COLLECTING TAXES
A COMMENTARY

John Prebble*

I INTRODUCTION

The essays in this volume demonstrate that during a long and productive career the Rt Honourable Sir Ivor Richardson has made an immense contribution to the jurisprudence of New Zealand and of the Commonwealth, over all areas of the law; but if there is one field that Sir Ivor has made his own, as a practitioner, as a Judge, and as a scholar, it is taxation. It is particularly felicitous that the contributors of the essays in the taxation chapters of Sir Ivor's *liber amicorum,* should be practitioners and scholars of the eminence and distinction of Mr Robert McLeod and Dr Geoffrey Harley. They have chosen as central themes of their essays subjects that have always been close to Sir Ivor's heart: the relationship between law and economics and the significance of the form/substance dichotomy for tax law as applied in the courts, though each author ranges well beyond the themes identified here.

In different ways, each essay establishes a systematic matrix of analysis that will serve as an invaluable platform for future scholarship. In a few pages, Mr McLeod sets out a theoretical framework for tax reform. He compares the work of Pigou,[1] with that of Pigou's pupil, Ramsay.[2] He explains that the initial appeal of Pigou's corrective taxes and of Ramsay's optimal tax theory have in modern times succumbed to the impossibility of obtaining enough data for governments to be confident that when they put these theories into practice they will hit upon the right recipe. Instead, tax economists nowadays advocate a broad-based, flat rate, paradigm[3] as likely to raise the most revenue while causing the least harm.

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* Professor of Law, Victoria University of Wellington. Barrister, Inner Temple.

1 Arthur Pigou *The Economics of Welfare* (Macmillan, London, 1920).

2 Ramsay "A Contribution to the Theory of Taxation" (1927) 37 Economic Journal 145.

3 Robert A McLeod "Collecting Taxes" (2002) 33 VUWLR, 793, 811, 814.

Dr Harley addresses the axiom so often expressed in tax cases that there is no halfway house between a transaction that must be treated as genuine and a transaction that is a sham. This axiom says that, apart from cases where a statutory anti-avoidance rule applies, the law recognises no concept of a transaction that is binding between the parties but that is ineffective as far as the Commissioner is concerned.[4] In tax cases, courts make the point that the no halfway house rule is a general rule of law, not a rule that applies specifically to tax cases. Tax cases that apply the rule simply follow orthodox jurisprudence. The platform that Dr Harley constructs is a systematic analysis of leading non-tax cases that support the proposition, from *Re Securitibank Ltd (No 2)*[5] to *Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)*.[6] He visits on the way, *Marac Finance Ltd v Virtue,*[7] *Mills v Dowdall,*[8] and *NZI Bank Ltd v Euro-National Corporation Ltd.*[9] After this excellent *tour d'horizon,* Dr Harley shows how the principle in these cases has been applied in tax cases.

II ECONOMICS AND TAX LAW

The juxtaposition of Mr McLeod's economic analysis and Dr Harley's study of an illuminating group of non-tax cases and their application to tax law illustrates a curious irony: that the discipline nowadays known as "law and economics" has had little to offer to the courts' approach to fundamental principles of income tax law.

For non-tax lawyers, this conclusion is counter-intuitive. One would have thought that of all areas of the law, taxation would furnish the most fertile field for the analytical tools of law and economics. Consideration of basic policies of income tax law supports that thought, wrong though it is. The fundamental policy of income tax law is to tax "income".

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4 For another view, see John Prebble "Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II – Criminal Law Consequences of Categories of Evasion and Avoidance" (1996) 2 NZ J Taxation and Policy 59, 63-67. There, it is argued that the courts' no halfway house axiom may mislead, because there are several judicial categories of argument that have the effect of locating transactions in halfway houses between sham and genuine, albeit that strictly speaking such transactions are genuine. The leading such categories are: that the transaction is mislabelled; that, in context, the transaction's effect is different from first appearances; that the transaction must be construed in the light of a related transaction; and that, as a matter of logic, the legal substance of a transaction is different from what it seems to be.

5 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA).

6 *Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)* [1996] 1 NZLR 528 (CA).

7 *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA).

8 *Mills v Dowdall* [1983] NZLR 154 (CA).

9 *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] 3 NZLR 528 (CA).

In this context, "income" must mean what is income in fact: that is, income as defined by economics. For purposes of the first principles of tax policy, "income" cannot mean income as defined by law. Otherwise, tax policy is circular: one would have to say that the policy of income tax law is to tax income as income is defined by the very law that is enacted to do the taxing.

No policy-maker or legislature would describe income tax policy in those terms, but as it happens the circular definition is what the courts follow, though they never put it exactly thus. Several of the cases that Dr Harley discusses, make the point with some clarity. For instance, he quotes Richardson J, as he then was, in *CIR v Smythe*:[10]

> It is that legal character of the transaction which is decisive - not the overall economic consequences to the parties, and not the legal consequences of an alternative transaction into which the taxpayer could have entered but chose not to do so. The true nature of the transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out.

Some would say that Richardson J here enjoins people to follow the form of a transaction, rather than its substance. The present author would argue, rather, that his Honour is saying that in tax cases it is the *legal substance* of a transaction that governs (the transaction's "legal character", in his Honour's words), not its economic substance.

Dr Harley illustrates this approach by considering *Marac Life Assurance Limited v CIR.*[11] That case involved a form of investment called "Marac Life Bonds". As their name implied, the "Life Bonds" were in economic effect tantamount to bonds that produced interest. However, as documented between the issuing company and investors the bonds were life assurance contracts and the returns to investors were in name and in legal substance "bonuses" from assurance contracts. The Commissioner taxed the "Bonds" as bonds producing interest. Richardson J rejected this approach. As Dr Harley explains, his Honour said:[12]

> The principal question must be whether the transaction is properly characterised as a contract of life insurance (or endowment insurance), not whether the expected or guaranteed return makes it a good investment if the investor survives to maturity when the return is compared with straight lending transactions.
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> ….

10 *Commissioner of Inland Revenue v Smythe* (1981) 5 NZTC 61,039; 61,040 (CA).

11 *Marac Life Assurance Limited v Commissioner of Inland Revenue* [1986] 1 NZLR 694 (CA).

12 *Marac Life Assurance*, above, 705-706, Richardson J.

> [His Honour rejected any submission] that a single non-severable contract could not be characterised as life insurance if on a wider assessment the Court concluded that the bonds were primarily designed and entered into as an investment but one containing an incidental insurance content.

As Dr Harley points out, Richardson J's approach in this, and in similar cases, is orthodox.[13] As Dr Harley goes on to say, the result is that "for many [people the orthodox application of tax law means that] there is a choice in some circumstances to pay or not to pay".[14] The courts are not to be blamed for this result. It comes about because of contradictions in the fundamental principles of income tax law. Dr Harley quotes[15] from Professor Parsons' seminal explanation, "Income Taxation: an Institution in Decay",[16] an explanation that the present author built on in 2001, in a lecture in memory of Professor Parsons.[17] While "legal substance over economic substance" is orthodox tax jurisprudence, only the brave would claim that this approach could withstand the blowtorch of analysis according to the principles of law and economics, if a court were to apply that blowtorch. The doctrine of precedent, together with cases like those that Dr Harley discusses, make this unlikely.

III LEGISLATIVE RESPONSE

The primacy of legal substance over economic substance in tax law typically, though not always, leads to a loss of government revenue.[18] Legislatures and policy makers will stand only so much of this sort of thing. They respond by amendments to the tax statutes that recharacterise the results of the courts' legal analysis. Take two examples from the cases that Dr Harley discusses.

The first is *Re Securitibank Ltd (No 2)*.[19] This case involved certain financing transactions. Instead of borrowing money, people needing funds would issue bills of exchange. In return, they received money, but less money than the face value of their bills.

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13 Dr Geoff Harley "Collecting Taxes" (2002) 33 VUWLR, 755, 782.

14 Harley, above, 775.

15 Harley, above, 761.

16 Ross Parson "Income Taxation: an Institution in Decay" (1986) 3 Aust Tax For 233, 234.

17 John Prebble "Income Taxation: A Structure Built on Sand" (Inaugural Ross Parsons Memorial Lecture, Sydney University, 2001) (2002) 24 Sydney LR 301.

18 *Commissioner of Inland Revenue v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA), discussed later in this article, is an example of a case where legal substance prevailed over economic substance to the detriment of the taxpayer.

19 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA).

That is, there was a discount. When the bills matured, the issuers paid face value to the holders as the holders presented the bills for payment. If the issuers had instead borrowed the money, and if instead of suffering a discount on the money that they received in return for issuing their bills the issuers had paid interest at the same rate as the discount, then the transactions would have been void by virtue of anti-usury legislation. In his judgment, Richardson J analysed the transactions and decided that in legal substance they escaped the Moneylenders Act 1908 and were therefore enforceable.

The result in *Re Securitibank Ltd (No 2)* was no doubt acceptable to the commercial community, which was accustomed to raising money by discounting bills of exchange. Furthermore, law and economics analysis would come to the same conclusion: from a policy point of view, it would be undesirable to apply the consumer protection ethos of the Moneylenders Act to the financing transactions of large commercial concerns who are well able to look after themselves. To deploy the threshold interest rates that trigger anti-usury legislation would be to stultify desirable commercial activity.

On the other hand, if the analysis of *Re Securitibank Ltd (No 2)* migrates unmodified into income tax law the result is an example of Dr Harley's "choice in some circumstances to pay or not to pay". Financing transactions that are loans produce interest that is taxable; financing transactions that involve discounts or premiums are on capital account for some taxpayers and have no tax consequences within an underdeveloped income tax regime. Parliament responded by enacting definitions of "money lent"[20] and "interest"[21] that bring virtually all forms of financing into the income tax net, treating them as species of loans.

To return to a case mentioned earlier, one of the issues in *Marac Life Assurance Limited v CIR*[22] was whether these wide definitions of "money lent" and "interest" extended to embrace premiums paid to a life insurance company and returned in the form of bonuses at the termination of the policy, sometimes only one year later. Richardson J held that they did not.[23]

The second example of legislative recharacterisation of legal concepts to make tax law achieve its economic objectives relates to premia for leases. Dr Harley discusses two cases that involve this issue in one form or another, *CIR v McKenzies (NZ) Limited*[24] and *CIR v*

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20 Now in the Income Tax Act 1994, s OB 1.

21 Income Tax Act 1994 s OB 1.

22 *Marac Life Assurance Limited v Commissioner of Inland Revenue* [1986] 1 NZLR 694 (CA), considered above.

23 *Marac Life Assurance,* above, 709, Richardson J.

24 *Commissioner of Inland Revenue v McKenzies (NZ) Limited* [1988] 2 NZLR 736 (CA).

Wattie.[25] In the first case, McKenzies (NZ) Ltd paid a lump sum to its landlord to quit an onerous lease of a building that it no longer wanted. In the second case, Wattie was a member of a firm of accountants that received a lump sum from a landlord in return for signing a lease. That is, the two cases in different ways mirrored a third, more standard, case, of a tenant paying a landlord a premium as the price of a lease.

Each premium (or negative premium) in the standard case, and in the *McKenzies* and *Wattie* cases, has a similar economic effect: to act as a surrogate for rent. Rent is almost invariably an item on revenue account. Nevertheless, the courts treat such premia as capital because they relate to leases, and leases are themselves traditionally classed as capital assets.[26]

In the absence of specific legislation, this judicial treatment of premia could lead to landlords receiving non-taxed windfalls, as they exacted premia from their tenants. Responding to this loophole, Parliament enacted what is now section CE 1(1)(e) of the Income Tax Act 1994, which treats premia as taxable income in the hands of landlords. There is no comparable provision in respect of negative premia like the payments in the *McKenzies* and *Wattie* cases; so the courts followed the traditional juristic characterisation and treated the sums in question as capital.

These two examples, discounts substituting for interest and premia substituting for rent, and their legislative sequels show that the courts are not well equipped to apply economic principle in the interpretation of tax law. Without legislative intervention, judicial orthodoxy will not treat sums that are tantamount in economic terms to interest and rent *as* interest or rent. Instead, such sums retain their juristic character even for the purposes of taxation, which is a quintessentially economic activity. Legislative intervention is the only remedy, but one result is that income tax statutes are much more complex than they might otherwise be.

IV PURPOSIVE STATUTORY INTERPRETATION

The qualities of income tax law that cause the courts to spurn the analysis of law and economics in the characterisation of juridical concepts have analogous effects in other areas. Mr McLeod discusses statutory interpretation, where the effect can be particularly marked. He cites Richardson J's judgment in *Smout v CIR*,[27] as an example of his Honour's deployment of a purposive approach.

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25 *Commissioner of Inland Revenue v Wattie* [1999] 1 NZLR 529 (PC).

26 *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 (HL); *McKenzies (NZ)*, above, 746, Richardson J; *Wattie,* above, 539.

27 *Smout v Commissioner of Inland Revenue* (1982) 5 NZTC 61,158 (CA).

The *Smout* case was from the time when New Zealand employed a classical system of company taxation; that is, profits were taxed in the hands of companies as earned and taxed a second time in the hands of shareholders when they were distributed as dividends. There was a rule that exempted inter-corporate dividends from tax; otherwise, there would have been yet more tax as profits flowed up corporate chains from one company to another. But people found even two bites of tax at least one too many. In response, they spent a long time thinking of ways to reduce taxation suffered by company profits to a single impost. Generally speaking, such mechanisms relied on the principle that money is fungible. That is, from the point of view of companies and their shareholders, if a company paid out revenue profits it did not much matter what the company chose to call the distribution. So long as the company retained enough money for its capital requirements, and so long as it observed the rules of company law, distributions to shareholders could, broadly speaking, be attributed to whatever account or labelled with whatever name yielded the best fiscal result.

The scheme in the *Smout* case relied also on a second principle: that New Zealand does not tax capital gains. Because of this exemption, Parliament enacted a corollary: corporate dividends paid from capital profits were exempt from tax in the hands of shareholders. The result was, therefore, equitable. For instance, if a manufacturing concern sold its factory at a profit, the tax consequence was the same whether the undertaking making the sale was a sole tradership or a company. For a sole trader, the profit was exempt as a capital receipt. For a company, the same applied, and when the company distributed its capital profit the distribution was exempt in the hands of individual shareholders.

Smout involved a scheme to enable companies to distribute accumulated revenue profits as if they were capital profits. The scheme did not exempt revenue profits from tax in the hands of the company, but it enabled the profits to go to shareholders without suffering the usual second bite of tax of the classical system.

Smout schemes required companies to have two things: accumulated revenue profits and a subsidiary that owned a capital asset. As occurred in *Smout* itself, the subsidiary sold its capital asset to its parent company, obtaining a price that resulted in a large profit. No economic value needed to change hands because economically all transactions belonged to the same individuals, the shareholders in the parent company. In effect, the profit was a paper profit, no more real than the profit made by a left-hand pocket if it sells a handkerchief to a right-hand pocket for the money in the right-hand pocket. Both handkerchief and money still belong to the owner of the pockets. The only things that have changed are the accounts of the pockets' contents.

Having realised a paper profit on the sale of its asset the subsidiary would declare a dividend of that profit in favour of the parent company. The parent company would then distribute this "capital" profit to its individual shareholders. Since there was no true

realised profit, the value that went to the shareholders was in effect the revenue profits that resided within the parent company. To take the distribution from anywhere else would breach the rule of company law that, generally speaking, requires dividends to be paid only out of profits.

A simplification of a *Smout* scheme was for a parent company with revenue profits to sell a capital asset of the parent to a subsidiary for another paper profit. The "profit" was thus immediately within the parent company and did not have to be fetched via a distribution from the subsidiary. When retained revenue profits were (in effect) distributed the company would debit the distribution to its "capital" profit.

As Mr McLeod explains, the *Smout* case involved the interpretation of two rules that provided for exemption from tax: a rule that exempted inter-corporate dividends, and a rule that exempted distributions of capital profits. For present purposes, the terminology of the rules is not important. What *is* important is the issue of how the court might apply a purposive interpretation to the rules. One option might be to say: a major purpose of the classical system of company tax legislation is to tax business profits, in the hands of both company and shareholder. Business profits have found their way into Mr Smout's hands by way of distribution from the company. Therefore, they should be taxed, notwithstanding that the company debited the distribution to an account that showed a capital gain.

In Mr McLeod's words, Richardson J resolved the problem differently, "by reference to the scheme and purpose of the dividend legislation. He concluded that inter-corporate capital dividends were exempt, and that they retained their character as a capital dividend when on-distributed to shareholders".[28] This decision promoted a different, perhaps more specific, scheme and purpose of the legislation than the broader purpose described in the previous paragraph. This different purpose that the *Smout* case identified was to protect capital gains from tax.

The problem was this: if Mr Smout had lost his case, and had had to pay tax, the result might not have been unfair in economic terms for him. After all, Mr Smout *did* derive what was *economically* a revenue profit. However, suppose that the subsidiary had sold its asset, at a profit, to an independent party that had paid cash. In these circumstances, the corporate group of parent and subsidiary would have had available two sources of funds for the proposed distribution: revenue profits and the subsidiary's capital profit. A distribution of the latter should be tax free in a system that exempts capital gains from tax. Interpreting the legislation to save such a distribution involved interpreting it to save the distribution received by Mr Smout.

28 Robert A McLeod "Collecting Taxes" (2002) 33 VUWLR, 793, 796.

If the problem is looked at in this light, the *Smout* court was faced with two legislative purposes: to tax revenue profits and to exempt capital gains. The first was a broad, general purpose. The second was more immediate in the context of the case. But who would say, with Mr McLeod, that one reflected the "scheme and purpose" of the Act better than the other?

Why does income tax law pose such intractable problems? The reason is that income tax law is based on the erroneous assumption that one can make a distinction between capital and revenue that is valid for purposes of economic policy. The *Smout* case demonstrates that this distinction is often a distinction of law rather than of economics and that it is sometimes possible to transform revenue into capital relatively easily. In such circumstances, applying a purposive approach to statutory interpretation takes on an esoteric quality that has meaning for tax law, but that is different from what lawyers mean by a "purposive approach" in other contexts.

Elsewhere in the law, the "purpose" of a purposive approach to interpretation refers to a purpose outside the law itself. For instance, the purpose of anti-trust legislation is not to prevent cartels for the sake of preventing cartels, but in order to promote economic efficiency. In tax law, as the courts interpret tax law, a statutory "purpose" may be self-referential, to promote the law's own purpose. Often, the result can be to promote the purpose of a concept that exists only within tax law. The best example is the distinction between capital and revenue that is at the centre of Mr McLeod's example. Economists and accountants may recognise the core of this distinction, but within the Income Tax Act it has a life of its own, as the *Smout* case demonstrates.

Sometimes Judges kick against the pricks of tax law. Dr Harley quotes the example of Thomas J in *Peters v Davison*:[29]

> The objective of the Income Tax Act is to collect tax on income. Income is derived from the [economic] substance of a transaction, not its form [nor, his Honour might have added, from its legal substance]. It is therefore necessary to have regard to the [economic] substance of a transaction and not just the form in which it is fabricated to determine the true income and the tax which is payable on that income. For either the tax authorities or the Courts to do otherwise is to thwart the objective of the Act.

Lay people and lawyers other than tax lawyers might regard Thomas J's remarks as self-evident. But to tax orthodoxy, as Dr Harley points out, "Thomas J's views were in error".[30]

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29 *Peters v Davison* [1999] 2 NZLR 164, 201 (CA). Also, Dr Geoff Harley "Collecting Taxes"(2002) 33 VUWLR, 755, 782.

The factors discussed in the preceding paragraphs show how difficult it is for Judges in tax cases to deploy Sir Ivor Richardson's "twin pillars" of statutory interpretation, to which Mr McLeod refers, namely,[31] "the scheme of the legislation and the purpose of the legislation".[32]

Apparently referring to a case such as *Smout*, Sir Ivor said:[33]

> [I]f the Commissioner invokes wide general provisions to justify treating as income distributions to shareholders from capital sources, it is appropriate to review the legislative history, the social and economic reasons for the separate treatment of companies and shareholders, and the design of double tax treaties and other international implications when considering the scheme of the legislation as a whole. All this is done in the course of determining the meaning and applicability of the specific provisions relied on.

When applied to the *Smout* case, the result of this test was to treat a distribution that for company law and for economic purposes was from revenue profits as if it were economically from a capital source, whereas in fact the source could be described as "capital" only in tax terms. As Sir Ivor went on to say:[34]

> The attempted reconciliation of the general objectives of the legislation and the quest for the assumptions underlying a new section may not help at all in determining the precise scope of a specific provision.

V CONCLUSION

Individually, the McLeod and Harley articles are very welcome contributions to tax law scholarship. Taken together, the articles afford valuable insights into several characteristics of income tax law that are often obscure. Take the no halfway house axiom,[35] as an example.

As is apparent from Dr Harley's article, direct migration of the "sham or valid, no halfway house" axiom from the general law to tax law causes a good deal of difficulty for tax collectors. The problem starts when taxpayers construct transactions in a manner that achieves legal results that are different from the transactions' economic effects. As Dr

30 Harley, above.

31 McLeod, above, 796.

32 Rt Hon Sir Ivor Richardson "Appellate Court Responsibilities and Tax Avoidance" (1985) 2 Aust Tax For 3, 8.

33 Richardson, above.

34 Richardson, above.

35 John Prebble "Collecting Taxes: A Commentary" (2002) 33 VUWLR, 743.

Harley explains, and as Mr McLeod's example of *Smout v CIR* demonstrates, courts seized of tax cases decide those cases on the basis of legal structures, not of economic effect.

The Commissioner is handicapped in that he is not privy to, much less a party to, taxpayers transactions that he may later impugn. Contrast this position with the circumstances in which the sham/valid issue is likely to arise in non-tax law. Take, for instance, cases on usury[36] or cases where it is alleged that a company has unlawfully supported the purchase of its own shares.[37] In such cases, the party that stands to benefit from a finding that the impugned transaction is a sham was usually a party to the original transaction: say, the borrower in a usury case or the company where support of share purchases is alleged. A sham/valid analysis can be a useful tool in such cases, perhaps demonstrating that the parties never intended to follow the purported formalities of their transactions.

In contrast, in a tax case it will almost always be in the interests of both parties first to construct their transaction in a manner that defeats the Commissioner, and secondly, jointly to defend that transaction against that official. In these circumstances, it is not surprising that the Commissioner rarely even alleges sham, let alone establishes it. A possible solution might be a judge-created concept of "tax sham". However, precedent has come too far for this to happen. Except in egregious cases, one can hardly criticise modern courts for hewing to long-established orthodoxy and eschewing a search for the economic realities of parties' transactions.

Sir Ivor Richardson's words that Mr McLeod quotes from "Law and Economics – and Why New Zealand Needs It"[38] summarise the all-too-frequent fate of economic analysis when there is a tax problem at bar: "[P]recedent may, when interpreting [tax] statutes … trump efficiency".

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36 Contrary to the Moneylenders Act 1908.

37 Contrary to the former Companies Act 1955, s 62.

38 Sir Ivor Richardson "Law and Economics – and Why New Zealand Needs It" (Paper presented to New Zealand Law Society Conference, Wellington, 2001) paragraph 65, quoted in Robert A McLeod "Collecting Taxes" (2002) 33 VUWLR, 793, 807.