COLLECTING TAXES

Robert A McLeod*

I INTRODUCTION

I am honoured to present at this conference to celebrate Sir Ivor Richardson's career in the law. It is generally accepted that Sir Ivor is a tax expert who has had more influence on tax law and practice than any other New Zealand Judge.

I have been privileged to have worked with Sir Ivor on various occasions, principally in the field of tax reform and tax education. There are three aspects of taxation that I wish to focus on in this paper, namely (a) the interpretation of tax legislation, (b) the resolution of tax disputes, and (c) the application of economic analysis to law. These are three topics that are hopefully of interest to a wider audience and where Sir Ivor has had a material influence. I intend to describe the key issues, outline Sir Ivor's perspectives alongside other perspectives, and conclude with my own opinions on these matters.

II INTERPRETING TAX LEGISLATION

Technically, taxation law originates from legislation, but its meaning is determined by the courts. Tax legislation is typically complex and ambiguous. History reflects a variety of judicial approaches to taxing statutes over time and across jurisdictions. Some Judges have preferred a literal approach on the principal basis that that gives a more certain and predictable outcome. Others have preferred to resolve ambiguity in favour of taxpayers on the basis that taxes are a confiscation of property and should only be imposed under clear rules. Other Judges (including Sir Ivor) have stressed a more purposive approach to statutory interpretation by reference to its broader scheme and purpose. Sir Ivor discusses the interpretation of tax statutes in his paper:[1]

> The twin pillars on which our approach to statutes rests are the scheme of the legislation and the purpose of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Act including the long title, analysing its structure and examining the relationship between the various provisions, and recognising any

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* Chair of the New Zealand Business Roundtable.

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

> discernible themes and patterns and underlying policy considerations. It presupposes that in that way the study of the statute or of a group of sections may assist in the interpretation of a particular provision in its statutory context. It may provide a detailed guide to the intentions of the framers of the legislation and in so doing may cast light on the meaning of the provision in question. Certainly that seems to me a preferable means of ascertaining the purpose or purposes of a provision rather than attempting to elicit it simply from consideration of the language of the section in isolation. Tax legislation is complex but it is also explicit and detailed. Once judges get to know the Act it is not difficult to discern the basic features of the income tax and to go on to consider the particular series of provisions having regard to their statutory history and so how they fit into the general scheme of the legislation. Thus, if 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.

The scheme and purpose approach to statutory analysis does not furnish an answer to all interpretation problems, least of all tax problems. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. Such legislation is invariably long and complex, reflecting the inevitable compromises that the subject matter demands, and it bears the hands of many draftsmen in the numerous amendments made over the years. So it is unwise to expect perfect logical symmetry in the drafting, particularly of provisions that are not closely related. Again, the general scheme of the legislation may not provide any clear answers to the meaning of a specific provision. 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 the provision. The objectives of the provision in that regard and their attainment in the circumstances simply may not be sufficiently discernible at the limits of its operation.

Giving full weight to those considerations I am still satisfied that the emphasis on trying to discern the scheme and purpose of the legislation is likely in many cases to lead to the resolution of interpretation problems in the tax avoidance field that best reflects the intention of Parliament as expressed in the statute.

Sir Ivor does not subscribe to the view that there should be any bias, either in favour of the taxpayer or the Crown, in applying tax legislation:[2]

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2 This is demonstrated by the decision in *Lowe v Commissioner of Inland Revenue* (1981) 5 NZTC 61,006, 61,021 (CA) Richardson J.

> But that does not entitle any court to make a pre-judgment as to the intention of the legislature in enacting section 88AA(1)(d). Our interpretation of the paragraph must turn on the scheme and language of the statutory provision giving the words their ordinary meaning in their context. Mr Molloy urged us to adopt what he described as a purposive construction, which in his submission would confine the profits reached by the paragraph (which he emphasised was concerned with the determination of assessable income in an income tax statute) to profits or gains traditionally regarded as of an income nature unless in its terms the paragraph was clearly shown to have a wider scope. No doubt he had in mind the injunction contained in section 5(j) of the Acts Interpretation Act 1924 to accord to legislation such fair, large and liberal construction as will best ensure the attainment of the object of the legislation according to its true intent, meaning and spirit. It may equally be said that in a general way, in imposing a new regime for the taxing of gains on certain land transaction, Parliament has in section 88AA demonstrated an intent to extend the tax net and include some gains previously regarded as capital in nature. However, I do not find the reconciliation of general objectives and the quest for the assumptions underlying the new section helpful in determining the precise scope of paragraph (d). The objectives of the provision in that regard and their attainment in the circumstances are not sufficiently clearly discernible at the limits of its operation. Accordingly I have preferred to follow the approach indicated in the classic statement of Rowlatt J:[3]
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> > Now of course it is said and urged by Sir William Finlay that in a taxing Act clear words are necessary to tax the subject. But it is often endeavoured to give to that maxim a wide and fanciful construction. It does not mean that words are to be duly restricted against the Crown or that there is to be any discrimination against the Crown in such Acts. It means this, I think; it means that in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no presumption as to a tax; you read nothing in; you imply nothing, but you look fairly at what is said at and that is the tax.

Sir Ivor stated his support for a purposive approach to interpretation quite emphatically:[4]

> In my view that interpretation approach does not depend on a prior characterisation of the particular provision as economic or fiscal. Rather the purpose of the approach mandated by section 5(j) is of general application and so applies to all the provisions of the Income Tax Act whether economic or fiscal in character. That approach requires consideration of the scheme

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3 *The Cape Brandy Syndicate v The Commissioners of Inland Revenue* (1920) 12 TC 358, 366 (CA).

4 *James Bull Limited v Commissioner of Inland Revenue* (1993) 15 NZTC 10, 337, 10,340 (CA) Richardson J.

> and language of the legislative provisions in question and the relevant objectives of those provisions. That is why in so many income tax decisions in recent years whether concerning incentive provisions or other provisions of the tax legislation we have adopted an avowedly purposive approach without specific reference to the International Importing case.

I support Sir Ivor's approach to resolving tax ambiguities by reference to the scheme of tax legislation. In New Zealand, this is given legitimacy by interpretation legislation. I also believe it to be good tax policy. The decision in *Smout v CIR*[5] provides a good illustration. In that case, a subsidiary company sold capital assets to its parent company for a capital profit. The subsidiary paid a dividend from this capital profit to its parent, which onpaid it to its individual shareholders. The legislation provided that capital profits were tax free to the subsidiary. It also provided that dividends paid from capital profits were deemed not to be dividends. Furthermore, dividends paid between companies were deemed to be exempt tax. The legislation was clumsy. First, if capital dividends were deemed to not be dividends, they could not qualify for the inter-corporate dividend exemption. Inter-corporate capital dividends would therefore attract harsher tax treatment than ordinary inter-corporate dividends. Secondly, deeming dividends from capital profits not to be dividends, on a literal reading, did not exclude them from some classes of assessable income. Sir Ivor resolved these anomalies 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 individual shareholders.

The most difficult and unsatisfactory part of taxation law, which is a particular problem of statutory interpretation, concerns tax avoidance. In my view, neither the Judges nor the legislators have developed an effective framework for regulating tax avoidance. Some say that a satisfactory law of tax avoidance is an impossibility, and that there should be no general income tax avoidance law. Others argue that avoidance law should be judicially formulated rather than legislative. We observe a diversity of judicial approach across time and place to defining and applying avoidance provisions. This diversity unfortunately contributes to an uncertain and unstable tax avoidance law.

I consider that the principal test for the adequacy of avoidance law is whether tax stakeholders can predict that an anticipated arrangement or determine that an actual arrangement constitutes tax avoidance. A contrary argument is that an uncertain tax avoidance law beneficially increases the cost of tax avoidance transactions: risk-averse taxpayers are more likely to engage in less tax avoidance around an uncertain boundary. Unfortunately, however, that uncertainty will also discourage legitimate transactions and

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5 *Smout v CIR* (1982) 5 NZTC 61,158 (CA).

complicate dispute resolution. I believe these latter costs are likely to outweigh the benefits of intimidation.

Sir Ivor addressed the question of the interpretation of avoidance provisions in the decision of *CIR v Challenge Corp Ltd*.[6] That case concerned the construction of a general anti-avoidance provision, namely section 99 of the Income Tax Act 1976. He stated:[7]

> Section 99 thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end, the legal answer must turn on an overall assessment of the respective roles of the particular provision and section 99 under the Statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to [s]tatutes mandated by section 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.

Certainly, the scheme and purpose approach to statutory analysis will not furnish an automatic easy answer to these interpretation problems. Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. There is force in the thesis that in many respects the tax base is so inconsistent and contains so many structural inequities that a single general anti-avoidance provision such as section 99 cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences.[8] Nevertheless, that emphasis on trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between section 99 and other provisions of the Act that best reflects the intention of Parliament as expressed in the Statute.

The necessary starting point is that each section has its function under the Statute. And where, as is often the case, there is a specific anti-avoidance provision, that will be a highly relevant consideration, but not one that is necessarily determinative.[9] For the inquiry is as to whether there is room in the statutory scheme for the application of section 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the

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6 *Commissioner of Inland Revenue v Challenge Corp Ltd* (1986) 8 NZTC 5,001 (CA).

7 *Challenge Corp,* above, 5,020, Richardson J.

8 Geoff J Harley "Structural Inequities and Concepts of Tax Avoidance" (1983) 13 VUWLR 38.

9 *McKay v Commissioner of Inland Revenue* (1973) 72 ATC 6058; [1973] 1 NZLR 592 (CA).

particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading section 99 in this way is to give it its true purpose and effect in the statutory scheme and so to allow it to serve the purposes of the Act itself. It is not the function of section 99 to defeat other provisions of the Act or to achieve a result, which is inconsistent with them.

In my view, tax avoidance legislation can be significantly improved. I recommend a two-tier approach. First, focus only on those arrangements in relation to which a tax objective is dominant. Secondly, save those arrangements in which the Legislature can reasonably be regarded as condoning the tax consequence sought by the taxpayer. This second test is necessary to save those commercial decisions in which tax factors must dominate, such as making certain tax elections. I am also of the view that avoidance provisions are a blunt instrument and cannot be relied on to substantially mitigate the economic costs of avoidance activity. Tax systems should be designed in ways that reduce the returns to avoidance activities, the key design elements being:

(1) A broad tax base;

(2) Lower tax rates;

(3) Effective penalty and interest systems;

(4) Effective disclosure, scheme registration and rulings regimes;

(5) Effective policy formation and implementation; and

(6) Effective detection, audit, and dispute (including judicial) resolution.

An aspect of tax avoidance that has also been contentious in tax law concerns the distinction between form and substance. Taxation is usually concerned with transactions and arrangements entered into by taxpayers. For example, an income tax deduction might be conferred on interest incurred by a parent company to buy shares in a subsidiary company. But what if the parent's intention is that its subsidiary company will use the proceeds of its share issue to buy shares in an arms' length company? If the subsidiary had borrowed and incurred interest to acquire the stranger company directly, it would not have obtained a tax deduction. Should the parent company get a tax deduction if the substance of the transaction was a borrowing by the subsidiary? But what is the substance of the transaction?

Some Judges prefer that tax legislation should be applied to the so-called substance of the transaction, either on the basis of avoidance legislation, or on a more generalised view of the nature of tax legislation. Other Judges prefer that it be applied to the legal form of the transaction. There are yet other Judges that approach the issue from another perspective. They say that applying the statute is not really a question of how transactions

are to be legally analysed independently of the statute, but rather how the legislation deals with those transactions for tax purposes.

The latter approach is exemplified by Lord Hoffmann's judgments in several recent decisions. For example, he states:[10]

> A loss which arises at one stage of an indivisible process and cancelled out at a later stage of the same process is "not such a loss as the legislation is dealing with". The tax was not imposed "on arithmetical differences". In that case, what kind of loss was the legislation dealing with? The contrast being made throughout Lord Wilberforce's speech is between juristic or arithmetical realities on the one hand and commercial realities on the other. He is construing the words "disposal" and "loss" to refer to commercial concepts which are not necessarily confined by the categories of juristic analysis. In the *Ramsay* case [1982] AC 300, a director, or an accountant concerned to present a true and fair view of the taxpayer's dealings, would not have said that the company had entered into a transaction giving rise to a loss which happened to have been offset by a corresponding gain. There had never been any commercial possibility that the transactions would not have cancelled each other out. Therefore, notwithstanding the juristic independence of each of the stages of the circular transaction, the commercial view would have been to lump them all together, as the parties themselves intended, and describe them as a composite transaction which had no financial consequences. The innovation in the *Ramsay* case was to give the statutory concepts of "disposal" and "loss" a commercial meaning. The new principle of construction was a recognition that the statutory language was intended to refer to commercial concepts, so that in the case of a concept such as a "disposal", the court was required to take a view of the facts which transcended the juristic individuality of the various parts of a preplanned series of transactions.

Lord Hoffmannn adopts the same approach in *O'Neil v CIR*,[11] an appeal from New Zealand, where he stated:[12]

> It may be more fruitful to concentrate on the nature of the concepts by reference to which tax has been imposed. In many (though by no means all) cases, the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis. A composite transaction like the Russell scheme, which may appear not to create any tax liability if it is analysed with due regard to the juristic

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10 *McKay*, above.

11 *O'Neil v Commissioner of Inland Revenue* (2001) 20 NZTC 17,051 (PC); also reported as *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC).

12 *O'Neil,* above, 17,057, Lord Hoffmann.

> autonomy of each of its parts, can be viewed in commercial terms as a unitary arrangement to enable the company's net profits to be shared between the shareholders and Mr Russell.[13] Their Lordships consider this to be a paradigm of the kind of arrangement which section 99 was intended to counteract. On the other hand, the adoption of a course of action which avoids tax should not fall within section 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.

It is interesting to compare Lord Hoffmann's approach with that taken by the House of Lords,[14] where Lord Steyn made the following remarks:[15]

> It is necessary to distinguish between two separate questions of law. The first is whether there is a special rule applicable to the construction of fiscal legislation. The second question is whether there is a rule precluding the court from examining the substance of a composite tax avoidance scheme. I consider first the construction of tax statutes.

Towards the end of the last century Pollock characterised the approach of Judges to statutory construction as follows: "Parliament generally changes the law for the worse, and that the business of judges is to keep the mischief of its interference within the narrowest possible bounds".[16]

Whatever the merits of this observation may have been when it was made, or even earlier in this century, it is demonstrably no longer true. During the last 30 years, there has been a shift away from literalist to purposive methods of construction. Where there is no obvious meaning of a statutory provision the modern emphasis is on a contextual approach designed to identify the purpose of a statute and to give effect to it. But under the influence of the narrow *Duke of Westminster* doctrine, tax law remained remarkably resistant to the new non-formalist methods of interpretation. It was said that the taxpayer was entitled to stand on a literal construction of the words used regardless of the purpose of the statute.[17] Tax law was, by and large, left behind as some island of literal interpretation. The second problem was that in regard to tax avoidance schemes the courts regarded themselves as compelled to adopt a step-by-step analysis of such schemes, treating each step as a distinct transaction producing its own tax consequences. It was

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13 Compare with *Macniven v Westmoreland Investments Ltd* [2001] 2 WLR 377 (HL).

14 *Inland Revenue Commissioner v McGuckian* [1997] 3 All ER 817 (HL).

15 *McGuckian,* above, 824, Lord Steyn.

16 Sir Frederick Pollock *Essays on Jurisprudence and Ethics* (Greenwood, London, 1882) 85.

17 *Pryce v Monmouthshire Canal and Rly Cos* (1879) 4 AC 197, 202-203 (HL); *Cape Brandy Syndicate v Inland Revenue Commissioner* [1921] 2 KB 64, 71 (CA); *Inland Revenue Commissioner v Plummer* [1980] AC 896 (HL).

thought that if the steps were genuine, that is to say, not sham or simulated documents or arrangements, the court was not entitled to go behind the form of the individual transactions. In combination those two features — literal interpretation of tax statutes and the formalistic insistence on examining steps in a composite scheme separately — allowed tax avoidance schemes to flourish to the detriment of the general body of taxpayers. The result was that the court appeared to be relegated to the role of a spectator concentrating on the individual moves in a highly skilled game: the court was mesmerised by the moves in the game and paid no regard to the strategy of the participants or the end result. The courts became habituated to this narrow view of their role.

On both fronts the intellectual breakthrough came in 1981, in the *Ramsay* case,[18] and notably in Lord Wilberforce's seminal speech, which carried the agreement of Lord Russell of Killowen, Lord Roskill, and Lord Bridge of Harwich. Lord Wilberforce restated the principle of statutory construction that a subject is only to be taxed upon clear words.[19] To the question "what are clear words?", he gave the answer that the court is not confined to a literal interpretation. He added, "There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded". This sentence was critical. It marked the rejection by the House of pure literalism in the interpretation of tax statutes.

But that left the problem of the courts' self-denying ordinance of not examining the true nature of a composite transaction. Lord Wilberforce observed that the *Duke of Westminster's* case did not compel the court to look at documents or transactions in blinkers, isolated from the context in which they properly belong.[20] Lord Wilberforce concluded:[21]

> While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step-by-step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established; and a legal analysis made; legislation cannot be required or even be desirable to enable the courts to arrive at a conclusion which corresponds with the parties' own intentions.

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18 *Ramsay* [1982] AC 300 (HL).

19 *Ramsay,* above, 323.

20 *Ramsay,* above, 323.

21 *Ramsay,* above, 326.

In other words, if it was shown that a scheme was intended to be implemented as a whole, legal analysis permitted the court in deciding a fiscal question to take into account the composite transaction.

While Lord Tomlin's observations in the *Duke of Westminster's* case[22] still point to a material consideration, namely the general liberty of the citizen to arrange his financial affairs as he thinks fits, they have ceased to be canonical as to the consequence of a tax avoidance scheme. Indeed, as Lord Diplock observed, Lord Tomlin's observations tells us little or nothing as to what method of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would otherwise be payable.[23]

The new *Ramsay* principle was not invented on a juristic basis independent of statute. That would have been indefensible since a court has no power to amend a tax statute. The principle was developed as a matter of statutory construction. That was made clear by Lord Wilberforce, in the *Ramsay* case,[24] and is also made clear in subsequent decisions in this line of authority (see the review in the dissenting speech of Lord Goff of Chieveley).[25] The new development was not based on a linguistic analysis of the meaning of particular words in a statute. It was founded on a broad purposive interpretation, giving effect to the intention of Parliament. The principle enunciated in the *Ramsay*[26] case was, therefore, based on an orthodox form of statutory interpretation. And in asserting the power to examine the substance of a composite transaction the House of Lords was simply rejecting formalism in fiscal matters and choosing a more realistic legal analysis. Given the reasoning underlying the new approach it is wrong to regard the decisions of the House of Lords, since the *Ramsay* case, as necessarily marking the limit of the law on tax avoidance schemes.

While Lord Hoffmann's reasoning can arguably be reconciled with Lord Steyn, the underlying philosophies are clearly different. Lord Templeman, whom I predict would wholeheartedly agree with Lord Steyn, believes the approach in *Westmoreland*[27] is inconsistent with the foundation fiscal nullity cases. In his article, he states: "The *Westmoreland* case fails to apply the principles and precedents established by *Ramsay,*

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22 *Inland Revenue Commissioner v His Grace the Duke of Westminster* [1936] AC 1 (HL).

23 *Inland Revenue Commissioner v Burmah Oil Co Ltd* [1982] STC 30, 32-33 (HL).

24 *Ramsay*, above.

25 *Craven (Inspector of Taxes) v White* [1988] 3 All ER 495, 531-532; [1989] AC 398, 520-521 (HL).

26 *Ramsay*, above.

27 *Westmoreland* [2001] 2 WLR 377 (HL).

Burmah and *Furniss*. The future is uncertain because the attempt by Lord Hoffmann to distinguish that which cannot logically be distinguished".[28]

Sir Ivor has maintained a conventional approach in the area of form and substance. For example, he summarised the position as follows:[29]

> The legal principles governing the ascertainment of the true legal character of a transaction are now well settled and for recent discussions in this Court it is sufficient to refer to, *Buckley & Young Ltd v Commissioner of Inland Revenue* [1978] 2 NZLR 485*, Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 and *Commissioner of Inland Revenue v Smythe* [1981] 1 NZLR 673. It frequently happens that the same result in a business sense can be attained by two different legal transactions. The parties are free to choose whatever lawful arrangements will suit their purposes. The true nature of their transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Not on an assessment of the broad substance of the transaction measured by the results intended and achieved; or of the overall economic consequences to the parties; or of the legal consequences which would follow from an alternative course which they could have adopted had they chosen to do so. The forms adopted cannot be dismissed as mere machinery for effecting the purposes of the parties. It is the legal character of the transaction that is actually entered into and the legal steps which are followed which are decisive. That requires consideration of the whole of the contractual arrangement and if the transaction is embodied in a series of inter-related agreements they must be considered together and one may be read to explain the others. In characterising the transaction regard is had to surrounding circumstances: not to deny or contradict the written agreement but in order to understand the setting in which it was made and to construe it against that factual background having regard to the genesis and objectively the aim of the transaction. The only exceptions to the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out are: (i) where the essential genuineness of the transaction is challenged and sham is established; and (ii) where there is a statutory provision, such as section 99 of the Income Tax Act 1976, mandating a broader or different approach which applies in the circumstances of the particular case. A document may be brushed aside if and to the extent that it is a sham in two situations: (a) where the documents does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions (as happened in *Marac Finance Ltd v Virtue*); and (b) where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

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28 Lord Templeman "Tax and the Taxpayer" (2001) 117 LQR 575.

29 *Mills v Dowdall* [1983] NZLR 154, 159-160 (CA) Richardson J.

The reason why the Courts have adopted the approach I have been discussing is obvious enough. Those in commerce are entitled to order their affairs to achieve the legal and lawful results that they intend. If they deliberately enter into a genuine transaction intended to operate according to its tenor, those intentions should be recognised. It is what they choose to do that counts and their rights and obligations should be determined on that basis except where the legislation has itself directed otherwise.

I support Sir Ivor's approach to transactional analysis because it gives a more predictable and clearer interpretation. I would prefer that the courts do not place the entirety of tax law on a more uncertain footing in order to contain tax avoidance. This is one reason why I prefer tax avoidance to be regulated by specific legislation. A substantive interpretation is typically elusive and subjective. In economics, uncertainty attracts a discount that reduces the expected after-tax benefits from market transactions. This translates to an increase in the dead-weight loss of taxation by either moving the relevant supply curve (being the marginal cost curve) up, or moving the relevant demand curve down.

III RESOLVING TAX DISPUTES

In 1993, the Government asked a Review Committee chaired by Sir Ivor to carry out a fundamental, strategic review of the Inland Revenue Department (IRD) and its activities. The Review Committee was to *investigate and recommend the optimal organisation arrangements for the tax assessment and collection system, and other activities that are currently part of the tax system, the provision of taxation policy advice, legislative management and Ministerial servicing*. The Review Committee developed a vision for tax administration in New Zealand, which included (among other things):

> IRD is collecting the highest net revenue over time that is practicable within the law; and taxpayers believe that if they disagree with any decision, the dispute will be handled fairly and quickly.

The Review Committee summarised several key issues including that *the resolution of tax disputes needs to be quicker and less cumbersome*. A number of problems were identified, including the ability of the Commissioner to reconsider the accuracy of his assessments, (thereby undermining the incentive to achieve accuracy at the outset), insufficient upfront technical skill, delay, excessive costs, and the dual role of the Commissioner as player and referee. The Review outlined a detailed process for the resolution of disputes. The key recommendations in dispute resolution were as follows:

> Most taxpayers' queries to IRD are resolved quickly. But taxpayers and IRD may not agree on the facts or interpretation of the law. Current procedures and practices for resolving disputes are not satisfactory, particularly for taxpayers. Yet it is vital that taxpayers believe any dispute

will be handled fairly and quickly. Otherwise they may not be willing compliers in the future. Recommendations to improve disputes resolution are:

(1) a revised tax disputes resolution process should be introduced. At the pre-assessment phase a revised approach is designed to ensure that, so far as possible, assessments will be correct. This will be supported by the availability of information, evidence exclusion provisions and early application of appropriate expertise. Post-assessment, the recommended approach provides for more effective taxpayer initiated litigation, subject to standard judicial procedures and timetabling; and

(2) a simple, "fast track", non-precedential procedure for dealing with small claims should be introduced as part of the jurisdiction of the Taxation Review Authority.

A comprehensive review of the present arrangements for resolving tax disputes through the High Court and the Taxation Review Authority would require considerable time. Although there is evidence of problems that contribute to overall delays at this stage of the process, the proposed new process should address most of the current concerns. A period of time should be allowed to assess the impact of these changes. Accordingly, it is recommended that a review of the operation of the new procedures for disputes resolution should be carried out two years after all elements of the new procedures are in place.

As a member of the Advisory Committee to the Review, I supported the view that the disputes resolution process was an area where a set of more comprehensive rules were needed. Some of the problems identified prior to the introduction of the disputes resolution regime have not been completely eliminated by the new rules. The Court of Appeal decision in *Simunovich Fisheries Ltd v CIR*[30] provides a good illustration of the style that was criticised in the Richardson review.

In *Simunovich Fisheries*, the taxpayer bought a ship and was first denied, and then later granted an input tax deduction for GST (Goods and Services Tax) purposes. The initial argument of the Commissioner was that the purchase was not a second-hand good (as claimed by the taxpayer), and therefore a valid tax invoice was needed. The Commissioner then conceded the input credit in response to the taxpayer's arguments that as a taxable supply, a tax invoice was not needed where the amount of the claim could be supported by other evidence. When the taxpayer subsequently sold the vessel, the Commissioner attempted to change the GST classification of the vessel back to a second-hand good, which would have had the effect of disqualifying it from a zero-rated classification, as an exported good. Part of the Commissioner's justification for doing this was the taxpayer's initial objection (more than four years earlier) that the acquisition was

30 *Simunovich Fisheries Ltd v Commissioner of Inland Revenue* [2002] 2 LLR 5/6 (CA).

of second-hand goods. The High Court described this as "transparently opportunistic", but still held that the Commissioner was entitled to classify the vessel as a second-hand good. In the Court of Appeal, however, Sir Ivor held that the Commissioner could not reclassify the vessel on sale as a matter of law, without reclassifying the vessel at the time of purchase. The assessment of GST at the time of purchase, namely that the input credit was claimable on the *taxable* supply, stood until it was formally challenged by the Commissioner. Without changing this assessment, the Commissioner could not legally reclassify the vessel in relation to later periods. Sir Ivor said:

> For the Commissioner to disregard a basic inconsistency of that kind would undermine the integrity of the tax system which he has the duty under section 6 of the [Tax Administration Act 1994] to use his best endeavours to protect.

IV LAW AND ECONOMICS

In his paper entitled "The Impact and Influence of Accounting and Economic Principles on Taxation Law",[31] Sir Ivor discussed the importance of economic analysis of legal rules. He states that:[32]

> The application of economic analysis to legal rules is important both when considering the current tax regime and when contemplating legislative change.
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> Economics is concerned with the use of society's limited resources. The resolution of disputes may involve the balancing of human rights and values with resource constraints and equity considerations. Those variables are important in the context of taxation. Resources are allocated and reallocated by the design and application of tax laws. The efficient and equitable use of scarce resources is an important starting point when considering how best to establish, operate, or reform a tax system, and how to resolve any disputes which arise.

Another reason why this field of study is important is that both law and economics are concerned with behaviour. A tax system depends in large part on anticipating the behaviour of individuals. The tax system develops rules of conduct that seek to influence behaviour. Sanctions are imposed for breach of those rules. As in other areas of law, rules, and sanctions should be designed and decisions made having regard to resource implications.

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31 Sir Ivor Richardson "The Impact and Influence of Accounting and Economic Principles on Taxation Law" (Paper presented to the Institute of Chartered Accountants of New Zealand 1997 Tax Conference, 6-8 November 1997).

32 Richardson, above, para 1.5.

In the last 30 years, a much wider use of economic analyses of legal rules has developed particularly in North America. The great American Judge, Justice Holmes of the United States Supreme Court, foresaw this 100 years ago. He said:

> For the rational study of the law the black letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics.

In this paper, Sir Ivor emphasises the importance of an empirical basis to economic analysis. He states that:[33]

> Regrettably there is very little published empirical research and analysis of our taxation laws and their administration. More research should be done to ascertain what happens in practice and to explore the costs and benefits of legal rules and administrative approaches. Empirical analysis is crucial in any public policy analysis. The links between the disciplines of economics and law need to be emphasised rather than be seen as boundaries beyond which it is unnecessary to travel. The same theme is picked up at paragraph 3: Only with the aid of reliable empirical data can theory be used to develop sound policy. This has not always been the case with the reforms which have occurred in New Zealand over the last decade or more. As the quantity and quality of empirical research improves, as it must notwithstanding the high resource costs of such research, the data which is revealed will be an important resource for policy-makers and tax reformers.

In his paper entitled "Law and Economics - and Why New Zealand Needs It",[34] Sir Ivor sounds caution about the limits of economic analysis. He states:[35]

> In short, there are two important qualifications that need to be made about economics. First, that the rational actor model may be overly simplistic, and second that, although there are important differences between positive and normative economics, the use of untested assumptions may, in effect, blur the distinction between them. Concerns of these kinds have been leveled particularly at some of the work of the "Chicago School", the most well known branch of the law and economics movement, particularly in the early days. But it is a mistake to equate law and economics with the Chicago School. Even in the United States things are changing as I will now explain.

These criticisms are related to Sir Ivor's emphasis on the need to ground economic analysis in empirical analysis. He refers to a need for a more realistic law and economics.[36] A good summary of Sir Ivor's overall perspective is provided where he states:[37]

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33 Richardson, above, para 1.6.

34 Richardson, "Law and Economics - and Why New Zealand Needs it" (Paper presented to New Zealand Law Society Conference, Wellington, 2001).

35 Richardson, above, para 9.

> To sum up at this point, I suggest that, a certain amount of skepticism on the part of judges is healthy, and in some cases may be warranted, particularly if the approach being adopted bears little relation to reality. It suggests that we should be wary of intuitive assessments of how people actually respond or are likely to respond in their economic and social behaviour under both existing and proposed new rules. If the economic theory has no empirical basis whatsoever – is simply a matter of theory – we as lawyers and judges have to be cautious about simply assuming its value in the practical world in which we operate. But my concern is that, certainly in New Zealand, the skepticism now appears to be so great in some quarters that the value of *any* economic analysis – even the more flexible, realistic and empirically grounded economics of the second wave - is neglected – often with little knowledge or understanding of what it can contribute to good legal development.

Sir Ivor seems to reject the position of Milton Friedman, reflected in his most famous article.[38] In this article, Friedman argues that the worth of a theory is to be determined by its ability to predict phenomena not yet observed. Friedman gives short shrift to the argument that the assumptions underlying a useful theory need to be *realistic*. He even addresses the same rational man model referred to by Sir Ivor, but with a different perspective:

> The abstract methodological issues we have been discussing have a direct bearing on the perennial criticism of "orthodox" economic theory as "unrealistic" as well as on the attempts that have been made to reformulate theory to meet this charge. Economics is a "dismal" science because it assumes man to be selfish and money-grubbing, "a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact"; it rests on outmoded psychology and must be reconstructed in line with each new development in psychology; it assumes men, or at least businessmen, to be "in a continuous state of "alert," ready to change prices and/or pricing rules whenever their sensitive intuitions ... detect a change in demand and supply conditions;" it assumes markets to be perfect, competition to be pure, and commodities, labour, and capital to be homogeneous.

As we have seen, criticism of this type is largely beside the point, unless supplemented by evidence that a hypothesis differing in one or another of these respects from the theory being criticised yields better predictions for as wide a range of phenomena. Yet most such criticism is not so supplemented; it is based almost entirely on supposedly directly

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36 Richardson 2001, above, para 13.

37 Richardson 2001, above, para 28.

38 Milton Friedman "The Methodology of Positive Economics", in Milton Friedman (ed) *Essays in Positive Economics* (The University of Chicago University Press, Chicago, 1953) 3-43.

perceived discrepancies between the "assumptions" and the "real world". A particularly clear example is furnished by the recent criticisms of the maximisation-of-returns hypothesis on the grounds that business people do not, and indeed cannot, behave as the theory "assumes" they do. The evidence cited to support this assertion is generally taken either from the answers given by business people to questions about the factors affecting their decisions — a procedure for testing economic theories that is about on a par with testing theories of longevity by asking octogenarians how they account for their long life — or from descriptive studies of the decision-making activities of individual firms. Little, if any, evidence is ever cited on the conformity of business people's actual market behaviour — what they do rather than what they say they do — with the implications of the hypothesis being criticised, on the one hand, and of an alternative hypothesis, on the other. A theory or its "assumptions" cannot possibly be thoroughly "realistic" in the immediate descriptive sense so often assigned to this term.

A couple of paragraphs summarise Sir Ivor's views about the overall role of law and economics:[39]

> My thesis is this: economics is relevant whenever a court is reviewing existing legal principles or is considering alternative legal rules. And it may be relevant in the exercise of discretionary power. Obviously, no judge can or should always privilege efficiency over all other values. The justice of compensating those who find themselves drinking decomposed snails may outweigh the costs associated with imposing a duty of care on gingerbeer manufacturers. And precedent may, and Parliamentary intention, when interpreting statutes, must, trump efficiency. But efficiency should at least be taken into account.
>
> I would hope that in the years to come we will see more use of rigorously argued and realistically grounded economic analysis - in the legislature, in and before the courts, and in the professional legal education arena - and also in the academic environment since it is there that the lawyers and judges of the future receive their first education (and there also where important research can usefully aid lawmakers in determining the direction their laws should follow).

I personally welcome Sir Ivor's enthusiasm to incorporate relevant economic principles in legal analysis. I also agree that there is a crucial distinction between positive and normative economics, and that one should be wary of relying on untested normative assumptions. While I agree with these perspectives, I believe that developing and understanding normative economic principles also requires emphasis however. Normative models give direction to lawmakers. Welfare economics, for example, is concerned with the philosophical questions of the goals of an economic system. At the

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39 Richardson, above, paras 65 and 101.

same time, there is a close interdependence between normative and positive thought. Most people choose between competing policies on the basis of predicted outcomes. Most disagreements about proposed actions or policies arise from differences in predictions.

Unlike Milton Friedman, I prefer to differentiate prediction from explanation. However, consistent with Friedman's view, I believe that theories or models do not have to be *realistic* in order to have explanatory power. Consider for example, the economist's model of perfect competition. That model is not a model of reality. Perfect competition does not exist in the real world. And yet that model survives, as an important part of economic teaching and understanding. It provides a market benchmark to an existing reality giving analysts an appreciation of the gap between that existing order and a perfect market order. I believe that lawyers would benefit from a better understanding of economics as a discipline, just as they benefit from understanding language as a discipline. Tax legislation has fiscal objectives and also focuses on economic concepts, such as income.

Unsurprisingly, the importance of theoretical frameworks were emphasised in the reports of the New Zealand Government's 2001 Tax Review, which I chaired. This is what we said about the need for frameworks in our first Issues Paper:[40]

> A framework of tax policy principles is needed to guide the reform of a complex tax system and to avoid *ad hoc* changes. The absence of a coherent (and preferably widely-understood and accepted) approach to tax policy makes for instability and uncertainty. We therefore focus in this chapter on establishing a general approach (or framework) to tax policy issues.
>
> A conventional approach to setting tax policy is to focus separately on the two objectives of making the system fairer and more efficient. We follow this approach in this chapter. We begin with a discussion of fairness, noting that while people will not always fully agree on what constitutes a *fair* system, it is possible to identify several tests that most people would agree a tax system must satisfy if it is to be considered fair. We also note that fairness is inextricably linked with the question of who actually bears the consequences of a tax – the economic impact of a tax will often be different from its statutory impact.
>
> Assessing the impact of changes to the tax system requires some understanding of the nature of the economic costs (and benefits) that taxes might give rise to. Our discussion of the efficiency effects of taxes therefore includes some discussion of the relevant economic concepts. We also discuss trade-offs between different aspects of efficiency and equity. Lowering the costs of the tax system in one direction may result in a higher cost elsewhere. Likewise, lowering the economic costs of the tax system may compromise the government's fairness goals.

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40 Tax Review "Issues Paper: Frameworks" (Wellington, 2001).

The Tax Review returned to the theme in its Final Report:[41]

> Most submissions did not take issue with the general principles of Chapter One, *Frameworks*, of the Issues Paper. However, some considered that they placed too much emphasis on economic theory rather than modern realities. Critics were keen to see a new approach, with a strong focus on lessons from either history or successful economies. Some submitters clearly consider that there is a lack of consensus about the effectiveness of economic frameworks, or that a focus on them has not coincided with a satisfactory performance of the New Zealand economy in recent times.
>
> We believe that principled frameworks are a prerequisite to designing effective tax policy. We also consider that the principles advanced in support of a particular framework only stand until displaced by a framework that enables better explanation and prediction. We also observe that frameworks that guide national tax reforms are inherently economic in nature.

I will attempt to demonstrate the value of a theoretical framework for income tax reform in helping resolve a public policy issue that is currently topical in New Zealand. There is a current debate as to whether tax incentives should be provided to stimulate particular industries. How should one think about this question? Proponents of tax incentives point to their existence in other countries. They point to the inability to effectively compete with tax subsidised foreign competitors. I believe tax economics still provides the best framework for thinking through this issue. It does not necessarily provide a silver bullet for its resolution however.

Tax economists draw a distinction between revenue taxes and corrective (or Pigouvian) taxes. The revenue tax is designed to raise a targeted amount of revenue at least cost. The total economic cost is called the dead-weight loss, or excess burden of the tax. This is the waste in economic resources that arises as a result of the tax. It includes administration costs by government and compliance costs by taxpayers. The essence of this cost is that as a result of the tax, things change from an otherwise optimal path. The loss refers to the differences in output arising from that change.

The corrective tax on the other hand is designed to correct some market imperfection. The market imperfections generally derive from what are called *externalities*. The theory of public goods is essentially an externality theory. Externalities or spillovers arise when transactions in the markets confer costs or benefits on third parties that do not come home to the transactors. Pollution is an example. A corrective tax is designed to get the transactors to internalise that external cost. The converse is also true. An activity might

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41 Tax Review "Final Report" (Wellington, 2001).

have positive third party consequences that are not factored into the decision. A tax subsidy might get the parties to internalise those external benefits.

A famous economist, Ramsey, proved that the most efficient tax is one that taxes activities according to their price sensitivities (elasticities).[42] The concept is to tax price sensitive activities relatively less and tax insensitive activities relatively more. This optimal tax results not in a flat tax system but a system with disparate tax rates. Ramsey's professor, Pigou, developed the theory of the corrective tax outlined above.[43] Both theories have practical limitations. In practice, most economists accept that we cannot capture the information necessary to design an optimal tax system under either Ramsey or Pigou. Note, however, that both these theories can be used to advance the use of incentives. An infant industry is price sensitive and therefore should be taxed more lightly. Price sensitivity is a function of substitutability, so if foreign jurisdictions give incentives, that increases price sensitivity in the New Zealand market. A winning industry produces national employment and reputation. These are external benefits and arguably can be justified using Pigou.

I have simplified the above analysis in order to communicate the essential points. We in the Tax Review 2001 sounded extreme caution in the use of these arguments. We said there should be a substantial burden of proof before moving away from a broad-base flat rate paradigm. Disparate taxes mean higher taxes for some activities. How sustainable is that? Disparate taxes also leads to political lobbying. They invoke difficult and subjective matters of fairness. Despite this approach, in my opinion, an objective understanding of the Ramsey and Pigouvian frameworks informs the analysis and leads to a better overall decision.

V CONCLUSIONS

The above review reveals a number of consistent qualities in Sir Ivor's work. There are three in particular I would mention. First, I note a basic consistency. Over his many years as a Judge, there is no evidence of an abandonment of basic methods. The second quality I perceive is pragmatism. The reasoning and approach emphasises an empirical focus. There is no obsession with theoretical abstract concepts. The third quality that strikes me is receptivity to new ideas, which will sometimes be adopted if consistent with the overall approach. This is exemplified by Sir Ivor's acceptance of the value of an economic analysis of law when most lawyers in this part of the world remain either sceptical or disinterested. These qualities have been enduring and have ensured Sir Ivor's outstanding contribution to the New Zealand tax system.

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42 Frank Ramsey "A Contribution to the Theory of Taxation" (1927) 37 Econ Jl 145.

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