on revenue or on capital account is ultimately a question of law. Accountancy evidence may be helpful in a case of this kind in so far as it discloses in what manner accountants deal in practice with a particular item; but it is for the Court to decide whether what is done in practice is in accordance with sound accountancy practices; and, further, what is in other respects properly done in practice may not, for the reasons given by Lord Greene M.R. in *Associated Portland Cement Manufacturers Ltd.* v. *Kerr* (1945) 27 T.C. 103, at page 116, accurately reflect the difference between income and capital expenditure for the purposes of income tax.

I agree that this appeal should be dismissed.

Bates Q.C.—My Lord, I ask for costs of the appeal.

Lord Denning M.R.—That must follow, I think.

Nolan Q.C.—That must follow, my Lord. I am, however, instructed to ask your Lordships for leave to appeal to their Lordships' House. I put it on two grounds. First, although your Lordships have reached the same conclusion

(1) 10 T.C. 155. (2) 45 T.C. 18. (3) Page 257 *ante*.
(4) 12 T.C. 621; 1924 S.C. 74.

A as Goulding J., your Lordships have done so not by the same route. The second ground is that your Lordships' judgments have been based on comparison of the recent House of Lords authority in *Carron*(1) and the other authority in *Atherton*(2). On this important topic we ask that their Lordships' views should be ascertained.

Lord Denning M.R.—What do you say, Mr. Bates?

B **Bates Q.C.**—My Lord, this is absolutely a question of fact. Given the facts, the conclusion of law follows; and in those circumstances I say, first of all, that it is not an appropriate case for appeal to be allowed to the House of Lords; and, secondly, this is a case in which, although I do respectfully differ from my learned friend perhaps on slightly different grounds, basically we have won on the facts before the Commissioners, in the High Court and now here; and C therefore if the Crown ask to go to the House of Lords, I would respectfully suggest that it should be on terms.

Lord Denning M.R.—I wonder how far this practice is widespread? Does this question often crop up—this question of arranging for a trust fund of this kind?

Bates Q.C.—I could not say for my part, my Lord. Perhaps those instruct- D ing my learned friend could say.

Lord Denning M.R.—I am wondering whether this is likely to affect any other cases.

Nolan Q.C.—In the sense that I suppose we have not got so used to it—capital or revenue—upon the statements of the House of Lords, it appears to those instructing me to be a case involving principles of very general importance.

E *(The Court conferred.)*

Lord Denning M.R.—You may have leave, Mr. Nolan.

Nolan Q.C.—I am much obliged, my Lord.

[Solicitors:—Solicitor of Inland Revenue; Waltons Bright & Co.]

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(1) 45 T.C. 18. (2) 10 T.C. 155.

Extracts from:
Avoidance and Other Consequences of Publishing Commissioner's Interpretation Guidelines
(2004) 19 Australian Tax Forum, 245 – 266.

John Prebble[1]

Contents

1. Introduction

1.1. Commissioner's statements

The New Zealand Commissioner of Inland Revenue issues several kinds of statements that are in effect legal opinions. This article relates to certain public statements formerly known as "policy statements" and now called "interpretation guidelines". The change of name occurred in 1995, when the department was reorganised and two

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new divisions were formed: Policy Advice and Adjudications and Rulings. "Policy statements" became the responsibility of Adjudications and Rulings. The new name of "interpretation guidelines" was chosen to avoid misleading people into thinking that such statements emanate from the Policy Advice Division.

As a preliminary matter, it is helpful to distinguish interpretation guidelines from other forms of opinions or statements that the Commissioner issues. There are two primary groups of such statements: binding rulings and standard practice statements.

2. Interpretation guideline exposure draft on form and substance in taxation law

2.1. Introduction

In 1998, the Inland Revenue Department published an exposure draft of an interpretation guideline, "*Form and Substance in Taxation Law.*"[2] As the draft explains:

> Interpretation guidelines are intended to clarify general points of interpretation that are causing, or may cause, difficulty for practitioners, taxpayers, and Inland Revenue. An interpretation guideline is Inland Revenue's opinion as to the better view of the law. That view is developed from an appreciation and assessment of the law on a particular topic, as gleaned from the cases.

The draft finishes with this warning:

> Draft items produced by the Adjudications and Rulings Business Group represent the preliminary, though considered, views of the Commissioner of Inland Revenue.
>
> In draft form these items may not be relied on by taxation officers, taxpayers, and (sic, or?) practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

Although the document is an "exposure" draft that is qualified by the explanations set out above, it is understood that it describes the manner in which the department interprets the law. There are several deficiencies in the department's approach.

2.2. Form and substance analysis

A cardinal shortcoming of the exposure draft is that its structure assumes that a bipartite division of form and substance is a sufficient analytical framework for the task that it addresses. In particular, it does not divide "substance" into legal substance and economic substance. It says, "The [courts'] only significant departure from [a

[2] New Zealand Inland Revenue Department document reference IG9703 (1998).

formalistic] approach is when the essential genuineness of a transaction is challenged" (by alleging that the transaction is a sham). This remark calls for two comments.

First, it does not sufficiently recognise that when a court deploys a form/substance analysis the exercise is, as it were, a sub-set of the discipline of statutory construction. The question in every tax case is, "On its true construction, does the statute capture the gain or allow the expense in question?". As Lord Hoffman put it in *Macniven v Westmoreland Investments Ltd*,[3]

> There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other "principles of construction" can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation. [There do not exist] overriding legal principle[s], superimposed on the whole of revenue law without regard to the language or purpose of any particular provision.

By way of exception, in New Zealand and Australia section BG 1 of the Income Tax Act 1994 and Part IVA of the Income Tax Assessment Act 1936 do in fact constitute "overriding legal principles superimposed on the whole of revenue law" or, at least, on income tax law, but these exceptions do not gainsay the general applicability of Lord Hoffman's dictum. The exposure draft attempts to achieve a certainty that is illusory. In doing so it fails to appreciate that its subject matter is statutory construction, which involves more a series of approaches than a group of rules.

2.3. Search for legal substance

Secondly, when a transaction is challenged as a sham and not genuine, or as being in substance something different from what its form suggests, the courts have essentially one response. This response is to seek the true legal obligations and rights that the transaction imposes or confers on the parties to it.

Courts often explain this exercise by adopting one of two bipartite frameworks. The first is the form/legal substance dichotomy. When the form of a transaction, or the label that the parties give to the transaction, is different from the true legal substance of the transaction, then the courts construe the transaction according to the true legal rights and obligations that it creates, that is, according to its true legal substance. An example is *Ensign Tankers (Leasing) Ltd v Stokes*.[4] In that case, the House of Lords

[3] (2001) 73 TC 1, para 29, Lord Hoffman (HL).
[4] [1992] 1 AC 655 (HL).

held that a transaction that was constructed as a non-recourse loan was in legal substance a partnership, and that it should be treated as a partnership for tax purposes.

The second bipartite framework entails distinguishing between a transaction's true legal substance and its economic effect. An example is *CIR v Wattie*.[5] In that case, the Privy Council held that a payment that the Commissioner of Inland Revenue argued was a rent subsidy was in legal substance a premium paid by a landlord to attract a tenant, notwithstanding that in economic effect the payment was just the same as a rent subsidy. Being a premium, the payment was a non-taxable capital receipt, whereas a rent subsidy would have been a revenue item.

2.4. Three elements in tripartite framework

Two features of these alternative bipartite arrangements require noting. First, the concept of legal substance is common to each framework. Secondly, whichever framework is appropriate to the case at hand, the correct answer is nearly always the same: the court must analyse the transaction according to its legal substance and the true legal rights and obligations that it creates. If the first framework is used, the courts reject form in favour of true legal substance. If the second framework is used, the courts reject economic substance in favour of legal substance. (The significance of the word "nearly" in the expression "nearly always the same" is explained in the next section of this article.)

The result is that a conspectus of the two types of cases, that is, cases like *Ensign Tankers* and cases like *Wattie*, reveal three relevant categories: form, legal substance, and economic substance. The courts reject the first and third in favour of the second. This principle does not mean that the first and third categories are never correct. Rather, and subject to what is said in the succeeding paragraphs, they are correct only if they happen to coincide with legal substance, with the parties' true rights and obligations. Thus in *Wattie*, a legal form (a premium) did in fact coincide with legal substance (a premium) and the Privy Council rejected analysis according to economic substance that would have led to classifying the payment as a rent subsidy. In *Ensign Tankers*, economic substance (a partnership) did in fact coincide with legal substance (a partnership) and the House of Lords rejected form (a non-recourse loan).

[5] [1999] 1 NZLR 529, 18 NZTC 13,991 (PC).

2.5. Limits of tripartite analysis

The tripartite framework of legal form, legal substance, and economic substance is useful and will explain and rationalise many cases. However, it is not a complete answer. It is not a rule of law but a principle of construction. In some cases the framework does not operate. For instance, in *Southern Railway of Peru Ltd v Owen*, Lord Radcliffe said:[6]

> The answer to the question what can or cannot be admitted into the annual account is not provided by any exact analysis of the legal form of the relevant obligation. In this case, as in the *Sun Insurance*[7] case, you get into a world of unreality if you try to solve your problem in that way, because, where you are dealing with a number of similar obligations that arise from trading, although it may be true to say of each separate one that it may never mature, it is the sum of the obligations that matters to the trader, and experience may show that, while each remains uncertain, the aggregate can be fixed with some precision.

The matters in question in the *Southern Railway* case were contingent obligations to disburse severance pay pursuant to contracts of employment, the obligations being individually unquantified. In the passage quoted, Lord Radcliffe both expressly rejected reliance on the legal form of the transactions and impliedly rejected legal substance, in that the form and substance of the unquantified obligations coincided. Instead, he chose the economic substance that "experience may show ... can be fixed with some precision".

Analysis such as that of Lord Radcliffe has been relatively rare in tax cases except where the statute uses general terms like "profit". Like Lord Radcliffe, judges may take such drafting as an invitation to call commercial concepts in aid to flesh out the meaning of words that do not have a precise legal meaning.[8]

2.6. Influence of Westmoreland Investments case

As a result of *Macniven v Westmoreland Investments Ltd*, this kind of reasoning may become more widespread. In that case, Lord Hoffman employed this reasoning in his explanation of *WT Ramsay Ltd v IRC*,[9] perhaps the leading case on the United Kingdom judge-created doctrine of fiscal nullity.[10] His Lordship said:[11]

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[6] [1957] AC 334, 357 (HL).

[7] *Sun Insurance Office v Clark* [1912] AC 443 (HL), footnote added.

[8] Eg, *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* (2001) TC 1, , para 41 Lord Hoffman (HL), discussed in next paragraph

[9] [1982] AC 300 (HL).

[10] For a review of the fiscal nullity doctrine, see, eg M Gammie "Tax Avoidance and the Rule of Law: A perspective from the United

> Thus in saying that the transactions in the *Ramsay* case were not sham transactions, one is accepting the juristic categorisation of the transactions as individual and discrete and saying that each of them involved no pretence. They were intended to do precisely what they purported to do. They had a legal reality. But in saying that they did not constitute a "real" disposal giving rise to a "real" loss, one is rejecting the juristic categorisation as not being necessarily determinative for the purposes of the statutory concepts of "disposal" and "loss" as properly interpreted. The contrast here is with a commercial meaning of those concepts. And in saying that the income tax legislation was intended to operate "in the real world", one is again referring to the commercial context which should influence the construction of the concepts used by Parliament.

In this passage, Lord Hoffman rejects both "juristic categorisation" (which no doubt includes legal form) and "legal reality" (that is, legal substance) as determinative. Instead, he chooses a "commercial meaning", that is, economic substance. Most people see *Macniven v Westmoreland Investments Ltd* as narrowing the scope of the *Ramsay* principle, which conclusion is probably correct as far as it goes. But the case may also widen the area within which courts will opt for economic over legal substance.

2.7. Self-cancelling transactions

The preceding paragraphs have tried to show that the exposure draft's relatively simple dichotomy of form and substance is insufficiently nuanced and too inflexible to serve as a useful tool of analysis of tax cases. The draft itself illustrates the point in its discussion of a practical example formed by a pair of opposing transactions that balance one another in both legal and economic substance. The draft specifically denies the possibility of considering the transactions together as a self-cancelling matrix. The example is:

> P purchases some assets from M for $100,000. P and M then enter into a simultaneous put and call option agreement under which:
> - M has the right to buy the assets back for $110,000 (call option);
> - P has the right to sell the assets to M, also for $110,000 (put option).

The draft states that these options must necessarily be treated as transactions that are separate from the purchase transaction, even though all three are part of a single

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Kingdom" in Graeme S Cooper (ed) *Tax Avoidance and the Rule of Law* (IBFD Publications BV, Amsterdam, 1997) 181, 190-191; *Inland Revenue Commissioners v McGuckian* [1997] 3 All ER 817, 821-823 Lord Brown-Wilkinson and 824-827 Lord Steyn (HL).

[11] *Macniven* para 41.

agreement. It is possible that there are circumstances where the opinion in the draft would be correct. However, there are not enough secondary facts in the example to decide whether a court would consider each transaction separately and give each transaction full effect, or whether it would conflate the transactions into a single, self-cancelling matrix. Indeed, there are no secondary facts given in the example.

Tax officials faced with cases where the primary facts match the balancing transactions in the example could be forgiven for following the analysis in the draft and assuming that the law will inevitably require each transaction to be given separate effect.

2.8. Self-cancelling in the Magnum case

Interestingly, some people seem to have adopted the approach just described in analysing the Magnum scheme in the Wine Box papers. The Wine Box papers were a cardboard box full of transaction and tax planning documents that had allegedly been stolen from a trust company in the Cook Islands. A copy of the documents came into the possession of a New Zealand Member of Parliament, the Honorable Winston Peters. At the time, the documents were in a carton that had formerly held bottles of wine: hence the name. Mr Peters tabled the documents in Parliament. The New Zealand Parliament published the documents in an Appendix to the Journals of the House of Representatives.[12] Litigation that resulted from the documents included a Commission of Inquiry[13] and several cases.[14]

Perhaps the most notorious of the schemes documented in the Wine Box papers came to be known as the "Magnum" transactions, after the New Zealand company that took the fiscal benefit from the scheme. The core transactions in the Magnum scheme were an agreement to sell a promissory note, and another agreement to buy the same note. The Magnum scheme's pair of transactions were, if anything, less closely inter-related than the put and call options in the exposure draft's example. The differences are first that the Magnum transactions were not formally part of a single agreement and secondly that, while one party was the same in both Magnum

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[12] "Papers presented, by leave, to the House of Representatives by the member for Tauranga, the Honourable Winston Peters, on 16 March 1994" [1994] 1 AJHR A.6.

[13] *Report of the Wine Box Inquiry: Comission of Inquiry into Certain Matters Relating to Taxation*,GP Publications, Wellington, 1997.

[14] Eg, *Peters v Davison* [1999] 3 NZLR 744 (HC), *Brannigan v Sir Ronald Davison* [1997] 1 NZLR 140 (PC).

transactions, the second parties to the two transactions were not identical but were sibling companies in the same group.

On their facts, there is a tenable argument that the Magnum transactions were self-cancelling and did not have the effect that was purported by their authors, to put the matter at its lowest. In fact, in *European Pacific Banking Corporation v Television New Zealand*[15] the Court of Appeal went further, and, taking into account the secondary facts of the Magnum scheme, held that Television New Zealand had established a seriously arguable case that the whole scheme was iniquitous. (Iniquity was relevant because the plaintiff's claim for an injunction was based on an allegation that Television New Zealand was relying on stolen documents. One defence was that the transactions involved iniquity; that is, the plaintiff did not come to equity with clean hands.) In the later case of *Peters v Davison*[16] the Court of Appeal confirmed its earlier opinion that the Magnum promissory note transaction could be ineffectual because one leg of the transaction cancelled the other.

Comparing the exposure draft's example with the Magnum scheme illustrates that form/substance analysis is much more subtle, elusive, and impressionistic than would appear to be the case to a reader of the draft. Although the draft purports to be no more than a draft, and is subject to correction, the ordinary course of events would not necessarily see the necessary corrections made. If there is reliance on the period of exposure of the draft to provoke professional comment that would identify errors, that reliance may well be misplaced. Nine times out of ten, the view that the draft espouses will suit the taxpayer rather than the Commissioner. It would be a most altruistic practitioner from the private sector who would seek to correct the draft.

2.9. Causes for concern

One does not want to be unfair to the department in criticising a document that is only an exposure draft. On the other hand, the draft was published on 4 June 1997, and remains an exposure draft at the time of writing. By the end of 1998 it had attracted only five submissions.[17] None of them made the points made in this article. It is unrealistic for the department to rely on voluntary public comment to correct this kind of document.

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[15] [1994] 3 NZLR 43 (CA).

[16] [1999] 2 NZLR 164 (CA).

[17] I McKay, AP Molloy, J Prebble & J Waugh, *Tax Compliance*, Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, Wellington 1998, 136.

The status and likely use of the draft are a matter for concern. The document is in essence a pedagogic text on how to approach transactions by using a form/substance analytical framework. But in status, and in some of its language, the document is a draft statement of the law as the Commissioner understands it. There are several problems here. They stem from the fact that the form or substance question, as part of the law of statutory interpretation, is more a tool of argument or analysis than it is a statement of law. Moreover, it is a deceptive tool, in that, like other principles of statutory interpretation, judges often state it in firm, almost dogmatic terms, whereas in fact it is infinitely flexible and elusive.

The matters discussed in the last paragraph give cause for concern about the users of the interpretation guideline. If people are knowledgeable about tax law, they will understand that, despite its form, the statement can in only a limited sense function as a statement of the Commissioner's view of the law. But these people will already know enough about tax law that they will either not need to use the statement, or, worse, they will be able to use it for their own ends, picking on passages that can be deployed against the Commissioner.

If people's knowledge of tax law is such that they need the statement to inform them about the form/substance distinction there is every risk that they will be misled. In difficult cases, the form/substance distinction is a matter of shadings of grey. The draft statement does not paint a picture that is purely black and white, but it does give an impression of much more certainty and logic than in fact exist. A tax official relying on the statement to help in analysing and categorising a difficult transaction could well come to the wrong conclusion.

Revising and correcting the statement is not the answer. The statement is not really an "interpretation" of a difficult or ambiguous rule of tax law, and hardly qualifies to be called an "interpretation guideline". As mentioned earlier, it is more in the nature of instruction in the use of a particular analytical technique. Because the technique is a tool, in close cases it can be used to argue either side. Publishing an explanation of such a technique as a formal statement of the Commissioner's view of the law can inadvertently give tax advisers in the private sector an argument that, in substance, does not exist. Further, it can cause officials to reach incorrect conclusions. As has been explained, it may be that the drafters of the statement themselves came to an incorrect conclusion in respect of self-cancelling transactions.

A further cause for concern is that, although the draft is subject to revision after exposure, at publication it stated the Commissioner's then (and apparently still) current "considered views". Have those views affected any private binding rulings that have been issued in recent years? Have they influenced decisions about completed transactions that have come to the attention of inspectors? One cannot answer these questions, because private rulings are not published, and because decisions about individual taxpayers are confidential.

2.10. General reflections on interpretation guidelines

In conclusion, consider the purpose of interpretation guidelines that set out not interpretations of law but, in effect, instructions or information on how to go about methods of legal reasoning. To the extent that users are Inland Revenue Department staff, the purpose is commendable and necessary: it is most important for staff to be educated in methods of legal reasoning. But are interpretation guidelines appropriate vehicles for such education? If interpretation guidelines are to fulfil the function that their name implies, they must be reasonably concise and dogmatic. Legal reasoning has many qualities, but concise dogmatism is not one of them. Where it is a question of education or instruction of officials on methods of legal reasoning, the conventional vehicles of textbooks, articles, and class instruction are more appropriate. There is no obvious need for a particular approach to be sanctioned by the Commissioner. Indeed, the expense of settling an agreed, concise, statement must be considerable, compared with the greater latitude that is appropriate in an educational context.

There must also be concern about directing interpretation guidelines of the kind under discussion to taxpayers and practitioners. Non-specialists who do not know how this kind of statement fits into the total context of the law would be ill advised to rely on them. Specialists do not need them and are apt to turn them against the Commissioner.

3. Interpretation guideline on shams

3.1. Bipartite analysis

The second statement to be considered is an interpretation guideline entitled *"Sham" – meaning of the term*, which was published in 1997.[18] The guideline is an item of three or four pages, much along the lines of a short expository

[18] (1997) 9 *Inland Revenue Department Tax Information Bulletin*, issue 11, 7.

article that one might find in a professional or scholarly journal or as part of a chapter in a textbook.

The guideline mentions relevant law, draws certain conclusions, and gives some examples. It suffers from the shortcoming that its analysis of shams takes place within an analytical framework that is not wholly adequate. It adopts the same bipartite approach as the exposure draft on form and substance that has just been discussed. Loosely, courts talk in terms of contrasting the form of a transaction with its substance. The guideline adopts this dichotomy, but a two-part framework is not sufficiently refined to elucidate the cases. As explained, in this context the courts use a framework that has at least three levels: economic substance, legal substance, and legal form. Generally speaking, courts adopt the second level, legal substance, as correctly representing the effect of transactions for the purpose of tax cases.

3.2. No halfway house

A second difficulty is that the guideline keeps to the assumption that there is no halfway house between a sham and an effective transaction. There are plenty of dicta in the cases that appear to support this principle,[19] and it is accurate as far as it goes. But the principle must be understood within a wider context. That context is that, above and beyond the doctrine of sham, the courts do in fact decline to accord to certain categories of genuine, non-sham, transactions the effect that those transactions purport to have. In strict logic, these impugnable transactions are sub-categories of genuine transactions, but for practical purposes they may well be thought of as forming a kind of halfway house between sham transactions and genuine transactions.

The main inhabitants of this quasi-halfway house are mislabelled transactions, self-cancelling transactions, and transactions that, when interpreted in context, have an effect different from the initial impression that the reader gains from one or more of the documents.[20] (The interpretation guideline mentions the third category by implication in its discussion of Richardson J's judgment in *Re Securitibank (No 2),*[21] but it does not explore the implications of the category in a manner that is sufficiently informative.)

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[19] Eg, *Re Securitibank Ltd (No 2)* [1978] NZLR 136, 186 Richardson J (CA), *Marac Life Assurance ltd v CIR* (1986) 9 TRNZ 331, 343 (CA), *Mills v Dowdall* [1983] NZLR 154, 159 Richardson J (CA).

[20] See J. Prebble "Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II – Criminal Law Consequences of Categories of Evasion and Avoidance" (1996) 2 *New Zealand Journal of Taxation Law and Policy*, 59, 63 - 66.

[21] [1978] 2 NZLR 136 (CA).

The difficulty with the Department's interpretation guideline is that most readers would take it to be comprehensive in scope, (in the sense of covering or referring to the whole relevant field, rather than in the sense of being a fully detailed analysis). The guideline reinforces this impression by quoting the "no halfway house" principle, which has misled a good many readers of judgments in the past. The problem is compounded by the fact that the guideline appears to be a general, authoritative statement. In contrast, reported judgments can be misleading enough, but at least most readers of law reports appreciate that statements of principle in judgments can be taken as generally authoritative only within limits.

4. Policy statement on section 99 of the Income Tax Act 1976

4.1. Introduction

The Commissioner's policy statement on the application of section 99 of the Income Tax Act 1976, the general anti-avoidance section, was published in 1990.[22] The statement seems to have governed much of the department's approach tax avoidance since it was published.

4.2. Four-step test

The statement sets out a four-step analytical framework that is said to be required of "the Commissioner's approach" to section BG 1 cases. This approach is said to require a careful and thorough analysis of:[23]

> (a) the underlying scheme and purpose of the Act as a whole and of the specific provisions under review;
> (b) the arrangement to ascertain its purpose or effect;
> (c) whether a fair and reasonable inference can be drawn that tax avoidance is one purpose of the arrangement (other than merely incidental);
> (d) whether following this analysis it can be inferred that the arrangement frustrates the underlying scheme and purpose of the legislation.

One problem with the phraseology of the four steps is that it seems to accept that the Commissioner has the burden of proof, which is not so. A second problem is that step (d) asks whether an arrangement that may already have been determined to involve more than merely incidental tax avoidance at step (c) "frustrates the underlying scheme and purpose of the legislation". The underlying scheme and purpose of the legislation is not mentioned in section BG 1. That is not to say that

[22] Taxpayer Information Bulletin no 8, February 1990, appendix C.
[23] Id 2.

underlying scheme and purpose are irrelevant to a section BG 1 inquiry, but tax inspectors accept too heavy a burden if they are required to elevate underlying scheme and purpose to the status of an independent test.

There is a further problem with the four-step test. Taxpayers began to use it to raise procedural objections to the Commissioner's assessments. Had the Commissioner conscientiously worked through each of the self-imposed steps? Did the reasoning in respect of each step withstand scrutiny? For a few years, it began to look as though the four steps would become four trip-wires that would give substance to judicial review applications in almost any section BG 1 case. Perhaps fortunately for the Commissioner and for the general body of taxpayers, this argument reached the Privy Council in the case of *Miller v CIR*,[24] a tax shelter appeal that drew a notably long bow. In that case, the policy statement was called the "CPS". The taxpayers argued that it was ultra vires for an inspector to come to a conclusion in an avoidance case without going through the four steps of the CPS. Lord Hoffman retorted:[25]

> ... the question of whether an arrangement is void against the Commissioner under s 99(2) is not a matter for his discretion or policy. The Act says that an arrangement falling within the terms of the section "shall be absolutely void". Likewise, the Commissioner is under a statutory duty to reassess the taxpayer's income to counteract any tax advantage. Discretion enters into the matter only as to the method of calculation by which the Commissioner discharges that duty.
>
> The CPS nevertheless reassured taxpayers that, before invoking s 99, the Commissioner would undertake a careful and thorough analysis of the meaning and purpose of the statute and the purpose or effect of the arrangement. He would consider whether it was a fair and reasonable inference that one purpose was tax avoidance. He would decide whether the scheme frustrated the underlying scheme and purpose of the legislation.
>
> ....
>
> ... their Lordships do not think that the CPS was intended to lay down conditions at all. ... the parts of the document relied upon by the appellants do [no] more than to reassure the public that the Commissioner and his officers will think very carefully about whether s 99 applies to any particular case. But his statutory duty is to reassess the taxpayer in any case in which s 99 applies and this duty cannot be made subject to internal conditions.

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[24] [2001] 3 NZLR 316 (PC)

[25] Id 330.

Thus, at least the policy statement does not constitute a procedural handicap for the Commissioner when it comes to litigation.

5. Conclusion

5.1. Anti-avoidance rules

Since it was published, the 1990 policy statement seems to have had considerable influence. It may be part of the explanation for the infrequency with which the Commissioner has invoked section BG 1 from the time of its re-drafting in 1974.

There is always a good deal of pressure for commissioners to continue writing statements or interpretation guidelines about general anti-avoidance rules, but from the point of view of sound tax administration it is questionable whether they should do so. Throughout the history of the New Zealand and Australian general anti-avoidance rules, taxpayers, and sometimes the courts, have asked Parliament for more details. What sorts of transactions are caught? What are acceptable? In New Zealand, Parliament has resisted this pressure.

In 1985, in *Challenge Corporation v CIR*,[26] Woodhouse P explained:

> [T]here can be no doubt that when the provision was amplified and given its present statutory form by Parliament in 1974 the deliberate decision was then taken that, because the problem of definition in this elusive field could not be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the Judges. .... [I]nherent in the approach taken by Parliament is an assurance that some expressed judicial misgivings as to the proper role of the Court concerning the earlier legislation have been misplaced.
>
> ... In New Zealand the Courts must now ensure that the anti-avoidance provision as it stands is given that purposive construction which will enable it to do its work in the balanced but effective way intended for it.

It is a curious irony that the Commissioner's policy statement fills a lacuna that Parliament intentionally left empty. The more detailed rules there are within the overall ambit of a general anti-avoidance rule, the greater the risk of people circumventing them. Formally, the Commissioner's statement does not constitute binding rules, but in practice the department is reluctant to deploy section BG 1 against taxpayers who have brought themselves within an example that is said to escape the section.

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[26] [1986] 2 NZLR 513, 534 line 30 (CA).

There is a parallel, though possibly not a close one, between the Commissioner's policy statement and the considerable detail that Australia added to Part IVA of the Income Tax Assessment Act 1936 when the Commonwealth Parliament replaced the former section 260 of that Act. The reason for having a general anti-avoidance rule is that income is an imperfect tax base. Parliament cannot foresee all the possible stratagems that taxpayers may employ to minimise their tax. The response is a general rule. The less general the rule becomes, the less effective it is. This consideration may explain some of the Australian Commissioner's failures.[27] As one might expect, though, the Commissioner has also had some successes under the detailed provisions of Part IVA.[28]

5.2. Interpretation statements in general

In the nineteenth century it was said that in the Irish Court of Common Pleas no case was certain but none hopeless.[29] While an exaggeration, there remains some truth in this statement when applied to tax cases today. This is particularly so in respect of cases that depend on the application of a somewhat flexible form of reasoning rather than on relatively black letter law. Examples of such flexible forms of reasoning include: applying the principles of statutory interpretation; drawing the line between capital and revenue items; applying the statutory anti-avoidance rule; and analysing facts according to the form/substance distinction (in effect a sub-set of statutory interpretation).

It is very difficult for anyone who is trying to manage a department of state according to the law to allow for the level of flexibility, and even of inconsistency, that is inherent in the jurisprudence of tax cases (not of individual cases, but of tax cases taken as a body). For efficiency, and from the perspective of the rule of law, it seems to make sense to try to produce reasonably formal, certain rules to govern officials' decision-making.[30] However, one result, seen in the *Interpretation Guideline on Shams*, the Exposure Draft of the Interpretation

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[27] Eg, *Eastern Nitrogen Ltd v FCT* (2000) 46 ATR 474 Fed Ct, Full Ct; *FCT v Metal Manufacturers Ltd* [2001] FCA 365, 46 ATR 497, Fed Ct, Full Ct.

[28] Eg, *FCT v Spotless Services Ltd* (1996) 186 CLR 404, *Peabody v FCT* (1993) 181 CLR 359.

[29] Sargeant AM Sullivan, "The Last Forty Years of the Irish Bar" (1927-1929) 3 CLJ 365.

[30] For further discussion of rule of law based arguments for certainty in income tax law, see J Prebble, *Fictions of Income Tax: Working Paper Series, Working Paper No. 7*, Centre for Accounting, Goverance and Taxation Research, School of Accounting and Commercial Law, Victoria University of Wellington, 2003.

Guideline on *Form and Substance in Taxation Law*, and the *Policy Statement on Section 99*, is that blunt instruments are used to try to achieve refined objectives, with unfortunate results.

It is easier to identify the problem than it is to suggest practical solutions. The Commissioner can only work within the budget that he has and with the staff that are available. As a minimum, however, it is suggested that the Commissioner should consider issuing interpretation guidelines very sparingly, if at all, in areas where the law depends primarily on an approach or method of reasoning, and where relevant facts vary infinitely from case to case.

In conclusion, my Lords, it seems to me that, unless the procedure adopted by the moving party is ill suited to dispose of the question at issue, there is much to be said in favour of the proposition that a court having jurisdiction ought to let a case be heard rather than entertain a debate concerning the form of the proceedings.

For the reasons already given I would dismiss this appeal.

Appeal dismissed with costs.

Solicitors: Capsticks; Hempsons.

C. T. B.

[HOUSE OF LORDS]

ENSIGN TANKERS (LEASING) LTD. . . . APPELLANT AND CROSS-RESPONDENT

AND

STOKES (INSPECTOR OF TAXES) . RESPONDENT AND CROSS-APPELLANT

1992 Jan. 14, 15, 16, 20, 21, 22; March 12

Lord Keith of Kinkel, Lord Brandon of Oakbrook, Lord Templeman, Lord Goff of Chieveley and Lord Jauncey of Tullichettle

Revenue—Corporation tax—Capital allowances—Transactions carried out to obtain fiscal advantage—Company entering into limited partnerships to acquire master negatives of films—Expenditure by partnerships to acquire exclusive rights to completed films—Whether partnerships trading—Whether capital expenditure incurred by partnerships—Whether company entitled to first-year allowances—Finance Act 1971 (c. 68), s. 41(1)

During 1980 the taxpayer company and four other British companies as limited partners entered into partnership with the subsidiary of an American film production company as general partner to produce and exploit the film "Escape to Victory" then in course of production by the production company. The object of the British companies was to claim first year tax allowances under section 41(1) of the Finance Act 1971[1] in respect of the whole of the cost of the film. The partnership entered into agreements with the production company and its subsidiaries whereby the partnership contributed $3·25m. (of which $2·3m. represented the taxpayers' contribution) towards

[1] Finance Act 1971, s. 41(1): see post, p. 661D–E.

the cost of the film and became entitled to the master negative of the film and the production company agreed to complete the film and to lend to the partnership the cost in excess of $3·25m. of making the film. The loans were non-recourse and were only repayable out of 75 per cent. of the net receipts from the exploitation of the film. The remaining 25 per cent. of the net receipts was received by the partnership. The taxpayer appealed against the refusal of the inspector of taxes to allow its claim to first year allowances based on the cost of the film amounting to $14m. The special commissioners dismissed the taxpayer's appeal holding that the transactions entered into by the partnership had fiscal motives as a paramount object and as such were not a trading transaction.

Millett J. allowed the taxpayer's appeal on the grounds that the commissioners had misdirected themselves, their conclusions could not be supported and that the only true and reasonable conclusion on the facts was that the partnership was trading. The judge further held that the facts did not support alternative contentions raised by the revenue that for the purposes of section 41(1) of the Act of 1971 the master negative never "belonged" to the partnership, that only 25 per cent. of the expenditure was "incurred" by the partnership on the provision of plant and that the transactions had no commercial purpose other than the avoidance of tax and should thus be disregarded. The Court of Appeal allowed the revenue's appeal but remitted the case to the commissioners to decide, applying the tests stated, whether the taxpayer was or was not trading.

On appeal by the taxpayer and cross-appeal by the revenue:—

Held, allowing the appeal in part, that, analysing the transactions entered into as a single composite transaction regarded as a whole the legal effect was a trading transaction whereby the partnership expended $3·25m. (but not $14m.) towards the production and commercial exploitation of the film in which they had a 25 per cent. interest and generated a first-year allowance of $3·25m. within section 41(1) of the Act of 1971; and that, accordingly, the case should be remitted to the commissioners for assessment of tax on that basis, in default of agreement (post, pp. 660H–661B, 675A–C, 676H–677A, C–F, 680A–C, 682D, 684C–D, 686C).

Dictum of Lord Keith of Kinkel in *Craven v. White (Stephen)* [1989] A.C. 398, 479, H.L.(E.) applied.

Inland Revenue Commissioners v. Duke of Westminster [1936] A.C. 1, H.L.(E.) explained.

Lupton v. F.A. & A.B. Ltd. [1972] A.C. 634, H.L.(E.) distinguished.

W.T. Ramsay Ltd. v. Inland Revenue Commissioners [1982] A.C. 300, H.L.(E.) considered.

Decision of the Court of Appeal [1991] 1 W.L.R. 341 varied.

The following cases are referred to in their Lordships' opinions:

Black Nominees Ltd. v. Nicol (1975) 50 T.C. 229

Chinn v. Hochstrasser [1981] A.C. 533; [1981] 2 W.L.R. 14; [1981] 1 All E.R. 189; 54 T.C. 311, H.L.(E.)

Coates v. Arndale Properties Ltd. [1984] 1 W.L.R. 1328; [1985] 1 All E.R. 15, H.L.(E.)

Commissioner of Inland Revenue v. Challenge Corporation Ltd. [1987] A.C. 155; [1987] 2 W.L.R. 24, P.C.

Craven v. White (Stephen) [1989] A.C. 398; [1988] 3 W.L.R. 423; [1988] 3 All E.R. 495; 62 T.C. 1, H.L.(E.)
Floor v. Davis [1978] Ch. 295; [1978] 3 W.L.R. 360; [1978] 2 All E.R. 1079; 52 T.C. 609, C.A.
Furniss v. Dawson [1984] A.C. 474; [1984] 2 W.L.R. 226; [1984] 1 All E.R. 530; 55 T.C. 324, H.L.(E.)
Inland Revenue Commissioners v. Burmah Oil Co. Ltd. (1981) 54 T.C. 200, H.L.(Sc.)
Inland Revenue Commissioners v. Duke of Westminster [1936] A.C. 1, H.L.(E.)
Iswera v. Commissioner of Inland Revenue [1965] 1 W.L.R. 663, P.C.
Lupton v. F.A. & A.B. Ltd. [1972] A.C. 634; [1971] 3 W.L.R. 670; [1971] 3 All E.R. 948; 47 T.C. 580, H.L.(E.)
Overseas Containers (Finance) Ltd. v. Stoker [1987] 1 W.L.R. 1521; 61 T.C. 473; [1989] 1 W.L.R. 606; 61 T.C. 473, C.A.
Ramsay (W.T.) Ltd. v. Inland Revenue Commissioners [1979] 1 W.L.R. 974; [1979] 3 All E.R. 213, C.A.; [1982] A.C. 300; [1981] 2 W.L.R. 449; [1981] 1 All E.R. 865; 54 T.C. 101, H.L.(E.)
Reed v. Nova Securities Ltd. [1985] 1 W.L.R. 193; [1985] 1 All E.R. 686; 59 T.C. 516, H.L.(E.)
Religious Tract and Book Society of Scotland v. Forbes (1896) 3 T.C. 415
Simmons (as liquidator of Lionel Simmons Properties Ltd.) v. Inland Revenue Commissioners [1980] 1 W.L.R. 1196; [1980] 2 All E.R. 798; 53 T.C. 461, H.L.(E.)

The following additional cases were cited in argument:

Baker v. Cook [1937] 3 All E.R. 509; 21 T.C. 337
Brighton College v. Marriott [1926] A.C. 192, H.L.(E.)
Coren v. Keighley [1972] 1 W.L.R. 1556; 48 T.C. 370
Customs and Excise Commissioners v. Faith Construction Ltd. [1990] 1 Q.B. 905; [1989] 3 W.L.R. 678; [1989] 2 All E.R. 938, C.A.
Finsbury Securities Ltd. v. Inland Revenue Commissioners [1966] 1 W.L.R. 1402; [1966] 3 All E.R. 105; 43 T.C. 591, H.L.(E.)
Griffiths v. J. P. Harrison (Watford) Ltd. [1963] A.C. 1; [1962] 2 W.L.R. 909; [1962] 1 All E.R. 909, H.L.(E.)
Inland Revenue Commissioners v. Incorporated Council of Law Reporting (1888) 3 T.C. 105
Inland Revenue Commissioners v. Livingston (1926) 11 T.C. 538
Lord Advocate v. Gibb (1906) 5 T.C. 194
Newstead v. Frost [1978] 1 W.L.R. 511; [1978] 2 All E.R. 241
Newton v. Commissioner of Taxation of the Commonwealth of Australia [1958] A.C. 450; [1958] 3 W.L.R. 195; [1958] 2 All E.R. 759, P.C.
Quistclose Investments Ltd. v. Rolls Razor Ltd. [1970] A.C. 567; [1968] 3 W.L.R. 1097; [1968] 3 All E.R. 651, H.L.(E.)
Ransom v. Higgs [1974] 1 W.L.R. 1594; [1974] 3 All E.R. 949; 50 T.C. 1, H.L.(E.)
Reed v. Young [1986] 1 W.L.R. 649; 59 T.C. 196, H.L.(E.)
Royal Agricultural Society of England v. Wilson (1924) 9 T.C. 62
Stubart Investments Ltd. v. The Queen (1984) 10 D.L.R. (4th) 1
Thomson v. Gurneville Securities Ltd. [1972] A.C. 661; [1971] 3 W.L.R. 692; [1971] 3 All E.R. 1071; 47 T.C. 633, H.L.(E.)

APPEAL from the Court of Appeal.

This was an appeal by the taxpayer, Ensign Tankers (Leasing) Ltd., by leave of the Court of Appeal, from an order dated 30 January 1991

of that court (Sir Nicolas Browne-Wilkinson V.-C. and Stuart-Smith and Leggatt L.JJ.) [1991] 1 W.L.R. 341 allowing the revenue's appeal from an order dated 14 July 1989 of Millett J. [1989] 1 W.L.R. 1222, who had allowed the taxpayer's appeal by way of case stated from a decision by the Commissioners for the Special Purposes of the Income Tax Acts. The commissioners had decided that the taxpayer was not entitled to claim first year allowances under section 41(1) of the Finance Act 1971 for its share of certain capital expenditure incurred (or allegedly incurred) by two limited partnerships of which it was a member and which were said to have been trading partnerships.

The revenue cross-appealed.

The facts are stated in the opinion of Lord Templeman.

John Gardiner Q.C. and *Jonathan Peacock* for the taxpayer. When considering whether a particular transaction effected by a taxpayer constitutes a trade a two-stage test has to be applied. (1) Whether, considered objectively, the transaction has the outward appearance of a trading transaction: *Inland Revenue Commissioners v. Livingston* (1926) 11 T.C. 538, 542, 545. (2) If so, whether it can be said that the transaction has a non-commercial, or fiscal, object such that it cannot constitute trade. Both are questions of fact for the tribunal of fact and must be answered by considering the transaction as a whole. [Reference was made to section 155(1) and (2) of the Income and Corporation Taxes Act 1970 and *Reed v. Young* [1986] 1 W.L.R. 649.]

To achieve a commercial (i.e. non-fiscal) object, a taxpayer is entitled to adopt the form of transaction which is most beneficial to him from a tax point of view; particularly where tax benefits of one form (e.g. capital allowances under section 41(1) of the Finance Act 1971) rather than another have been specifically conferred by Parliament. It would be strange if it were the law that a trader who is motivated to enter into transactions by tax benefits conferred by Parliament is not trading when he enters into those transactions. The motive or intention of the taxpayer is only relevant to the question of trade or investment where the transaction is ambiguous, e.g. the purchase and sale of assets which are capable of being investments: *Simmons (as liquidator of Lionel Simmons Properties Ltd.) v. Inland Revenue Commissioners* [1980] 1 W.L.R. 1196 and *Iswera v. Commissioner of Inland Revenue* [1965] 1 W.L.R. 663.

The only remaining question is whether a transaction can, because of the motives of a taxpayer, be regarded as a raid on the public purse. This must be answered objectively by looking to the nature and effect of the transaction itself. Motive is relevant only where fiscal or other non-commercial motivations so affect the nature of the trading transactions that they cease to be normal trading transactions: *Religious Tract and Book Society of Scotland v. Forbes* (1896) 3 T.C. 415. It is the object or purpose of the transactions themselves which falls to be judged: *Newton v. Commissioner of Taxation of the Commonwealth of Australia* [1958] A.C. 450, 465 and *Newstead v. Frost* [1978] 1 W.L.R. 511, 519. Either there is trade or there is no trade. There is no half way house of partial trade: *Ransom v. Higgs* [1974] 1 W.L.R. 1594.

The revenue's claim that motive is a relevant factor in the determination of the existence of a trade appears to be based on the series of decisions generally known as the "dividend stripping cases:" see *Lupton v. F. A. & A. B. Ltd.* [1972] A.C. 634; *Finsbury Securities Ltd. v. Inland Revenue Commissioners* [1966] 1 W.L.R. 1402 and *Thomson v. Gurneville Securities Ltd.* [1972] A.C. 661. But those cases only establish that transactions the sole object of which is to manufacture a tax recovery claim cannot be trading transactions. The crucial distinction is that in the present case a trading loss was not a certainty and profit was not built into the transactions in advance at a fixed sum or rate.

Other transactions which have been held to be non-trading are transactions between groups of companies with no money passing and where assets are not acquired as stock in trade: see *Reed v. Nova Securities Ltd.* [1985] 1 W.L.R. 193 and *Overseas Containers (Finance) Ltd. v. Stoker* [1989] 1 W.L.R. 606. [Reference was also made to *Coates v. Arndale Properties Ltd.* [1984] 1 W.L.R. 1328.]

If the transactions effected by a taxpayer are of a commercial character, whether trade or investment, then the taxpayer's motives are irrelevant. Thus, a charity which acts from charitable or philanthropic motives is nevertheless trading if its acts have a commercial character and a commercial object or purpose: see *Brighton College v. Marriott* [1926] A.C. 192; *Inland Revenue Commissioners v. Incorporated Council of Law Reporting* (1888) 3 T.C. 105 and *Royal Agricultural Society of England v. Wilson* (1924) 9 T.C. 62.

A trading transaction does not cease to be such merely because it involves a high degree of risk. [Reference was made to *Lord Advocate v. Gibb* (1906) 5 T.C. 194; *Baker v. Cook* [1937] 3 All E.R. 509 and *Stubart Investments Ltd. v. The Queen* (1984) 10 D.L.R. (4th) 1.]

Christopher McCall Q.C. and *Launcelot Henderson* for the revenue. The crucial question is whether the partnership was trading. There was no trading. Consistently with *W. T. Ramsay Ltd. v. Inland Revenue Commissioners* [1982] A.C. 300 and *Furniss v. Dawson* [1984] A.C. 474 there is no first-year allowance available to the taxpayer under section 41(1) of the Finance Act 1971. Partial trading is unknown to the law. Either the partnership was trading or not; it is not possible to say that it was trading but only to a limited extent.

Although motive is conceded to be irrelevant to the question whether the partnership was trading, there is a fundamental difference between intention and motive. Intention means seeking to do something and is linked to purpose, which is the same as object. The intention of the taxpayer was to achieve the benefit of the first-year 100 per cent. allowance under section 41(1). The transactions were specially entered into for that purpose. Motive, on the other hand, relates to the reason for doing something. The taxpayer's reason was to improve the tax position of the taxpayer's group.

The transactions were not trading transactions. Trading requires an intention to trade: *Simmons (as liquidator of Lionel Simmons Properties Ltd.) v. Inland Revenue Commissioners* [1980] 1 W.L.R. 1196 and *Iswera v. Commissioner of Inland Revenue* [1965] 1 W.L.R. 663. The question is whether an asset was acquired for the purpose of investment

or as stock in trade. To show trading the asset has to be acquired as stock in trade: *Reed v. Nova Securities Ltd.* [1985] 1 W.L.R. 193. If the object is to obtain a fiscal purpose the transaction is not trading: *Overseas Containers (Finance) Ltd. v. Stoker* [1989] 1 W.L.R. 606.

In dividend stripping cases it is difficult to apply the principle that one has to look at the transaction objectively: see *Lupton v. F. A. & A. B. Ltd.* [1972] A.C. 634, 646, 654 and *Thomson v. Gurneville Securities Ltd.* [1972] A.C. 661. In view of those decisions there is no need to overrule *Griffiths v. J. P. Harrison (Watford) Ltd.* [1963] A.C. 1. In the present case the question to be answered is whether the film was acquired for trading or fiscal purposes. [Reference was made to *Commissioner of Inland Revenue v. Challenge Corporation Ltd.* [1987] A.C. 155.]

The cross-appeal arises if the appeal is allowed because it will be necessary to determine the extent to which the taxpayer incurred expenditure in relation to the making of the films.

The taxpayer (and others) executed a series of interdependent agreements. In accordance with principles expressed in *W. T. Ramsay Ltd. v. Inland Revenue Commissioners* [1982] A.C. 300, 323–324, 326, 337–338 and in *Furniss v. Dawson* [1984] A.C. 474, 526, to ascertain what is within the meaning of "expenditure" for the purposes of section 41 of the Act of 1971 the agreements have to be construed as a whole. The answer can only be: to the extent of the 25 per cent. capital which was introduced by the limited partners and not to the extent of 75 per cent. of the expenditure which was nominally undertaken by the taxpayer.

Gardiner Q.C. on the cross-appeal, after referring to *Craven v. White (Stephen)* [1989] A.C. 398 in reply. There is no room for the principle in *Ramsay* and related authorities for the reasons given in the speech of Lord Oliver of Aylmerton in *Craven v. White*. Looking at it as a matter of ordinary principle, the revenue has assumed that under section 41(1) expenditure is not incurred until payment has been made. But the section is satisfied and expenditure is incurred either when a contract to purchase plant is made or, if later, when the sums due under the contract become payable. The actual payment or funding thereof however arranged is irrelevant. Since payment is not the operative event for section 41, the source of finance is irrelevant. *Coren v. Keighley* [1972] 1 W.L.R. 1556 shows that expenditure is incurred even in a case where a vendor of property acts, in the same transaction, in the capacity of lender. [Reference was made to *Quistclose Investments Ltd. v. Rolls Razor Ltd.* [1970] A.C. 567 and *Customs and Excise Commissioners v. Faith Construction Ltd.* [1990] 1 Q.B. 905.] The revenue's argument wholly confuses the taxpayer's obligations to pay for the films with their arrangements for funding the same.

McCall Q.C. replied.

Their Lordships took time for consideration.

March 12. LORD KEITH OF KINKEL. My Lords, I have read the speech to be delivered by my noble and learned friend, Lord Templeman,

and I agree with it. For the reasons he gives, I would allow this appeal and make the orders for remit to the commissioners and for costs which he proposes.

LORD BRANDON OF OAKBROOK. My Lords, I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Templeman. I agree with it and for the reasons which he gives I would dispose of the appeal and cross-appeal in the manner proposed by him.

LORD TEMPLEMAN. My Lords, this appeal is concerned with a tax avoidance scheme, a single composite transaction whereunder the tax advantage claimed by the taxpayer is inconsistent with the true effect in law of the transaction. In the present case the taxpayer claims for itself and its partners capital allowances for expenditure of $14m. although the partners were never liable to spend more than $3¼m. of their own money.

By section 41 of the Finance Act 1971 Parliament sought to encourage a British trader to spend capital on machinery or plant for the purposes of his trade. The encouragement took the form of allowing the trader in the computation of his income tax or corporation tax to deduct the expenditure from his profits in the year of expenditure.

Section 41(1) is in the following terms:

> "where (*a*) a person carrying on a trade incurs capital expenditure on the provision of machinery or plant for the purposes of the trade, and (*b*) in consequence of his incurring the expenditure, the machinery or plant belongs to him at some time during the chargeable period related to the incurring of the expenditure, there shall be made to him for that period an allowance (in this chapter referred to as 'a first year allowance') which shall be of an amount determined in accordance with section 42 below . . ."

In 1980 the master negative of a commercial film constituted plant for the purposes of this section and the first year allowance was 100 per cent.

In March 1980 Lorimar Productions Inc. ("L.P.I."), a Californian company engaged in the production of films, embarked on the production of "Escape to Victory." By an agreement dated 6 June 1980 Chemical Bank agreed to provide finance to make the film in the form of a revolving loan credit up to a maximum of $11m. repayable by L.P.I.

Guinness Mahon, a merchant bank specialising in the manufacture of tax avoidance schemes persuaded the appellant, Ensign Tankers (Leasing) Ltd., and four other British companies to participate in a scheme whereby they would contribute $3¼m. to the cost of making the film "Escape to Victory" in return for 25 per cent. of the net receipts from the exploitation of the film and whereby, so they were advised, they would be entitled to a first year allowance equal to the total cost of the film. The scheme procured for L.P.I. the sum of $3¼m. plus various substantial production and distribution fees and interest and 75 per cent. of the net receipts from the exploitation of the film. The scheme was a

single composite transaction embodied in 17 documents all of which are dated 14 July 1980. The appellant accepts that all the documents which constituted the scheme must be read as a whole. For present purposes some only of the documents need to be considered.

A partnership agreement was made between Victory Films Productions Ltd. ("Victory Productions"), as general partner and the five British companies as limited partners. The partnership was called "Victory Partnership" and its objects were to carry on in the United Kingdom the business of making and distributing films. The capital of the partnership was $3½m. contributed by the limited partners including $2,375,800 contributed by the appellant. Under the Limited Partnerships Act 1907 and by the express terms of the partnership agreement the limited partners were not liable for the debts and obligations of the partnership beyond the capital they had contributed and were not entitled to take part in the management of the partnership or to bind the partnership. The management of the partnership was in the hands of Victory Productions which was a wholly owned subsidiary of L.P.I.

By a rights agreement, L.P.I. granted Victory Partnership in consideration of $1 the exclusive licence to make and exploit the film "Escape to Victory" throughout the world for the entire period of copyright.

By clause 6 of a production services agreement, L.P.I. agreed to make the film "Escape to Victory" in Hungary or elsewhere as L.P.I. should decide in accordance with an approved budget of $12,996,502 but on behalf of Victory Partnership. By clauses 6 and 17 the approved budget included the sum of $4,780,951 which had already been spent by L.P.I. in making the film. By clause 7, Victory Partnership agreed to provide the finance required for the approved budget and L.P.I. agreed to provide the finance required to complete the film if the costs exceeded the approved budget. By clause 13, L.P.I. assigned to Victory Partnership the film negative which had already been shot and the right to the complete film negative as and when the film was continued and completed.

By a loan agreement, Victory Partnership agreed to provide $3½m. towards the cost of the film and L.P.I. agreed to lend Victory Partnership $9¾m. ("the production loan") required to provide the balance of the cost of the approved budget and also to lend to Victory Partnership the amount required ("the completion loan") to complete the film if, in the event which happened, the film cost more than $13m. Clause 1.2 of the Loan Agreement required Victory Partnership to maintain a current account ("the scheme current account") with a bank designated by L.P.I., and to pay into that account all advances by L.P.I. Withdrawals from the scheme current account required the concurrence of a person designated by L.P.I. The scheme current account was maintained with Guinness Mahon. The film cost $14m. so that the production loan of $9¾m. was supplemented by the completion loan of $1m. By clause 1.7 it was agreed that until Victory Partnership had received the sum of $3½m. from 25 per cent. of the net receipts from the exploitation of the film, an amount equal to 75 per cent. of the net receipts should be applied towards repayment of the production loan. Thereafter all the net

receipts were to be applied in repayment of the production loan and the completion loan and interest thereon. Clause 1.11 of the loan agreement, however, entitled "non-recourse loan," freed and discharged Victory Partnership and all the partners of Victory Partnership from any liability to repay the production loan or the completion loan or interest or any other moneys which became due to L.P.I. under the terms of the loan agreement.

By a distribution agreement and by a U.K. agency (Firrilee) agreement, Victory Partnership vested in Lorimar Distribution International Inc. and Firrilee Ltd. ("the distributors"), two wholly owned subsidiaries of L.P.I., the exclusive right to distribute and exploit the film "Escape to Victory" throughout the world in perpetuity. The distributors were authorised to pay the costs of distributing and exploiting the film and to retain percentage fees out of the receipts from the exploitation of the film. By clause 11 the distributors were directed to pay 100 per cent. of the net receipts from the exploitation of the film to Victory Partnership until Victory Partnership had received an amount equal to the production loan and the completion loan plus interest at the rate prescribed by the loan agreement. Thereafter the distributors were to retain 75 per cent. of the net receipts and to pay 25 per cent. to Victory Partnership. In the event the net receipts from the exploitation of the film have so far amounted to $12m., that is $2m. less than the cost of the film.

By a letter addressed by Victory Partnership to and accepted by the distributors and agreed and accepted by L.P.I., the provision in clause 11 of the distribution agreement providing for 100 per cent. of the net receipts from the exploitation of the film to be paid to Victory Partnership was replaced by an irrevocable authority and direction to the distributors to pay 25 per cent. of the net receipts to Victory Partnership and to pay 75 per cent. of the net receipts to L.P.I. until Victory Partnership had received $3¼m. Thereafter 100 per cent. of the net receipts from the exploitation of the film were to be paid to L.P.I. until L.P.I. had received an amount equal to the production loan, the completion loan and interest and other moneys payable under the loan agreement. Thereafter 75 per cent. of the net receipts were to be retained by the distributors and 25 per cent. were to be paid over to Victory Partnership.

By a waiver and consent, Chemical Bank which, as will appear, was to receive the benefit of the payment of $3¼m. by Victory Partnership in reduction of its loan to L.P.I., agreed to the documents I have outlined and thereby reduced its security to the amounts of the net receipts from the exploitation of the film from time to time payable to L.P.I.

On 24 July 1980 the scheme current account was duly opened with Guinness Mahon in the name of Victory Partnership. On 25 July 1980 $3¼m. was credited to that account from the limited partners of Victory Partnership in the amounts of their contributions to the partnership capital. That sum was remitted to L.P.I. on the same date and thence to Chemical Bank.

On 31 July 1980 the sum of $1,530,951 was paid into the scheme current account by L.P.I. and on the same day that sum was returned to

L.P.I. by way of a credit to its account at Chemical Bank. The sums of $1,530,951 and $3¼m. amounted to the costs incurred by L.P.I. in making the film before 14 July 1980 namely $4,780,951 as appears from clauses 6 and 17 of the production services agreement. In the result by the end of July Victory Partnership had paid $3¼m. to L.P.I. The sum of $1,530,951 had been paid by L.P.I. into the scheme current account and promptly transferred back to L.P.I. and the debt owed by L.P.I. to Chemical Bank had been reduced by $3¼m. Thereafter, when L.P.I. required to spend or spent money in making the film, the amount involved was credited by L.P.I. to the scheme current account (which was controlled by L.P.I.) and returned to L.P.I. on the same day for credit to its account at Chemical Bank. The scheme current account was thus never in credit or debit at the close of any day and Victory Partnership was never in debt as a result of the scheme. The cost of the film, namely $14m. was borne as to $3¼m. by Victory Partnership and as to $10¾m. by L.P.I. which was indebted to Chemical Bank for that amount.

In March 1982 the distributors became accountable for receipts from the exploitation of the film as a result of contracts entered into by the distributors with cinema and television operators. Pursuant to the scheme, 75 per cent. of the net receipts were paid to L.P.I. and 25 per cent. to Victory Partnership. Although the film had cost $14m., the net receipts from the exploitation of the film have so far only amounted to $12m. and further receipts are not anticipated. Victory Partnership, having paid $3¼m. towards the cost of the film, has received 25 per cent. of the net proceeds amounting to $3m. L.P.I., having paid $10¾m. towards the cost of the film, has received 75 per cent. of the net receipts or $9m. No one is liable to pay L.P.I. anything in the future save the distributors if and so far as they receive further moneys from the exploitation of the film.

Victory Partnership in the tax year 1980 to 1981 incurred capital expenditure amounting to $3¼m. in the provision of plant, namely the film. The negative belonged to Victory Partnership subject to the exclusive rights of exploitation vested in the distributors and there also belonged to Victory Partnership 25 per cent. of the net receipts from the exploitation of the film. In these circumstances Victory Partnership fulfilled all the conditions necessary to generate a first year allowance of $3¼m. provided that the expenditure of that amount was incurred for the purposes of a trade carried on by Victory Partnership namely the production and distribution of the film "Escape to Victory."

By section 155 of the Income and Corporation Taxes Act 1970 the benefit of any first year allowance generated by Victory Partnership in connection with the cost of the film "Escape to Victory" accrued to the appellant and the four other British limited partners of Victory Partnership in the proportions in which they respectively contributed to the capital of the partnership. The appellant having contributed $2,375,800 to the partnership capital of $3¼m. is entitled to a first year allowance of $2,375,800.

The appellant, disputing this analysis, claimed that Victory Partnership had generated a first year allowance of $14m. being the total cost of the

film. That claim was rejected by the commissioners on the grounds that in its activities with regard to the film "Escape to Victory," Victory Partnership was not carrying on a trade but was carrying out a device to avoid tax. Millett J. [1989] 1 W.L.R. 1222 disagreed with the commissioners and decided that the activities of Victory Partnership with regard to the film constituted the trade of making and exploiting films and decided also that Victory Partnership had incurred capital expenditure of $14m. for the purposes of section 41 of the Act of 1971. The Court of Appeal (Sir Nicolas Browne-Wilkinson V.-C. and Stuart-Smith and Leggatt L.JJ.) [1991] 1 W.L.R. 341 reversed the decision of Millett J. but referred the dispute back to the commissioners to decide whether, applying the tests indicated by the Court of Appeal, Victory Partnership was or was not trading. The appellant appeals and asks for the order of Millett J. to be restored. The respondent inspector of taxes argues that Victory Partnership did not generate any first year allowance because Victory Partnership was not engaged in trade. Alternatively, by cross-appeal, the revenue contend that any first year allowance generated by Victory Partnership is limited to the sum of $3¼m.

The parties agree that the 17 documents dated 14 July 1980 were interdependent, and constituted one single composite agreement or transaction, which was a tax avoidance scheme and must be read as a whole.

If the documents constituting the scheme are read as a whole, the rights of Victory Partnership under the scheme are the rights which were and remained vested in Victory Partnership after all the documents had been signed. Similarly the obligations of Victory Partnership under the scheme are the obligations which were and remained enforceable against Victory Partnership after all the documents had been signed. The financial consequences to Victory Partnership of the scheme are the consequences which flowed from the rights conferred and the obligations imposed on Victory Partnership. The taxation allowances and taxation liabilities of Victory Partnership are the allowances and liabilities which, pursuant to the taxing statutes, are applicable to the financial consequences.

When all the documents had been entered into, Victory Partnership was subject to an obligation to pay $3¼m. to L.P.I. and subject to an obligation whereby any money paid by L.P.I. into the scheme current account was immediately transferred back to L.P.I. The financial consequence to Victory Partnership of its obligations under the scheme was the expenditure by Victory Partnership of $3¼m. When all the documents had been entered into, Victory Partnership had a right to 25 per cent. of the net receipts from the exploitation of the film. The financial consequence to Victory Partnership of its rights under the scheme was the receipt by Victory Partnership of $3m., being 25 per cent. of the net receipts from the film. The taxation consequences were that Victory Partnership, provided it were trading, generated a first year allowance of $3¼m. and Victory Partnership became in due course liable to corporation tax on the profits of $3m. which it received.

Mr. Gardiner submitted on behalf of the appellant, as he had successfully submitted to Millett J., that Victory Partnership carried on the trade of producing and distributing films in connection with "Escape to Victory" and that Victory Partnership incurred capital expenditure of the cost of the film namely $14m. between July 1980 and March 1982 when the film was completed. The negative of the film belonged to Victory Partnership between 14 July 1980 and March 1982 and therefore Victory Partnership generated under section 41 of the Act of 1971 first year allowances amounting in the aggregate to $14m.

Mr. Gardiner said that the 17 documents were not sham documents and that the parties to the scheme were free to enter any transaction in any form they pleased. A taxpayer who chooses a form of transaction which reduces his burden of tax is not to be criticised or punished or deprived of that reduction in tax which his ingenuity has achieved. Mr. Gardiner said further that by the scheme Victory Partnership purchased the film for $3¼m., spent $10¾m. completing the film with money borrowed from L.P.I. and repaid $9m. of the loan to L.P.I. by directing the distributors to pay to L.P.I. 75 per cent. of the net proceeds which arose from the exploitation of the film. But as I have indicated, Victory Partnership only expended $3¼m. and was never liable to pay more. L.P.I. had no right to recover from Victory Partnership or anyone else any part of the moneys expended by L.P.I. on the film. L.P.I. did not partially recoup the production loan and the completion loan of $10¾m. out of 75 per cent. of the net receipts from the exploitation of the film any more than Victory Partnership recouped a loan of $3¼m. out of 25 per cent. of the net receipts. Victory Partnership paid $3¼m. towards the cost of the film and received 25 per cent. of the net receipts. L.P.I. paid $10¾m. towards the costs of the film and received 75 per cent. of the net receipts. If 75 per cent. of the net receipts had produced exactly $10¾m. that would have been a miraculous coincidence but would not have changed the expenditure incurred by L.P.I. in making the film into a loan to Victory Partnership.

In the course of his judgment Millett J. said [1989] 1 W.L.R. 1222, 1228:

> "In purely financial terms, Victory Partnership was in effect a sleeping partner with a minority interest. It was putting up 25 per cent. of the cost and taking a 25 per cent. equity participation. L.P.I. was putting up the remaining 75 per cent. of the cost and its associated company was retaining a 75 per cent. participation."

This statement is not wholly accurate. Victory Partnership did not put up 25 per cent. of the cost but only $3¼m. L.P.I. did not put up 75 per cent. of the cost but the whole of the cost of $14m. in excess of $3¼m. The associated company did not retain a 75 per cent. participation. In the events which happened, the participation was that of L.P.I. which was entitled to receive and did receive 75 per cent. of the net receipts amounting to $9m. Allowing for these inaccuracies the judge was quite right in his analysis of the true legal effect of the transaction. The transaction was a joint venture and contained no element of loan. That analysis leads to two conclusions. First, upon the true construction of

the 17 documents dated 14 July 1980 read as a whole the only expenditure of Victory Partnership for the purposes of section 41 of the Act of 1971 or for any other purpose for that matter amounted to $3¼m. and no more. Secondly, the 17 documents do indeed incorporate a tax avoidance scheme, that is to say, a single composite transaction whereunder the tax advantage claim by the taxpayer, namely a first year allowance of $14m., is inconsistent with the consequence of the transaction, in this case the expenditure of $3¼m. Unfortunately, the judge continued as follows:

> "In legal terms, however, L.P.I. was not an equity participant, for it was making its contribution by way of loan. But a loan creditor would normally expect to be repaid before equity participants recovered any part of their capital, whereas L.P.I.'s advance was recoverable only out of film receipts and was repayable pari passu with instead of ahead of Victory Partnership's capital investment. In these circumstances, the retention of a 75 per cent. participation in the profits by the loan creditor or its associated company is not difficult to justify."

This analysis ignores the fact that by reason of the non-recourse provision of the loan agreement, the loan was not repayable by Victory Partnership or any one else. A creditor who receives a participation in profits *in addition* to repayment of his loan is of course a creditor. But a creditor who receives a participation in profits *instead of* repayment of his "loan" is not a creditor. The language of the document in the latter case does not accurately describe the true legal effect of the transaction which is a capital investment by the "creditor" in return for a participation in profits.

In a later passage Millett J. said, at p. 1230:

> "The non-recourse nature of the borrowing and the use of the limited partnership (either of which would have been sufficient without the other) provided a desirable protection for participants but were not necessary to the securing of the tax advantages sought to be obtained."

But the non-recourse nature of the borrowing ensured that L.P.I. paid the whole cost of the film exceeding $3¼m. and conversely that Victory Partnership would not be liable for the cost of the film in excess of $3¼m. By the operation of the scheme current account in accordance with the provisions of the scheme, the money of L.P.I., at all times under the control of L.P.I., was electronically transferred from Hollywood to the City of London and back again without serving any useful purpose and leaving no trace except entries on computer prints. The scheme is one of many; it reflects no credit on Guinness Mahon, the merchant bank which invented it, or on the appellant and the other industrial companies which purchased it for many hundreds of thousands of pounds. If successful, the scheme would have been operated at the expense of the British public and, whether successful or unsuccessful, involved the exploitation of British capital allowances for the making of a foreign film.

Mr. Gardiner sought to escape from the legal, financial and taxation consequences of the true effect in law of the scheme documents read as a whole by submitting that a taxpayer may enter into a transaction in any form he chooses and that the court is not entitled to ignore or contradict the form of the transaction. In the present case the transaction took the form of a purchase of the film by Victory Partnership and the completion of the film by L.P.I. as agent for Victory Partnership with money borrowed from L.P.I. on terms that the borrowing would only be repayable out of 75 per cent. of the net receipts from the film. The form of the transaction was admittedly designed to avoid tax. But there is no morality in a tax and no illegality or immorality in a tax avoidance scheme. The taxpayer may reduce his income tax by giving away income bearing property; by entering into a covenant to make payments to a charity for four years if he so long lives; by selling high-yielding gilt-edged stock and purchasing equities which produce a low income; a self-employed person may reduce his income tax by paying a premium for a self-employed pension; a trader company may save corporation tax by incurring capital expenditure on plant or machinery for the purpose of its trade; a taxpayer, it is submitted, may also save tax by participating in a tax avoidance scheme. If the scheme takes the form of a purchase, development and borrowing by the taxpayer and even if the borrowing is not repayable, the revenue cannot impose another form of transaction on the taxpayer by analysing the rights and obligations conferred and imposed by the scheme and charging tax as if the scheme had taken the form of a purchase of a limited interest in consideration of a contribution to cost.

The revenue on the other hand argue that a tax avoidance scheme is ineffective and taints any transaction involved in the scheme. In the present case Victory Partnership entered into a scheme with the object of avoiding tax and not with the object of trading. In the course of the scheme Victory Partnership contributed $3¼m. to the cost of the film and became entitled to 25 per cent. of the net receipts; that transaction in isolation would admittedly constitute trading in the making and exploiting of films. But the transaction was only part of a tax avoidance scheme. It follows therefore that the conditions of section 41 of the Act of 1971 are not fulfilled. In relation to "Escape to Victory" Victory Partnership did not carry on a trade and did not incur capital expenditure for the purposes of a trade; Victory Partnership did not generate any first year allowance. The commissioners accepted these submissions. The Court of Appeal referred the case back to the commissioners to decide whether the agreement reached on 14 July 1980 "was in reality merely a device to secure a fiscal advantage or a genuine trading activity:" *per* Sir Nicolas Browne-Wilkinson V.-C. [1991] 1 W.L.R. 341, 357.

There are therefore two rival submissions. Mr. Gardiner submits that the taxpayer may enter into any transaction in any form he pleases and the court is confined to that form and cannot have regard to the rights and obligations which flow from the transaction because the court cannot consider the substance of the transaction. The revenue on the other hand appear to look upon tax avoidance as a corporate cancer which infects and destroys any fiscal effect advantageous to the taxpayer.

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LAW IS NECESSARILY VAGUE

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In fact, law is necessarily *very* vague. So if vagueness is a problem for legal theory, it is a serious problem. The problem has to do with the ideal of the rule of law and with the very idea of law: if vague standards provide no guidance in some cases, how can the life of a community be ruled by law? The problem has long concerned philosophers of law; the papers at this symposium address it afresh by asking what legal theory may have to learn from (or contribute to) work on vagueness in philosophy of language and philosophy of logic. Here I will not try to state the implications of vagueness for philosophy of law; I will try to set the stage by showing that vagueness is both an important and an unavoidable feature of law.

But I should emphasize that I will use the term "vagueness" as I understand it to be used generally in the other papers, in the sense set out in Dorothy Edgington's paper. So the claim is not that law is necessarily obscure or radically indeterminate. The claim is that a legal system necessarily yields a significant range of "borderline cases"—cases in which the application of the standards of the law is subject to doubt and disagreement.

We will see that it *is* possible to make precise laws. So it may seem that vagueness is a contingent feature of law that we could avoid by precise lawmaking. And it may seem that it would be desirable to do so, because precise laws bring us closer to the ideal of the rule of law.

I hope to persuade you otherwise in three short sections claiming (1) that lawmakers use vague laws because precision is not always desirable; (2) that because law is "systemic,"[1] enactments formulated in precise language do not always make precise laws; and (3) that law must perform functions that can only be performed by means of vague standards.

I. PRECISION IS NOT NECESSARILY GOOD

Law is vague because precision is not always useful in regulating communities, and lawmakers know that. It is true that precision offers certain benefits that are commonly associated with the rule of law—I will call them "rule-of-law benefits." Perhaps the major rule-of-law benefits of precision are that it reduces doubt and disagreement: (1) It tells people governed by law where they stand; and (2) It avoids legal disputes. Because of those two rule-of-law

1. As Joseph Raz calls it in his contribution to this issue.

benefits, precision restricts the discretion of officials in the enforcement of the law.

The first rule-of-law benefit is a reason for imposing precise income tax rates rather than requiring taxpayers to pay, say, a substantial part of their income, or in proportion to their ability to pay and to the needs of the government. Income tax rates yield the second rule-of-law benefit as well, of course, but the main virtue of their precision is that it leaves the taxpayer in no doubt as to what tax is to be paid and gives no discretion to tax collectors.

The second rule-of-law benefit explains why lawmakers use precise blood-alcohol limits as a standard for the prohibition of drunk driving. Few people use the precise standard to guide their conduct precisely, but the level has the benefit of making it clear, in enforcement and adjudication, whether the law has been broken. So blood-alcohol limits, like tax rates, restrict official discretion.

But those virtues of precision are not general reasons to make laws precise. Every precise law incurs arbitrariness in virtue of its precision: Income taxes and blood-alcohol limits are examples. A good tax regime relates tax to ability to pay; a precise tax necessarily abandons that policy to some extent. Some drivers are affected by alcohol more than others; a blood-alcohol limit ignores that and, by doing so, it departs from its purpose of controlling a risk without unduly interfering with freedom. The precision of the limit detracts from the law's capacity to give effect to its rationale.

The precision of tax laws and blood-alcohol limits is undoubtedly justified in spite of their arbitrariness. That is partly because laws that give effect to their purpose in so many words (prohibiting, for example, driving that creates unreasonable risks) would incur other forms of arbitrariness by leaving it to enforcers and adjudicators to decide what is reasonable. To see that, we only have to think how a law imposing a duty to pay a reasonable tax would put people at the mercy either of the tax collectors or of the judges. The rule-of-law benefits of precision are genuine benefits but they always come at a price. The price may or may not be excessive. So precision is not generally an aim of legislation.

You may be thinking: "Yes, but the lawmakers *could* make all laws precise if they were misguided enough to accept the resulting arbitrariness." But I will argue in the next section that such a drive for precision would be doomed in any actual legal system by the *system's* own techniques for dealing with arbitrariness.

II. PRECISE FORMULATIONS DO NOT ALWAYS MAKE PRECISE LAWS

Laws are typically made by linguistic utterances.[2] Legal obligations and rights under contracts, wills, and other legal instruments are typically ex-

2. Statutes are the familiar example, but common-law systems of precedent often give legal force (in varying ways) to the judges' expression of their reasons for decision.

pressed in language. And lawmakers and private actors can use precise language.[3] But the legal effect of their utterances depends on the law's techniques of interpretation. And aside from interpretive techniques, equity (in systems that distinguish equity from law) and the law's own equitable techniques may relieve parties from precisely formulated obligations or prevent the exercise of precisely formulated rights. Interpretive techniques and equitable powers of judges (and other officials) are only two among many ways in which the law's own techniques may give a vague effect to precise formulations.[4]

Note that there may be good reasons of principle for such techniques. Those reasons correspond to the reasons against precise lawmaking, identified in the previous section. Suppose that a lawmaker sets out to control traffic at an intersection by requiring cars to stop at a precisely marked line on the road when the traffic light is red. All the lawmaker's communications on the issue may be precise, but the effect on the law is not likely to be precise: Judges hearing a dispute are likely to find resources in the law to dispense drivers from the prohibition in cases of necessity, or duress, or on grounds of certain sorts of mistake. Those grounds are grounds of principle, each of which is vague. All grounds of principle are vague because all rely on general evaluative and normative considerations that themselves are vague.[5]

Precise utterances by lawmakers make precise laws only when the officials of the system have good legal reason to give them precise effect. By saying this, I do not mean that precise laws are impossible or even rare—that depends on the principles of the legal system. There may be very good reason, according to law, for officials to treat a precise blood-alcohol level as creating a uniform, precise, legal limit (and not, e.g., to create a vague exemption from its operation for people who can tolerate lots of alcohol). But the systemic nature of law means that a legislative drive for precision would face dim prospects: In the increasing arbitrariness it would bring, officials would increasingly find legal reason to tamper with it. Lawmakers have no reason to think that they can achieve an ideal of precision by using red lights.

You may be thinking: "Yes, but what if a whole *system* were dedicated to precision? It might be misguided, but sufficiently bloody-minded lawmakers could achieve precision, if they had the aid of sufficiently literal-minded officials." Even then, the drive for precision would be doomed.

3. At least, language as precise as "0.85% blood alcohol." I will not worry about the fact that such language is itself vague, because its vagueness is unimportant, and I will argue below that law is necessarily vague in important ways.

4. Others include duties and powers to reason by analogy, discretions of various kinds including judicial powers to make law, and common-law and statutory rules against, e.g., oppressive clauses in contracts.

5. I argue that general evaluative and normative terms (*and* legal principles) are vague in VAGUENESS IN LAW 126–131, 163–6 (2000).

III. THE FUNCTIONS OF LAW REQUIRE VAGUE STANDARDS

Laws can be precise, but a legal system with no vague laws is impossible. The reason is that any legal system needs to regulate a *variety* of human activity in a *general* way. No decent traffic scheme can stop with blood-alcohol limits and traffic lights: it also needs prohibitions on dangerous driving. I will call such standards "abstract." Abstract standards are vague, and the law of a community necessarily includes abstract standards.

Generality in itself is not enough to make a standard abstract—blood-alcohol limits apply generally. But blood-alcohol limits are not abstract, because of the specificity of the consideration they appeal to. The blood-alcohol limit applies generally to a class, but that class (the class of people who have a certain proportion of alcohol in their blood) is uniform in a way that allows precision. A prohibition on dangerous driving is not merely general but abstract, because it regulates activities that do not share any such uniform feature that would allow precision. The important variations among the class of dangerous drivers (the class of people using a motor vehicle in a way that unreasonably causes a serious risk to others) make it impossible to specify the class in a way that allows precision. The point of a law against dangerous driving is to give the law the unspecific technique it needs for controlling behavior that varies in ways that make specific rules useless.

Traffic cannot be regulated without abstract standards. Traffic regulation rightly includes various precise standards (using, e.g., lines on roads and red lights), but the purposes of regulation can be achieved only if it also uses abstract standards—because it needs to regulate such a wide variety of things that people might conceivably do with cars.

Abstract standards are often made with (or can be stated in) extremely vague evaluative terms, such as "dangerous," "careless," or "reasonable." But they are also made using abstract descriptive terms that identify the conduct that is regulated. Although tax rates are typically precise, the tax base is generally described in vague terms such as "income." And legislators' definitions of "income" use abstract terms in order to avoid creating avoidance mechanisms through precise definitions that exclude economic activities that are similar to the central instances of income.

So far, it may seem that I am only repeating the point that *good* lawmaking is vague—which would certainly not show that law is necessarily vague. But now consider how far-reaching the need is for abstract standards in law.

A legal system regulates the life of a community. That is only possible if the law controls the use of force among members of the community, and controls the ownership and use of things, and exerts some control over family and commercial relations. These are necessary functions of law. Nothing that fails to regulate such things is a legal system. None of those things can be done without abstract standards. And law must allow forms of private ordering, giving legal powers to individuals to create and to assume rights and duties in ways that are liable to be vague.

That set of claims about what law necessarily does strikes me, incidentally, as very abstemious. I am not concerned here either to work out a complete view of what law must necessarily do or to defend my abstemious suggestions. It does not matter if you wish to deny, for instance, that regulation of the life of a community necessarily includes regulation of something that can usefully be called "family" or "commerce," or that law necessarily allows for any private ordering at all. I will not reply to such objections because you can agree with my argument even if you will admit only that law must control the use of force among people in a community. If you deny that law must do that (saying, perhaps, that law may have any content), then you preclude yourself from distinguishing between the law of the United States and the rules of tiddlywinks, or the rules of the Rotary Club, or any other system of rules.

Consider, then, the abstemious claim that law must control the use of force: That cannot be done with precise standards. The variety of things that one person might do to another calls for control through abstract standards, because prohibitions on (and tort liability for) assault and other ways of causing personal injury cannot refer to the actions that are to incur liability, without abstracting from the variety of forms and contexts of human contact and imposing a standard that can be applied to them generally. Imagine a precise standard for assault: perhaps a prohibition on exerting more than 100 newtons of force on a human body. That would not even count as regulation of the use of violence because it would not distinguish between a ride in a car and a shooting. And if we were mad enough to set out to make precise laws that *would* count as regulating violence (specifying in precise terms all forms of contact with human bodies that do and do not count as assault), we would never succeed: (i) We would not be able to foresee the forms of violence that someone might conceive of that would lie outside our scheme; and (ii) The more comprehensive our precise set of definitions became, the more useless it would become both as a guide to individuals' conduct and as a guide to enforcement by officials. Long before our mad scheme of precise definition of violence against persons became even moderately comprehensive, it would become incapable of serving as a guide to conduct either of citizens in general or of officials. And if our scheme is incapable of serving as a guide to conduct, it is not law.

There is one final reason why law must be vague: Its regulation of the life of a community cannot proceed without holding *human beings* responsible for actions (such as commissions of offences, exercises of rights, exercises of power, etc.). And all general standards of causation and all general standards of responsibility for wrongs caused (such as intention, recklessness, etc.) are vague.

Even drink-and-drive law is vague, because it consists not only of a precise limit on blood alcohol but also of vague doctrines concerning what counts as a motor vehicle, and what counts as being in charge of it, and what counts

as being responsible for being in charge of it. Traffic regulation includes much vaguer laws than the drink-and-drive laws, and a legal system includes laws that are vaguer than traffic regulation.

IV. CONCLUSION: HOW VAGUE IS A VAGUE LAW?

Law is necessarily vague because it necessarily uses (or can be stated in) abstract terms such as "reasonable" or "substantial." We should bear in mind that the fact that the law can be stated in such vague terms does not by itself mean that there are no clear cases—and in some areas regulated by vague standards, there may be nothing but clear cases. The number and the importance of borderline cases depend on context, and in some contexts even very vague laws will have few borderline cases or none at all. If the law requires electrical appliance manufacturers to use insulation of reasonable quality on electrical wiring, it may be the case that the only way to comply with the law is to use certain very specific substances in fairly precise minimum thicknesses. That is a fact about vagueness in general: It is clear how to divide the bald people in a room from those who are not bald, if there are no borderline cases in the room.

But there is bound to be *significant* lack of clarity in the application of vague laws for the same reasons that the regulation of communities requires vague standards. Because the things you can do with a motor vehicle vary so widely, the legal effect of an abstract standard is very different from the legal effect of the reasonableness standard on the electrical appliance manufacturer. There is bound to be a significant range of borderline cases for the application of a tort standard of reasonable care or a criminal standard of dangerous driving, because of the abstract nature of the standard.

When legal standards are vague, they are very vague. Let's call a standard "very vague" if there is, potentially, significant variation among borderline cases (the context determines whether that potential is realised). Let's call a standard "trivially vague" if there is no significant variation among borderline cases. Vagueness is trivial only when it is pegged to a precise standard: otherwise, vagueness always allows the possibility, depending on the context, for a significant range of borderline cases.

Lawmakers never lay down trivially vague standards. No legislature ever made it an offence to drive "with more than approximately 0.85% blood alcohol." The reasons not to use precise laws (in traffic regulation or the regulation of violence against persons) are reasons not to use almost-precise (that is, trivially vague) laws. A precise standard is always better, from the lawmaker's point of view, than a trivially vague standard, because it offers the rule-of-law benefits of precision and is not much more arbitrary than a trivially vague standard. Legal techniques such as *de minimis* standards may occasionally give a trivial vagueness to standards laid down in precise language—often for reasons that have to do with the law of evidence and the

control of judicial process. Such forms of vagueness are not important because they do not yield a significant range of borderline cases. By contrast, there are very significant ranges of borderline cases for the application of the abstract standards that are needed for the regulation of the life of communities.

So law is necessarily very vague.

Law should not (and cannot) be reformed to pursue precision—or even to avoid significant vagueness. The reason is really the same as the reasons for which Dorothy Edgington says that we should not try to reform language to achieve precision: Law, like language, should not make arbitrary, pointless distinctions. And while many laws do make arbitrary, pointless distinctions, no legal system could succeed in committing itself wholesale to that sort of thing.

NO. 1396—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—26TH AND 27TH JUNE, 1946

COURT OF APPEAL—18TH AND 19TH NOVEMBER, 1946

HOUSE OF LORDS—29TH AND 30TH JANUARY AND 19TH MARCH, 1948

COMMISSIONERS OF INLAND REVENUE v. WESLEYAN AND GENERAL ASSURANCE SOCIETY(1)

Income Tax—Annuity—Monthly loans free of interest and recoverable only by set-off against sum due at death—Income Tax Act, 1918 (8 & 9 *Geo.* V, *c.* 40), *General Rules, Rule* 21; *Finance Act*, 1927 (17 & 18 *Geo.* V, *c.* 10), *Section* 26.

By an agreement dated 25th May, 1944, *the Society, in consideration of the payment of* £500, *agreed to pay H during his life an annuity of* £7 11*s. per annum and on his death a sum equal to the aggregate of* £4 14*s.* 8*d. for each completed month between 25th May*, 1944, *and the date of his death. The agreement also provided that H should have the option of borrowing such sums as he might request but not exceeding the amount that would have been payable by the Society if he had died on that date. Such sums were to be free of interest and recoverable only at H's death by set-off against the lump sum payment due under the bond. H informed the Society that he wished to exercise the option to the maximum extent and at the earliest date permitted by the agreement. Accordingly in the eight months following 25th May*, 1944, *the Society paid to him monthly sums of* 12*s.* 7*d. as annuity and* £4 14*s.* 8*d. as loan. Income Tax was deducted by the Society from the former but not from the latter.*

The Society was assessed to Income Tax for the year 1944-45 *under Rule* 21 *of the General Rules of the Income Tax Act*, 1918, *as amended, in the sum of* £42 18*s., representing the total payments made under the agreement during that year. The Society appealed against the inclusion in the assessment of the sums described as loans on the ground that they were not income payments. The Special Commissioners allowed the appeal.*

Held, *that the decision of the Special Commissioners was correct.*

CASE

Stated under the Income Tax Act, 1918, Section 149, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the King's Bench Division of the High Court of Justice.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 15th May, 1945, the Wesleyan and General Assurance Society (hereinafter called "the Respondent Society") appealed

(1) Reported (K.B. and C.A.) 176 L.T. 84; (H.L.) 64 T.L.R. 173.

against an assessment to Income Tax in the sum of £42 18*s.* made upon it for the year ended 5th April, 1945, under the provisions of Rule 21 of the General Rules applicable to Schedules A, B, C, D and E of the Income Tax Act, 1918, as amended by Section 26 of the Finance Act, 1927.

2. The question raised by this appeal is whether certain sums paid by the Respondent Society to Mr. C. Hart constitute the payment of an annuity or of money loaned to him by the Respondent Society by reason of the matters hereinafter set out.

3. On 24th May, 1944, Mr. C. Hart signed a proposal form for an annuity and life assurance with optional interest-free loans with the Respondent Society. The said proposal form states that, in consideration of a payment of £500 by Mr. C. Hart, the Respondent Society agreed to pay him (1) an annuity of £7 11*s.* by monthly instalments of 12*s.* 7*d.* and (2) a lump sum payment at death equal to the aggregate of £4 14*s.* 8*d.* for each completed period of one month between the date of receipt of the purchase money by the Respondent Society and the date of his death. In addition Mr. C. Hart had the option of borrowing on the bond to be entered into, sums not exceeding what would be payable by way of lump sum as aforesaid if he had died on the date the loan was granted. The loans were to be free of interest, and were repayable at death by set-off against the lump sum payment due under the bond.

4. Mr. C. Hart elected to borrow from the Respondent Society to the maximum extent permitted by the bond, and an endorsement was made on the bond that loans had been requested and would be granted under the bond. On 25th June, 1944, and monthly thereafter, Mr. C. Hart gave the Respondent Society a receipt for the amount of the annuity less tax, and for the amount received as loan free of interest. In making this payment the Respondent Society deducted Income Tax from the annuity, but not from the loan.

5. Eight monthly payments were the subject-matter of the assessment appealed against, which was computed as follows:—

	£	*s.*	*d.*
Gross annuity 12*s.* 7*d.* x 8 ...	5	0	8
Interest-free loans £4 14*s.* 8*d.* x 8	37	17	4
	£42	18	0

The Respondent Society admitted that the payments were made otherwise than from profits or gains brought into charge to tax, and that the said assessment was correct in respect of the said annuity payments. The inclusion of the amount of £37 17*s.* 4*d.* in the said assessment advanced by way of loan was disputed.

6. The following documents are annexed hereto and form part of this Case(1):—

(1) Copy of the said proposal form, marked "A".
(2) Copy of the said bond, marked "B".
(3) Copy of letter dated 26th May, 1944, from Mr. C. Hart to the Respondent Society requesting loans, marked "C".
(4) Copy of receipt for the said annuity and loans to be signed by Mr. C. Hart, marked "D".
(5) Copy of Respondent Society's annual report and statement

(1) Not included in the present print.

of accounts for the year ended 31st December, 1944, marked "E".

7. Mr. A. W. Joseph gave evidence before us at the hearing, which we accepted, as follows.

He was a Fellow of the Institute of Actuaries and assistant actuary to the Respondent Society. The said annuity of £7 11*s.* was calculated as follows. The Respondent Society took Mr. C. Hart's expectation of life, at the time he was 75½, then it estimated the interest it would receive on the purchase money of £500 in the expected period, a sum was deducted to cover expenses and an adjustment made to compensate itself for the option to borrow free of interest. The balance was the annuity of £7 11*s.* per annum. If Mr. C. Hart had required an annuity only, he would have received £67 18*s.* per annum. In calculating the capital sum payable at death no interest factor was included. If Mr. Hart should die on the date which, according to the Respondent Society's tables, he might be expected to die, he would get a capital sum of £500. If he lived longer he would get more, if he died earlier he would get less. In the Respondent Society's balance sheet as at 31st December, 1944, the item "Loans on the Society's "Polices within their Surrender Values" included the amount of the aforesaid loans to Mr. C. Hart totalling at that date £33 2*s.* 8*d.*

8. It was contended on behalf of the Respondent Society that the sums advanced to Mr. C. Hart as loans under the said bond amounting to £37 17*s.* 4*d.* were not payments of income to him and should be excluded in computing the said assessment.

9. On behalf of the Appellants it was contended:—

(1) That the monthly sums of £4 14*s.* 8*d.* were payments of an annuity, and that this being their true nature it was immaterial that they were described in the said bond as loans.

(2) That the assessment was correct and should be confirmed.

10. We, the Commissioners, gave our decision as follows:—

Under the bond, the bona fides of which was not challenged, Mr. C. Hart had power to borrow certain sums if he so desired. We held that it was not permissible to go behind the terms of the bond and that the sum in dispute was not an annuity but was money loaned to him by the Respondent Society at his request. We held that the appeal succeeded and reduced the assessment of £5 0*s.* 8*d.*

11. The representative of the Appellants immediately after the determination of the appeal declared to us his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to Section 26 of the Finance Act, 1927, and the Income Tax Act, 1918, Section 149, which Case we have stated and do sign accordingly.

R. COKE,
MARK GRANT-STURGIS, } Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94/99 High Holborn,
London, W.C.1.
30th November, 1945.

The case came before Macnaghten, J., in the King's Bench Division on 26th and 27th June, 1946, and on the latter date judgment was given in favour of the Crown, with costs.

The Solicitor-General (Sir Frank Soskice, K.C.), Mr. J. H. Stamp and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. Terence Donovan, K.C., and Mr. L. C. Graham-Dixon for the Society.

JUDGMENT

Macnaghten, J.—By an instrument in writing described as a bond, dated 25th May, 1944 (a copy whereof is annexed to the Case and marked "B"), the Respondents, the Wesleyan and General Assurance Society, in consideration of the payment of £500 covenanted to pay to Mr. Charles Hart during his life an annuity of £7 11*s.* 0*d.* by instalments of 12*s.* 7*d.* on the twenty-fifth day of each month, the first payment to be made on 25th June, 1944, and to pay, on the death of Mr. Hart, a sum equal to the aggregate of £4 14*s.* 8*d.* for each completed period of one month between 25th May, 1944, and the date of his death. The bond also provided that Mr. Hart should be entitled during his life to borrow from the Society, on the twenty-fifth day of each month of any year, such sum or sums as he might request, not exceeding the amount which would have been payable by the Society if the annuitant had died on that date. Such loans were to be free of interest, and were not to be recoverable by the Society otherwise than on the death of the annuitant and out of the sum then payable under the provisions of the bond. A loan which carries no interest and which neither the borrower nor any other person can ever be under any obligation to repay seems almost too good to be true, and Mr. Hart hastened to take advantage of that provision in the bond. On 26th May, 1944, the day following the delivery of the bond, he addressed the following letter to the Society: "I wish to avail myself of the privilege "of borrowing upon the security of the above Bond. Will you kindly "make loans to me free of interest to the maximum extent and on the "earliest date permitted by the Bond unless and until this request is "cancelled."

Accordingly, during the eight months following 25th May, 1944, the Society paid to Mr. Hart month by month, on the twenty-fifth day of each month, the sum of 12*s.* 7*d.*, amounting to £5 0*s.* 8*d.*, in respect of the annuity of £7 11*s.* 0*d.*, and also pursuant to his request the sum of £4 14*s.* 8*d.*, amounting to £37 17*s.* 4*d.* The moneys so paid by the Society were paid otherwise than out of profits or gains brought into charge, and accordingly, pursuant to the provisions of Rule 21 of the All Schedules Rules of the Income Tax Act, 1918, the Society deducted from the 12*s.* 7*d.* paid in respect of the annuity of £7 11*s.* 0*d.* Income Tax at the standard rate. The Society did not, however, deduct any Income Tax in respect of the so-called loans of £4 14*s.* 8*d.* per month.

The bond recited that it was agreed that a proposal signed by Mr. Hart dated 24th May, 1944 (a copy whereof is annexed to the Case, marked "A"), should be the basis of the contract between him and the Society; and in the proposal it was stated that the interest-free loans would not be subject to Income Tax. In these circumstances an assessment to Income Tax was made upon the Society in respect of the said sums of £5 0*s.* 8*d.* and £37 17*s.* 4*d.* On appeal to the Special Commissioners that assessment was reduced by excluding therefrom the said sum of £37 17*s.* 4*d.* From that decision of the Special Commissioners the Crown appeals to this Court.

The case for the Crown is that these payments of £4 14*s.* 8*d.* per month, though they are called "loans" in the bond, have none of the

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characteristics of a loan and are in truth and in fact "an annuity or annual "sum" within the meaning of the Income Tax Acts, since no interest is payable thereon and they are not repayable by anyone. It is said for the Crown that it is an essential charactertistic of a loan that it should be repayable. The description given to a payment does not necessarily conclude the question whether it is or is not an annuity or annual sum within the meaning of the Income Tax Acts. The payment may be described as an annuity and yet it may not be assessable to tax, as in the case of *Perrin* v. *Dickson*, 14 T.C. 608. So, too, a payment which is in truth and in fact an annuity within the meaning of the Income Tax Acts cannot escape liability to tax by being described as a loan.

I agree with the contention for the Crown that the payments in question were not loans; that they were payments which, in the event that happened, namely, the request by Mr. Hart, the Society was bound to make month by month, and were therefore an annuity.

Mr. Donovan, who argued the case very clearly as usual, contended that the "loans" were repayable out of the sum payable by the Society on the death of Mr. Hart; but unless and until Mr. Hart revokes the request made in his letter of 26th May, 1944, no sum will be payable by the Society on his death and, therefore, the "loans" cannot be repaid.

In my opinion the contention of the Crown is right, and the assessment originally made on the Society must be restored.

The Solicitor-General.—Your Lordship orders that the appeal be allowed with costs and the original assessment restored ?

Macnaghten, J.—Yes.

An appeal having been entered against the decision in the King's Bench Division, the case came before the Court of Appeal (Lord Greene, M.R., and Cohen and Asquith, L.JJ.) on 18th and 19th November, 1946, and on the latter date judgment was given unanimously against the Crown, with costs, reversing the decision of the Court below.

Mr. Terence Donovan, K.C., and Mr. L. C. Graham-Dixon appeared as Counsel for the Society, and the Solicitor-General (Sir Frank Soskice, K.C.), Mr. D. L. Jenkins, K.C., and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Lord Greene, M.R.—We need not call upon you, Mr. Donovan.

The Appellants, the Wesleyan and General Assurance Society, appealed to the Special Commissioners against an assessment to Income Tax in respect of certain sums which had been paid by them to a policy-holder, Mr. Charles Hart. The question—and the only question—arising on this appeal is whether or not, on the true construction of the contractual documents executed between Mr. Hart and the Appellants, and in view of the legal rights and obligations which those documents create, the sums so paid were payments of an annuity, or, as the Appellants contend, merely loans. If the Crown is right the payments attract Income Tax. If the

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Appellants are right Income Tax is not payable. That is the short point. The Special Commissioners decided in favour of the Appellants that the payments, on the true understanding of the contractual documents, were loans and not payments of an annuity. Macnaghten, J., reversed that decision, and this appeal results.

It is perhaps convenient to call to mind some of the elementary principles which govern cases of this kind. The function of the Court in dealing with contractual documents is to construe those documents according to the ordinary principles of construction, giving to the language used its normal ordinary meaning save in so far as the context requires some different meaning to be attributed to it. Effect must be given to every word in the contract save in so far as the context otherwise requires.

Another principle which must be remembered is this. In considering tax matters a document is not to have placed upon it a strained or forced construction in order to attract tax, nor is a strained or forced construction to be placed upon it in order to avoid tax. The document must be construed in the ordinary way and the tax legislation then applied to it. If on its true construction it falls within a certain taxing category, then it is taxed. If on its true construction it falls outside the taxing category, then it escapes tax.

In dealing with Income Tax questions it frequently happens that there are two methods at least of achieving a particular financial result. If one of those methods is adopted, tax will be payable. If the other method is adopted, tax will not be payable. It is sufficient to refer to the quite common case where property is sold for a lump sum payable by instalments. If a piece of property is sold for £1,000 and the purchase price is to be paid in ten instalments of £100 each, no tax is payable. If, on the other hand, the property is sold in consideration of an annuity of £100 a year for ten years, tax is payable. The net result from the financial point of view is precisely the same in each case, but one method of achieving it attracts tax and the other method does not.

There have been cases in the past where what has been called the substance of the transaction has been thought to enable the Court to construe a document in such a way as to attract tax. That particular doctrine of substance as distinct from form was, I hope, finally exploded by the decision of the House of Lords in the case of *Duke of Westminster* v. *Commissioners of Inland Revenue*, 19 T.C. 490. The argument of the Crown in the present case, when really understood, appears to me to be an attempt to resurrect it. The doctrine means no more than that the language that the parties use is not necessarily to be adopted as conclusive proof of what the legal relationship is. That is indeed a common principle of construction. To take one example, where parties enter into a contract, though they describe it as a licence, but the contract according to its true interpretation creates the relationship of landlord and tenant, the parties can call it a licence as much as they like but it will be a lease. There are other cases in the books in which the parties have described a particular document as a lease when the relationship created by it is that of licensor and licensee. In those cases it is not a lease but a licence. Similarly here, if the parties have entered into a contract the legal result of which on its true construction is to create an annuity, the parties could not avoid the legal consequences by referring to the payments as loans.

Bearing in mind those principles I will briefly examine the facts of

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this case. The assured, Mr. Hart, signed a proposal form for what was described as an "annuity and life assurance with optional interest-free "loans." Under paragraph 3 of that form he is to receive an annuity of £7 11*s.* 0*d.* a year by monthly instalments of 12*s.* 7*d.* There is no question that that sum is an annuity and therefore taxable. It has no real importance in this case because precisely the same points would have arisen if that annuity had not formed part of the transaction. Then, under paragraph 4, he is asking for what is described as a "sum payable at the death "of the person described in 1, above"—that is, Mr. Hart. Against that this is said: "A sum equal to the aggregate of £4 14*s.* 8*d.* for each com- "pleted period of one month between the date of receipt of the purchase "money at the Chief Office of the Society and the death of the person "described in 1, above"—that is, Mr. Hart. That is described, and correctly described, as a "sum payable at death". In the title of the proposal form it is correctly described as "life assurance", which in fact it is. The sum payable at death is not, as in the case of the ordinary type of life assurance, a sum which is fixed when the contract is made, but is a sum which will fall to be ascertained when it is known what are the number of months for which the assured survives. It is an assurance under which a lump sum is to be payable at the death of the assured quantified by reference to the number of months he lives. It seems to me that there is no reason whatever to construe that contract as anything different from what it purports to be, namely, a contract of life assurance under which the Company is to pay a lump sum at the death of the policy-holder.

Then paragraph 5 sets out the purchase money, £500; in other words a single premium is payable. Then comes this clause which has given rise to the controversy: "The owner"—that is, Mr. Hart—"will have the "right to borrow on the security of the Bond"—that is how they describe the policy which is going to be issued—"sums such that the aggregate "of the loans outstanding at any date shall not exceed the amount which "would have been payable by the Society if the Annuitant had died on "that date." So far that language seems to me to be completely free of ambiguity. The right which the assured is given, which he is not bound to exercise if he does not want to, is to borrow certain sums on the security of the policy. That would mean, in so far as he exercised the power of borrowing, that the assurance office would be entitled to call for the deposit of the policy. The policy is to be security for the amounts which he so borrows, which may be nothing, or may be a very small sum for a month or two, or may cover every month for the rest of his life.

Then it goes on: "Such loans shall be free of interest". Of course, to make an interest-free loan is a perfectly legitimate transaction. If a party chooses to lend money free of interest the fact that it is free of interest does not make it any the less a loan. Then the clause proceeds: "and shall not be recoverable by the Society otherwise than on death and "out of the sum then payable." There, again, I see no ambiguity in that language. The fact that a sum of money advanced is not to be recoverable by action, for instance, but is only to be recoverable out of a named asset, is a familiar transaction and is perfectly consistent with the ordinary legal conception of a loan. This is the position therefore. If one takes the language of the clause down to that point, one can find no ambiguity about it at all. The proposal form is a proposal for life assurance under which a sum of money quantified in the way indicated would be payable at death, with the right to borrow against that sum up to the stated amounts free of

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interest, and the Company is only of recoup itself out of the amount which is to be paid at the death of the assured.

The clause goes on: "When the Bond is issued the Purchaser may "request the Society to make loans free of interest to the maximum extent "and on the earliest date permitted unless and until the request is can- "celled." That enables the assured to obtain month by month a loan of the amount stated, namely, £4 14*s.* 8*d.*, but he is entitled, so to speak, to make a running request which remains valid until it is cancelled, and by that means he secures for himself into his pocket a sum of £4 14*s.* 8*d.* in every month. It is in respect of sums so advanced—I should not say "advanced" because that is begging the question—or so paid to him that the assessment was made.

Then comes this explanatory clause: "Assuming maximum loans are "requested to be advanced at the earliest possible date the total annual "payments under the Bond will be Annuity . . . £7 11*s.* 0*d.* subject to "income tax; Interest Free Loan (equal to twelve month's increase in the "sum payable at death . . .) £56 16*s.* 0*d.* not subject to income tax", total "£64 7*s.* 0*d.*, by Monthly Instalments of £5 7*s.* 3*d.*" That is merely an example of how the contract works out as a matter of pounds, shillings and pence. It is to be noted that the Company is disclaiming any right to deduct tax from the interest-free loans. If the payments of what are called loans are in fact payments of an annuity, that provision that their payment is not to be subject to Income Tax would be void under Rule 23 of the General Rules. That is all that I need read in the proposal form.

I now come to the policy itself, which was dated 25th May, 1944. By the terms of the policy the proposal form was to be the basis of the contract. That means that the two documents are to be read together, and the proposal form is to be regarded as the basis of the definitive policy. It contains a covenant by the Society to pay to the assured or his executors: "(1) an annuity or annual sum as stated in the third section of "the said Schedule" to the policy during the lifetime of Mr. Hart, that is to say, £7 11*s.* 0*d.* as mentioned in the proposal form. Then (2) is: "the "sum as stated in the fourth section of the said Schedule on the death of" Mr. Hart. That I will come to in a moment. Then it goes on to put in the provisions stipulated for by the proposal form under which Mr. Hart was entitled to borrow every month £4 14*s.* 8*d.*, and it contains a provision that any sum so borrowed should not be recoverable by the Society otherwise than on the death of Mr. Hart, "and out of the sum then payable under the "fourth section of the said Schedule." So far the policy is following the stipulations of the proposal form, and what I have said with regard to the construction of the proposal form applies equally to the construction of the policy. The other provisions in the body of the policy I need not mention. The schedule sets out £500 which is called "Consideration money", but which, of course, is really a single premium. Then the schedule sets out the name of Mr. Hart, who is described as the "Annuitant." It sets out the amount of the annuity, £7 11*s.* 0*d.*, payable by monthly instalments. Then comes the following: "Sum payable at death." That is described as: "A sum equal to the aggregate of £4 14*s.* 8*d.* for each completed "period of one month between the 25th day of May One thousand nine "hundred and forty-four and the date of death of the Annuitant". So far that is following exactly the provisions of the proposal form. It is what the assured had stipulated for, and what the Company, in accepting the

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proposal, agreed to give him, namely, a lump sum payable at death quantified in the manner indicated. Then the clause goes on to say in brackets, "less the amounts of any loans made by the Society to the "Purchaser"—that is, Mr. Hart—"under the provisions of this Bond." Some emphasis was laid on those words in connection with an argument which I shall have to describe in a moment. I think it is worth noticing that, if the introduction of those words had the effect of varying what was stipulated for in the proposal form, it would appear that Mr. Hart would be entitled to have the policy rectified by striking them out. Either they are consistent with the proposal form or they are inconsistent with it. If they are consistent with it, then the proposal form has not been departed from. If they are inconsistent with it, then the policy does not follow the terms of the proposal form which was what Mr. Hart was stipulating for.

On considering the language of that contract I see no reason why what it says should not be accepted. If full effect is given to the language the parties have used, the obligation of the Assurance Company is to provide a sum at death. The right of the assured is to borrow such sums as he thinks fit month by month, subject to the limitation, against the sum so to be paid at death. He is not to pay interest upon such advances, and he is not to be bound to repay them save out of the sum payable at death. That seems to me to be a perfectly intelligible and ordinary type of operation. Why the legal relationship which the parties have in terms created of lender and borrower in respect of those sums should not be given effect to, I fail to understand, unless it be that, by giving effect to what the parties have said, the transaction would avoid tax. I cannot think myself that, if it had not been for the existence of the Income Tax Acts, anyone would have dreamt of suggesting that this contract means anything else than what it sets forth. It is because, if effect is given to it according to its terms, tax will be avoided, that the argument has come into existence, simply in order to try and get tax out of a transaction which, if it had been done in a different way, achieving the same financial result, would undoubtedly have attracted tax. The Company could have contracted to pay Mr. Hart £4 14*s*. 8*d*. a month, if it had chosen to do so, as an annuity, and in that case tax would have been payable. The Company would have had to deduct tax, and under Rule 21 of the General Rules, which admittedly would apply in the present case, would be accountable for it to the Crown. But to say that when parties set up a legal relationship, according to their language and its meaning, of lender and borrower you must construe the word "loan" as meaning annuity and modify or alter or strike out all the provisions relating to that loan as being inappropriate to an annuity, seems to me to be rewriting the contract, and I can see no justification for doing so.

The points upon which the Crown based its contentions were of this nature. It was argued that, if Mr. Hart exercised his right of borrowing up to the full permissible amount, no sum would be payable to his executors at his death. That is perfectly true. It was also pointed out that, if he did not exercise the right of borrowing up to its full extent, the sum payable at his death to his executors would be *pro tanto* diminished, and it was said that that shows that this was nothing more than the payment of an annuity.

It was argued that in effect no sum on that basis could be treated as payable at death, because it was meaningless to say that a loan was to be repayable out of a sum of money which *ex hypothesi* might never come

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into existence at all. It is perfectly true that if he exercised his borrowing right up to the limit no sum would in fact be payable at death. But I do not see myself what that has to do with it. If you borrow up to the limit of a sum which would otherwise be payable to you, that sum can never in fact come into your pocket because you have exhausted it. That does not alter the fact that the liability of the Company under the policy was unquestionably a liability to pay a lump sum at death. If no borrowing took place that lump sum would be payable. If borrowing did take place it would either not be payable at all in fact, or it would be smaller than it would otherwise have been. But to say that the provision for recovering these so-called loans out of the sum payable at death is meaningless is an argument which I confess I do not understand.

At this point I may return to the language of the schedule to which I referred a moment ago, because, if the schedule is looked at by itself, it might be thought to suggest that the sum which is to be payable at the death of the assured is to be only such a sum as is arrived at after deducting the amounts of any loans. It is said that the only sum which is covenanted to be paid at death is a net sum and not a gross sum. I do not so construe the language because it seems to me that that would run counter to the whole tenor of the transaction and, in particular, as I have said, would be contrary to what is stipulated for in the proposal form. It seems to me that, reading the two documents together, the reference in the schedule in the words in brackets, "less the amounts of "any loans made by the Society to the Purchaser under the provisions "of this Bond", is merely put in as a warning, as Cohen, L.J., pointed out in the course of the argument, to show that the sum which the executors will receive at the death of the assured is liable to be diminished by any advances made against it which by the terms of the contract are recoverable at death and not otherwise by the Society.

The argument was put in rather a different way by Mr. Jenkins. I think his main point was this. He said: "Looking at the contract and "the actuarial method by which these various sums were arrived at, the "assured, if he did not exercise his right of borrowing so-called, would "not be getting the full financial benefit of the policy, because the cal-"culations on which the policy was based were made on the assumption "that he would exercise the right of borrowing." So be it. I cannot myself see that that alters the legal relationship of the parties. He is not bound to take the full financial benefit by borrowing. He might have very good reasons for not doing so because he might prefer not to borrow, with the result that the sum payable to his executors would remain at the agreed figure. He might find this desirable even if he incurred a small loss by not exercising the right of borrowing. Moreover, he would be entitled, if he did borrow, to repay on whatever day he pleased the amount that he borrowed. It is a loan and is described as a loan and he could repay it when he liked. It is perfectly true that he is under no obligation to repay it, but there is nothing to prevent him repaying it if he wants to. Again, that seems to me to stamp it with the character of a loan, not the character of an annuity.

Then Mr. Jenkins said that the contract was really of this nature. The Appellants, he said, were really contracting to pay at death what must be regarded as deferred payment of an annuity built up month by month, but not payable at death. He said that what Mr. Hart would become entitled to under that provision for payment at death was a month-

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ly sum which could not be called for, save by his executors at his death, unless he exercised the right of borrowing, and the right of borrowing really amounted to taking from the Assurance Company the monthly sum which it was said the Assurance Company was obliging itself to pay to him. With all respect I cannot accept that view. It seems to me quite inaccurate to refer to the sum which the Company convenanted to pay at the death of the assured as a series or collection of monthly sums. The real interpretation of that particular obligation seems to me to be this. It is an obligation to pay at death a lump sum which is to be quantified by reference to the number of months which the assured lives. There is all the difference in the world between that and an undertaking to pay a monthly sum. It is a sum the quantum of which increases month by month, but that is not the same thing as saying that it is a monthly sum. The object of the argument, of course, was to get the character of a collection of monthly sums imprinted upon the sum payable at death in order then to say that, when the assured borrows a monthly sum against that, he is merely getting the prepayment of what, in its essence, is a monthly sum, and that stamps it with the character of an annuity. But, with all respect to the argument, I cannot go through the mental process which would involve arriving at that result. It seems to me to be rewriting this contract—to be placing upon the legal relationship created by it something quite different to what the language imports.

Putting it quite shortly, I find the parties to this contract express in clear language the nature of the legal relationship which they are entering into, using language properly adapted to create that legal relationship. I cannot see any reason for rewriting their contract and construing the language they have used in some unnatural and strained sense.

There were only two cases referred to by the Crown, *Perrin* v. *Dickson*, 14 T.C. 608, and *Sothern-Smith* v. *Clancy*, 24 T.C. 1. I cannot find that either of those cases gives any assistance to the solution of the present question. *Perrin* v. *Dickson* was a very special case, and, speaking for myself, I should not find it possible to extract from it any principle which would be applicable to a case which was different on its facts. *Sothern-Smith* v. *Clancy* also was a very special case, and it does no more—I think neither of those cases does more— than to lay down the proposition that in each contract the true meaning and effect of the contract is to be ascertained on ordinary principles of construction. When you have done that you have done all that is necessary.

I must say a word as to the judgment of Macnaghten, J., who took a different view to that taken by the Special Commissioners. He began in the early part of his judgment by using this language: "A loan which "carries no interest and which neither the borrower nor any other person "can ever be under any obligation to repay seems almost too good to be "true". With all respect to the learned Judge, that approach to the question does not seem to me to be the right one. There is an obligation to repay the loans provided for by this contract. It is an obligation to repay, not by personal payment, but to repay out of a sum which under the contract is going to be payable to the borrower at a future date. To say that that is a transaction where there is no obligation to repay seems to me, with all respect, to be misunderstanding the true nature of the transaction.

(1) Page 14 *ante*.

(Lord Greene, M.R.)

Then the learned Judge goes on to state the argument for the Crown, and perhaps I had better read that: "The case for the Crown is that "these payments of £4 14*s.* 8*d.* per month, though they are called 'loans' "in the bond, have none of the characteristics of a loan and are in truth "and in fact 'an annuity or annual sum' within the meaning of the In- "come Tax Acts, since no interest is payable thereon and they are not "repayable by anyone." As I have already said, the fact that a loan is made free of interest does not make it any the less a loan. The fact that it is only repayable out of a sum which is payable in future does not make it any the less a loan. One of the commonest forms of loan is of that description. I do not understand the proposition that these payments "are in truth and in fact 'an annuity or annual sum'". That is, as I ventured to suggest at the beginning of this judgment, no more than an attempt to revive the old suggested principle of substance and form. It is really saying that this transaction has produced the same financial result as if it were an annuity and, therefore, the contract must be construed as a contract to pay an annuity and not to pay what it says it is to pay. The phrase "in truth and in fact" appears to me in the context to be very misleading, and I am afraid it must have misled the learned Judge.

He then goes on to say: "I agree with the contention for the Crown "that the payments in question were not loans; that they were payments "which, in the event that happened, namely, the request by Mr. Hart, the "Society was bound to make month by month, and were therefore an "annuity."(2) I need not go into that because my reasons for disagreeing with it appear from what I have already said.

Then he refers to Mr. Donovan's argument that the loans were repayable out of the sum payable by the Society on the death of Mr. Hart. Then he says: "but unless and until Mr. Hart revokes the request made in his "letter of 26th May, 1944, no sum will be payable by the Society on his "death and, therefore, the 'loans' cannot be repaid."(2) I do not think I have mentioned that letter before, but it was the letter under which Mr. Hart said he wished to avail himself of the privilege of borrowing. His request was in this form: "Will you kindly make loans to me free of in- "terest to the maximum extent .... unless and until this request is can- "celled." It is perfectly true, if he did not cancel this request, the sum payable at death would melt away. But there was nothing to compel him to go on borrowing. He might stop the next day and the result would be that there would be a sum payable at death, the loans being repayable out of that sum. In any event it seems to me that the primary obligation on the Company is to pay the sum payable at death, and, even if borrowings which are equal to that amount eventually turn out to be made, it is, nevertheless, true to say that the loans are repaid to itself by the Assurance Company by setting them against what is primarily a capital obligation, namely, to pay a sum at death.

I think that disposes of the case. In my opinion the Special Commissioners were perfectly right in the conclusion to which they came, and this appeal should be allowed with costs.

Cohen, L.J.—I agree, and I do not think I can usefully add anything.

Asquith, L.J.—I also agree.

Mr. Jenkins.—Will your Lordships give leave to appeal to the House of Lords? Your Lordships are differing from the learned Judge, and the case is obviously one of great general importance. The actual transaction

(1) Page 14 *ante.* (2) Page 15 *ante.*

(Mr. Jenkins.)

in the particular case is small in amount, but obviously it involves a principle which is widespread in its application.

Lord Greene, M.R.—What do you say, Mr. Donovan ?

Mr. Donovan.—I would say this. It is quite clear from the argument between the parties that there is no difference of principle at all in this case. The Income Tax principles which have been canvassed here are principles upon which we are both agreed. Therefore, all there was in this case really was the question of the true construction of a particular contract. I would ask your Lordships whether in that case it might not be better to leave the House of Lords to decide for themselves whether they wish to hear an appeal.

Lord Greene, M.R.—I quite understand what you say, Mr. Donovan, but this decision is one which will have a fairly wide effect.

Mr. Donovan.—Yes, my Lord.

Lord Greene, M.R.—I do not know what your Company will do, and whether it has issued other policies of this kind, but it is a matter that does interest your Company and no doubt will interest a great many other companies. Whatever we may think in this Court about the lack of foundation in the Crown's argument, it is in a sense unsatisfactory not to have a matter of this kind decided by the final tribunal.

Mr. Donovan.—I fully appreciate that.

Lord Greene, M.R.—That applies as much to you, as representing the Assurance Company, as to the Crown.

Mr. Donovan.—Yes, my Lord.

(The Court conferred.)

Lord Greene, M.R.—Mr. Jenkins and Mr. Donovan, the view of this Court is perfectly clear and expressed without any hesitation, but nevertheless I think it is unsatisfactory that a matter, far-reaching in importance both to the Crown and to insurance companies and policy-holders, should be left without a final decision of the final Court. On that basis we will give leave to the Crown to go to the House of Lords.

Mr. Jenkins.—If your Lordship pleases.

Mr. Donovan.—Might I ask the Crown to say whether, in view of the widespread importance of the case to them, they are prepared to pay the costs of the appeal in any event ?

Lord Greene, M.R.—The Crown will pay the costs of the appeal to this Court.

Mr. Donovan.—And in the House of Lords ?

Lord Greene, M.R—If you wish to suggest that they should be put on some undertaking about the costs in the House of Lords of course we will hear you, but it is right to point out this. In the ordinary case, where the taxpayer is only concerned with a particular transaction and the Crown is concerned with it as it affects other taxpayers, we often put the Crown on terms, but here we have a transaction which not only affects this policy which you have issued but no doubt will affect many other policies which you will issue in the future.

Mr. Donovan.—That is why I did not ask your Lordships to put the Crown on terms. I am really addressing a query here to the Crown through your Lordships as to whether they would be willing to do so.

Lord Greene, M.R.—Is the Crown, Mr. Jenkins, prepared to do anything about this?

Mr. Jenkins.—No doubt the Commissioners will consider the matter, but it does not seem at first sight to be an appropriate case, if I may say so. It is a matter of great importance to this Assurance Company. It affects every single policy of this kind they have entered into so far, or may enter into hereafter. It would be quite a different matter if the question were raised in proceedings against one individual annuitant only. Then he would, of course, require protection.

Lord Greene, M.R.—Mr. Jenkins, we are not imposing terms upon you, but if the authorities consider that they might make some concession it would be entirely for them to decide.

Mr. Jenkins.—If your Lordship pleases.

The Crown having appealed against the decision in the Court of Appeal, the case came before the House of Lords (Viscount Simon and Lords Porter, Uthwatt, du Parcq and Oaksey) on 29th and 30th January, 1948, when judgment was reserved. On 19th March, 1948, judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Solicitor-General (Sir Frank Soskice, K.C.), Mr. J. H. Stamp and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. Terence Donovan, K.C., and Mr. L. C. Graham-Dixon for the Society.

JUDGMENT

Viscount Simon.—My Lords, this appeal comes before the House in the following circumstances. The Respondent Society appealed to the Commissioners for the Special Purposes of the Income Tax Acts against an assessment to Income Tax of the sum of £42 18*s.* made upon it for the year ended 5th April, 1945. The assessment purported to be made under the provisions of Rule 21 of the General Rules applicable to all Schedules of the Income Tax Act, 1918, on the ground that this sum was "payment of any interest of money, annuity, or other annual payment "charged with tax under Schedule D" from which the Respondent Society was bound to deduct tax, and was thus rightly assessed against the Respondent Society, who paid the amount to a Mr. Hart without deduction in pursuance of a transaction between Mr. Hart and the Respondent Society. The Respondent Society denied that the sum which it paid to Mr. Hart was a payment from which tax had to be deducted and contended that it was money lent to him.

The Commissioners decided in favour of the Respondent Society, but stated a Case for the opinion of the High Court. Macnaghten, J., reversed the Commissioners' decision, holding that the payment in question was not a loan, but was an annuity or other annual payment. On appeal to the Court of Appeal, that Court (Lord Greene, M.R., and Cohen and Asquith, L.JJ.) reversed the decision of Macnaghten, J., and restored the conclusion of the Commissioners. The Crown now comes to this House and argues that the decision of the Court of Appeal is wrong.

The whole matter depends on the terms of the transaction entered into between Mr. Hart and the Respondent Society, and this transaction is con-

(Viscount Simon.)

tained in three documents—a proposal form "for Annuity and Life Assur-"ance", dated 24th May, 1944; a policy dated 25th May, 1944, which is described as a bond and in which Mr. Hart is called the purchaser; and a letter dated 26th May, 1944, from Mr. Hart to the Respondent Society exercising an option under the terms of the bond. The bond, which recites that the proposal is agreed to be the basis of the contract, provides, in return for the sum of £500 paid by the purchaser to the Society, for the payment of a sum at Mr. Hart's death equal to the aggregate of £4 14*s*. 8*d*. for each month between 25th May, 1944, and the date of death, less the amounts of any loans made by the Respondent Society to Mr. Hart under the provisions of the bond. The bond also provides that he may borrow from the Respondent Society on the security of the bond on the twenty-fifth day of each month "such sum or sums as the Purchaser may request "provided that the aggregate of the amounts of such loans at any date "shall not exceed the amount which would have been payable by the "Society . . . if the Annuitant had died on that date. Such loans shall "be free of interest and shall not be recoverable by the Society "otherwise than on the death of the Annuitant and out of the sum then "payable". By his letter of 26th May, 1944, Mr. Hart called on the Respondent Society to make loans to him free of interest to the maximum extent and on the earliest date permitted by the bond unless and until this request was cancelled.

In accordance with the option thus exercised, the Respondent Society paid to Mr. Hart £4 14*s*. 8*d*. in eight successive months until the end of the fiscal year, amounting to £37 17*s*. 4*d*. in all, and the question is whether such payments are in the nature of annuities or are, as the Respondent Society contends, loans. The balance of £5 0*s*. 8*d*. making up the £42 18*s*. is admittedly an annuity.

It may be well to repeat two propositions which are well established in the application of the law relating to Income Tax. First, the name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction. To call a payment a loan if it is really an annuity does not assist the taxpayer, any more than to call an item a capital payment would prevent it from being regarded as an income payment if that is its true nature. The question always is what is the real character of the payment, not what the parties call it.

Secondly, a transaction which, on its true construction, is of a kind that would escape tax, is not taxable on the ground that the same result could be brought about by a transaction in another form which would attract tax. As the Master of the Rolls said in the present case(1): "In "dealing with Income Tax questions it frequently happens that there are "two methods at least of achieving a particular financial result. If one "of those methods is adopted tax will be payable. If the other method "is adopted, tax will not be payable . . . The net result from the financial "point of view is precisely the same in each case, but one method of "achieving it attracts tax and the other method does not. There have been "cases in the past where what has been called the substance of the trans-"action has been thought to enable the Court to construe a document in "such a way as to attract tax. That particular doctrine of substance as "distinct from form was, I hope, finally exploded by the decision of the "House of Lords in the case of *Duke of Westminster* v. *Commissioners of* "*Inland Revenue*, 19 T.C. 490."

(1) Page 16 *ante*.

(Viscount Simon.)

Applying these principles, I reach the same conclusion as that arrived at by the Court of Appeal and expressed by the Master of the Rolls in a manner which I find quite conclusive. The obligation of the Respondent Society is to provide a sum at death; the right of Mr. Hart is to borrow such sums as he thinks fit month by month, subject to the limitation above set out, against the sum so to be paid at death. He is not to pay interest upon such advances, and there is no obligation to repay them save out of the sum payable at death. Though he is not bound to repay them in his lifetime, it seems to me that upon the true construction of the documents he would be entitled to do so if he chose—though, as the loan carries no interest, this would not seem to be a very likely choice for him to make. The legal relationship created by the transaction between the parties to it is that of lender and borrower, and there seems no reason for denying that this is their real relationship on the ground that, if Mr. Hart exercises his right of borrowing up to the full amount permitted, his executors will find that the net sum to be payable at his death has been reduced to nothing. While it is true that Mr. Hart's letter of request of 26th May, 1944, if it remained uncancelled, would reduce the sum payable at death to zero, there was nothing to compel Mr. Hart to go on borrowing these monthly sums. If he cancelled his request, then there would be a sum payable at death arrived at by deducting the loans which had been paid out of what would otherwise be the total sum. The primary obligation of the Respondent Society is to pay the sum payable at death and, however much or however little is borrowed in the meantime, the loans are repaid by setting them against what is a primary capital obligation.

The Special Commissioners were right in deciding that these payments were loans, and I move that the appeal be dismissed with costs.

Lord Porter.—My Lords, I agree with the reasoning and conclusion reached by the noble Lord upon the Woolsack and have nothing to add.

Lord Uthwatt.—My Lords, it is conceded by the Commissioners of Inland Revenue that the whole transaction between the Respondents and Mr. Hart is to be found in the bond of 25th May, 1944, and the letter of 26th May, 1944, and that the transaction so disclosed is to be taken at its face value. It follows that the task before your Lordships is to ascertain what, upon the true construction of the deed, are the legal rights of the parties, and in the light of that construction to determine whether the sums paid to Mr. Hart in accordance with the direction given in his letter fall within the description "annuities, and other annual profits or "gains".

There is no exceptional rule of construction applicable to the case. Here, as in all other cases of construction, mere nomenclature descriptive of an operation provided for by the bond may be disregarded as of no weight, if it mis-describes the operation. But under cover of that rule it is not right to attribute to words appearing in the bond a sense they do not naturally bear by reason of the odd legal or practical position that results. The argument for the Commissioners appears to me to have embodied this error.

In my opinion the construction of the bond is clear. Mr. Hart's executor was to be entitled at Mr. Hart's death to receive payment of a sum (I will call it the gross sum) ascertained by multiplying £4 14*s.* 8*d.* by the number of calendar months he might live after 25th May, 1944. He was to be entitled on the 25th day of each month to borrow money

(Lord Uthwatt.)

from the Society, but so that the aggregate of the amounts of the loans at any date should not exceed the amount payable by the Society if he died on that date. Interest was not to be charged on any loan and the Society could not sue to recover any loan. When Mr. Hart died the aggregate of the loans was to be deducted from the gross sum.

It will be observed that if Mr. Hart chose to exercise his right of borrowing to the full and at the earliest date open to him, he would receive £4 14*s.* 8*d.* every month and his executor would receive nothing. Financially it would pay him so to exercise his right. The transaction has the same commercial result as an agreement to pay a monthly annuity of £4 14*s.* 8*d.* coupled with a stipulation that Mr. Hart was to be entitled to leave in the hands of the Society any instalment of the annuity which he did not wish to receive when it became due and was to be entitled to demand payment at a later date. There was no automatic set-off between sums borrowed and the gross sum.

One other matter has to be added. Mr. Hart was entitled, in my opinion, as a matter of construction of the bond, at any time to repay the moneys borrowed. If he wished to exercise that right he would, I apprehend, be bound, unless the Society otherwise agreed, to repay all. Commercially that right might be worth little or nothing, but it existed.

Those are my views as to the construction of the bond. What is the legal transaction embedded in it? My Lords, in my opinion, the transaction, both in substance and in form, is an obligation to pay on Mr. Hart's death a sum quantified in the manner I have stated above, with a right on Mr. Hart's part to borrow on the security of that sum without subjecting himself to personal liability, Mr. Hart being at liberty to make repayment. There is a coincidence between the payer of the gross sum and the lender of the money. In my view that coincidence does not alter the transaction. Indeed, for the purpose in hand I do not regard the case as differing in legal effect from a case where the obligation to make the loan rested on a third party, whether a subsidiary of the Society or not.

Taking this view of the construction of the contract and the transaction, the sums received by Mr. Hart do not fall within the description "annuities, and other annual profits or gains". A man may live by borrowing; but that habit of life does not attract Income Tax.

I would dismiss the appeal.

Lord du Parcq.—My Lords, I concur.

Lord Uthwatt.—My Lords, my noble and learned friend, **Lord Oaksey,** who is unable to be present today, asks me to say that he has had the advantage of reading my opinion and he agrees with it.

Questions put:

That the Order appealed from be reversed.

The Not Contents have it.

That the Order appealed from be affirmed and the appeal dismissed with costs.

The Contents have it.

[Solicitors:—Solicitor of Inland Revenue; Field, Roscoe & Co., for Eversheds & Tomkinson, Birmingham.]

Federal Commissioner of Taxation v. Myer Emporium Ltd.

(1987) 163 CLR 199 (HCA)

On appeal from the Federal Court of Australia.
1 October 1986, 2 October 1986
14 May 1987

THE COURT delivered the following written judgment:- 1987, May 14

Mason ACJ, Wilson, Brennan, Deane and Dawson JJ.

The Myer Emporium Ltd. ("Myer") is the parent company of a group of companies ("Myer group") which carry on business predominantly in the areas of retail trading and property development. On 20 February 1981 Myer acquired Margosa Ltd., a shelf company incorporated in the Australian Capital Territory. The name of the company was later changed to Myer Finance Ltd. ("Myer Finance"). Myer Finance then undertook the greater part of the financing activities carried on for the Myer group, which had previously been carried out by Myer.

On 6 March 1981, Myer lent $80,000,000 to Myer Finance. The loan was made pursuant to a loan agreement ("the loan agreement") which provided that the principal would be repaid to Myer "on but not prior to the 30th day of June, 1988" and that, in the meantime, Myer Finance would pay interest to Myer at the rate of 12.5 per cent per annum on the dates and in the amounts set out in Sched. 1 of the loan agreement. Under that Schedule, the first payment of interest was to be made on the day of the loan and was to be in the amount of $82,192 which represented three days' interest. This amount was duly paid by Myer Finance to Myer. The loan agreement provided (cl. 5) that Myer had the right during the term of the loan:

> "... to sell, transfer or assign the Principal Amount and/or the interest payable or prepayable ... provided that it shall give written notice of such sale, transfer or assignment to the Borrower."

On 9 March 1981, Myer assigned to Citicorp Canberra Pty. Ltd. ("Citicorp") "absolutely the moneys due or to become due as the ***206** interest payments and interest thereon ... pursant to" the loan agreement. The consideration for the assignment was the sum of $45,370,000 which was paid by Citicorp to Myer on that day. Whether this sum was income or capital in the hands of Myer is the principal question in this appeal. The sum was calculated on the basis of the outstanding interest payable under the loan agreement which was then discounted at the rate of 16 per cent per annum. Myer gave notice of the assignment to Myer Finance which thereafter paid the interest due under the loan agreement to Citicorp. Myer remained entitled to the repayment of the principal sum of $80,000,000 by Myer Finance in accordance with the terms of the loan agreement.

The loan agreement and the related assignment of interest formed part of a wider reorganization within the Myer group. During 1980 the board of directors of Myer had considered reorganizing the Myer group so that the property and retail arms would be separated. The reorganization proposal included a property trust, but this was abandoned after an announcement by the government of a forthcoming change to the taxation treatment of property trusts set up as part of company reorganizations. Myer's advisers suggested a reorganization that would maintain, in their view, the benefits of the original proposal while including taxation or other financial benefits intended to counter the costs of the reorganization.

The proposal had four aspects, one of which was the financial arrangement set out above. First, Myer would remain the parent and holding company of other companies in the Myer group. Secondly, all trading operations would be transferred to Myer Melbourne Ltd. and would become divisions of that company, thereby eliminating the costs involved in operating numerous subsidiary companies carrying on parallel activities. Thirdly, all property assets would be placed under Myer Shopping Centres Ltd. Fourthly, Myer would

enter into a financial arrangement with an organization whereby an income stream within the Myer group would be sold for a lump sum. It was intended that the transaction would be arranged in such a way that the income stream which was sold would provide to Myer a lump sum payment which would be a non-taxable capital receipt.

Citicorp's parent company had indicated to Myer's advisers that a company in the Citicorp group would be willing to pay a lump sum of the order of $42,000,000 - the amount was later increased - for the acquisition of an income stream from Myer. The financial benefits to Myer as summarized by its financial advisers, Hill Samuel Australia Ltd., were expressed in a review dated 28 August 1980 of the Citicorp proposal in these terms:***207**

> "Financial Benefits
>
> The financial benefits of the Citicorp proposal can be illustrated by considering the example of an interest stream of $10m p.a. for 7 years. Under this proposal, Myer would give up $70m over the seven year period; however, after-tax Myer would give up only approximately $38m. In return for giving up this amount over seven years, Myer will receive a lump sum payment of approximately $42m. Thus, Myer will receive a greater sum than it gives up and will receive that greater sum at an earlier date. This amounts to a negative cost of financing. The net present value of this benefit and the interest savings would be approximately $9m after tax."

It seems that Citicorp was able to set off the interest payments that it received from Myer Finance as a result of the assignment from Myer to Citicorp against accumulated tax losses which were available to it. Had it not been for the availability of the tax losses, the transaction would have had no attraction for Citicorp. The tax liability on the interest payments, in the absence of the tax losses, would have reduced the net worth of the future interest payments to an amount less than the amount of the consideration payable by Citicorp to Myer.

The assignment of the right to interest was an integral part of the Myer group reorganization. It formed part of the financial arrangement set up to replace the aborted property trust. The loan would not have been given to Myer Finance if Citicorp had not been in a position to take the assignment of the right to interest. The accounting and legal advice, including the opinion of counsel, were all given on the instructions that the assignment would follow the loan, and that this arrangement was part of a larger reorganization of the Myer group. The minutes of the directors' meeting dated 23 February 1981, and the attached report "A Summary of Proposed Citicorp Fund Raising and Related Matters", dated 20 February 1981, treated the financial arrangement as involving both the loan and the assignment. The correspondence between Myer and the National Bank of Australasia Ltd. in respect of the daylight loan to obtain the $80,000,000 proceeded on the footing that the assignment would follow the loan. Mr. Tope, a director of Myer, in his evidence agreed that apart from the initial interest payment of $82,192 it was never intended that Myer receive any of the interest from the loan, because at the time Myer made the loan it intended and had arranged to sell the right to the interest.

The Commissioner of Taxation assessed the sum of $45,370,000 as income in the hands of Myer under s. 25(1) of the Income Tax Assessment Act 1936(Cth) ("the Act"). Myer appealed against the Commissioner's disallowance of its objection to the Supreme Court ***208** of Victoria. The Commissioner relied upon s. 25(1) and, alternatively, s. 26(a) of the Act. The Commissioner also argued that, if neither of these sections applied, s. 260 would apply to make the sum assessable. Murphy J. found that at all material times Myer had intended to assign for a lump sum the right to the future income stream arising from the loan. He was satisfied that the motivating purpose of the transaction was for Myer to obtain working capital to enable it to diversify. The ability of the company to obtain capital from public borrowings was limited by its debenture trust deed, and the transaction was the most feasible way, in the view of the board of directors of Myer, for the company to raise the working capital it sought. His Honour held that the sum was not income in the hands of Myer and that s. 260 of the Act had no application.[1]

[1] (1985) 81 F.L.R. 372; 16 A.T.R. 256; 85 A.T.C. 4111.

On appeal to the Full Court of the Federal Court (Fox, Lockhart and Jenkinson JJ.), Murphy J.'s decision was upheld.[2] The Court held that the receipt of $45,370,000 was of a capital nature and therefore was not income under s. 25(1) of the Act, that neither limb of s. 26(a) had any application because no profit could be discerned, and that s. 260 did not apply because there was no "antecedent transaction" evident. Major elements in the Court's reasoning to the conclusion that the sum was capital were findings that the assignment was not made in the ordinary course of Myer's business and that the sum was not received in substitution of interest. The Federal Court concluded that the agreement between Myer and Citicorp operated to assign all Myer's entitlement to receive interest under the loan and was therefore to be characterized as a capital receipt. In the words of Lockhart J., "the rights of the taxpayer under the loan agreement were converted to a capital amount", although his Honour conceded that if it had been an agreement to assign payments as they fell due, the amount may well have been income.

The members of the Federal Court differed in their reasons for concluding that the $45,370,000 was not a profit and that s. 26(a) did not apply. Fox J. said the sum was best seen as recompense for deprivation of interest on the loan. Lockhart J. held that the sum was capitalization of Myer's entitlement to interest. There was, in his Honour's opinion, no profit-making undertaking or scheme that had a nexus with the sum paid by Citicorp to Myer. Jenkinson J. found that the difference between the $80,000,000 lent to Myer Finance and the value of the right to repayment of that amount at a future date must be brought into account to determine whether the *209 $45,370,000 was a profit. His Honour said: "There is nothing in the evidence to suggest that, if that obligation were valued, the amount received by Myer from Citicorp would be found to exceed that value." In his Honour's view[3] the "application of a business conception to the facts" (see *Federal Commissioner of Taxation v. Becker*[4]) disclosed no profit.

The questions before this Court are: (1) whether the amount of $45,370,000 was income in the hands of Myer under s. 25(1) of the Act in its then form; (2) alternatively, whether the amount was assessable income of Myer under s. 26(a) of the Act in its then form; and (3) alternatively, whether the assignment to Citicorp fell within s. 260 of the Act.

In this Court argument in the first instance was limited to questions (1) and (2) above.

The Commissioner submits that a gain made by a taxpayer as the result of a business deal or a venture in the nature of trade is income of the taxpayer, even if the transaction that yields the gain is outside the ordinary course of business. According to the argument, the amount falls within either s. 25(1) or the second limb of s. 26(a). The taxpayer makes two responses to this argument: (1) that a gain made as the result of a business deal or a venture in the nature of trade is not income unless it is made in the ordinary course of carrying on a business; and (2) that the realization of a capital asset is capital, not income, the amount received by Myer representing the receipt of a capital asset.

Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will *210 be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income: *Federal Commissioner of Taxation v. Whitfords*

[2] (1985) 8 F.C.R. 136.
[3] (1985) 8 F.C.R., at p. 151.
[4] (1952) 87 C.L.R. 456, at p. 467.

Beach Pty. Ltd..[5] The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.

The celebrated decision in *Californian Copper Syndicate v. Harris*[6] makes the point. There, the Copper Syndicate bought a mining property for the purpose of exploiting it so that the Syndicate could resell it at a profit. The profit was held to be income because the Syndicate never intended to work the property with a view to deriving income from mining operations on the property. The transaction, though one which the Syndicate was authorized to enter into under its articles of association, and therefore one which fell within the business which it was empowered to carry on, was an isolated transaction. None the less the profit was income. The Lord Justice-Clerk (the Right Honourable J. H. A. Macdonald) drew a distinction between a mere realization or change of investment and "an act done in what is truly the carrying on, or carrying out, of a business". His Lordship went on to express the distinction in this way:[7]

> "Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?"

This test was approved by the Privy Council in *Commissioner of Taxes v. Melbourne Trust Ltd.*[8] and was applied by the House of Lords in *Ducker v. Rees Roturbo Development Syndicate*[9]. There a company was formed primarily for the purpose of acquiring, developing and exploiting an invention relating to a centrifugal turbine pump by way of granting manufacturing licences under patents. In the course of its business the company acquired additional English and foreign patents in connexion with the invention. Although its main business was the grant of manufacturing licences, the company always contemplated the possibility of a sale of its interest in the foreign patents. Receipts from the sale of ***211** that interest were held to constitute income. Lord Buckmaster[10] stated that this was not "a mere accidental dealing with a particular class of property" but "was part of their business which, though not of necessity the line on which they desired their business most extensively to develop, was one which they were prepared to undertake".

The important proposition to be derived from Californian Copper and Ducker is that a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.

Several different strands of thought have combined to deter courts so far from accepting the simple proposition that the existence of an intention or purpose of making a profit or gain is enough in itself to stamp the receipt with the character of income. The first was the notion that the realization of an asset was a matter of capital, not income. The second was the apprehension that windfall gains and gains from games of chance would constitute income unless the concept of income, apart from income from personal exertion and investments, was confined to profits and gains arising from business transactions. And the third notion, itself associated with the idea that the carrying on of a business involves a systematic series of recurrent acts or activities, was that a gain generated by recurrent transactions is income, whereas a gain generated by an isolated transaction is capital.

In the United Kingdom, Sched. D of the Income Tax Act 1918(UK) reinforced these notions. The Schedule seemingly confined the concept of income to (a) profits or gains from any trade, profession, employment or vocation, and (b) annual profits and gains from investments, though "trade" is defined so as to include every "manufacture, adventure or concern in the nature of trade". These provisions naturally provoked the question: Was a profit made on an isolated transaction of purchase and sale income, if the purchase was made with the intention, or for the purpose, of making the profit, even though the transaction

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[5] (1982) 150 C.L.R. 355, at pp. 366-367, 376.
[6] (1904) 5 T.C. 159.
[7] (1904) 5 T.C., at p. 166.
[8] [1914] A.C. 1001, at p. 1010.
[9] [1928] A.C. 132, at p. 140.
[10] [1928] A.C., at pp. 141-142.

was not one entered into in the course of carrying on a business?

In *Jones v. Leeming*,[11] the House of Lords answered this question in the negative. There was a finding that the taxpayer never meant to hold the land bought as an investment. Nevertheless it was found that the transaction "was not a concern in the nature of *212 trade". This led to the conclusion that a profit on an isolated sale, not being an adventure in the nature of trade, was a capital accretion.[12] Central to the reasoning was the view that in order to constitute a trading or business transaction, an element of recurrence or repetition is needed and that the intention or purpose of making a profit or gain, is not enough. Viscount Dunedin said:[13]

> "The fact that a man does not mean to hold an investment may be an item of evidence tending to show whether he is carrying on a trade or concern in the nature of trade in respect of his investments, but per se it leads to no conclusion whatever."

And Lord Buckmaster[14] discounted the suggestion that a profit made on the sale of an asset acquired in the expectation that it would rise in value (and presumably result in a realized gain) is income. To him all that was involved in such a case was the realization of a capital asset.

On the other hand in *Edwards (Inspector of Taxes) v. Bairstow*[15] joint venturers who engaged in an isolated transaction of buying and selling a complete spinning plant, with a view to making a profit, having no intention of using the plant or deriving income from it, were held liable to income tax on the profit made on resale. Lord Radcliffe concluded[16] that it was a profit from an adventure in the nature of a trade because the joint venturers had no intention of using the machinery and therefore did not buy it to hold as an income-producing asset or to consume it or for the pleasure of enjoyment; and, instead of having any intention of holding the plant, they planned to sell it even before they bought it. This they did, making a net profit, as they hoped and expected to do. In his Lordship's opinion this was "inescapably, a commercial deal in second-hand plant".

In rejecting the argument that the profit was not income because it arose from an isolated transaction, Lord Radcliffe observed:[17]

> "... that circumstance does not prevent a transaction which bears the badges of trade from being in truth an adventure in the nature of trade. The true question in such cases is whether the operations constitute an adventure of that kind, not whether they by themselves or they in conjunction with other operations, constitute the operator a person who carries on a trade. Dealing is, I think, essentially a trading adventure, and the respondents' operations were nothing but a deal or deals in plant and machinery."

The judgments in some of the English decisions naturally reflect *213 the language of the United Kingdom statutory provisions, which have no precise counterpart in this country. However, over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-making scheme are income, whereas the proceeds of a mere realization or change of investment or from an enhancement of capital are not income: *Ruhamah Property Co. Ltd. v. Federal Commissioner of Taxation*;[18] *McClelland v. Federal Commissioner of Taxation*;[19] *London Australia Investment Co. Ltd. v. Federal Commissioner of Taxation*;[20] and see *Whitfords Beach*.

The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective "mere": *Whitfords Beach*.[21] Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the

[11] [1930] A.C. 415.
[12] [1930] A.C., at p. 430.
[13] [1930] A.C., at p. 423.
[14] [1930] A.C., at p. 420.
[15] [1956] A.C. 14.
[16] [1956] A.C., at pp. 36-37.
[17] [1956] A.C., at p. 38.
[18] (1928) 41 C.L.R. 148, at pp. 151-152, 154.
[19] (1970) 120 C.L.R. 487, at pp. 495-496.
[20] (1977) 138 C.L.R. 106, at pp. 115-116.
[21] (1982) 150 C.L.R., at p. 383.

profit arising from their expected increase in value: see the discussion by Gibbs J. in *London Australia*.[22] It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.

If Myer's decision to assign to Citicorp the moneys due or to become due under the loan agreement had been unrelated to and independent of its decision to enter into the loan agreement, the argument that the assignment amounted to no more than the realization of a capital asset would perhaps have had more force, though, as will appear later, we do not consider that the respondent's argument would have prevailed even in such a situation. However, in the actual circumstances, as we have stated them, the consideration received for the assignment is necessarily income. This conclusion may for present purposes be demonstrated by distinguishing the facts in ***214** *Inland Revenue Commissioners v. Paget*[23] on which Myer strongly relied. The Court of Appeal held that the proceeds from the sale of coupons were capital in the hands of Miss Paget. Lord Romer[24] said this would be the case even if Miss Paget had only sold the right to interest for one or a few years. But Miss Paget had not acquired the bond coupons with a view to sell her right to interest on the coupons.

Myer also relied strongly on the statement made by Dixon and Evatt JJ. in *Commissioner of Taxes (Vict.) v. Phillips*:[25]

> "It is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning (cf. *Californian Oil Products Ltd. (in Liquidation) v. Federal Commissioner of Taxation*;[26] *Van den Berghs Ltd. v. Clark*[27]). It is erroneous because, for example, the right to future income may be an asset of a capital nature and the sum measured by reference to the loss of the future income may be a capital payment made to replace that right. Or, again, the computation may be done for the purpose of ascertaining what capitalized equivalent should be paid for the future income."

There the taxpayer was employed as the governing director of a company under a contract which specified his term to be of ten years' duration and that his remuneration was to be at the rate of 12.5 per cent of net profits. The company disposed of its business and Mr. Phillips' services were dispensed with. It was agreed between the company and Mr. Phillips that the sum of £20,301, being 12.5 per cent of the company's estimated net profits in the unexpired term of ten years, should be paid to him, in monthly instalments, as compensation. The monthly payments were held to be of an income nature. Dixon and Evatt JJ. said:[28] "No prima facie reason exists for regarding as instalments of capital annual payments which are taken in place of the contractual rights such a contract gave." Their Honours pointed out[29] that the total amount of the compensation was not the present value of the future contractual payments but merely their sum, noting that in these circumstances even receipt of a lump sum might be regarded as of the same nature as the ingredients of which it was composed.

Neither the decision nor the discussion in Phillips is decisive of the present case. The transaction in Phillips was of a very different kind and, as in Paget, no question of a profit-making scheme arose. The ***215** point is that the consideration for an assignment of the right to future income may constitute income in a variety of circumstances. Many instances may be given of the sale of a capital asset for a consideration which is income in the hands of the seller. For the most part these are instances of the sale of a capital asset for periodic, regular or recurrent receipts, periodicity, regularity or recurrence being characteristics of an income

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[22] (1977) 138 C.L.R., at pp. 116-118.
[23] [1938] 2 K.B. 25.
[24] [1938] 2 K.B., at p. 45.
[25] (1936) 55 C.L.R. 144, at p. 156.
[26] (1934) 52 C.L.R. 28, at pp. 46, 49, 51.
[27] [1935] A.C. 431, at p. 442.
[28] (1936) 55 C.L.R., at p. 156.
[29] (1936) 55 C.L.R., at pp. 156-157.

receipt: see, e.g., *Egerton-Warburton v. Deputy Federal Commissioner of Taxation*,[30] where a property was sold in return for an annuity. But there is no reason for thinking that the conversion of a capital asset into an income receipt is confined to such cases.

The periodicity, regularity and recurrence of a receipt has been considered to be a hallmark of its character as income in accordance with the ordinary concepts and usages of mankind. Likewise, the need to distinguish capital and income for trust purposes and other purposes has focused attention on the difference between the right to receive future income and the receipt of that income, a difference which has given rise to the analogical difference between the fruit and the tree: see *Shepherd v. Federal Commissioner of Taxation*.[31] Both the "ordinary usage meaning" of income and the "flow" concept of income derived from trust law have been criticized - see Professor Parsons, "Income Taxation: An Institution in Decay?": The 1986 Wilfred Fullagar Memorial Lecture. For present purposes it is sufficient for us to say, without necessarily agreeing with these criticisms, that, valuable though these considerations may be in categorizing receipts as income or capital in conventional situations, their significance is diminished when the receipt in question is generated in the course of carrying on a business, especially if it should transpire that the receipt is generated as a profit component of a profit-making scheme. If the profit be made in the course of carrying on a business that in itself is a fact of telling significance. It does not detract from its significance that the particular transaction is unusual or extraordinary, judged by reference to the transactions in which the taxpayer usually engages, if it be entered into in the course of carrying on the taxpayer's business. And, if it appears that there is a specific profit-making scheme, it is pointless to say that it is unusual or extraordinary in the sense discussed. Of course it may be that a transaction is extraordinary, judged by reference to the course of carrying on the profit-making business, in which event the extraordinary character of the ***216** transaction may reveal that any gain resulting from it is capital, not income.

Myer's business at all relevant times was that of retailer and property developer. Before acquiring Myer Finance, Myer carried on business as a financier, though its business as a financier seems to have been confined to transactions relating to the Myer group. The transactions in question here were entered into by Myer in the course of its business. The transactions, more particularly the assignment, were novel in the sense that it was the first time that Myer had entered into such an arrangement. But this fact does not take them out of the course of the carrying on of Myer's profit-making business.

By no stretch of the imagination is it possible to describe the transactions, or the assignment standing on its own, as the mere realization of a capital asset. As we have seen, the assignment was not unrelated to and independent of the loan agreement. The two transactions were interdependent in the sense that Myer would not have entered into the loan agreement unless it knew that Citicorp would shortly thereafter take an assignment of the moneys due or to become due for a sum approximating the amount payable in consideration of the assignment. Indeed, from the viewpoint of Myer the two transactions were essential and integral elements in an overall scheme, that scheme being a profit-making scheme.

If the two transactions, namely the loan agreement and the assignment, are considered as separate and independent transactions, Myer's argument that no relevant profit arose from the assignment has compelling force. The consideration payable for the assignment reflected the true value of the chose in action which Myer assigned. But once the two transactions are seen as integral elements in one profit-making scheme, it is apparent that Myer made a relevant profit, that profit being the amount payable on the assignment. As a result of the two transactions Myer, having lent $80,000,000 on 6 March 1981 repayable in accordance with the terms of the loan agreement, had profited by 9 March 1981 to the extent of the first interest payment received on 6 March 1981 and the sum of $45,370,000 paid for the assignment, the principal on the loan being intact. Of course the value of the chose in action, the right to recover the principal sum, was substantially less than the amount of the principal sum because there was no obligation to repay until 30 June 1988. But this

[30] (1934) 51 C.L.R. 568.
[31] (1965) 113 C.L.R. 385, at p. 396

circumstance cannot affect the character of the consideration for the assignment. It exists in every case where money is lent for a fixed term.

The accounting basis which has been employed in calculating profits and losses for the purposes of the Act is historical cost ***217** (*McRae v. Federal Commissioner of Taxation*;[32] and see *Lowe v. Inland Revenue Commissioner (N.Z.)*[33]) not economic equivalence: *Inland Revenue Commissioner v. Europa Oil (N.Z.) Ltd*.[34] And so a taxpayer who lends money for a stipulated period at interest is treated as exchanging the money lent for a debt of the same amount, unless the loan is made at a discount or premium, in which case there may be a gain or loss on capital account: *Lomax (H.M. Inspector of Taxes) v. Peter Dixon & Co. Ltd*[35] In the ordinary case, the debt is brought to account in the same amount as the money lent. The amount of the debt is not reduced because the lender is kept out of the use and enjoyment of the money lent for the period of the loan.

If economic equivalence were the appropriate accounting basis, the debt would be brought to account at the beginning of the period in an amount less than the amount of the money lent and would increase day by day until it equalled the amount of the money lent when the period expired. On that basis the right to interest on the money lent would be brought to account at the beginning of the period at a maximum figure reducing to nil when the period expired. The aggregate of the two amounts - the debt and the right to interest - would equal, throughout the period, the amount of the money lent, assuming that the rate at which the principal debt was discounted and the rate of interest payable on the principal debt were the same. On that basis, both the debt and the right to interest might be treated as capital assets.

But 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 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.

That is not to say that a right to interest is not an existing chose in action. It is an existing chose in action unless, perhaps, the borrower can avoid any liability for interest by repaying the loan: see ***218** *Norman v. Federal Commissioner of Taxation*;[36] *Shepherd*[37]. But the interest which becomes due is not the produce of the mere contractual right to interest severed from the debt for the money lent. Interest is regarded as flowing from the principal sum (*Federal Wharf Co. Ltd. v. Deputy Federal Commissioner of Taxation*[38]) and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum: *Riches v. Westminster Bank Ltd*[39]. A covenant to pay interest on a principal sum may, according to the terms of the lending agreement, be independent of or accessory to a covenant to repay the principal sum or the covenants may be integral parts of a single obligation, but it is of the essence of interest that it be referable to a principal sum: per Rand J. in Reference as to the Validity of Section 6 of the Farm Security Act, 1944, of the Province of Saskatchewan.[40] The source of interest is never the mere covenant to pay. Interest is not like an annuity. Annuity payments are not derived from the money paid for the annuity; they are derived solely from the annuity contract. And so, when a contractual right to be paid an annuity is sold for a price, the proceeds of sale are ordinarily capital in the hands of the vendor: *Paget*[41]; cf. *Kelsall Parsons & Co. v. Commissioners of Inland Revenue*.[42] The vendor receives the price in exchange for a capital asset - the contractual right which produces payment of the annuity. If a lender who sells a right to interest severed from the debt were regarded as disposing of an income-producing right, Paget would indicate

[32] (1969) 121 C.L.R. 266.
[33] (1983) 15 A.T.R. 102.
[34] [1971] A.C. 760, at p. 772.
[35] [1943] 2 All E.R. 255.
[36] FN(66) (1963) 109 C.L.R. 9.
[37] (1965) 113 C.L.R., at pp. 395-396.
[38] (1930) 44 C.L.R. 24, at p. 28.
[39] [1947] A.C. 390, at p. 400.
[40] [1947] S.C.R. 394, at pp. 411-412.
[41] [1938] 2 K.B., at pp. 35, 44-45.
[42] (1938) 21 T.C. 608, at p. 624.

that the price should be treated as capital. But the contractual right is not the source of the interest to which it relates: a contractual right severed from the debt is not the structure which produces that income.

If the lender sells his mere right to interest for a lump sum, the lump sum is received in exchange for, and ordinarily as the present value of, the future interest which he would have received. This is a revenue not a capital item - the taxpayer simply converts future income into present income: see *Commissioner of Internal Revenue v. P.G. Lake Inc.*[43] By a transaction consisting in the making of a loan and a sale of the right to interest on the money lent, the lender acquires at once a debt and the price which the sale of the right has fetched. The price of the right is the lender's compensation for being kept out of the use and enjoyment of the principal sum during the ***219** period of the loan and, like the interest for which it is exchanged, it is a profit. It is immaterial that the lender receives the profit not from the borrower but from the other party to the transaction, and it is immaterial that the profit is received immediately and not over the period of the loan.

In *Page*,[44] Lord Romer said that the proceeds of the sale for a lump sum of an annuity are capital in the hands of the vendor and not income. That case bears some similarity to the present case, for Miss Paget sold interest coupons attached to foreign bearer bonds to dealers in those coupons, and the question was whether the price she received for the coupons was "income arising from securities in any place out of the United Kingdom". Had she received the interest to which the coupons related that interest would have been brought to charge, but the authorities which had issued the bonds - the City of Budapest and the Government of Yugoslavia - had defaulted in due performance of their interest obligations. The purchase price of the coupons was not interest nor were the benefits which purchase of the coupons conferred on the dealers. What Miss Paget sold was, as MacKinnon L.J. described it,[45] "the possibility of making some money abroad" by accepting in lieu of the promised interest certain payment in local currency or a mixture of U.S. dollars and funding bonds. The coupons were the sole source of the possibility of making some money abroad; they were the sole source of the expectation of substitutionary payment. The substitutionary payment offered by the defaulting borrowers (or the expectation of obtaining that payment) on production of the coupons was not regarded as interest and the sale of the coupons was not by way of assignment of a right to interest but by way of transfer of the instruments of title to the substitutionary payment. The coupons had come to represent, like a contract to pay an annuity, the sole source of the expected payments. Lord Romer[46] drew that analogy, treating the sale for a lump sum of an annuity as an instance of a sale of a right to receive income in the future, the proceeds of which are not treated as income. Unlike the sale of the coupons in Paget, the sale of a right to interest severed from the debt is not a sale of a tree of which the future payments are the fruit. The present case may thus be distinguished from the view of the facts which was the foundation of the decision in Paget. If Paget is not to be distinguished in this way, we should be unable to accept its authority for the purposes of the Act.

In this case, the sale of Myer's right to interest produced an ***220** immediate cash receipt. For an outlay of $80,000,000 in the transaction Myer acquired a debt of $80,000,000 owed by Myer Finance and $45,370,000 in cash from Citicorp. It has made a profit of $45,370,000. True it is that Myer will not now receive the interest which would have become payable to it during the period of the loan but that will be reflected only by an absence of the income by way of interest which would otherwise have been received in future years. Myer received the profit of $45,370,000 during the 1981 income year and that receipt forms part of its assessable income for that year.

What we have said leads to the conclusion that the amount in question formed part of the income of Myer under s. 25(1) of the Act. A similar chain of reasoning would have led to the conclusion that the amount constituted assessable income under the second limb of s. 26(a). The relationship between ss. 25(1) and 26(a) has been the subject of much previous discussion involving considerable differences of

[43] (1958) 356 U.S. 260, at pp. 266-267.
[44] [1938] 2 K.B., at p. 45.
[45] [1938] 2 K.B., at p. 48.
[46] (1938] 2 K.B., at pp. 44-45.

opinion about the extent (if any) to which the provision of the second limb of s. 26(a) supplemented the provision of s. 25(1): see, e.g., *Whitfords Beach*.[47] It is, however, unnecessary that we examine that question here since, as we have indicated, we consider that the amount in question in the present appeal constituted income of the taxpayer both pursuant to ss. 25(1) and 26(a).

For the foregoing reasons we would allow the appeal.

Appeal allowed with costs.

Order that the order of the Full Court of the Federal Court dated 8 October 1985 be set aside and in lieu thereof order that the appeal to that Court be allowed with costs.

Further order that the order of the Supreme Court of Victoria dated 20 March 1985 be set aside and in lieu thereof order that the appeal to that Court be dismissed with costs.

Solicitor for the appellant, Australian Government Solicitor.

Solicitors for the respondent, Gledhill Burridge & Cathro.

[47] (1982) 150 C.L.R., at pp. 379-381.

Peterson v Commissioner of Inland Revenue - [2006] 3 NZLR 433

Judicial Committee

[2005] UKPC 5

28 February 2005

Lord Bingham of Cornhill, Lord Millett, Lord Scott of Foscote, Baroness Hale of Richmond and Lord Brown of Eaton-under-Heywood

The judgment of Lord Millett, Baroness Hale of Richmond and Lord Brown of Eaton-under-Heywood was delivered by

LORD MILLETT.

[1] These appeals are brought from a judgment of the Court of Appeal of New Zealand (Gault P, Keith and Anderson JJ) delivered on 19 February 2003 and reported at [2003] 2 NZLR 77. The detailed facts are set out in the judgments below and are sufficiently summarised in the dissenting opinion herein of Lord Bingham of Cornhill and Lord Scott of Foscote, to which reference can be made. There is no need for Their Lordships to repeat them.

[2] There are two appeals before the Board with the same appellant in each case. They arise out of a tax-avoidance scheme of a kind which has been widely used, has excited the attention of the revenue authorities in many countries, and has frequently been challenged by them, sometimes successfully and sometimes not. The success of any challenge depends on the specific features of the scheme, the particular fiscal background, the weaponry available to the tax authorities to counter the effect of the scheme, and the marksmanship with
[2006] 3 NZLR 433 page 436
which such weaponry is discharged. In the present case the Commissioner of Inland Revenue relies on the provisions of s 99 of the Income Tax Act 1976 of New Zealand to enable him to disallow a tax deduction claimed by the taxpayer.

Section 99

[3] So far as material s 99 is in the following terms:

> **99. Agreements purporting to alter incidence of tax to be void** --
> (1) For the purposes of this section -
>
> "Arrangement" means any contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect:
>
> "Liability" includes a potential or prospective liability in respect of future income:
>
> "Tax avoidance" includes -
> (a) Directly or indirectly altering the incidence of any income tax:
> (b) Directly or indirectly relieving any person from liability to pay income tax:

(c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax.

(2) Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly, -
(a) Its purpose or effect is tax avoidance; or
(b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, -
whether or not any person affected by that arrangement is a party thereto.

(3) Where an arrangement is void in accordance with subsection (2) of this section, the assessable income . . . of any person affected by that arrangement shall be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement . . .

[4] Section 99 is a general anti-avoidance provision which entitles the commissioner to adjust a taxpayer's assessable income in order to counteract a tax advantage which he has obtained by a tax-avoidance scheme. Their Lordships observe that reliance by the commissioner on the section presupposes that he accepts that but for its provisions the scheme would have succeeded in achieving its object; for, if not, the taxpayer has not obtained a tax advantage and there is nothing for the commissioner to counteract. As Richardson P said in *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 at p 464:

> ". . . it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation."

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For this reason it is usually prudent for the commissioner to contend in the alternative either that a scheme does not in fact achieve the desired tax advantage or, if it does, that it can be countered by the application of s 99. This is how the commissioner put his case before the Taxation Review Authority (the TRA) and the High Court; but before the Court of Appeal and the Board he has relied exclusively on the operation of s 99, thereby tacitly accepting that, but for the provisions of the section, the tax deductions would be allowable.

[5] The grounds on which the commissioner has challenged the scheme have varied as the cases have progressed through the Courts; many of the grounds advanced at one stage have later been abandoned in favour of others. The only issue before Your Lordships is whether, having regard to the facts which have been agreed or found by the TRA, the way in which the commissioner has put his case, and the allegations and concessions which he has made, he can invoke s 99 to disallow the tax deductions which the appellant taxpayer claims.

The background

[6] In each of the cases before the Board the appellant was a member of a syndicate formed to finance the production of a feature film in New Zealand. The cases concern different films, one entitled *The Lie of the Land* and the other *Utu*. The financing arrangements were similar in all material respects, though they differed in detail and in the monetary amounts involved. There are only two significant differences between the two cases. One is that *The Lie of the Land* was never commercially released and so never generated any receipts, while *Utu* has been one of the most successful films ever made in New Zealand. The film has earned substantial income and is still continuing to earn income 17 years later. The other is that, whereas both films were financed in part by a non-recourse loan provided in the course of a circular movement of funds, external funds were inserted into the circle in *The Lie of the Land* but not in *Utu*, where the lender was not put in funds to make it. The loan was, however, supported by cheques which were duly honoured, was treated by all concerned as received and applied by the borrowers, and has been fully or partially repaid by them in accordance with its terms.

[7] In order to enable them to deal with both cases together, Their Lordships propose to use algebraic symbols to represent the monetary sums involved.

Film financing

[8] It is generally recognised that investing in the production of feature films is a high-risk enterprise. The great majority of such films lose money, that is to say they fail to generate sufficient net receipts after deducting the marketing and distribution costs to recoup the costs of production. The rewards of investing in a successful film, on the other hand, can be enormous. Investors may be persuaded to put their money into several films rather than one in the hope that they will thereby increase their chances of profit by enabling them to recoup their losses from a series of failures by a single success. This, however, only increases their exposure; and it is unlikely that finance for film production would be found were it not for the possibility of obtaining non-recourse financing, which reduces the investor's exposure to loss, and the substantial tax incentives which many countries offer.

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[9] In the present cases high-rate taxpayers were induced to enter into arrangements to finance the production of a film by the prospect of obtaining significant tax advantages. These arose from a combination of two features which are not uncommon in commercial financing arrangements lacking any overriding tax motivation. One was the prospect of obtaining a depreciation allowance for the cost of the investment; the other was the opportunity to fund it in part with moneys borrowed under a non-recourse loan agreement.

Depreciation

[10] Income tax is chargeable on the profits of a trade or business, not on gross earnings, and revenue expenditure incurred in earning those profits, if genuinely incurred, normally falls to be deducted from gross receipts in order to arrive at the taxpayer's taxable profits for the year. Capital expenditure incurred in the course of a trade or business, on the other hand, is not normally deductible in arriving at trading profits. Instead a depreciation allowance may be available to permit the capital cost of an asset with a limited life to be written off against the taxpayer's taxable income

over the expected life of the asset (see, for example, s EG1 of the Income Tax Act 1994 of New Zealand). Income tax is charged on an accruals basis, not on a receipts and payments basis, and expenditure is deductible when it is incurred, not when it is paid.

[11] Film production and distribution have, however, been long accorded special treatment in New Zealand. A ruling (IR 52.3) published by the commissioner in 1952 and which it is common ground applied to the films in question provided (inter alia) that all income from the sale or other exploitation of a film was taxable and that the costs of producing films should not be deductible in the year incurred. Instead they should be capitalised and depreciated at the rate of 50 per cent on cost price, that is to say the cost should be written off over a period of two years. In this respect no distinction was to be drawn between investors in films and persons engaged on a full-time basis in the business of producing or distributing films. Both were entitled to offset their share of the costs of producing or marketing the film against income from the film and income from other sources.

[12] Counsel seemed to think that the ruling is not happily worded. Although no distinction is to be made between investors and those engaged in producing or marketing films, they were troubled by the fact that the ruling appears to cover only the costs of producing or marketing a film and not the costs of financing or acquiring it. Nevertheless they were agreed that, in relation to investors, the ruling does cover the capital costs of financing or acquiring the film, and that such costs, if genuinely incurred, can be set off against the investor's income either from the film or from other sources over a period of two years. Their Lordships agree, but they think that the effect of the ruling may have been misunderstood. It is concerned with the tax treatment of persons engaged in the business of producing or distributing films and assimilates it to the treatment accorded under the general law to persons who invest capital in film production. Films are assets with a relatively short life (evidently taken to be two years) and investors can write off the capital costs of acquiring or investing in such assets over their expected life under the general depreciation provisions of the taxing Acts. The effect of the ruling is to deny persons engaged in the business of film production or distribution the right which they

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would otherwise have to deduct their revenue costs immediately they are incurred, and requires them instead to capitalise such costs and write them off over a period as if they constituted capital expenditure.

[13] In the present cases high-rate taxpayers were induced to invest in the films in part by the prospect of obtaining a depreciation allowance which would allow them, over a period of two years, to set off against their taxable income from other sources the whole of their investment in the film, even if the film was never commercially released and so never generated any income at all. This was an attractive proposition, for it significantly reduced, though it did not extinguish, their exposure to loss.

Non-recourse financing

[14] A further inducement to invest in the films was the prospect of funding the investment in part with money borrowed under a non-recourse loan agreement. A non-recourse loan is a loan made on terms that the borrower has no personal liability to repay it. Such loans are normally made to enable the borrower to acquire a capital asset; in such cases the lender may be content to look for repayment to the income stream which the asset is

expected to generate. Non-recourse loans are common in the mining and extraction industries. Arrangements of this kind may be entirely commercial; but they are also undeniably attractive to those devising tax-avoidance schemes.

[15] Borrowed money belongs to the borrower, not to the lender, and this is so whether the borrower incurs a personal liability to make repayment or not. Depreciation allowances depend on the taxpayer having incurred the cost of acquiring an asset, not on his liability to repay the lender. It does not matter how he came by the money to acquire the asset; he may have been given it by a friend or relative. Accordingly, the fact that the cost of acquisition is funded wholly or in part by a non-recourse loan ought ordinarily to be irrelevant; and in his ruling IR 52.3 the commissioner confirmed that this was his approach.

[16] The ability to borrow funds on a non-recourse loan is particularly attractive to a prospective investor in films. It allows him to increase the amount of his investment, and therefore the amount available for deduction from his taxable income, without increasing his exposure to loss. If the proportion of his total investment which is funded by the loan is sufficiently high, he may be able to make a profit after taking the tax deduction into account even if the film generates no income at all. Of course he will have to pay a price for these advantages. The price usually takes the form of a deferment of his right to participate in the profits of the film if it is successful, for a lender will normally require to be repaid in full before the borrower has recourse to the source of repayment to recoup his investment. But this is a matter for negotiation; the lender may instead insist on payment of an exceptionally high rate of interest or a procuration fee, neither of which would, in the ordinary course of things, be deductible expenditure in the hands of the borrower; or the lender may insist on taking (or be in a position to take) a share of the profits made by the production or distribution company.

The facts

[17] The facts, which are common to both cases, can be summarised as follows:

(1) The appellant was a member of a syndicate of investors which acquired the screenplay, the film, and other rights, and acquired the film (by commissioning a production company to produce it) for a fixed price.

(2) The film was expected to cost $x to make but the investors were falsely led to believe that it would cost $x+y.

(3) Accordingly, they were induced to sign a production contract by which they incurred a liability to pay $x+y to the production company to make the film.

(4) This sum was payable in cash at the outset and was to be funded as to $x by the investors out of their own resources and as to $y by the proceeds of a non-recourse loan from a third-party lender connected with the production company.

(5) The investment was highly geared: $y represented more than half (56.6 per cent) of the investors' total investment of $x+y.

(6) The investors received (or were treated as receiving) $y by way of loan and paid it (or were treated as paying it) together with $x out of their own resources to the production company

in the discharge of their contractual liability under the production contract.

(7) The production company applied $x in making the film. Unknown to the investors, however, it did not use the $y to make the film (for which it was not needed), but recycled the money to the lender immediately it was received.

(8) *Utu* has proven to be extremely successful and is still generating income. In the absence of evidence to the contrary, it may be assumed that the lender has wholly or nearly recouped the loan of $y and interest out of the receipts of the film and that the investors have suffered a corresponding reduction in their (taxable) share of the film receipts. *The Lie of the Land* has never been commercially released, the investors have lost the whole of the investment of $x which they made out of their own resources (though if their claim is successful they will recover more than this in tax relief), and although not out of pocket the lender has failed to recover any part of its loan of $y.

The rival contentions

[18] In each case the investors contend that they have borrowed $y, incurred and discharged a liability to pay $x+y to acquire the film, incurred a liability to repay the loan of $y out of any film receipts, and (in the case of *Utu*) have done so. They claim to set off $x+y, being the cost to them of acquiring the film, against their taxable income. The commissioner has accepted their claim to deduct $x, but has disallowed the balance of their claim on the ground that it does not represent expenditure incurred by the partnership at all.

[19] It is not surprising that the commissioner challenged the scheme. In opposing the investors' claim he cited the deceitful inflation of the costs of production (of which the investors were found to be unaware), the use of a non-recourse loan to fund part of the investment, the high gearing of the investment and the circular movement of funds. The use of a non-recourse loan to leverage the amount of the investors' direct investment had the effect that they were not exposed to any risk of loss after tax relief was taken into account, so that it could be argued that the films were being financed by the general body of taxpayers. The recycling of the loan demonstrated that it was not needed for and was not applied in film production. While there clearly was an underlying commercial activity with a potential for profit, the actual amount which was

applied in that activity was only a small part of the investment for which tax relief was claimed. The underlying activity could not sustain the total amount of the investment which the investors claimed they had made.

[20] While the commissioner was able to point to features of the scheme which he considered to be unacceptable, however, he never gave a satisfactory answer to the investors' case that they had paid $x+y to acquire a capital asset and were in consequence entitled to a depreciation allowance of a corresponding amount.

8The course of the proceedings below

The Lie of the Land

[21] In the TRA the commissioner contended that the non-recourse loan was a sham because there was no evidence that the money was advanced to the investors or spent by the production company on the making of the film. In fact there was clear evidence that the money was advanced to and received by the investors and was applied by them in payment to the production company to acquire the film. In the alternative the commissioner relied on s 99. He identified the non-recourse loan as constituting the relevant arrangement and contended that its effect should be counteracted under s 99. The TRA rejected the commissioner's allegation that the loan was a sham and his claim under s 99 also failed.

[22] In the High Court the commissioner abandoned his claim that the loan was a sham and relied almost entirely on s 99. He identified the recycling of the loan to the lender as the relevant arrangement and sought to counteract the effect of the whole loan agreement, which the Court declined to do. Alternatively he argued that the payment of $y should be disallowed because "there ought not to be a deduction on inflated costs" for "if the marketing costs were never expended and drawn down from the available loan the [investors] had no liability to repay what they had not received". The High Court had little difficulty in rejecting this confused submission and upholding the investors' claim to tax relief.

[23] In his notice of appeal to the Court of Appeal the commissioner relied exclusively on s 99. He contended that the entire investment scheme was an arrangement by which (or by the relevant parts of which, and in particular the recycling of the loan) the investors were affected whether they were parties to it or not. The Court of Appeal would have found in favour of the commissioner without recourse to s 99 on the ground that, despite the investors' obligation to repay it out of the receipts of the film, the loan did not form part of the cost of making the film because it was repaid to the lender. While plainly correct, this resurrected the confusion between the costs of making the film which were incurred by the production company and which were only $x, and the costs incurred by the investors, who had not made the film but acquired it from the production company, which were the relevant costs and which were $x+y.

[24] The Court of Appeal could not and did not decide the case on this ground, however, because of the limited grounds of appeal. Instead it held that the arrangement which could be counteracted under s 99 included the immediate recycling of the loan to the lender so that "the deduction for depreciation was overstated" and the liability to pay $y was not "truly incurred". Their Lordships find this difficult to follow. The recycling of the loan shows that the production company did not apply it to make the film;
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but it does not show that the investors did not pay it to the production company in accordance with the production contract in order to acquire the film or incur a genuine liability to repay it out of the receipts of the film. The commissioner did not contend that the investors paid the money to the production company for any other purpose, so that the choice was between holding that the money was not paid at all (that is, that the payment was a sham, a finding which the TRA had rejected) or that it was paid to acquire the film.

Utu

[25] In this case the TRA found that the lender never obtained the finance necessary to enable it to make the loan to the investors. It made clear findings that neither the investors not their accountant knew of this or of the inflation of the cost of making the film. It did not, however, base its conclusion on its finding that no external funds were injected into the circular movement of money. It held that the question for determination was whether the investors could claim a deduction for what they understood to be the contract price for the film irrespective of whether or not the total contract price was actually spent in making the film. The TRA answered this question in the negative, finding that the production company had made the film as agent for the investors, so that the expenditure of $y had never been incurred. This made it unnecessary for the TRA to consider the application of s 99.

[26] In the High Court the Judge (Hammond J) accepted the investors' argument that on a proper construction of the production contract the relationship between the investors and the production company was not that of principal and agent but of purchaser and vendor under a fixed-price contract (reported at (2002) 20 NZTC 17,761). He therefore disagreed with the TRA that the cost to the investors was limited to the expenditure of $x on the film. On his view, it was the full $x+y. But he agreed with the commissioner that the inflation of the costs of making the film was the "arrangement" for the purposes of s 99 and that the commissioner was entitled to adjust the investors' income under s 99 as persons who were affected by the arrangement even though they did not know of it. The investors contended that they had not obtained a tax advantage from the arrangement, observing that they were not claiming a fictitious amount but the amount that they were obliged to pay pursuant to the production contract. The Judge found that the investors had obtained a tax advantage, albeit indirectly, through what he described as "a share in the inflated price of the film".

[27] In the Court of Appeal the commissioner was content to have the matter determined under s 99. As Their Lordships have already observed, this is inconsistent with a contention that the loan was a sham; the section is not needed and has no application to deny effect to a sham transaction. The Court of Appeal would have decided the case on the ground that the obligation to repay $y out of the proceeds of the film was not incurred or, if incurred briefly, was extinguished. This was because the money had passed back in a circle to the lender, thereby repaying the loan. It did not need to be repaid again from the proceeds of the film. The difficulty with this reasoning, which the commissioner did not attempt to support before Their Lordships, is that he did not obtain a ruling from the TRA, and there was no evidence, that the production company paid the money to the lender in repayment of the loan. Moreover it is impossible to reconcile it with the finding of the TRA that the investors knew

nothing about the movement of the money (and therefore did not authorise the production company to repay the loan on their behalf) and the evidence that the investors have actually repaid all or part of the loan.

[28] The Court of Appeal could not and did not decide the case on this ground, however, because of the limited way in which the commissioner put his case. It held that s 99 applied to the case in the same way that it applied in *The Lie of the Land*. It said that the

> ". . . assumption of liability for [the] loan moneys constituted part of the cost which the [investors] agreed to pay. No such liability endured, if it was ever assumed. The depreciation [allowance was] to be calculated not on what was agreed to be paid but on the cost actually incurred. The arrangement to falsely inflate that cost was for the purpose of increasing the loss for tax purposes. The [investors were] directly affected by that arrangement and obtained a tax advantage under it".

[29] Their Lordships do not find this easy to follow. The investors' obligation to repay the loan was not, with respect, "part of the costs which the investors agreed to pay" on which their claim to depreciation was based, but the means by which they funded their liability to pay them. As they understand it, the Court of Appeal adopted the same analysis as they had adopted in *The Lie of the Land*. This does not depend on a finding that the loan was never actually received by the investors or paid by them to the production company, but on the proposition, which the commissioner did not support before the Board, that the investors' liability to repay the loan was discharged by its recycling to the lender.

Summary of the commissioner's contentions below

[30] It will be seen that the commissioner advanced a variety of arguments, based on the fact that it cost the production company only $x to make the film coupled with the fact that the loan of $y was either not made at all or if made was immediately recycled to the lender, to contend that the investors did not pay or incur a liability to pay the full amount of $x+y to the production company. At no stage did the commissioner contend that, if they did pay the whole of that sum, they did not pay $y as consideration for the acquisition of the film but paid it for some other purpose.

The commissioner's contentions before the Board

[31] Before the Board counsel argued the case of *The Lie of the Land* at length and referred only briefly to *Utu*, it being tacitly assumed that the outcome of the two cases should be the same. The commissioner made the following concessions:

(i) the investors incurred a contractual obligation to pay $x+y to the production company as the consideration for the making of the film;

(ii) as to $y they discharged (or in the case of *Utu* were treated as having discharged) this obligation by applying the proceeds of the non-recourse loan in payment to the production company;

(iii) the recycling of $y by the production company to the lender did not discharge the investors' liability to repay the loan out of the receipts of the film, so that the Court of Appeal's conclusions (that the liability to

repay $y was not "truly incurred" or that the investors' obligation to repay the loan, if ever incurred, was extinguished) could not be supported; and

(iv) (tacitly) that absent s 99 the taxpayers were entitled to succeed.

[32] For the purpose of s 99 the commissioner took the scheme as a whole to constitute the relevant arrangement, comprising as it did the non-recourse loan, the inflation of the costs of the film and the circular movement of the $y. He contended that the arrangement had the purpose or effect of generating a claim to tax relief which was achieved by the contrivance or pretence that the film cost $x+y to make when in reality it cost only $x. The investors thereby reduced their liability to tax without suffering the economic consequences which Parliament intended should be suffered by a taxpayer qualifying for the tax relief in question.

Discussion

[33] Their Lordships consider that the commissioner is entitled at his option to identify the whole or any part or parts of a single composite scheme as the "contract, agreement, plan or understanding" which constitutes the "arrangement" for the purpose of s 99. Whether there was a single "arrangement" or two or more connected but distinct "arrangements" (as there were in *Commissioner of Inland Revenue v BNZ Investments Ltd*) is a question of fact for the TRA. The commissioner must then show: (i) that the "arrangement" which he has identified has the purpose or effect of avoiding tax, an expression which includes reducing any liability to pay income tax; (ii) that whether or not the taxpayer was a party to the "arrangement" he was affected by it; and (iii) that he obtained a tax advantage from it. If he can satisfy these conditions, he can adjust the assessable income of any person affected by the "arrangement" in order to deny him the tax advantage which he has derived from it.

[34] Their Lordships are satisfied that the "arrangement" which the commissioner has identified had the purpose or effect of reducing the investors' liability to tax and that, whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it. Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either. On this point they respectfully prefer the dissenting judgment of Thomas J in *Commissioner of Inland Revenue v BNZ Investments Ltd*. Moreover the investors did not merely obtain an economic advantage from the "arrangement" (as in that case); they obtained a tax advantage, namely a depreciation allowance which reduced their liability to pay tax.

[35] The critical question is whether the tax advantage which they obtained amounted to "tax avoidance" capable of being counteracted by s 99, for the Courts of New Zealand have long recognised that not every tax advantage comes within the scope of the section; only those which constitute tax avoidance as properly understood do so.

[36] In *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 at p 549 Richardson J pointed out that it was obviously never intended that transactions should be struck down merely because they were influenced by the prospect of obtaining a tax advantage. In many cases, but for

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the anticipated availability of a tax benefit, the taxpayer would never have entered into the transaction at all. Basic features of the tax system, such as depreciation and trading stock valuations, he said, clearly allow for the deliberate pursuit of tax advantage.

[37] When that case reached the Board, Lord Templeman explained at p 561 the distinction between an acceptable tax advantage (which he described as tax mitigation), which was not caught by s 99, and an unacceptable one (which he described as tax avoidance), which was:

> "The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax . . .
>
> Income tax is mitigated by a taxpayer who reduces his income *or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability* . . .
>
> Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.
>
> Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had." (Emphasis added.)

[38] Lord Nolan said much the same in the English case of *Commissioners of Inland Revenue v Willoughby* (1997) 70 TC 57 at p 116:

> "The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability . . . But it would be absurd in the context of [the provision there affording relief from tax] to describe as tax avoidance the acceptance of an offer of freedom from tax which Parliament has deliberately made."

[39] Investors in films are entitled to depreciate their full acquisition costs. This is so however much the film actually costs the production company to make and by whatever means the investors have obtained the funds to finance the acquisition. Given the fact, never challenged and now conceded by the commissioner, that the investors paid $x+y to acquire the film, they incurred the expenditure which Parliament contemplated should entitle them to the depreciation allowance which they claim. If viewed alone this amounted to a tax advantage but not to tax avoidance within the scope of the section.

[40] It is, however, necessary to look a little further and consider the acquisition of the film in its wider setting. Their Lordships endorse the observations of Richardson P in *Challenge Corporation Ltd v Commissioner of Inland Revenue* at p 549:

> ". . . s 99 would be a dead letter if it were subordinate to all the specific provisions of the legislation. It, too, is specific in the sense of being specifically directed against tax avoidance . . . while the use [of trusts and
> *[2006] 3 NZLR 433 page 446*
> companies] is regarded as perfectly legitimate and not on its own affected by s 99, it may be only one element in a wider arrangement which is caught by the section."

The wider setting on which the commissioner relies includes the false inflation of the costs of production, the leverage obtained by use of a non-recourse loan and the recycling of the loan to the lender.

[41] Before considering the effect of these features, Their Lordships must say something about the purpose for which depreciation allowances are granted by Parliament. They are not specific to film financing but are of general application and have nothing to do with encouraging people to invest in films or indeed anything else. The statutory object in granting a depreciation allowance is to provide a tax equivalent to the normal accounting practice of writing off against profits the capital costs of acquiring an asset to be used for the purposes of a trade (see *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] 3 WLR 1383 per Lord Nicholls of Birkenhead at para [39]).

[42] Consistently with the statutory purpose, it is not only necessary but also sufficient that the taxpayer should have incurred capital expenditure in acquiring an asset for the purposes of trade. The focus is on the party who acquires the asset. It does not matter what the party who disposes of the asset does with the money (see *Barclays* at para [39] per Lord Nicholls of Birkenhead). It is therefore quite wrong to suggest that the purpose of the statutory depreciation regime, when invoked by persons who have incurred a liability to pay a capital sum to acquire a film, is not satisfied unless the disponor applies the proceeds in making the film. If the commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke s 99 to disallow the deduction.

[43] This, however, the commissioner never succeeded in doing. The inflation of the costs of making the film meant that the production company made a secret profit at the investors' expense; but it did not alter the fact that they incurred a liability to pay $x+y to the production company in accordance with the contract to acquire the film. The costs of making the film were incurred by the production company, and these must not be confused with the costs incurred by the investors, which were the relevant costs in respect of which the deduction was claimed. The fact that the production company made a profit of $y at the expense of the investors did not mean that they did not suffer the economic cost of paying it. As Lord Diplock, speaking for the Board, said in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 at p 556:

> "Their Lordships' finding that the monies paid by the taxpayer company . . . is deductible under s 111 as the actual price paid by the taxpayer company for its stock-in-trade under contracts for the sale of goods entered into with Europa Refining . . . is

> incompatible with those contracts being liable to avoidance under [the predecessor of section 99]. In respect of these contracts the case is on all fours with *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 in which it was said by the High Court of Australia 'it is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income.' (ibid p 434) . . ."

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[44] The leverage obtained by use of a non-recourse loan meant that the investors did not sustain an economic loss after the tax deduction is taken into account. Their Lordships suspect that it is this feature of the scheme which has most exercised the commissioner. But a moment's reflection shows that what Lord Templeman had in mind was expenditure or loss *before* any tax advantage is taken into account. Tax relief often makes the difference between profit and loss after tax is taken into account; and a transaction does not become tax avoidance merely because it does so. The fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of $x+y. It was not and could not be suggested that either loan was on terms which meant that it was unlikely ever to be repaid. The investors have repaid one of the loans in whole or in part, albeit out of the film receipts; and they incurred a liability to repay the other if the film generated sufficient receipts, as it was hoped it would.

[45] The circular movement of money sometimes conceals the fact there is no underlying activity at all. But each of the payments in the circle must be examined in turn to see whether it discharged a genuine liability of the party making the payment. It does not matter whether external funds were introduced into the circle or whether cheques were handed over and duly honoured. If the money movements did not discharge a genuine liability the introduction of external funds will not save it; if they did, their absence will not affect it. In either case the payments are interdependent, in the sense that each of the payments is dependent on the receipt which funds it and each receipt on the payment by which it is funded. On the way in which the commissioner put his case the relevant payments were those by which the investors received the non-recourse loan and paid it out to the production company. Subsequent payments through the circle of which the investors were unaware and which they could not control or prevent did not alter the fact that they had borrowed $y and used it towards the discharge of their liability to pay $x+y to the production company, thereby suffering the loss or incurring the relevant expenditure for which the depreciation allowance is granted.

[46] The $x+y was ostensibly paid as consideration for the acquisition of the film, and while the commissioner was at pains to argue that it was never "truly" paid, it was no part of his case at any stage that it was paid for any other purpose. Before the Board he conceded that it was paid as consideration for the making of the film. Their Lordships consider that this concession, which was inevitable from the way in which the commissioner has conducted the case throughout, is fatal to his case.

Could the commissioner have challenged the nature of the consideration for the payment?

[47] Their Lordships wish to make it plain that they have reached their conclusion on the facts agreed or found by the TRA, the way in which the commissioner has put his case from time to time, and the allegations and concessions which he has made. They should not be understood as deciding that, had the necessary allegations been made and the necessary facts found, he might not have successfully challenged the investors' case that the obligation to make a payment of $x+y which they incurred was exclusively incurred as the consideration for the acquisition of the film.
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[48] The starting point would be for the commissioner to obtain a finding of the TRA that the loans were made on uncommercial terms such that no commercial lender would advance money unless it received some additional consideration for doing so. But this was never alleged by the commissioner, established by evidence or found by the TRA.

[49] The next step would be to consider the disbursement of the $y by the production company. The production company paid the money away immediately it was received. The payment is not recorded in the production company's books, has never been explained and appears to have been made without consideration. Such a payment would normally be improper. It is more likely that it was properly made but for a consideration which it was considered impolitic to disclose. The commissioner could plausibly invite the TRA to infer that the production company agreed to recycle the money to the lender in order to procure it to make the loan to the taxpayers. But he never did so, and the TRA made no such finding in either case.

[50] On these facts the commissioner could contend that the investors paid the production company $x+y not merely as consideration for the acquisition of the film but also for its services in procuring the lender to make the loan to them. The argument would be particularly cogent in the case of *Utu*, where it could be said that the investors did not merely indirectly procure the lender to make the loan by paying $y to the production company, but the lender's ability to lend $y to the investors depended on the indirect receipt of $y from them.

[51] The production company attributed the whole of the consideration of $x+y which it received from the investors as consideration for making the film and nothing as consideration for procuring the loan. Where, however, a single consideration is given for the supply of two or more goods or services the commissioner is probably entitled even without s 99 to go behind the allocation agreed between the parties and allocate the consideration among the several goods or services for which it was paid on a proper basis. The commissioner could argue that $x should be treated as paid to the production company as consideration for making the film and $y for procuring the loan. On this basis $y would not form part of the cost of acquiring a depreciating asset and would not qualify for the deduction claimed.

[52] If such an argument were countered by the investors' ignorance of the scope of the arrangements which had been made on their behalf (as to which Their Lordships say nothing) the commissioner could contend in the alternative that the arrangement by which the production company allocated the payment of $y as part of the consideration for acquiring the film instead of as consideration for the procurement of the loan (which affected the investors whether or not they were parties to it) could be counteracted under s 99.

[53] The commissioner, however, has never put any such case forward, it is not supported by the necessary evidence or findings, and it is contrary to a concession made before the Board. It cannot be said to be unanswerable; and it is not open to Their Lordships to adopt it.

Conclusion

[54] Their Lordships will humbly advise Her Majesty that both appeals should be allowed and the orders of the Court of Appeal set aside, and that the order of the High Court in *The Lie of the Land* should be restored and a similar order (mutatis mutandis) made in *Utu*. The commissioner must pay the costs of the appellant of both appeals before the Court of Appeal and the Board.

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LORD BINGHAM OF CORNHILL AND LORD SCOTT OF FOSCOTE.

...

The facts

[66] The two films whose production has led to the dispute with the commissioner were *The Lie of the Land* and *Utu*. They were produced by, and the arrangements for raising the finance for their production was orchestrated by, Mr McLean in the case of *The Lie of the Land* and a Mr Blakeney in the case of *Utu*. In both cases the producers were anxious to raise finance from investors in order to meet the expected costs of production. But, as has been mentioned, capital provided for film production is high-risk capital. An attractive inducement must be offered to investors if they are to be persuaded to risk their capital in such a venture. One such inducement is, of course, the possibility of high reward if, against the odds, the film should turn out to be a box office success. Fortunes are possible. In addition, the tax advantages offered by IR 52.3 are an inducement. The investor knows that he can depreciate over two years 100 per cent of his contribution to the cost of production. The depreciation will be an allowable deduction from his taxable income. If he is a high-rate taxpayer, paying tax at the top marginal rate of 66 per cent, and we imagine that most investors in film production would fall into that category, the investor can recover via tax deductions 66 per cent of his investment even if the film does not earn a penny. But Mr McLean and Mr Blakeney were not content to offer merely those inducements. They wanted to offer something more. Each of them represented to the investors that the cost of production would be a significantly higher sum than the true expected cost. In each case the producer invited investors to meet the cost of production in two ways: first, by providing the producer with a cash sum and, secondly, by making available to the producer the proceeds of a non-recourse loan. In each case the amount of the non-recourse loan was, roughly, the amount by which the cost of production had been inflated by the producer's representations. The terms of the respective deeds of loan entered into by the investors had differences, some of them important, but both had in common the feature that the borrower had no personal liability in any circumstances to repay anything at all or to pay any interest to the lender. Repayment of the loan and payment of interest to the lender were to be made solely out of the income produced by the venture. If the venture produced no income, nothing would be paid. The lender would lose his money but the borrower would not

be out of pocket. But the borrower, the film investor, would be entitled, under IR 52.3, to depreciate the amount of the non-recourse loan in the same manner as he could depreciate the amount of the cash he had paid. So, without incurring any risk over and above the risk of losing the cash he had paid and in respect of which he was entitled to tax deductions, the investor would be entitled to tax deductions equal to 100 per cent of the amount of the non-recourse loan and thereby to tax savings equal to 66 per cent of that amount.

[67] The attraction to an investor of the tax deductions attributable to a non-recourse loan can be easily demonstrated. Take the example of an investment of $20,000 provided as to $10,000 by a cash payment and as to the other $10,000 by a non-recourse loan. If the film were to fail the investor would

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stand to lose only his $10,000 cash payment. The $10,000 non-recourse loan would, theoretically at least, be a loss to the lender. But, whether the film were to succeed or fail, the investor, assuming he paid tax at the marginal rate of 66 per cent, would obtain a tax saving of 66 per cent of $20,000, that is, $13,200. At worst, therefore, the investor would be $3200 to the good. He could not lose and would stand only to gain.

[68] But what of the non-recourse loan lender? The lender stood to lose his money. The lender was, on the face of it, providing risk capital, the recovery of which depended on the success of the film. But in the case of both films the money that was being provided by the lender was not needed to fund the production of the film. The representations about the cost of production, made by the producers, were false. So it is not surprising to find that in the case of each film the non-recourse loan money, after apparently being made available by the lender to the investors and by the investors to the production company, travelled a circuitous route unconnected with the cost of production of the film and, after a few days, found its way back to the lender.

[69] The investors did not know that the cost of production had been inflated by the producers in order to justify the representation that there was a commercial need for the non-recourse loans. They did not know that the money representing the non-recourse loans had, very shortly after apparently being made available for the cost of production, travelled back to the lenders. They were apparently innocent dupes.

[70] The description in the foregoing paragraphs of the arrangements made by the respective producers has been painted with a broad brush. There were in fact differences between the arrangements made regarding *The Lie of the Land* and those made regarding *Utu*. It is necessary to add a little detail.

The Lie of the Land

[71] The detailed facts are to be found set out in the judgment of 12 March 1999 of the Taxation Review Authority (the TRA), in which the appellant's objection to the disallowance of a tax deduction in respect of his share of the non-recourse loan was upheld, in the judgment of 19 February 2002 of Hammond J, in which the commissioner's appeal against the TRA judgment was dismissed, and again in the judgment of the Court of Appeal of 19 February 2003 (delivered by Gault J) which allowed the commissioner's appeal. It is not necessary to repeat these details here but we would draw attention to some of the terms of the non-recourse loan and to the manner in which the loan money was dealt with.

[72] The terms of the non-recourse loan are to be found in the deed of loan dated 5 July 1984. The parties were Steadfold Ltd, described as "of Andorra" but in fact an English company, and South Pacific Broadcasting Corporation Ltd and Company, described as "a Special Partnership established under the provisions of Part II of the Partnership Act (NZ) 1908 acting through its General Partner South Pacific Broadcasting Corporation Limited". South Pacific Broadcasting Corporation Ltd and Company (SPBCC) was the investment vehicle, shares in which were taken by the investors. South Pacific Broadcasting Corporation Ltd (SPBC) was the general or managing partner of the special partnership. Mr McLean was a director of SPBC and signed the deed on behalf of SPBC and, thereby, on behalf also of SPBCC.
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The commissioner's investigations failed to discover whether Steadfold had ever carried on any business (other than being the lender under the deed of loan). Its name was removed from the register of companies in 1987.

[73] The deed recited that:

> "[SPBCC] intends to make and produce in New Zealand for sale and exploitation worldwide a film [*The Lie of the Land*] at a total cost of approximately $NZ2,760,000 to be financed by cash contributions of [SPBCC] totalling $NZ1,200,000 and borrowings of $NZ1,560,000."

Steadfold agreed to advance the $1.56m to SPBCC on the terms and conditions set out in the Deed. Clause 3(a) of the deed assigned to Steadfold the right to exploit and market the film in the home video market in the United States of America and required all net receipts therefrom to be applied in repayment of the loan. But net receipts from the exploitation and marketing of the film everywhere other than in the United States of America were to be applied first in repaying to the SPBCC partners their $1.2m cash contributions plus any income tax payable on those receipts. In other words these net receipts were to be applied first in producing a sum which after deduction of income tax at 66 per cent would produce $1.2m. That sum was to be applied in reimbursing the investors their respective contributions to the $1.2m. Only after that had been done were the net receipts (other than any United States receipts) to go towards repayment of the loan and interest thereon (at 10 per cent pa with yearly rests). A final provision of the deed that must be mentioned is para 3(c), which expressly limited Steadfold's right to repayment of the loan and interest thereon to the rights already referred to and stated that:

> "the Lender shall have no recourse against the Borrower in respect of the loan or interest thereon."

[74] The terms of this deed of loan do not seem to us to allow the loan to be described as a commercial non-recourse loan. Would a commercial lender advance capital where repayment entirely depended on the success of the film to be produced with the advanced money, where the borrower's own investment in the production was to be repaid free of tax out of income generated by the film before any repayment of the advance or payment of any interest thereon to the lender could be made, and where the rate of interest on the loan was no more than 10 per cent? We think the answer must be No.

[75] We now come to the way in which the $1.56m was made available to Filmcraft, and to the fate of the money. Leigh Carr & Partners were a firm of London accountants whose clients included Mr McLean or Filmcraft (or both). Mr Ralph de Souza was a partner in Leigh Carr. In a telex from Mr McLean to Mr de Souza sent shortly before 19 June 1984, Mr McLean gave Mr de Souza these instructions:

> "1. You will receive a cheque from Steadfold Ltd for UK £ 702,000.
> 2. Please deposit same in Leigh Carr Trust Account then establish escrow for special partnership [that is, SPBCC].
> 3. Send telex to Euan Wright Arthur Young & Co . . . advising that you have received funds being loan from Steadfold and request instructions.
> 4. You will receive instructions by telex to pay Creative Arts Ltd.
> 5. Creative Arts will repay the loan."

On 19 June 1984 Mr de Souza telexed Mr Wright of Arthur Young & Co in New Zealand confirming that his firm had received "funds being loaned from Steadfold" and requesting instructions. The funds received were £ 702,000, the equivalent at the then rate of exchange of NZ$1.56m. And, finally, a telex dated 19 July 1984 from Arthur Young & Co in London to Mr Wright in New Zealand said that Mr de Souza had confirmed that Steadfold had paid Leigh Carr £ 702,000 and that Leigh Carr had paid Creative Arts Ltd the £ 702,000.

[76] Creative Arts was a company incorporated in Liberia. It appears to have carried on business from Jersey, in the Channel Islands. It too was a client of Mr de Souza, and there was some evidence that it was controlled by Mr McLean (see para [14] of the Court of Appeal's judgment). Creative Arts was party to an agreement dated 14 June 1984, the other parties to which were Filmcraft and South Pacific Media Distributors Ltd (SPMD), a company of which Mr McLean was governing director. The agreement said that in return for $1.56m, which Filmcraft was to pay to Creative Arts, Creative Arts would procure for the purposes of *The Lie of the Land* the acting services of a named actress and various other services required for the production, marketing and exploitation of the film. This agreement, signed by Mr McLean on behalf both of Filmcraft and SPMD, might be thought to explain why Mr McLean instructed Mr de Souza to pay the £ 702,000 to Creative Arts. But the clear inferences to be drawn from Filmcraft's draft accounts for the relevant years were that the services for which Filmcraft had apparently paid Creative Arts $1.56m were in fact all paid for by Filmcraft itself.

[77] There was no positive evidence of any payment by Creative Arts to Steadfold. But there were two items of evidence which supported the inference that the £ 702,000 found its way back to Steadfold. First, there was the telex from Mr McLean to Mr de Souza saying that "Creative Arts will repay the loan". Secondly, a handwritten note was found in Mr McLean's London office which said "Asked J Ruther to lend money + circle same day". Mr J Rutherford was the director of Steadfold who signed the deed of loan on Steadfold's behalf. No record of the receipt by Filmcraft of the £ 702,000 (or of $1.56m) from Steadfold (or the investors) or of the payment of that sum by Filmcraft to Creative Arts appeared in any of Filmcraft's accounts.

[78] The Court of Appeal expressed the opinion that "on the evidence . . . it was open to the Commissioner to take the view that the amount of the non-recourse loan had been returned to Steadfold in repayment of the loan". We agree with this. Any other conclusion would be shutting one's eyes to the obvious.

Utu

[79] As with *The Lie of the Land*, the *Utu* facts are to be found set out in the judgments of the TRA, Hammond J and the Court of Appeal, each of which dismissed the appellant's objections to the commissioner's disallowance of the tax deductions in issue. It is not necessary to repeat all those details here. A brief summary will suffice. It was represented by Mr Blakeney to the investors that the expenditure expected to be incurred for the production and marketing of *Utu* was $3.1m (see para 3.2 of the deed of production dated 20 March 1982). The production company was Utu Productions Ltd, a company controlled by Mr Blakeney. Paragraph 4.1(c) of the deed of production required the investors to make the $3.1m available to the production

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company in tranches with 50 per cent of the amount to be paid by 1 April 1982. But para 4(d) said that no investor would be obliged to contribute any amount unless a "Loan Contribution" at least equal to 50 per cent of the amount to be contributed had been provided under the proposed deed of loan. The deed of loan provided, therefore, for a non-recourse loan of $1.55m to be made available to the investors.

[80] The "lender" in respect of the $1.55m non-recourse loan was to be Utu Funding Ltd, a company incorporated in New Zealand on 17 March 1982 with a share capital of $100. Ninety of the 100 shares were owned by Mr Blakeney. Utu Funding was plainly in no position to provide the $1.55m from its own resources. But US$800,000 (equivalent to NZ$1.143m at the then rate of exchange) was to be made available to Utu Funding by Glitteron Films Ltd under a loan document dated 1 August 1982 and $350,000 was to be provided to Utu Funding by the New Zealand Film Commission (the NZFC). Glitteron Films was a shadowy company incorporated in Hong Kong. The identity of those who controlled the company was never established. Much time appears to have been taken before the TRA in examining the reality of the US$800,000 loan which Glitteron Films purported to have made to Utu Funding and the judgment of the TRA records at p 8 that:

> "By the end of the hearing the objector conceded that the 'loan' from Glitteron was never made."

[81] As to the $350,000 that the NZFC was to make available to Utu Funding, the provenance of this is explained in a letter dated 12 March 1982 from Mr Blakeney to the finance director of the NZFC. The letter said that:

> "The private investors will not part with their money until they are satisfied that the project is fully funded and that loans arranged by Utu Funding Ltd are available."

and then went on to propose that:

"(a) The NZFC pay Utu Funding Ltd $350,000.
(b) Utu Funding Ltd pay Wilkinson Wilberfoss Trust Account $350,000.
(c) Wilkinson Wilberfoss pay Utu Productions Ltd $350,000.
(d) Utu Productions Ltd pay the NZFC $350,000."

Wilkinson Wilberfoss were the firm of accountants advising the investors. The TRA succinctly summed up this "loan" arrangement:

> "The proposal was a fraud on the investors. It was intended to induce them to believe (and they did believe) that the Film Commission had loaned $350,000 to Utu Funding Ltd for use in making the film. In fact it had not and at that time was never intended to. With the full knowledge of the Film Commission, they were only out of pocket for $350,000 overnight. The money was returned to them the next day."

[82] There is no suggestion that the investors or Wilkinson Wilberfoss knew that the $1.55m "loan" by Utu Funding was not intended to meet production costs. As Hammond J commented:

> "The loan from Utu Funding flowed in a complete circle by way of a round robin of 13 cheques. This was a fraud on the investors and was designed to cause the investors to put in their own cash."

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[83] The falsity of the arrangements regarding this non-recourse loan was not confined to the misrepresentations made to the investors to induce them to part with their own money. In addition, false invoices, totalling $1,152,010, were produced purporting to show how the money had been spent (see para [10] of Hammond J's judgment).

[84] The deed of loan which set out the terms on which the non-recourse loan would be made available was dated 20 March 1982. The parties were Utu Funding and the investors. The $1.55m was to be made available to the investors in tranches to be paid on the same dates as those specified in the production deed for the payments the investors were to make to Utu Productions Ltd. Paragraphs 3.1 and 3.2 of the deed of loan provided, in effect, that instead of the right to require repayment by the borrowers of the loan (with interest at 15 per cent pa), the lender would receive a specified percentage of the "Net Proceeds of the Exploitation" of the film that were received by the borrowers.

[85] The terms of this deed of loan were not so obviously uncommercial as those of *The Lie of the Land* deed of loan. But for present purposes the terms do not perhaps matter because it seems clear that no part of either of the non-recourse loans was applied in payment of any of the costs of production or distribution of the films.

[86] A distinction between *The Lie of the Land* and *Utu* that should be mentioned is that *Utu*, unlike *The Lie of the Land* which never achieved a commercial release, was a great box office success. Repayment of the amount of the non-recourse loan was, presumably, made out of the receipts. Whether the loan was in fact repayable, having regard to the TRA finding that the Glitteron loan to Utu Funding never took place, is questionable. But nothing, for present purposes, turns on these post-production and distribution events.

Conclusions

[87] In relation to each of these films, was there an "arrangement made or entered into . . ." for s 99(2) purposes? It seems to us clear that there was. The steps taken in order to induce investors to invest money in the production of the films fit very easily within the definition of "arrangement" in subs (1). The "plan" included in each case the following features: (1) representations were made to investors about the expected cost of production and marketing that deliberately inflated the expected cost; (2) it was intended that the amount of the inflation would be met by a non-recourse loan; (3) it was intended that the sum advanced by means of the non-recourse loan would not be applied in meeting any of the costs of production or marketing but would, after the lapse of no more than a few days, be returned back to the lender; (4) false or misleading documents were to be created in order to conceal the fact that the money had not been used in meeting any of the costs of production or marketing and in order to serve the pretence that the money had been so used; and (5) the purpose of the plan was to allow the investors to claim tax deductions equal to the face value of the non-recourse loan. The plan was carried into effect. It seems to us clear that this plan was an "arrangement" as defined in s 99(1).

[88] The next question is whether the purpose or effect of this "plan" or "arrangement" was tax avoidance (s 99(2)). The purpose was to produce a capital sum that could, for IR 52.3 purposes, be treated as part of the cost of

production of the film, thereby enabling the borrower to claim tax deductions equal in amount to that capital sum. The appellant says that the effect of the plan, once it had been implemented, was to entitle the investors to those tax deductions. The obtaining of the right to make deductions from assessable income is, in ordinary language, obtaining a tax advantage. In our opinion, this "plan" or "arrangement" is clearly within the language of subs (2). If that is so, then the mandatory consequence imposed by subs (3) would seem to follow: ". . . the assessable income . . . of any person affected by that arrangement *shall* be adjusted in such manner as the commissioner considers appropriate . . ." (emphasis added).

[89] But the question still to be answered is whether the "tax advantage" obtained by the investors from the arrangement should be regarded as acceptable tax mitigation, and thus free from attack under s 99. On this critical question a number of considerations have been pressed on behalf of the appellant. It has been stressed that the investors were ignorant of the various falsities for which the producers (Mr McLean and Mr Blakeney) were responsible. They (the investors) thought that the sum to be advanced as a non-recourse loan was needed for, and would be used for, the costs of production and marketing of the film. The investors were not part of the consensus underlying the "plan" or "arrangement" as described; they were not parties to it. We would accept, on the findings of the Courts below, that that is so. But subs (2) says, in terms, that the arrangement "shall be

absolutely void as against the Commissioner . . . whether or not any person affected by the arrangement is a party thereto". The fact that the investors were not parties to the arrangement cannot be enough to allow them to escape s 99. Any other conclusion would involve a judicial rewriting of s 99(2).

[90] It is said that the whole of the $2.76m in the case of *The Lie of the Land* and of the $3.1m in the case of *Utu* constituted the cost required to be paid and actually paid by the investors to acquire their rights in the respective films, that IR 52.3 allows depreciation of the cost of acquisition of film rights as well as the cost of production of film rights (see para [62] above) and, therefore, that they, the investors, were doing no more than claiming the tax deductions that the statutory regime intended they should have. The case, they say, should be regarded as acceptable tax mitigation.

[91] It has been suggested, in support of the argument referred to, that if an investor is asked to pay and agrees to pay an inflated price for the film rights in a particular film, he is entitled under IR 53.2 to depreciate the whole of the cost of acquisition, whether inflated or not. We doubt this proposition. The statutory right to depreciate an item of cost and to deduct the amount of the depreciation from assessable income is plainly a tax advantage. Whether it is a tax advantage vulnerable to attack under s 99 depends, in our opinion, on whether it is within the purpose of the statutory regime. We cannot believe that, if the cost of acquisition of a film is inflated for no commercial reason other than that of qualifying for a higher tax deduction than would otherwise be available, the amount of the inflation could be regarded as the sort of cost that the statutory regime was intended to assist or encourage. In any event, in the present case the

amount of each non-recourse loan was not presented to the investors as a premium on the cost of production that they had to pay. It was presented to them on the basis that the amount was needed for the cost of production and that it would qualify for depreciation as part of the cost of production. The non-recourse loan was, in fact, nothing of the sort but was no more than a device to produce a higher capital sum to be depreciated and, thereby, a higher tax deduction. Moreover the amounts represented by the non-recourse loans were not received by the respective production companies as premiums that had to be paid as part of the investors' acquisition costs. They were not recorded in their books as having been received at all.

[92] If the approach recommended by Richardson J in the *Challenge* case is followed (see para [61] above) it seems to us that these appeals cannot succeed. The arrangements devised by Mr McLean and Mr Blakeney were tax-avoidance arrangements of a plainly undesirable kind and of a kind that cannot, in our opinion, be reconciled with the statutory purpose of encouraging investment in the production of films. To hold that the apparent ignorance of the investors excuses them from vulnerability to the statutory avoidance measures provided by s 99 would be, in our opinion, to emasculate the section. We are not willing to be party to that emasculation and would advise that these appeals ought to be dismissed.

Postscript

[93] Since writing the above dissent we have had the advantage of considering the full reasons of the majority as set out in the opinion prepared by Lord Millett. We respectfully concur in the conclusions expressed by Lord Millett at paras [33] and [34] of the opinion and that the "critical question" (para [35]) is whether the tax advantage obtained by the investors

amounted to "tax avoidance" for the purposes of s 99. The opinion of the majority that it did not appears to us to be based on the proposition that, on the facts as found by the TRA in each case, the $y (adopting Lord Millett's symbolism) represented a payment by the investors to discharge a "genuine liability" (see para [45]), with the consequence that it could be characterised as a "fact" that they had suffered "the economic burden" of paying the $y (para [44]).

[94] We would protest that this representation of the $y not only is not supported by, but indeed is inconsistent with, the TRA's findings of fact.

Utu

[95]

(i) At p 2 of the TRA judgment it records that it was accepted by the investors that "the loan transactions which evidence these purported payments were . . . a fraud on the investors".

(ii) At p 8 the TRA record that the investors "conceded that the 'loan' from Glitteron *was never made*, conceding that this aspect of the transaction was a fraud on the investors and therefore a sham for tax purposes" (emphasis added).

(iii) At p 11, the TRA refer to the $350,000 allegedly loaned by the Film Commission to Utu Funding and say "The proposal was a fraud on the investors intended to induce them to believe (and they did believe)
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that the Film Commission had loaned $350,000 to Utu Funding Ltd for use in making the film. *In fact it had not* and at that time was never intended to" (emphasis added).

(iv) At p 15, the TRA repeat that ". . . in this case there is no evidence of such loans" and say that "This was a transaction involving the making and selling of a film for a sum of money significantly less [that is, by $y] than that alleged by the objector".

[96] We would respectfully suggest that in the face of these findings the contention that the TRA found as a fact that the investors had paid the $y is unsustainable. The source of the $y that the investors allegedly paid was the non-recourse loans. But the loans were never made. The investors were unaware of the falsity of the representations that had led them to think that $y had been expended on their behalf, but a clearer case can hardly be imagined of an arrangement that has not in fact involved the taxpayer "in the loss or expenditure which entitles him to that reduction" (per Lord Templeman in the *Challenge* case cited at para [37] of Lord Millett's opinion).

[97] As to the alleged repayment of the *Utu* loan via the receipts earned by the film on its commercial release, since, as the TRA found, neither the Glitteron loan nor the Film Commission loan was ever made, the retention of receipts to be applied in repayment was unlawful and the "lender" would be accountable to the investors for those receipts. So, too, in our opinion, would be the individuals and companies responsible for the false representations on which the investors acted.

The Lie of the Land

[98] The TRA's findings of fact regarding *The Lie of the Land* non-recourse loan are less clear cut than those regarding the *Utu* loan, but we think they lead to the same conclusion. They show:

(i) that the accounts of the alleged recipient of the $1.56m loan money from the investors, that is, Filmcraft, showed no record of receipt of the money (p 9);

(ii) that although the purported application of the $1.56m loan was a payment of that sum by Filmcraft to Creative Arts for "services", the accounts of Filmcraft contained no record of such a payment having been made or of any services rendered by Creative Arts (pp 8, 9 and 22); and

(iii) in relation to the evidence suggesting that there had been an arrangement for the loan money to travel in circular fashion from Steadfold (the lender), to Filmcraft, to Creative Arts and back to the lender, that the investors had not been aware of this arrangement (pp 11 and 12).

The TRA took the view that, since the investors had not known of this intended circularity, it did not detract from their claim that the $1.56m, the $y, represented a loan to and expenditure by them qualifying for a depreciation allowance. It is implicit, however, in the TRA findings that they accepted the fact of this circularity.
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[99] The Court of Appeal concentrated, at paras [31] and [34], on the fact that the loan had apparently been repaid to the lender very shortly after it had been made:

> "In our view [the] crucial issue is whether or not the loan from Steadfold to the partnership was repaid . . ."

They pointed out that if the loan had been repaid, nothing remained owing by the investors and there was nothing left of $y to depreciate (paras [32] - [34]).

[100] The description in Lord Millett's opinion of the circumstances in which a s 99 challenge to an "arrangement" could properly be made seem to us to fit the *The Lie of the Land* circumstances.

(i) At para [42] it is said that the commissioner needed to show that the investors "had not suffered the economic burden of [the] expenditure before tax which Parliament intended . . .". But, if the true position was that the loan had been repaid to Steadfold by Creative Arts, that indeed was the position (see also para [44] where there is another reference to the investors suffering the "economic burden of paying the full amount of $x+y"). They did not pay the full or any part of the $y. The money was returned to the lender by Creative Arts.

(ii) At para [43] it is said that the inflation of the costs of making the film meant that the production company made a "secret profit at the investors' expense" but did not alter the fact that the investors

had incurred a liability to pay $x+y. But there was no "secret profit". The $1.56m, the $y, simply travelled in a circle. It did not end up with Filmcraft. The fraudulent misrepresentation was not intended to enrich Filmcraft; it was intended to boost the depreciation allowance and thereby induce investors to support the film by investing the $x. Filmcraft did not make a profit of $y at the expense of the investors. The analysis at para [43] is not in accordance with the facts.

(iii) At para [45] there is reference to the "money arrangements" discharging a "genuine liability". There is no evidence that the movement of the money from Creative Arts to Steadfold was in discharge of any liability other than that created by the arrangement under which Steadfold made the money available in the first place.

[101] The issue regarding the $y, so far as *The Lie of the Land* is concerned, is whether the Courts, in deciding whether s 99 can be employed to reverse the undoubted tax advantage that would otherwise be claimable, must shut their eyes to what happens to the $y after it has left the hands of the investors. The majority have taken the view that that is the position. But in our opinion to so hold would deprive s 99 of its proper effect in relation to transactions such as these. If the later events show that the money, the $y, had nothing to do with the cost of production of the film, and nothing to do with the price that the vendor of the film wanted to extract for the rights in the film that he was selling, but

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was simply a means of boosting the depreciation allowance that could be claimed, we find it extraordinary to rule out the application of s 99. We confirm our dissent.

Appeal allowed.

Reported by: Tania Richards, *Barrister*

THE PETERSON CASE AND ITS IMPACT ON THE RULES IN BNZ INVESTMENTS LTD AND CECIL BROS

JOHN PREBBLE[1]

I.

The Privy Council delivered its advice in the film shelter case of *Peterson v Commissioner of Inland Revenue*[2] on 28 February 2005, allowing Mr Peterson's appeal and discharging the Commissioner's assessment. Tax practitioners in general welcomed the result. Mr David Patterson, for instance, described the decision as a "great victory for the little man".[3] The "little man" in question is no doubt a little investor whose income is high enough to make it worthwhile to invest in tax shelters, rather than a run-of-the-mill little taxpayer.

The *Peterson* tax case was indeed a notable win for Mr Peterson, but this chapter argues that in a broader context it was a major victory for the Commissioner of Inland Revenue and for taxpayers who do not invest in shelters. The Privy Council put paid to several judicial heresies that threatened to enfeeble section BG 1 of the Income Tax Act 2004, the Commissioner's heaviest anti-avoidance artillery. Perhaps even more importantly in the long run, their Lordships interpreted the legalistic deduction rule in *Cecil Bros Pty Ltd v FCT*[4] almost into oblivion and recognized powers of apportionment in the Commissioner that no one thought he possessed.

The Commissioner won every point of strategic significance. Mr Peterson won the battle because of what three of their Lordships, the majority, saw as a tactical error in the Commissioner's case. If error it was, it was an error that the Commissioner can easily remedy in future litigation. If any of Mr Peterson's co-investors still have objections outstanding they should strike camp and go home, because the judgment contains a detailed forensic template for the Commissioner to win against them

The case involved two films, *Lie of the Land* and *Utu*, The story of *Utu* sufficiently illustrates the facts of the case for

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[1] BA, LLB (hons) Auckland; BCL Oxon; JSD Cornell; Inner Temple. Barrister. Professor and former Dean of Law, Victoria University of Wellington.

[2] (2005) 22 NZTC 19,098 PC.

[3] *National Business Review*, Auckland, 4 March 2005, 19.

[4] (1964) 111 CLR 430.

purposes of the discussion in this chapter.[5] *Lie of the Land* was not very different, except that while *Utu* was a commercial success, *Lie of the Land* was never issued. Apparently important though this difference might seem to be, it was not of material significance to the decision of either the majority or the minority.

II.

Mr Peterson and others invested in the films. They deducted their investment against their other income. They claimed half the cost each year for two years. These deductions were allowances for depreciation of the value of the films from cost to zero over 24 months.

The Privy Council explained that the true cost of making and marketing the films was $x, but the promoters pretended that the cost was $x+y. $x+y was more than twice $x. For simplicity of explanation, the minority of Lords Bingham of Cornhill and Scott of Foscote postulated that $x was $10,000 and $x+y was $20,000.[6] Assume on these figures that Mr Peterson and nine others each invested $1000, enough in aggregate to cover the true cost of the film ($x) but only half of the pretended cost ($x+y).

The promoters kept secret that the true cost was $10,000. The investors thought that it was $20,000. To cover the shortfall, the investors were each to borrow another $1000 and invest that sum in addition, making a total cost for each investor of $2000. In respect of *Utu*, the money was to be borrowed from a company called "Utu Funding Ltd". Utu Funding had no resources of its own, but was to borrow from two sources, to be described below.

The borrowings were non-recourse. That is, individual investors were not liable to repay. On the documents, the lenders would get their money back only if the film was profitable, and even then the lender did not rank before the borrowers for distributions of profits but shared with the

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[5] The cases involving the two films were reported separately when they were before the lower courts. Reports of the *Utu* case contain facts additional to those in the advice of the Privy Council. *Case U 32* (2000) 19 NZTC , 9,302, Willy DCJ, Taxation Review Authority, *Peterson v Commissioner of Inland Revenue (No 2)* (2002) 20 NZTC 17,761 Hammond J, (2003) 21 NZTC 18,069 CA.

[6] *Peterson v Commissioner of Inland Revenue* (2005) 22 NZTC 19,098, [67] per Lord Bingham of Cornhill and Lord Scott of Foscote, dissenting.

borrowers. The documents mentioned interest of 15 per cent[7] but only to say that it would not be charged.[8]

> Paragraphs 3.1 and 3.2 of the Deed of Loan provided, in effect, that instead of the right to require repayment by the borrowers of the loan (with interest at 15 per cent per annum), the lender would receive a specified percentage of the "Net Proceeds of the Exploitation" of the film that were received by the borrowers.

Do such generous lenders exist? The Taxation Review Authority was sceptical. It found as regards *Utu* that $350,000 of the loan came from the New Zealand Film Commission but went back to the Commission the next day. The Authority said that this transaction was a fraud on the investors. The transaction induced them to believe that the money was for making *Utu*. The Film Commission knew that it was not.[9]

Mr Peterson conceded that the rest of the money purportedly borrowed for *Utu* ($US800,000 from Glitteron, a "shadowy company incorporated in Hong Kong"[10]) was never borrowed at all,[11] which entailed an irresistible inference that it could not have been spent on the film. This did not matter to the producers, because the investors' $x was enough to make the film. The purportedly borrowed $y was always going to be surplus to requirements. (Mr Peterson was not aware of these facts at the time; they became apparent after investigation.)

Why all this complexity, when the films were able to raise their costs from direct investor contributions, without anyone borrowing anything? The answer is tax saving. On the hypothetical figure of a total contribution of $2000 to the cost of the film, each investor qualified for a tax deduction of $2000 spread over two years. The cost of this saving was the taxpayer's contribution from his own cash resources of $1000. The second $1000 that the taxpayer contributed was at no cost: it was borrowed money that the taxpayer did not have to repay, and, as it happened, did not even borrow. The result was that:

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[7] The Taxation Review Authority, Willy DCJ, recorded the rate as 18 per cent. *Case U 32* (2000) 19 NZTC , 9,302, 9,306.

[8] *Peterson v Commissioner of Inland Revenue* (2005) 22 NZTC 19,098, [84] per Lord Bingham of Cornhill and Lord Scott of Foscote, dissenting. Curiously, their Lordships' description of the terms of the deed of loan are much more detailed than the descriptions in the judgments in the courts below, *Case U 32* (2000) 19 NZTC , 9,302, Willy DCJ, Taxation Review Authority, *Peterson v Commissioner of Inland Revenue (No 2)* (2002) 20 NZTC 17,761 Hammond J, (2003) 21 NZTC 18,069 CA.

[9] *Case U 32* (2000) 19 NZTC , 9,302, 9,309, Willy DCJ.

[10] Ibid, [80].

[11] Idem.

> [W]hether the film were to succeed or fail, the investor, assuming he paid tax at the marginal rate of 66 per cent, would obtain a tax saving of 66 per cent of [$2000, namely $1320]. At worst, therefore, the investor would be [$320] to the good. He could not lose and stood only to gain.[12]

That is, general taxpayer funds financed the total cost of the film and also delivered a fiscal bonus to individual investors of $320 per $1000 contributed. Without the loan, with only the cash contributions of $1000, investors would have suffered an actual cost of $340 and the general public a cost of $660 for each $1000 of expenses incurred.

III.

Since Mr Peterson in the end kept both his bonus and his deductions, why was the case a victory for the Commissioner? The answer lies in the reasons for Mr Peterson's win and in arguments that he advanced that were rejected.

Crucially, the Privy Council held that the *Utu-Lie of the Land* transactions were "tax avoidance scheme[s]"[13] that were potentially vulnerable to attack under section BG 1 (using the numbering in the Income Tax Act 2004). Mr Peterson argued first that even if this were so, he had not known about the avoidance; in particular, he had not known that the promoters had deceitfully inflated the purported cost of the film, though not its actual cost. Secondly, there had been no consensus between him and the promoters as to the ingredients of the scheme. Therefore, he said, section BG 1 should not apply to him.

These arguments relied on *Commissioner of Inland Revenue v BNZ Investments Ltd.*[14] There, in what must have been a brilliant argument, Mr AR Galbraith QC had persuaded both the High Court and the Court of Appeal that where the Commissioner alleges avoidance the taxpayer must have knowledge of the alleged tax arrangement and must be party to a consensus[15] as to its crucial details before the Commissioner can invoke section BG 1.[16] Thirdly, there was also a corollary, that if the tax benefit came not from a single scheme but from two interconnected schemes, and if the taxpayer knew the details of one scheme but not of the other,

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[12] Ibid [67] per Lord Bingham of Cornhill and Lord Scott of Foscote, dissenting.

[13] Ibid, [2].

[14] (2000) 19 NZTC 15,732 McGechan J; [2002] 1 NZLR 450, (2001) 20 NZTC 17,103 CA.

[15] [2002] 1 NZLR 450, [50], Richardson P, Keith and Tipping JJ.

[16] Ibid, [52]. Blanchard J agreed at [172].

then section BG 1 could not affect him.[17] Thomas J dissented on all three of these points.[18]

The courts in the *BNZ Investments* case adopted these ideas even though section BG 1 contains no such requirements and even though the Act says almost the opposite, in that what is now section GB 1 provides that when there is an avoidance scheme the Commissioner may (formerly, "shall") adjust the tax of anyone who is affected, *whether a party to the scheme or not*. The Commissioner must have welcomed the opportunity that Mr Peterson gave him to refer these issues to the Privy Council. The Commissioner was successful. Pointing out that section BG 1 expressly applies to non-parties, their Lordships preferred Thomas J's dissenting opinion in the *BNZ Investments* case and delivered the quietus to the judge-made rules that that case had added to the jurisprudence of anti-avoidance.[19]

We must accept that the Privy Council is correct in adopting an interpretation of section BG 1 that overrules the *BNZ Investments* case, but was their Lordships' interpretation of the law fair? People may agree that when investors buy into tax minimization schemes with full knowledge of the details they should repay the tax if the schemes fail as avoidance. But what of the investor who believed that he was embarking on no more than acceptable tax mitigation, later to discover that a scheme that was both secret and void lay behind the promoters' sales talk? The tax that was avoided has been lost to the fisc. Should investors in tax minimization schemes keep the benefit of deductions and fiscal bonuses that they have reaped, with the loss lying where it has fallen, on the taxpaying public, or should the loss bounce back onto the investors? Which of these two innocent parties should bear the loss? (The writer accepts that there are two points of view as to whether a taxpayer who invests in a shelter knowing that even if the project fails completely he will make an economic profit can accurately be called "innocent". But for purposes of the present argument, assume that the appellation is correct.)

In the *BNZ Investments* case, BNZ Investments kept its tax benefit and the public bore the cost. In the *Peterson* case, the Privy Council said that this outcome resulted from an incorrect interpretation of section BG 1, and even innocent investors should repay tax that they save as a result of someone else's avoidance arrangement,[20] albeit that Mr

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[17] Ibid, [56]. Blanchard J agreed at [178].

[18] Ibid, [130], (*semble*) [140].

[19] (2005) 22 NZTC 19,098 PC §34.

[20] *Peterson*, ibid [34], entails this conclusion.

Peterson himself did not suffer this consequence. No doubt, disgruntled investors can sue the promoters if they can find them, but that may not be much of a remedy.

IV.

In the face of all this, how did Mr Peterson win? He did so by relying on *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*[21]. That case says that when a taxpayer incurs an expense you look only at what the taxpayer is legally entitled to get for his money, and calculate fiscal results from there. Cecil Bros itself was a footwear retailer. It paid higher than market prices for some of its trading stock.

These higher prices came about because, rather than buy directly from its usual supplier, the controllers of Cecil Bros Pty Limited dealt through a third company, Breckler Pty Ltd for some of its trading stock. Breckler bought at wholesale and sold to Cecil Bros Pty Ltd at increased prices, the aggregate increase amounting to £19,777. Cecil Bros was willing to pay the higher prices because Breckler was owned by related parties who enjoyed lower rates of tax. The Commissioner disallowed the £19,777. The Australian High Court held that because Cecil Bros was a retailer it was entitled to deduct the cost of its trading stock. Legally speaking, the transactions netted Cecil Bros only trading stock; the economic benefit to Breckler and its shareholders should be ignored; so Cecil Bros could deduct the whole price, inflated though it was.

The Commissioner also relied upon the Australian general anti-avoidance rule, then section 260 of the Income Tax Assessment Act 1936. Section 260 avoided transactions that had the purpose or effect of tax avoidance, but unlike the New Zealand general anti-avoidance rule as it stood at the time of the *Peterson* case,[22] section 260 did not include a power of reconstruction. Holding that avoidance of the transactions between Cecil Bros and Breckler did not reveal that Cecil Bros' "real outgoings for its supplies were £19,777 less than the price it paid or that the additional £19,777 was not paid or was a gift to Breckler Pty Ltd,"[23] Menzies J, who delivered the leading judgment, averred that "To arrive at any such conclusion would ... be an unauthorized reconstruction of what occurred and, moreover, would not be in accordance with the true facts."[24] Had it been necessary to do so, Dixon CJ might have gone further. His Honour had "great difficulty in seeing how [section 260] could apply to defeat or reduce

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[21] (1964) 111 CLR 430 FC.

[22] Income Tax Act 1976 s 99.

[23] (1964) 111 CLR 430 FC

[24] Idem.

any deduction otherwise truly allowable under s 51,"[25] which is the counterpart of what is now section DA 1 of the New Zealand Income Tax Act 2004, the general deductions permission. Kitto,[26] Taylor,[27] and Windeyer[28] JJ agreed with the learned Chief Justice.

The *Cecil Bros* rule, sometimes called the "legal benefit" test, has been a thorn in the side of fiscal authorities ever since. In New Zealand, a conglomerate, the Todd group, called *Cecil Bros* in aid in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*,[29] sometimes known as the "second *Europa* case".[30] In that case, a Todd company, Europa Oil (NZ) Ltd, paid over the odds for petroleum products supplied by the multinational, Gulf Oil. The excess above an arm's length price made its way back to New Zealand in the form of an exempt dividend.

The courts allowed Europa Oil a deduction for the full price that it paid to Gulf because, legally, Europa Oil was entitled only to the product that it bought from Gulf.[31] Economically, Europa's expenditure also paid for the dividend, but the dividend went to another Todd company, and, according to the documents, only a third Todd company, not Europa Oil, had the right to enforce that payment. In the second *Europa* case the Privy Council held that the *Cecil Bros* test trumped section 108 of the Land and Income Tax Act 1954, a predecessor to section BG 1;[32] so the resulting tax minimization was not void as avoidance. The majority in *Peterson* quoted this well-known passage from the *Europa* case:[33]

> Their Lordships' finding that the monies paid by the taxpayer company ... is[34] deductible under section 111 as the actual price paid by the taxpayer company for its stock-in-trade under contracts for the sale of goods entered into with Europa Refining ... is incompatible with those contracts being liable to avoidance under [the predecessor of section 99]. In respect of

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[25] Ibid 438.

[26] Idem.

[27] Idem.

[28] Ibid, 442.

[29] [1976] 1 NZLR 546, PC.

[30] The "first Europa case" was *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] 1 NZLR 641, [1971] AC 760 PC.

[31] Ibid 555 line 30.

[32] [1976] 1 NZLR 546, 556 lines 40 – 50, PC

[33] Ibid, 556, per Lord Diplock, delivering the advice of the Board, quoted at *Peterson v Commissioner of Inland Revenue* (2005) 22 NZTC 19,098 [43] PC.

[34] Sic. The *Peterson* majority accurately quoted Lord Diplock in the *Europa* case.

> these contracts the case is on all fours with *Cecil Bros Pty. Ltd v Federal Commissioner of Taxation* (1964) 111 CLR in which it was said by the High Court of Australia "it is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income." (Ibid 434).[35]

Although this passage, and both *Cecil Bros* and the second *Europa* case, related to the general deductions rule, now known as the "general permission",[36] the majority in the *Peterson* case had no hesitation in applying the passage, and the *Cecil Bros* rule itself, to the depreciation allowances that Mr Peterson claimed. No doubt the basis for this cross-species infection was the unstated, but, it is submitted, reasonable, assumption that the same rule must apply both to outgoings on revenue account and to expenditure of capital that qualifies a taxpayer to claim allowances for depreciation.

On the facts as the majority saw them, it followed that Mr Peterson must win because the Commissioner conceded that Mr Peterson and his fellow investors had paid $x+y for the making of the film, but for no other purpose.[37] Not only did they acquire no other legal benefit, conceded the Commissioner, but, it seemed in the view of the majority, they acquired no other economic benefit, either.[38]

V.

In Part VII this chapter will revisit the question of the relationship between the general deductions permission and the general anti-avoidance rule and reconsider what is said in the immediately preceding paragraphs. First, however, what was the effect of the majority's advice as far as the rule in Cecil Bros is concerned? Their Lordships started by implying that the Commissioner was wrong to make the concession that has just been described. Surprisingly, they re-framed the *Cecil Bros* principle as a test that examines not only the legal purpose of expenditure, but also its economic purpose.[39] They said:[40]

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[35] In fact, the *Cecil Bros* court took this passage from *Ronpibon Tin NL & Tongka Compound NL v Federal Commissioner of Taxation* (1949) 78 CLR 47, 60, cited in *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430, 431 per Owen J at first instance. See also ibid 441 per Menzies J.

[36] Income Tax Act 2004 s DA 1.

[37] (2005) 22 NZTC 19,098 PC [46].

[38] Ibid [42], [46].

[39] Ibid [43].

[40] Ibid [51]. See also ibid [42]: "If the Commissioner had shown ... that the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure ... then he could invoke section 99 to disallow the deduction," discussed below in text following footnote 72.

> Where, however, a single consideration [here, the $x+y] is given for the supply of two or more goods or services the Commissioner is probably entitled even without section [BG 1] to go behind the allocation agreed between the parties and allocate the consideration among the several goods or services for which it was paid on a proper basis. The Commissioner could argue that $x should be treated as paid to the production company as consideration for making the film and $y for procuring the loan.

This passage drives a coach and four through the *Cecil Bros* rule. Mr Peterson did not even know about the arrangements with the Film Commission and Glitteron for borrowing and immediate repayment. The contracts gave him no legal power to make those transactions happen. On the papers, the investors' only benefit from the $x+y was that in paying it over they paid for the film to be made. If it was any benefit at all, procuring the loan was an economic benefit, not a legal one. Nevertheless, contrary to the *Cecil Bros* rule, their Lordships said that under the statute's general permission for income tax deductions the Commissioner was "probably" entitled to disallow the $y as a sum spent for a benefit or purpose that did not relate to Mr Peterson's income earning process.

The logic of their arguments leads to the conclusion that their Lordships were too cautious in saying "probably". Once they had decided that to qualify for a deduction taxpayers must show that the economic purpose of the expense in question relates to the income-earning process and that it is not enough alone to examine the formal legal benefit obtained by the expense (albeit that this legal benefit is on revenue account), it followed inexorably that the general permission for deductions[41] requires the Commissioner to apportion deduction claims on an in-substance basis that takes account of economic effects.

This approach is wholly inconsistent with the basic assumptions and arguments in the *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*.[42] As Menzies J explained in that case:[43]

> [I]t was at all material times open to the taxpayer company to buy directly from its usual suppliers at lower prices or to order its requirements from Breckler Pty Ltd at higher prices so that the latter could make profits. When [Cecil Bros] bought from Breckler Pty Ltd, therefore, it chose to pay more than was necessary for the purpose of allowing that company to make a profit.

For the Commissioner, Mr Byers QC argued that "Section 51 [the Australian general deductions provision] permits the

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[41] Now Income Tax Act s 2004 DA (1).

[42] (1964) 111 CLR 430.

[43] Ibid, 440.

apportionment of a lump sum"[44] and that, "One cannot say of the £19,777 [that Cecil Bros paid for trading stock in excess of an arm's length price] that it was a payment necessarily incurred in the production of assessable income".[45]

At first instance, Owen J rejected Mr Byers's submission,[46] citing *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation*,[47] where the High Court said,[48] "it is not for the court or the commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent." As Lord Diplock said in the second *Europa* case,[49] the Full Court agreed with Owen J on this point.[50] It followed that the £19,777 had to be classified as part of Cecil Bros' "real outgoings"[51] for trading stock, even though, in the words of Mr Bowen QC, counsel for Cecil Bros, "The purchases were made in this way for the purpose of benefiting the family" members who were shareholders in Breckler Pty Ltd, not for making profits for Cecil Bros.[52]

This reasoning cannot stand with *Peterson v Commissioner of Taxation*.[53] There, Lord Millet said that the conclusion of the case would in all probability have been very different if the Commissioner had alleged and proved that the $y portion of the $x+y that the investors paid for the films had been paid for some reason other than to acquire the film. For instance:[54]

> The Commissioner could plausibly invite the TRA to infer that the production company agreed to recycle the money to the lender in order to procure it to make the loan to the taxpayers.
>
> On these facts [his Lordship continued] the Commissioner could contend that the investors paid the production company $x+y not merely as consideration for the acquisition of the film but also for its services in procuring the lender to make the loan to them.

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[44] Ibid, 437.

[45] Idem.

[46] Ibid, 434.

[47] (1949) 78 CLR 47.

[48] Ibid, 60.

[49] *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, 556 PC, quoted above at text accompanying footnote 33.

[50] *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430, 438 Dixon CJ and Kitto J, 441 Menzies J, 442 Windeyer J, Taylor J did not mention this point.

[51] Ibid, 440, per Menzies J.

[52] Ibid, 436.

[53] (2005) 22 NZTC 19,098 PC.

[54] Ibid, 49.

If Lord Millet is right (and, since he spoke for the majority of the Privy Council, how can he not be?) the *Cecil Bros* legal benefit rule has gone. After all, if in the *Peterson* case (on the assumption that proof was available or that the necessary inference could appropriately be drawn) the Privy Council would have disallowed a deduction for $y which was spent for a purpose of which Mr Peterson was ignorant, how much more certainly would the Privy Council disallow Cecil Bros' £19,777, which was spent for a purpose that Cecil Bros not only knew about but had contrived to achieve?

VI.

In the context of the discussion of *Cecil Bros Pty Ltd v Federal Comissioner of Taxation*, there is a good deal of irony about the advice of the minority of the Board, Lords Bingham of Cornhill and Scott of Foscote. Their Lordships delivered a remarkably trenchant dissent in *Peterson v Commissioner of Inland Revenue*, which, unusually, includes a postscript[55] that analyses the majority's reasoning to find it "extraordinary".[56]

The postscript considers the facts as found by the Taxation Review Authority. Quoting from the Authority, their Lordships explained that in respect of *Utu*, the Authority had found that the proposed loan from the Film Commission

> was a fraud on the investors intended to induce them to believe (and they did believe) that the Film commission had loaned $350,000 to Utu Funding Ltd for use in making the film. In fact it had not and at that time was never intended to.[57]

> [Further] the investors conceded that the "loan" from Glitteron was never made [and] that this aspect of the transaction was a fraud on the investors and therefore a sham for tax purposes.[58]

For their Lordships, it followed that the $y was never paid. Therefore, the issue of whether for depreciation purposes the cost of the films included the $y and the question of whether the legal benefit test from *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* never arose. Consequently, Lord Bingham and Lord Scott had no occasion to comment on whether the Commissioner had power to apportion the expenditure on the film and to disallow the fraction of the claimed depreciation allowances that were based on an assumption that $y was part of the cost. As a result, although their Lordships' speech supported the Commissioner in respect of the *Peterson* case itself, in the longer term the Commissioner will find more to assist him in the advice of the majority.

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[55] Ibid [93] – [101].

[56] Ibid [101].

[57] Ibid, [95(iii)]

[58] Ibid, [95(ii)]

VII.

The irony that emerges from comparing the opinions of the majority and the minority in respect of apportionment of depreciation claims, and as regards the related question of apportionment in deductions claims in general, is only one of a number of contradictions in the case. Another is the effect of the advice of the majority on the question of the relationship between the general anti-avoidance rule and the general deductions provision.

In principle, this relationship should be the same as the relationship between the general anti-avoidance rule and any other permission in the Income Tax Act. That is, as the majority in *Peterson v Commissioner of Inland Revenue* put it:[59]

> ... it is inherent in [section BG 1] that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation.

That is, whether on the facts of any particular case the general anti-avoidance rule overrides a specific statutory provision is a subsequent question,[60] but in principle the general rule may override any specific rule.

It has been thought in some quarters that the general deductions provision, now section DA 1 of the Income Tax Act of 2004, constitutes an exception. The basis for this belief are the cases of *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*[61] and *Europa Oil (NZ) Ltd v Commissioner of Taxation*[62] and, in particular, the passage cited from the latter case[63] in *Peterson v Commissioner of Inland Revenue*[64] and quoted earlier in this chapter.[65] Indeed, at first impression the citation in *Peterson* appears to place the majority's imprimatur on the supposed exception. If first impressions are correct, the corollary is that the *Cecil Bros* legal benefit test constitutes an island of invulnerability that overrides the general anti-avoidance rule.

No provision in the legislation of either New Zealand or Australia offers any support to these arguments. Closer analysis of the majority's judgment in the *Peterson* case leads

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[59] Ibid, [4], quoting Richardson P in *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450, 464.

[60] See, eg, ibid [35].

[61] (1964) 111 CLR 430 FC.

[62] [1976] 1 NZLR 546, PC.

[63] Ibid, 556, per Lord Diplock, delivering the advice of the Board, quoted at *Peterson v Commissioner of Inland Revenue*.

[64] (2005) 22 NZTC 19,098 [43] PC.

[65] Text accompanying footnote 33.

to the opposite conclusion. As has been explained, Lord Millet said that if the Commissioner had made the appropriate contentions and had invited the Taxation Review Authority to draw the appropriate inferences, the case might have had a very different outcome.[66] The Commissioner could have argued successfully that although the only legal benefit that Mr Peterson acquired when he spent his contractual $x+y was acquisition of his share in the films, the $y was in fact paid for a purpose other than acquiring the film, to wit, the purpose of immediately repaying the loan. This purpose can only be termed an economic purpose, in that Mr Peterson had no contractual or other legal right that it should be carried into effect. Indeed, he did not even know about it. As has been explained, Lord Millet said that despite these circumstances the Commissioner could have disallowed the portion of the depreciation allowances that depended on $y being part of the acquisition price.[67]

Disallowance of depreciation was not the Commissioner's only weapon, said Lord Millet. Indeed:[68]

> [T]he Commissioner could contend in the alternative that the arrangement by which the production company allocated the payment of $y as part of the consideration for acquiring the film instead of as consideration for the procurement of the loan (which affected the investors whether or not they were parties to it) could be counteracted under section 99.

Importantly Lord Millet's words do not purport to recharacterize the legal relationship between the investors and the production company. The former paid $x+y as legal consideration to have the film made. The only legal benefit that they obtained was ownership of the film. Therefore, if the rule in *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* governed it would follow that the investors had satisfied the general deductions provision in respect of the whole $x+y. By the analogy that the majority adopted,[69] it followed that in respect of depreciation rates the investors had established an acquisition price of $x+y.

In these circumstances, if the majority had hewed to the supposed rule that the general deductions rule trumps the general anti-avoidance rule, that is, the rule that appears to emerge from Lord Diplock's words in *Europa Oil (NZ) Ltd v Commissioner of Taxation,*[70] it would follow that no matter how the production company treated the funds, the taxpayers,

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[66] Text accompanying footnote 54.

[67] Text accompanying footnote 55.

[68] *Peterson v Commissioner of Inland Revenue* (2005) 22 NZTC 19,098 [52] PC.

[69] Ibid, [43]. See text earlier in this chapter accompanying footnote 33.

[70] [1976] 1 NZLR 546, 556 PC, quoted above at footnote 33.

having satisfied the depreciation rules (treated as the same as the deductions rules) would have been invulnerable to the general anti avoidance rule. But the passage just quoted shows that this was not the majority's conclusion. On the contrary, the majority said that the tax advantage "could be counteracted under section 99". That is, in the view of the majority neither the depreciation rules nor, by inexorable analogy, the general deductions rule, enjoy any special advantage vis-à-vis the general anti-avoidance rule.

This conclusion leaves two questions. First, is there an inconsistency within the judgment of the majority in *Peterson*? Secondly, can the majority's judgment be reconciled with the *Cecil Bros* case?

As to the first question, there is an apparent inconsistency between Lord Millet's seeming approval of Lord Diplock's words in the second *Europa* case[71] and the passage that this chapter has just quoted from his Lordship.[72] The former suggests that the general deductions rule takes precedence over the general anti-avoidance rule and the latter suggests the opposite. The explanation is that Lord Millet did not mean what he appears to mean by quoting Lord Diplock. The passage from Lord Diplock appears in paragraph 43 of the majority's judgment. In paragraph 42, Lord Millet had just said:

> If the Commissioner had shown that ... the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke section 99 to disallow the deduction.

These words can only mean that notwithstanding that a taxpayer may incur an expense in legal terms, if the taxpayer does not suffer the expense economically (for example, if part of it is returned to the taxpayer by a roundabout route) then section BG 1 can disallow the expense pro tanto. (This corollary must follow: even if a taxpayer *has* suffered an expense economically, section BG 1 can disallow any portion of the expense the economic purpose of which does not relate the income-earning process.) Whatever Lord Diplock meant, Lord Millet must have assumed that his words are relevant where it is not proven that the taxpayer does not suffer the expense in question economically. If there is no such proof, the case falls within the classical paradigm for the application of the general anti-avoidance rule.[73]

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[71] Quotation accompanying footnote 33.

[72] Quotation accompanying footnote 68

[73] See, eg, *Peterson v Commissioner of Inland Revenue*, (2005) 22 NZTC 19,098 PC, 37, quoting Lord Templeman in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513, 561 PC.

As regards the second question posed above, it is arguable that Lord Millet's conclusion in the *Peterson* case *can* be reconciled with the *Cecil Bros* case. Arguably, the core ratio of the latter case is that the Commissioner could not deploy section 260, the Australian general anti-avoidance rule, to disallow the £19,777 because s 260 contained no power of reconstruction.[74] As Menzies J said,

> I do not think that the section authorizes the Commissioner to substitute a different price for that actually paid in accordance with [the] contracts [that apply]. .... To arrive at any such conclusion would , I think, be an unauthorized reconstruction of what occurred ....

It is true that others of their Honours went further, and appear to have said that section 260 could not in any event override a deduction that was allowed by section 51,[75] but their holding was not necessary, they gave no reason for it, and, in particular, they gave no explanation as to why section 51 might have this unique status within the Australian legislation. That is, it is strongly arguable that the true ratio of *Cecil Bros* insofar as that case relates to the relationship between the general deductions rule and the general anti-avoidance rule depends on the absence of a power of reconstruction in the latter rule. That is, this ratio of the case has not been relevant in New Zealand since 1974, when Parliament added a reconstructive power to what was then section 108 of the Land and Income Tax Act 1954.[76]

VIII.

The *Peterson* case is remarkable in the history of tax litigation. Both sides won. Mr Peterson saved all his tax and also his fiscal bonus. The Commissioner achieved a poultice of judicial rulings against tax planners and in favour of the general public that bids fair to mark a watershed in a switch of tax jurisprudence from form to substance.

Mr Peterson won because of the Commissioner's concession. For the majority, Lord Millet said that if the Commissioner had made the necessary allegations he might have successfully challenged the investors' case.[77] Unusually, his Lordship explained just how the Commissioner might mount that challenge.[78] The Commissioner could contend, he said, that the investors paid their shares of the $y not for

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[74] *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* [1964] 111 CLR 430, 441.

[75] Ibid 438 per Dixon CJ. Kitto J, 438, Taylor J, 439 and Windeyer J 442 agreed.

[76] Income Tax Amendment (No 2) Act 1974.

[77] Ibid, [47] ff.

[78] Ibid [48] – [53].

acquiring the film but for procuring the circular loan, even though they did not realize that this was happening.[79] That is, the Commissioner could rely on what is now section DA 1 to disallow the expenditure, without even bothering to argue avoidance.

The Commissioner has laboured long in the toils of *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*. Individuals have used the rule to shift the burden of taxation from themselves to the general public for 40 years. If the Commissioner had not made his concession in the *Peterson* case it is unlikely that the Privy Council would have explored the expense allocation issue as it did. For the Commissioner, losing the *Peterson* case would have been a small price to pay to achieve even a crack in the *Cecil Bros* rule. In fact, the Commissioner did much better, and the tactic that their Lordships thought was a mistake appears to have provoked the majority into demolishing the rule. From the Commissioner's point of view, he could hardly have done much better if he had engaged Mr Peterson as an *agent provocateur* and had planned the tactical error.

On top of all this, the Commissioner achieved a reversal of the *BNZ Investments* consensus and two schemes heresies. The cat truly got the cream, at the cost of a little skim milk.

Mr David Patterson may have been correct when he said in the *National Business Review* of 4 March 2005[80] that the *Peterson* case will give fresh hope to investors. But the well-advised investor will see that this fresh hope is based on no more than a gamble on the improbable eventuality that in future cases the Commissioner will make mistakes similar to the mistake in the *Peterson* case, if mistake it was. On analysis, the *Peterson* case offers no succour even to Mr Peterson's co-investors in *Utu* and *Lie of the Land*. If there remain outstanding *Utu* and *Lie of the Land* tax objections where there is no agreement between taxpayer and Commissioner that the outcome must follow the *Peterson* result the Commissioner may well feel that he is duty-bound to follow the course that Lord Millet charted for him. It appears to be Lord Millet's view that this course would lead to success for the Commissioner.

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[79] Ibid [50].

[80] At 19.