THE CONCEPT OF INCOME AND TAX POLICY

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Why should lawyers and law students be concerned with the concept of income and with broad questions of tax policy? Are they not the proper preserve of public finance experts and economists? Is not the proper concern of lawyers the interpretation and application of the income tax legislation?

The short answer to each of those questions is that the interpretation of tax legislation and advisory work in the tax field require an understanding of the policies underlying the legislation. There are three major reasons for this. The first is the complexity of the legislation. The second is that because the legislation can never be a complete code it is necessary for those involved in the interpretation and administration of tax legislation to have an understanding of those policies. The third reason why the policies underlying tax legislation are of central importance is because tax legislation is readily and frequently changed to reflect the changing perception of public policies involved. I shall consider each in turn.

The first is the complexity of the legislation. The development of the income tax to meet both revenue raising and other economic and social objectives, the burden of the tax and the growth in tax planning have all contributed to the marked increase in the length and complexity of the legislation. As to sheer length, the original Land and Income Assessment Act 1891 ran to 48 sections and to 24 pages in the Statute book; the 1923 Act ran to 77 sections and 48 pages; and the Land and Income Tax Act 1954 to 246 sections and 179 pages. It has been added to considerably since then. 1988 was an extraordinarily productive year; the Income Tax Amendment Acts passed added 116 sections and amended over 140 and added a further 331 pages. Our experience in this respect is not unique. Other developed countries have followed similar paths. For example, in March 1978 the Australian Income Tax Assessment Act was ten times as long as when first enacted in 1936.¹

The reasons for this are well understood. The impact of income tax on taxpayers, on the economy and on society generally, is so great that a simple, inflexible code would operate unevenly over the community. There are various, and at times conflicting, values involved. Fairness, certainty, and the recognition of individual circumstances are objectives which become more and more important as the burden of tax and its economic and social significance increase. There is no other legislation which is so far-reaching and pervasive and which touches human activities at so many points. So the legislation cannot avoid being as comprehensive and complicated as the subject matter with which it deals.

There is a further consideration which compounds the drafting problems in this field. The greater the burden of income tax the greater the effort on the part of taxpayers, and their astute advisers, to utilise the advantages of the system so as to minimise the total tax paid in respect of their productive efforts. In turn, the drafters of tax legislation recognise that, to an extent

¹ 7 A.T.R. 1.
not met with in other areas, entry into commercial transactions and the shaping of commercial transactions will be influenced by the letter of the legislation.

All this calls for detailed drafting to cover a wide range of circumstances. It is crying for the moon to urge that tax legislation be simple and brief. When income tax was imposed in the United Kingdom in 1799 it was felt necessary to issue a memorandum, appropriately entitled “A Plain, Short and Easy Description of the Different Classes of the Income Tax so as to Render it Familiar to the Meanest Capacity”. Later governments did not repeat that attempt. But in pursuit of the goal of simplicity a committee was appointed in the United Kingdom in 1927.

Modern tax legislation is necessarily detailed. Even so, it is not possible to anticipate and provide for every situation that may arise. It is important, too, that legislation should not become inordinately long and complex. As in a great many other countries, the course adopted in New Zealand in large areas of the tax law is to draft in some detail so as to reflect, in the treatment of the obviously distinct situations calling for separate recognition, the policy underlying the provision; and then to repose discretions in an officer of the Revenue, here the commissioner, to allow him to determine the application of the provision in all other cases. These discretions are also buttressed by specific and general anti-avoidance provisions designed to protect the tax base against unacceptable depredations of tax planners.

So no matter how detailed, the legislation can never be a complete code. This brings me to the second and third reasons why the policies underlying the legislation are of central importance.

The second is that, because the legislation can never be a complete code, it is necessary for those involved in the interpretation and administration of tax legislation to have an understanding of those policies. The basic concept — the concept of income — is not defined. As we shall see, there are tensions between concepts of income held by economists and those of trusts and property law. Those tensions are not completely settled in the legislation and where they are settled a consistent pattern is not available.

There is a complicating factor. Because tax policy and tax law operate in the real world, there are four other features which impinge on what might be called pure tax policy. The first is the relationship between legislation and accounting principles and commercial practices (I shall come back to this later).

The second is the relationship between tax law and tax practice. With two million taxpayers and well over 5,000 staff members in the Inland Revenue Department, to a very large extent taxation is a voluntary compliance system.

2  Cmd. 5131, para.26 pp.18, 19.
In order to attract substantial support and compliance from taxpayers, tax laws must be seen to be fair and to operate fairly. Tax practice must be workable. It is essential to consider and balance the objectives of complexity, certainty, economic efficiency and acceptability, both in terms of taxpayers’ willingness to pay tax and the costs of compliance.

The third is the exercise by the commissioner of his statutory powers. An appreciation of the policy underlying the particular statutory provision is required in order to predict how discretion will be exercised and to challenge, if necessary, its actual exercise.

The fourth is the approach of the courts in construing tax legislation. As in other areas of statutory interpretation the cardinal rule laid down by section 5(j) of the Acts Interpretation Act applies equally to tax legislation. Gone are the days when taxes were regarded in law as confiscation of private property and tax legislation and other penal laws were to be construed strictly against the Crown. The twin pillars of statutory construction are the scheme of the legislation and the object of the legislation. The courts must consider the public policies which the legislation serves. That is why in many decisions of the Court of Appeal there are quite extensive discussions of tax policy and of the scheme of the legislation.

The third reason why the policies underlying tax legislation are of central importance is because tax legislation is readily and frequently changed to reflect changing perceptions of the public policies involved. In recent years we have experienced some distinct changes in the recognised goals of taxation reflected in changes in detailed policies. Reporting in 1967 the Taxation Review Committee saw taxation as having three purposes: to raise revenue to finance government expenditure; to assist in the attainment of national economic objectives; and to further broad social objectives. The achievement of these purposes involves the identification, evaluation and reconciliation of a host of values and considerations. What is the role of the government in the economy and in society? What are our national economic objectives? What ranking should we give to economic stability, efficiency, allocation of resources and real growth? How are those economic objectives best fostered? What are our social objectives? What part does tax play in distributing and redistributing resources to meet those objectives?

Twenty years on since the committee reported, current economic orthodoxy tends to emphasise the revenue raising and economic efficiency goals of tax policy. Tax systems should be as neutral as possible in their treatment of different activities and in their economic effects. And in terms of that philosophy there is limited scope for the achievement through the tax system of some of the economic and social objectives to which tax policies have been directed in the past. The debate continues but the changing emphasis has had its impact on tax laws and practice. Perhaps the best example relates to the use of tax incentives. For over twenty years tax concessions were widely used in order to encourage particular economic developments. Thus in the early 1980’s the incentive provisions ran to about 100 pages in the 1976 Income Tax Act. Since 1984 that particular trend has markedly diminished as the distorting effects and economic costs of tax incentives have been increasingly emphasised.

Much of the work of lawyers as tax advisers is prospective. Tax planning is for the future. It is seldom confined to single transactions. So lawyers are concerned with the future of the arrangements they devise. If it seems
there is an obvious gap in the legislation, it may well become the subject of a legislative amendment applying thereafter to the income earning activity involved. Understanding of tax policy necessarily precedes any sensible attempts at predicting future change.

There are three basic features of every tax: (1) the tax base, i.e. the definition of the subject of the tax, here what is to be included in income; (2) the rate structure, i.e. the rate or rates expressed in percentage terms, and the exemptions and rebates which affect the effective average percentage rate in respect of taxable income; and (3) the taxable unit or entity, e.g. the individual, or the marital unit or the family unit; and under this head is the treatment of other entities such as companies and trusts.

The three features are inter-related and the decisions made in respect of them substantially affect the scheme and the complexity of the legislation. For example, the wider and more comprehensive the tax base, the lower the rate of tax required to produce the particular yield. Again, the more graduated the rate structure and the more exemptions and rebates provided, the greater the care which needs to be taken in defining the tax entities which are to be recognised and the relationships between them. And, of course, the greater the burden of income tax, the greater the effort on the part of taxpayers and their astute advisers to utilise the advantages of the system so as to minimise the total tax paid.

There are limits to what can be achieved through tax legislation and its administration. This is not always appreciated by those who may have particular social goals in view but are not directly involved in the actual operation of the tax system as are accountants, lawyers and, of course, tax administrators. There are three constraints. First, the more complex the tax system the greater the tax design problems and so the greater the difficulty of countering tax planning since the economic rewards to the taxpayer are so great. Second, tax considerations inevitably play a major role in investment decisions and tend to distort economic behaviour. Third, as part of an increasingly international economy the New Zealand tax base, structures and rates have to provide a suitable economic climate consistent with international tax practice.

After that extended discussion of tax policy and its significance for lawyers, I turn now to the concept of income. There is an attractive simplicity in the philosophy, widely endorsed by fiscal economists and reflected in the reports of many tax reform inquiries in various countries, that the true measure of income is the command over resources achieved during the year. Or in more direct terms: a buck is a buck is a buck! It is said that, if a person obtains increased command over goods and services for his or her personal satisfaction, does it matter from the point of view of the capacity to pay tax whether it was earned from work, derived from owning property, made from selling an asset, received as a gift or won at the races? It seems to me that this is pre-eminently an area requiring a careful balancing of principle and pragmatism.

Undoubtedly the wider the definition of income, the more even the application of the tax and the less scope for tax avoidance and for misallocation of effort and resources in that respect. At the same time, there are administrative problems. There are also problems in terms of taxpayer resistance to an all embracing definition. Two examples are imputed income and windfall gains. The benefit to the taxpayer of living in his or her own home compared
with paying rent out of after tax income may be imputed to the taxpayer; and for many years the income tax legislation of Australia and the United Kingdom did just that. Inevitably there are problems of valuation (unless a formula based on government valuation is used) and of taxpayer resistance. They are compounded when you move on to consider items such as benefits from handyman activities and hobby pursuits. Again, in logic, should education, police protection, health, welfare and other social benefits received from the state be taxed? At these extremes the comprehensive tax base breaks down in practice. Again, windfall gains such as gifts and inheritances tend to be viewed — by recipients and in the tax system — as wealth to be dealt with outside the income tax regime.

This brings me at last to the concept of income and its recognition for income tax purposes. The economists’ concept of income is as an accretion to the resources of the taxpayer. Income thus equals consumption plus the increase (or decrease) in net worth over a period of time. The judicial approach has been different in a number of respects. Those differences are due only in part to the dictates of the legislation. In part they stem from a quite different concept of income and its recognition.

Let me give two examples each of which will take some time to discuss. The first concerns the distinction between income and capital gains. The second concerns timing — when is income derived and subject to tax.

The first is not a distinction clearly mandated by the original statutory language. Compare the answers given in the United States and in New Zealand. The American courts, in interpreting the words “income” and “income . . . from all sources”, evolved a concept of income which embraces all accretions to wealth except those expressly excluded by the legislation. Indeed the capital gains tax in the United States began as an amelioration of the treatment of such gains as ordinary income.

Here, under similar statutory language, we took a different path. It is clearly arguable that, read literally, the old New Zealand statutory expression now contained in section 65(2)(a) of the Income Tax Act 1976 including as income “all profits or gains derived from any business” extends to profits and gains in the form of capital gains. But traditionally New Zealand has not taxed such gains except for specific items expressly treated for tax purposes as ordinary income, for example, profits from certain land transactions. Historically the reason has been that in the administration of the New Zealand tax system we followed the British approach in that regard.

Income tax was introduced in Britain in 1799 and was developed in the 19th century, long before its introduction in New Zealand. At that time the United Kingdom had a developed agricultural economy and a developing industrial society. It was very different from the pioneering, entrepreneurial, less static and more mobile United States. Ingrained in English legal thinking affecting both the political establishment and the judiciary was the use of trusts and the succession to property. Trust law concepts differentiate the interests of the life tenant (entitled to income) from the interests of the remainderman (entitled to capital and so to the proceeds of realisation of capital assets of the trust). So we see the familiar analogies of the tree and the fruit, and the land and the crop. With hindsight it seems surprising that concepts of trust law were considered an appropriate substitute for a direct focus on economic efficiency and equity concerns in the raising of taxes. In practice, too, the distinction between capital and income is often elusive or unreal and it has given rise to an immense amount of litigation.
Just to give one example — gains from holding shares in companies. The market value of the shares should increase to reflect the profits earned by the company. For income tax purposes the starting point is different. If no dividends are paid there is no income to be taxed; if dividends are paid they are taxable. But in the intermediate position where bonus shares have been issued or the shareholders have received some benefit separate from the original shares, the income tax consequences have in different circumstances turned very much on the way the courts have viewed the transactions, the extent to which they have drawn the capital/income distinction and whether they have focussed on the substance of the transactions as distinct from the formal steps followed.

Clearly, real capital gains must represent an increase in purchasing power for a period similar to real increases in wages, interest or dividends for the same period. Clearly, too, if as academic theory tells us the value of an asset is the capitalised present value of expected future earnings less expenses, capital gains apart from the inflation element are simply sums received in anticipation of future income.

The second example concerns timing. When is income derived and subject to tax? The underlying problem is the practical need to compartmentalise an earning activity into periods of time. If we took a lifetime survey of income earning there would be a totally different perspective and little need for arbitrary rules of recognition. There would be other difficulties of course. The point, however, is that income earning activity is a continuing process which does not fit tidily into annual compartments. It is necessary to decide how to allocate income and expenses straddling two or more income years.

The relevant statutory provisions are elliptical and incomplete. Income tax is payable on all income “derived by [the taxpayer] during the year for which the tax is payable”,3 and income, although not actually received or receivable, credited in account or otherwise dealt with on behalf of the taxpayer, is deemed to have been derived by the taxpayer.4 In a rather rudimentary way section 75 thus recognises both cash and accruals accounting for income. Again, any income tax system has to deal with revenue assets on hand at balance date such as trading stock, with capital assets that are wearing out through use in income earning activities and with trade debtors and creditors. A special feature of the New Zealand legislation is that it has never been subject to a complete review and redrafting. In the result the basic structure and much of the statutory language is the same as it was at the turn of the century. In particular, that structure has not been revised in the light of the development of accounting principles and commercial practices over that period. So there is an uneasy ambivalence as to their recognition in tax practice.

Let me give two examples. One is that the basic legislation, the 1976 Act, does not specifically recognise accruals accounting. The language of the crucial provisions does not consistently distinguish between cash accounting and accruals accounting. In practice, of course, a pragmatic approach is adopted with, broadly speaking, business taxpayers accounting on an accruals basis and other taxpayers on a cash basis.

The other is that tax accounting is an amalgam of accounting principles and statutory rules. The commercial community and the department, and

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3 Ss.38(2), 242.
4 S.75.
usually too, the courts, rightly emphasise the importance in the administration of the legislation of applying generally accepted accounting principles and ordinary commercial practices in the computation of business income, so far as the statutory language permits. There are sound practical reasons for that approach. But it is a matter of having to read in to the statutory language a policy approach which one would have thought could have been spelled out in the legislation.

However, the real problem is that the statutory scheme itself only allows the adoption of a "half-way house" approach. Accounting principles are taken into account only where they are consistent with the scheme of the Act. On the critical question of the calculation of business income there is a curious inconsistency between two basic provisions. Under section 65(2)(a) of the Income Tax Act 1976 assessable income includes "all profits or gains derived from any business", and paragraphs (e) and (f) also apply to "profits or gains" of particular activities. A profit or gain is a net figure. On its face it involves ascertaining what in the circumstances of the taxpayer should properly be regarded as the profits or gains derived from his or her business or other income earning activity. That might reasonably be considered in New Zealand, as it is in the United Kingdom (the source of our reference to the profits or gains derived from a business), to require the application of commercial accounting principles in the calculation of the profits of the business except for the application of special rules in particular cases. However, section 101 of our Act bars deduction of any expenditure or loss except as expressly provided in the Act. And the general provisions of section 104 and the specific provisions relating to particular items adopt the statutory formulation of deductibility and do not import the application of accounting principles and commercial practices.

In short, gross income is calculated in accordance with the principles of accruals accounting, but deductions are calculated on a statutory basis. This means that the resulting profit figure is a statutory fiction. It is not one that satisfies generally accepted accounting principles. It is not one that meets the true and fair view disclosure provisions of the Companies Act.

At the same time it must be recognised that in a few areas there may be no sufficiently clearly accepted accounting principle applicable to provide the relative certainty required for the administration of the income tax.

Summing up at this point, tax accounting involves the application of general accounting principles but only in so far as they are consistent with the scheme and language of the legislation and with current perceptions of commercial reality.

An associated problem concerns the taxability of fringe benefits. There is now, of course, a fringe benefits tax covering certain specified fringe benefits, for example, motor vehicles, low-interest loans and goods and services provided by the employer. Others remain subject to the general provisions of the legislation. An important point which led eventually to the fringe benefits legislation is that the general provisions of the Act had been found wanting when relied on by the Commissioner. In part it was due to a narrow interpretation given to "allowances" in section 65(2)(b) which in C.I.R. v. Parsons confined its meaning to those employee allowances in use in 1900. In part it was a problem of valuing employee benefits. But also in part it was due to an aspect of the concept of income adopted by the courts. It

5 (No.2) [1968] N.Z.L.R. 574.
is called the convertibility principle. A leading New Zealand case is *Stagg v. Inland Revenue Commissioner*. In that case non-transferable air tickets provided by the employer were held not taxable to the employee because they were not convertible into money. It follows that any expense met directly by the employer which confers a personal non-transferable benefit on the employee is not likely to be taxable to the employer in the absence of a specific provision. It is a tax planner’s dream.

Sufficient then has been said to indicate that even taking into account the major changes made in the last four years to extend the tax base and to close avenues for tax planning, there is still a significant gulf between the concept of income held by economists and the concepts of income adopted generally by the courts and applied by lawyers, accountants and the Inland Revenue Department in the administration of the income tax legislation.