

**FICTIONS OF INCOME
TAX**

**WORKING PAPER SERIES
Working Paper No. 7**

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**Australasian Tax Teachers Association
14th Annual Conference
Manukau Institute of Technology January 2002**

Fictions of Income Tax¹

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Contents

Ectopia.....	2
Criticisms of the ectopia thesis	6
Accountancy.....	7
General and specific rules	9
Fictions	10
History	14
Theory of fictions.....	15
Analeptic fictions.....	16
Apologetic, deeming, and expository fictions	18
Fictions show tax law is different.....	19
Consequences of fictions: general anti-avoidance rules.....	21

Ectopia

Income tax law generally taxes the results of legal transactions rather than their underlying economic effect. The courts often tell us that tax law does not tax on the basis of economic equivalence.³ But the problem is deeper. In order to make income tax work at all, the law must make a number of assumptions that are not in fact correct, assumptions as to both the factual and the legal nature of the taxpayer's income. The effect of these assumptions is that the base that the law taxes becomes removed from the facts of the case.

¹ This paper has been developed from a theme introduced in "Income Taxation: a Structure Built on Sand", the inaugural Ross Parsons Memorial Lecture, delivered by the author at Sydney University in June 2001. It repeats some material, particularly introductory passages, from that lecture.

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³ Eg *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, 648 PC.

I have written several articles on this phenomenon,⁴ which I call “ectopia”. “Ectopia” means “displacement” or “dislocation”.

The fundamental difficulty is that we cannot have an income tax without a concept of income. For a number of reasons, our concept of income must be artificial. Tax law’s concept of income is not the fact of income itself but a legal simulacrum of income. The separation of income tax law from its subject matter can be seen best in the law’s efforts to tax business profits. Business profits arise independently of the law, and sometimes even in spite of the law. They are not a result even of contract law, let alone of tax law. They are the result of people’s economic transactions with one another. Income tax law cannot tax economic transactions directly. Rather, it taxes the legal forms that we use to represent economic transactions.⁵

People may challenge this analysis by saying that, apart from the wholly exceptional case of honour clauses,⁶ business profits are in fact always derived within legal frameworks. Business people may talk mostly about prices, goods, and services, but their transactions are in fact able to be analysed in terms of contracts, leases, trusts, companies, and so on. Moreover, that picture is not a matter of chance. Business people generally ensure that they pay attention to the legal

⁴ “Ectopia, formalism, and anti-avoidance rules in income tax law” (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers*, Duncker and Humblot, Berlin, 367-383; “Philosophical and design problems that arise from the ectopic nature of income tax law and their impact on the taxation of international trade and investment”, (1995) 13 *Chinese Yearbook of International Law and Affairs*, 111-139, reprinted as “Ectopia, tax law, and international taxation” [1997] *British Tax Review* 383; “Can income tax law be simplified?” (1996) 2 *NZ Journal of Taxation Law and Policy* 187; “Should tax legislation be written from a principles and purpose point of view of a precise and detailed point of view?” [1998] *British Tax Review* 112; see also “Why is tax law incomprehensible?” (1994) BTR 380-393.

⁵ Exceptionally among common law jurisdictions, the United States of America tries to circumvent this problem by employing a substance-over-form approach in tax cases. *Gregory v Helvering* 293 US 465 (1935). The United States has not always managed to maintain this approach. See, eg, the cases known as the “Mexican railcar cases”, such as *Chicago, Burlington, & Quincy R Co v United States*, 455 F. 2d 993 (Ct Cl 1972) and *Missouri Pacific Railroad Co v United States*, 497 F. 2d 1386 (Ct Cl 1974). For a recent discussion and references, see P.A. Glicklich and M.J. Miller “Appeals Court adheres to precedent, tells IRS that it’s too late to issue regulations” in Glicklich & SH Goldberg, *Selected US Tax Developments*, newsletter of Roberts & Holland LLP, New York, (2001).

⁶ See, eg, *Rose & Frank Ltd v Crompton Bros* [1923] 2 KB 261, reversed [1925] AC 445.

implications of their transactions, if only in case things go wrong.

All this is true, but history demonstrates that profits are independent of the law. In Anglo-Saxon times, it was impossible to enforce any contracts at all, except contracts of betrothal. Even in the case of betrothal, if a man reneged on his engagement the bride's family did not turn to the courts for help. To mark the engagement, the family had confirmed the promise by taking from the groom a wed, which was a valuable object, handed over as a pledge. Grooms who failed to appear at their weddings forfeited their weds.

The position did not change much for hundreds of years. It was not until 1602 in *Slade's*⁷ case that the common law began to enforce executory contracts. But throughout this entire time people continued to make business profits,⁸ profits that in principle could have been subject to income tax. That is, history reveals the obvious point that profits, the subject matter of income taxation, arise from transactions, not from the law. Nevertheless, it is the legal substance of transactions that the law taxes, not the underlying economic substance. Often, perhaps even usually, these two substances coincide. Nevertheless, they are different. The legal substance of a transaction is a simulacrum of its economic substance, a likeness that often diverges from its original.

This is the first reason for the dislocation between income tax law and the economic profits that are its substance. Other reasons include the problem of place and the problem of time.

The problem of place arises in connection with international transactions. Income tax law assumes that all income can be located in one jurisdiction or another as a matter of physical fact, or, as Isaacs J put it, as “a hard, practical matter of fact”⁹. Almost any example of an international transaction will dispel this assumption. Where is the source of the profit that a multi-national company makes on selling a computer to a retail buyer in Sydney? In one

⁷ 4 Co Rep 91a.

⁸ This paragraph slightly overstates the case, but not in a way that detracts from its basic thesis. In Anglo-Saxon times, apart from betrothals it was also possible to enforce a promise to appear at court to answer the claims of a plaintiff, achieved as with betrothals by taking security. For some periods of history people could enforce mercantile contracts in the courts of fairs and boroughs or “piepowder” courts. Many standard texts on the law of contract, such as the various editions of Cheshire & Fifoot, *Law of Contract*, begin with an historical introduction that includes references works on the history of contract in the common law.

⁹ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, 189–190.

sense the question makes no sense. Profit is a net concept, the difference between receipts and expenditure. A difference cannot exist physically in space.

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

Problems of residence are just as bad as problems of source. That is especially true of problems of corporate residence. For tax systems to work, companies must be made to reside somewhere, but the whole concept of corporate residence is artificial. We can think of a company in a number of ways: as a pile of papers in a filing cabinet; as a collection of people who are shareholders, albeit often living in different countries; as a congeries of contracts that is reduced to a constitution or memorandum and articles; or as an inchoate legal person through which shareholders interact with third parties. But whichever way we look at it, to say that a company resides anywhere involves a metaphor.

These problems of source and residence are endemic in a world where taxing jurisdictions are defined by reference to geographical facts, that is, by reference to national borders on a map. To cope with companies one must operate as if the fiction of corporate residence were a fact. To cope with profits, one must attribute a fictional physical source to income. That is the problem of place in a nutshell.

The problem of time is worse. Ideally, we would wait for a business to go through its whole life, from foundation to liquidation, before determining whether there had been profits and, if so, how much they were. Of course, tax systems, like shareholders, cannot wait that long; so, like accountants, tax authorities require businesses to divide their lives into periods delimited by dates. We always use twelve months, but there is no special reason for this convention apart from convenience.

One result is that Parliament must legislate so that receipts and expenses are treated not as the taxpayer actually meets them, but as they might have occurred had they been spread evenly over time. Income smoothing for farmers is a good example. Another result is that, to reduce tax, people try to accelerate expenses and to defer receipts. In response,

Parliament treats receipts and expenses as if they arose at times different from when they arose in law. For instance, for tax purposes, the law may spread interest paid on day one of a long-term loan over the duration of the loan. The policy of such a rule is to reflect the true economic position, but the result is that tax law treats interest as paid at times that are different from the times when it was paid in fact and in law.

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

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

Criticisms of the ectopia thesis

I have tried to explain the thesis that income tax law is different in kind from most other law because of the dislocation between income tax law and the facts to which it relates. People have responded with three criticisms or questions, which are directed to suggesting that income tax law is not so very unusual. The questions are first, are not the rules of accountancy similar in character to the rules of income taxation? Secondly, is the apparent uniqueness of income tax law not just a matter of requiring more detail, in the sense that legislators could make rules for all the different possibilities of income taxation if they wished? That is, one might argue that if there is a difference between tax law and other law it is essentially a matter of degree rather than kind. More densely woven legislation would demonstrate the point should legislators choose to go down that path. Thirdly, the law is well used to fictions. Are not the assumptions that give us our concept of income just examples of legal fictions? Dr Alex Frame suggests that the concept of ectopia appears to be essentially the same as that of the fiction understood sufficiently widely.¹⁰ Is he correct? I shall attempt to answer these questions first generally and then individually.

¹⁰ Alex Frame "Fictions in the Thought of Sir John Salmond" (1990) 30 VUWLR 159, 168 n 26.

Regarding the matter in general, I have made the point a number of times that it is a characteristic of law as an institution to enjoy an almost symbiotic relationship with its subject matter. When sovereigns legislate, they make sure that their laws relate as closely as possible to the subject matter of those laws, if only for efficiency. A sovereign who wants to forbid assault does not create an offence of consensual hugging, at least not intentionally. But a sovereign who wants to tax the profits of hire purchase transactions efficiently may pass a law that pretends that hire purchase transactions are credit sales. Section FC 10 of the New Zealand Income Tax Act 1994 is such a provision.

Factually, such a law does not involve pretence at all. Hire purchase transactions are indeed fundamentally credit sales. Retailers construct their sales as hire purchases not to change the basic nature of the transactions but in order to keep title to their goods against the possibility of buyer default. All section FC 10 does is to tax such transactions according to their economic effect rather than according to their legal form. Take another example. A sovereign that wants to tax the world-wide income of a resident may pass controlled foreign company legislation that says that income of a company in another country is the income of the resident.¹¹ To some people, such a rule is a jurisprudential anathema; to a tax economist it seems an obvious measure.

Accountancy

I turn to the three questions or criticisms. First, it is true that accountancy must grapple with exactly the same problems of timing as must income tax. Should receipts or expenses be recognised all at once, or should they be spread? Should we have a concept of capital to deal with matters of a particularly long-term nature? On the face of it, accountancy seems to respond to these sorts of questions in the same manner as tax law. For instance, like law, accountancy must divide the life of a business into artificial intervals and must force receipts and expenses into those intervals whether they fit well or not. Secondly, law and accountancy share the same basic policy: to measure profits.

Nevertheless, the response of accountancy is different from the response of income tax law. Despite its apparent formality, accountancy has an overriding requirement to reach the factual substance of things, whereas for income taxation the goal is legal substance. If generally accepted principles of accountancy lead to a picture that is incorrect in substance,

¹¹ Eg Income Tax Act 1994 (NZ) s CG 1.

then, at least in principle, accountants who are trying to calculate the profits of an enterprise either should follow different rules or should add explanatory notes to their accounts. That is, at least in principle the rules of accountancy are flexible enough to accommodate all the different varieties of business experience that accountants may be asked to record. Income tax law is different, in that it allows only one correct answer, and only one route to that answer. Further, the answer is the answer that emerges from taxing a legal simulacrum, which may not be the answer that financial economics would reach.

Let me illustrate by an example. Suppose a shipping company starts business under-capitalised. It copes with the problem by chartering its ships on balloon leases, that is, leases where the rent starts low and increases from year to year. The result will be that in year one profits will be higher than they would have been had the leases provided for flat rate payments. Accurate accounts for the company should note that part of the cost of the first year has been deferred to future years, and should make provision for that cost; but income tax will simply assess the apparent profit, and that will be that. My point is that at least in principle accountancy endeavours to record the true substance of business, whereas income tax assesses an apparent profit that may be some distance removed from the true profit.

This difference between tax law and accountancy is sometimes masked by apparent over-formality on the part of accountants. This over-formality occasionally emerges as an entertaining by-product of judgments in tax cases. For instance, both *FCT v Myer Emporium Ltd*¹² and *AA Finance Ltd v CIR*¹³ had their origins in stratagems designed to circumvent limits on borrowing powers that earlier lenders had imposed on the companies in question. Clever accountants had devised schemes of a circumventing nature that, in each case, involved the taxpayer selling financial assets. Tax people are interested in the cases because the courts held the sales to be on revenue account, but in the present context one's interest in the schemes is different. It arises from the fact that the companies were able to persuade auditors who represented the interests of the earlier lenders that these schemes (which had no obvious substantive effect) did in fact allow the companies to circumvent borrowing limitations.

¹² (1987)18 ATR 693 HC.

¹³ (1994) 19 TRNZ 133 CA.

Despite the story of the *Myer* and *AA Finance* cases, to conclude that accountancy is as formalistic as tax law is to be misled. Accountancy aims to reflect substance, but sometimes allows accountants to follow rules that lead to a formalistic rather than substantive result. That is, accountancy sometimes follows *permissive* rules that permit accounts to diverge from economic truth. Tax law, on the other hand, is obliged to operate according to *mandatory* rules that sometimes require accounts to diverge from economic truth. The irony is the tax law took the accounting ledgerdemain in both the *Myer* and *AA Finance* cases seriously and, in each case, taxed a profit that did not exist in economic terms.

General and specific rules

Secondly, is the apparent problem of ectopia simply a result of the rules of tax law being too general? Could enacting increasingly detailed rules that would reflect all of the many facets of modern business solve the problem? The answer is no, for two reasons. First, some aspects of income tax law are truly irrational. It would not be possible to enact detailed rules that would be both comprehensive in coverage and consistent with one another. Take, for instance, the simple example of private investors who own portfolios of corporate shares that are pregnant with profits. If the investors sell the shares the receipt is capital; if they take the dividend the receipt is income. Modern income tax laws mitigate the irrationality with imputation systems and capital gains taxes, but they cannot dispel it.

My second response to the argument that the dislocation of income tax law could be remedied by greater detail in legislation is an analogy with science. These days, most of the great problems of science are solved, or, at least, people are well on the way to solving them. It is only a matter of time before someone reaches a unified theory for the forces of physics, and since the discovery of DNA biology has been transformed once and for all. The last great-uncharted field in science is human consciousness. We know very little about it, and there is no major breakthrough on the horizon.¹⁴

In my analogy, law corresponds with science in general, and income tax law with the science of human consciousness. Law in general is rooted in the objective facts to which it relates, as physics and biology are nowadays rooted in proven fact. In contrast, income tax law hovers around the facts to which it relates, as the study of consciousness hovers around

¹⁴ Explanation from Lodge, David, *Thinks ...*, (2001) London, Secker & Warburg, 35.

the brain. The novelist, David Lodge, has described the problem of consciousness in words that fit the problem of income tax law with remarkable aptness. Lodge says that the problem of consciousness is “How to give an objective, third-person, account of a subjective, first-person, phenomenon.”¹⁵ Income tax law relates to profits that emerge from transactions conducted between two or more individuals. How can income tax law give an objective account of these transactions to the state, which as a third person is independent of the transactions, but which as a taxing power is vitally interested in them? If my analogy is good, Lodge’s further elaboration of the problems of studying human consciousness offers little encouragement to people who might hope to bring income tax law closer to the reality of the tax base. Lodge explains that there are about one hundred billion neurones in the human brain, and there are more possible connections between them than there are atoms in the universe.¹⁶ The problems of income tax law can form only a small sub-set of these many inter-neurone connections, but they are certainly a subjective sub-set, in the sense that citizens are for the most part free to organise their commercial relationships how they choose, and free to construct the legal record of those relationships in whatever manner they like. There is a gap between these subjective relationships and the objective appraisal of the relationships that tax law must undertake.

Fictions

I’ll turn now to the third critical question, relating to legal fictions. My thesis is that the fictions of income tax law are of a different character from other legal fictions. I shall illustrate by considering several fictions from history. Roman law had many fictions. For instance the *fictio Legis Corneliae* addressed the problem of Romans dying in captivity. If a Roman was captured he lost his citizenship, and with it his capacity to make a valid testament. The Romans glossed the Lex Cornelia with a fiction that for succession purposes Roman citizens should be deemed to have died at the instant of capture, while still free men and citizens.¹⁷

¹⁵ Id 42.

¹⁶ Id 52.

¹⁷ Justinian *The Institutes*, translated and annotated and with commentary by T.C. Sandars, 7th ed (new impression) London 1962, 180. The *Lex Cornelia de falsis* (BC 81) provided the same penalty for forging the testament of a person dying in captivity as for forging the testament of someone dying in his own country. The law could not have intended to attach a penalty to forging a testament that was invalid. Accordingly, it

That is a fiction from Roman Law. Two fictions from the common law are the doctrines of trover and of attractive nuisance. When you sued someone for the return of your goods you pleaded that he had found them, even if the defendant had taken the goods by force. This pleading was to bring your claim within the form of action of trover and detinue, which did not allow for theft.¹⁸ The courts well knew what was going on and assumed the fictional fact that the defendant had indeed found the goods.

My second common law example is the attractive nuisance. An attractive nuisance is something on your land that is dangerous but that attracts children to play on it. The common law said that you did not have to worry as the children were crushed under tons of falling scrap metal or had their limbs torn off by locomotive turntables that were out of control. You did not invite the children; they were trespassers and they got what was coming to them. Occasionally the courts found all this too robust and held that people leaving attractive but dangerous articles on their land must be taken to have issued an invitation to come in and play on those articles; so the maimed children were not trespassers, and the occupiers were liable.¹⁹

The three fictions that I have mentioned share a common characteristic: by implication, they created rules that someone could have drafted expressly. Rome could have ruled that the wills of former citizens dying in captivity were valid. England could have created a form of action for suing a thief for one's goods or could have passed a statute providing for a greater degree of liability on the part of occupiers, as in fact it did many years later.²⁰ That these things did not happen, at least when they were first needed, and that the legal systems in question remedied the injustices by fictions, were functions of conservatism and of a wish to advance law reform slowly. They were not a result of any inherent difficulty in direct reform of the laws in question.

The fictions of income tax law are very different. The classic legal fiction entails pretence, but taxation fictions entail duplicity. The pretence of the classic legal fiction is a vehicle to provide transport on the road to a just result, but the

must be assumed that the deceased had the power of making a testament both when he in fact made it and when he died.

¹⁸ Blackstone III *Private Wrongs* 152.

¹⁹ See *Sioux City & Pacific Rly Co v Stout* (1873) 17 Wall. 657 (US SC), *City of Pekin v McMahon* 154 Ill 141 (1895), and *United Zinc v Bruitt* 258 US 268, 275 (1921) per Holmes J. But see *Addie v Dumbreck* [1929] AC 358 HL.

²⁰ Occupiers' Liability Act 1957.

duplicity of a taxation fiction is part of the result itself. Let me illustrate.

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

Take a more complex example: the basic assumption of income tax law that there is a logical real-world distinction between capital and revenue is a fiction. There are innumerable pairs of cases that illustrate the flaws in that assumption, but I'll use the classic teacher's comparison between *Californian Oil Products Ltd v Federal Commissioner of Taxation*²¹ on one hand and *Heavy Minerals Pty Ltd v Federal Commissioner of Taxation*²² on the other. In both cases, the business of the taxpayer was destroyed. Both taxpayers received compensation for the loss; but Californian Oil Products' compensation was capital and Heavy Minerals's compensation was revenue. *Heavy Minerals* was the later case; so the court had to distinguish *Californian Oil Products*. Windeyer J distinguished the earlier case by explaining that Californian's business was destroyed as a matter of law, whereas Heavy Minerals's business was destroyed only as a matter of fact. That analysis is correct from the point of view of a tax lawyer, but a tax payer could be forgiven for finding it unpersuasive.

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

In effect, Windeyer J told Heavy Minerals that it could ignore these facts and proceed to mine rutile if it wanted to do so. There was no legal impediment.

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

²¹ (1934) 52 CLR 28.

²² (1966) 115 CLR 512.

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

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

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

This is not to say that law and economics never coincide. They often do. One occasion was in the *Californian Oil Products* case. In reality, the business of the company was destroyed. The legal position exactly reflected that reality, because it was the cancellation of the contract with Union Oil that wrought the destruction. Thus, the legal position in *Californian Oil Products* was not a fiction. The problem for Heavy Minerals was that in its case factual reality and legal context parted company, leaving an ectopia between them. The point that I emphasise here is that this ectopia was not an occasional incident but an example of a fiction that is fundamental to income tax law (that is, the fiction that income tax law does in fact relate to the reality of its subject matter). This fiction is different from an ordinary legal fiction in that if we are to have a concept of income, and if we are to have a tax that operates on an annual basis, the tax must assume that the fiction is true.

If it chooses, tort law can redraft itself so as to operate without the fiction of inviting children to enter premises and

play on dangerous turntables. Indeed, it did so in several Occupiers' Liability Acts in the 1950s and '60s.²³ But income tax law cannot abandon the fiction of a logical and factual boundary between capital and revenue.

History

The courts have grappled with the distinction between capital and revenue for decades, and will no doubt continue to do so. Early cases attempted to assess tax on the basis of economic fact rather than of legal fact. Viscount Haldane said in *Sun Insurance Office v Clark*:²⁴ “[I]t is plain that the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business”. In *Riches v The Westminster Bank Ltd*,²⁵ Lord Wright said, “The distinction [between capital and income] depends on substance, not on mere name.” In context, it is clear that his Lordship was referring to economic substance, not to legal substance.

In the same case, Lord Simmonds, said, “But the real question is still what is [a receipt's] intrinsic character, and in the consideration of this question a description due to the authority under which it is paid may well mislead”.²⁶ That is, Lord Simmonds distinguished factual, or intrinsic, reality from legal reality in holding that the question of whether a payer is authorised to pay does not necessarily determine whether what is paid is “interest”.

Nowadays, this sort of reasoning is consigned to history. In *Europa Oil (NZ) Ltd v CIR*,²⁷ Lord Diplock explained that in this context, “reality” is “directed only to the legal character of the payment and not to its economic consequences”.

Lord Diplock's words are undoubtedly good law, but they are not calculated to achieve precision in executing the policy of income taxation, to tax business profits. As has been explained, there is a gap between legal reality and economic reality. To tax legal reality rather than economic reality may perhaps be thought of as taxing by fiction, but the fiction is different in kind from what is usually meant by a legal fiction.

²³ Eg Occupiers' Liability Act 1957 (England), Occupiers' Liability (Scotland) Act 1960, Occupiers' Liability Act 1962 (New Zealand).

²⁴ [1912] AC 443, 455 HL.

²⁵ [1947] AC 390, 403, [1947] 1 All ER 469, 474 HL.

²⁶ Id 406, 476.

²⁷ [1976] 1 NZLR 546, 553 PC.

Theory of fictions

Lon Fuller, the great American jurist of the mid-20th century, identified several characteristics of legal fictions.²⁸ He said that fictions are like scaffolding. As the law develops we can abandon them without injuring the policy or vested interests that they are designed to sustain.²⁹ In contrast, it is my thesis that the fictions of income tax law are an integral part of the law's *modus operandi*.

Tourtoulon argued that “judicial theory is all the more objective when it presents itself as fictions, and all the more delusive when it claims to do without fictions”.³⁰ Fuller agreed. He said, “A doctrine that is plainly fictitious must seek its justification in considerations of social and economic policy; a doctrine that is nonfictitious often has a spurious self-evidence about it”.³¹ That insight hardly applies to the fictions of income tax. For a start, judges often deny them. I have already mentioned Isaacs J's remarks, which are an express denial that the concept of the source of income is a fiction.³² Windeyer J's reasoning in *Heavy Minerals* is an implied denial that the company had gone out of business. In Fuller's words, the whole doctrine of the capital/revenue boundary has a spurious self-evidence about it. For instance, the identifiable asset test saved the taxpayer in *Inland Revenue Commissioners v Carron Co*,³³ where the House of Lords held that expenditure on a company's constitution, the single item that stays with it from incorporation to liquidation, was a matter of revenue. The same test sank the taxpayer in *Tucker v Granada Motorway Services Ltd*,³⁴ where Lord Wilberforce denied a deduction for a payment to reduce the taxpayer's rent because the payment was consideration for an alteration in a lease. These results are hardly dictated by considerations of economic and social policy, apart from the consideration that income tax law must operate somehow, and that this “somehow” necessarily entails a distinction between capital and revenue.

The German philosopher, Vaihinger, posed a similar question to those of Tourtoulon and Fuller. He asked in his

²⁸ *Legal Fictions* (Stanford, 1967).

²⁹ *Id* 70.

³⁰ Cited at *idem*, from Tourtoulon, *Philosophy in the Development of Law* (1922) 295.

³¹ *Legal Fictions* (Stanford 1967) 71. I thank Dr Alex Frame, of Wellington, for drawing this monograph to my attention.

³² *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, 189–190.

³³ 1968 SC (HL) 47, 45 Tax Cas 18.

³⁴ [1979] 2 All ER 801 HL.

book, *The Philosophy of As If*, “How does it come about that with consciously false ideas we are yet able to reach conclusions that are right?”³⁵ Vaihinger was referring to thinking in general rather than to law. For instance, most of the modern developments in atomic physics stem from people making calculations *as if* atoms were comprised of a number of particles with varying qualities. As it turns out, they probably are, but people did not know this at the beginning. Fuller points out that Vaihinger’s question is equally applicable to legal fictions because they help the law to develop towards the truth.³⁶ On the other hand, as we have seen, the fundamental fictions of the concept of income are apt to lead us away from truth.

Vaihinger explained that “The greatest and most important human errors originate through thought-processes being taken for copies of reality itself”.³⁷ If we distinguish between law and fact, law, being a collection of norms, is a “thought-process” while facts are reality. Business profits are an aspect of economic reality, but a legal simulacrum of business profits is not an exact copy of the underlying facts of those profits. Fuller expanded:³⁸

[T]hese constructs must be used as instruments of thought only; we must treat them as servants to be discharged as soon as they have fulfilled their functions. They are foreign elements which may be inserted into the equation provisionally to render the computation simpler, but which must be dropped from the final reckoning.

Income tax law’s problem is that in the context of business profits it is itself a “foreign element”. We cannot drop it from the reckoning once it has fulfilled its function because it is the means of fulfilment. Income tax’s fictions are fictions, but not fictions as they are known in other parts of the law.

Analeptic fictions

It is useful to call such fundamental fictions of the concept of income “inherent fictions”, in that they are inherent in that concept. Fictions about source, residence, capital, revenue, and time in general are inherent fictions. As well as inherent fictions, income tax law is replete with what may be called analeptic, or remedial fictions. Most analeptic fictions in tax

³⁵ *Die Philosophie des Asl Ob* (1911), quoted in L Fuller, *Legal Fictions* (Stanford 1967) 103.

³⁶ *Idem*.

³⁷ Quoted by Alex Frame in “Fictions in the Thought of Sir John Salmond” (1990) 30 VUWLR 159, 167 from Hans Vaihinger *The Philosophy of As-if*, trans C.K. Ogden (London 1924) 8.

³⁸ Lon Fuller, *Legal Fictions* (Stanford 1967) 121, quoted by Frame, *id*, 166.

law are statutory. They are legislative efforts to take charging provisions closer to the subject matter of income taxation. Examples include rules to treat hire purchase transactions as credit sales or to attribute the income of a controlled foreign company to its shareholders who are resident in the jurisdiction. The *Ralph Report's* recommendation of rollover relief for people affected by take-overs is a recommendation for an analeptic fiction. In effect, the report says that where there is a take-over there is only a legal realisation, not an economic realisation and tax should not bite at that point. That is, the report says that tax treatment should be brought more closely into line with economic reality. The fiction is that the legal realisation is ignored.

On the face of it, these analeptic fictions of income tax law look very much like some classic fictions of general law. For instance, the *fictio Lex Corneliae* told Romans to treat a living captive as a dead citizen for purposes of testamentary succession. In an apparent parallel, for purposes of taxation section FC 6 of the New Zealand Income Tax Act 1994 treats finance leases as if they were sales accompanied by loans.

On closer examination, the parallel is not exact. The Romans had an alternative to the *fictio Lex Corneliae*. They could have simply enacted that the wills of people who lost their citizenship because of captivity remained valid. But there is no obvious parallel in respect of the tax consequences of a finance lease. If the government wants to tax the lease according to economic reality it has to tax it as a sale accompanied by a loan. The Act achieves that result by preferring economic substance to legal substance. Section FC 6 takes the taxing power of the Act closer to economic reality at the cost of employing a fiction in respect of the legal relationships that are involved. In contrast, the hypothetical alternative to the *fictio Lex Corneliae* achieves a valid testament without resorting to fictions of either law or fact.

One reason for the difference is that the *fictio Lex Corneliae* was concerned with the law of succession alone, whereas section FC 6 is concerned with both tax law and the law of leases. Economic reality for tax law is not necessarily the same as legal reality for leasing law. It is a characteristic of tax law that this kind of problem is always potentially present. That is, there are always two different laws potentially applicable to any one transaction, namely the law of the transaction itself and tax law.

The comparison of inherent and analeptic fictions within tax law prompts two observations. First, I conclude that the fictions of income tax are of two kinds, inherent, which relate

to fictions of fact, and analeptic, which relate to fictions of law. The first arise as a result of the need to have a concept of income. The second make tax law work better as an economic instrument, but only at the cost of distorting non-tax law.

The second observation is that it is at first sight curious that modern tax legislation uses analeptic fictions to the extent that it does, or even at all. After all, fictions are a fairly crude and old-fashioned way of reforming the law. Fictions were very numerous in Roman law because of the need to appease sensitivities of citizens who believed fundamental legal precepts were god-given. If a fiction did the job, Roman reformers thought it better to work round a fundamental precept than to attack it head on and to buy a fight. Fictions were very numerous in the common law for another reason: because of the need to circumvent the dead hand of the forms of action. But nowadays we give superstition short shrift and elevate substance above form, with the result that legislative drafting favours a plain, transparent, direct style. Fictions seem out of place. The reason that fictions remain so entrenched in tax law is the reason that I have mentioned so often, that tax law is different from other law, and tax law reform requires different tools.

Apologetic, deeming, and expository fictions

I have considered fictions inherent in tax law and analeptic fictions that are employed to improve tax law. I have tried to demonstrate that both kinds of fiction are symptoms of the underlying malaise of tax law that I have called “ectopia”. Nevertheless, some people may point to certain fictions in tax law and see that they appear to function much as similar fictions function in other areas of law.

The simplest examples are apologetic fictions, that is, explanations for elements in the law that people might consider harsh. Examples include, “everyone is presumed to know the law” and “the King can do no wrong”.³⁹ Apologetic fictions work in the same manner in tax law as anywhere else.

A second example is the deeming fiction. Drafters use deeming fictions for convenience. Suppose that there is already a set of rules that deals with the taxation of salaries, and suppose that the legislature wants employer-provided accommodation to be taxed in the same way. A drafting short cut is to deem employer-provided accommodation to be salary.⁴⁰ Deeming fictions are simply a drafting technique and

³⁹ Id 83 – 85. “Apologetic fiction” is Fuller’s label.

⁴⁰ See, eg, the definition of “monetary remuneration” in the New Zealand Income Tax Act 1994, s OB 1.

tell us nothing about the character of the subject matter to which they are applied.

A third category is the expository fiction.⁴¹ An expository fiction is ambitious shorthand. The best example is “company”. The company is a fiction in the sense that it is not a real person, and yet it is a legal person. In another sense, “company” is shorthand for a congeries of contracts and state-created rights and duties that result from investors banding together in a manner that complies with relevant legislation. Analytically, a company comprises truth rather than fiction, in that, given time, one can trace back from the company itself through all the formalities that have endowed the company with a personality separate from the personalities of its shareholders. Nevertheless, it is sometimes more convenient to think of a company simply as a disembodied being that is fictionally, but effectively, endowed with a legal personality. However one cares to look at it, the word, “company”, and other expository fictions perform the same role in income tax law as they do in the general law.

I have just described three categories of fiction: apologetic, deeming, and expository. It is convenient to call them “fictions” in ordinary discourse. But for purposes of the present argument I must distinguish them from the pure legal fictions that I have been discussing, that is, inherent and analeptic fictions; so I’ll call them “quasi fictions”. Strictly speaking, what I can call a pure legal fiction is a statement that is truly false, whereas these quasi fictions contain within themselves their own explanations, so they only appear to be false until one examines them closely. Quasi fictions do not illuminate the difference between income tax law and general law.

Fictions show tax law is different

In contrast, pure fictions do illustrate the difference between income tax law and other law. As I explained, where there is a true legal fiction in the general law, the law can be reformed and can operate directly, without using the fiction. As Fuller explained, legal fictions justify themselves by reference to social and economic policy. Neither explanation is true of the fictions of income tax law. Tax law can operate *only* by using fictions; and these fictions are based not in policy but in the pragmatic need to make income tax work.

Some tax fictions say something false about the underlying facts; others say something false about the legal simulacrum that lies over the facts. Fuller had some useful observations on

⁴¹ Id 53 – 55. Likewise, Fuller coined “expository fiction”.

this phenomenon, also, though he did not think of the particular case of income tax. Fuller said that:

A fiction is either (1) a statement propounded with a complete or partial consciousness of its falsity, or (2) a false statement recognised as having validity.⁴² [But] ...

A fiction taken seriously, that is 'believed' becomes dangerous and loses its utility. It ceases to be a fiction under either alternative of the definitions given above.⁴³ ...

[T]he danger of a fiction varies inversely with the acuteness of [the] awareness [of its falsity]. A fiction becomes wholly safe only when it is used with complete awareness of its falsity.⁴⁴

Fuller's words have an almost uncanny resonance when we apply them to income tax law. Windeyer J really did seem to think that it made some sort of sense to say that Heavy Minerals Pty Ltd was free to go on mining rutile even though it could not carry on that business at a profit. To take another example, for Lord Wilberforce, *Tucker v Granada Motorway Services Ltd*⁴⁵ turned on the existence of a lease that was so onerous that it could not even be shown as a balance sheet asset. As Fuller puts it, the courts "believed" the fiction, yet we would all agree that both judgments were right in law.

Lord Wilberforce put his finger on it when he said that there "may not be much commercial difference between a payment [to free a taxpayer of a long-term agency agreement, which is deductible] and a payment to get rid of an onerous lease" which is not.⁴⁶ He agreed that the test is "to some extent arbitrary" but he defended the test on the basis that it provides a means which the courts can understand for distinguishing capital and income expenditure". He thought the courts "would be wise to maintain it".⁴⁷

If we apply Fuller's words to the present debate, the courts "believe" the fiction of a logically defensible boundary between revenue and capital. Fuller would say that the fiction is unsafe because the courts employ it with only a partial awareness of its falsity. To put words into Fuller's mouth, the fiction is therefore dangerous and has lost its utility. This conclusion that I have put into Fuller's mouth is only partially correct. It is correct that the fiction is dangerous, but it is wrong to say that it lacks utility. The fiction is dangerous in the sense that it leads to decisions that cannot be justified by reference to any criterion outside the law. The law can defend these decisions only by bootstraps, self-referential arguments.

⁴² Id 9.

⁴³ Idem.

⁴⁴ Id 10.

⁴⁵ [1979] 2 All ER 801, HL.

⁴⁶ *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 HL.

⁴⁷ Idem.

Lord Denning MR put it well in *Heather v P-E Consulting Group* when he said:⁴⁸

The question—revenue expenditure or capital expenditure—is a question which is being repeatedly asked by men of business, by accountants and by lawyers. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other; but this is simply not possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night or the border between red and orange. In this area, at least, where no decision can be said to be right or wrong the only safe rule is to go by precedent.

This is an unpropitious verdict. It seems to vindicate the conclusion that Fuller would draw, that the capital/revenue fiction lacks utility. But that conclusion is not correct. The problem is that Fuller assumed that law by its nature has a close relationship with its subject matter. That is a reasonable assumption in general, but it is not true of large areas of income tax law. Because income tax law is based on a number of false assumptions, it can operate only by using fictions that assume that those assumptions are true. Here, oddly enough, two wrongs do make a right. This is not to say that income tax law is law of high quality as compared to law in general. It certainly is not. But if people are to tax income they must make shift with whatever law they can construct.

Let me return to where I started on the discussion of fictions. For some years, I have argued that income tax law is different from other law in that it is separated from its subject matter in a way in which other law is not. One symptom is that income tax law employs many fictions. People have responded to my thesis by saying that fictions are nothing new; law often uses fictions. My rejoinder is that the fictions of tax law are different in kind from ordinary legal fictions. They are essential to tax law in a way in which ordinary fictions are not essential to the general law. Far from showing that tax law is similar to the rest of law the fictions of tax law vindicate my argument that it is different.

Consequences of fictions: general anti-avoidance rules

In a number of articles I have tried to identify various consequences that flow from the separation between tax law and its subject matter. First, that separation helps to explain

⁴⁸ [1973] 1 All ER 8, 17h-18a CA.

why tax law is unduly complex.⁴⁹ Secondly, it means that there is limited scope for simplifying tax laws by re-drafting them as principled codes, despite people's optimism in that direction.⁵⁰ Rowlatt J was right when he said that there is no "intendment"⁵¹ about a tax; income tax, in particular, is structurally not capable of following a logical, thematic principle.

Thirdly, there are some areas of law where ectopia is particularly marked. Parliaments typically respond with increasingly complex analeptic fictions that are calculated to bring tax law and its subject matter closer together. Take, for example, rules about source and residence; transfer pricing; controlled foreign companies; foreign tax credits; and conduit taxation, from the international field.⁵²

Fourthly, tax law is forever undergoing reform, as parliaments try to remedy the results of the fundamental defects that this paper has tried to describe. The inexorable flow of tax Bills in almost all jurisdictions is too familiar to need elaboration.

Fifthly, the ectopia of tax law leads to the enactment of open-ended general anti-avoidance rules like Part IVA of the Australian Income Tax Assessment Act 1936 and section BG 1 of the New Zealand Income Tax Act 1994.⁵³ Dr Frame has very perceptively explained the relationship between cause and effect in this context. He focuses on what this article has called analeptic fictions, that is, in the context of taxation, fictions that tell taxpayers that their transaction X (not taxable) will be treated as if it is transaction Y (taxable). But Dr Frame's words apply equally to the inherent fictions of tax law. He says:⁵⁴

⁴⁹ "Why is tax law incomprehensible?" (1994) *British Tax Review* 380-393; "Can income tax law be simplified?" (1996) 2 *NZ Journal of Taxation Law and Policy* 187.

⁵⁰ See, eg, J Avery Jones, "Tax law, rules or principles?" (1996) 17 *Fiscal Studies* 63, 75-76.

⁵¹ *Cape Brandy Syndicate v IRC* [1921] 1 KB 64, (1920) 12 TC 358.

⁵² "Philosophical and design problems that arise from the ectopic nature of income tax law and their impact on the taxation of international trade and investment", (1995) 13 *Chinese Yearbook of International Law and Affairs*, 111-139, reprinted as "Ectopia, tax law, and international taxation" [1997] *British Tax Review* 383.

⁵³ "Ectopia, formalism, and anti-avoidance rules in income tax law" (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers*, Duncker and Humblot, Berlin, 367-383.

⁵⁴ Alex Frame "Fictions in the Thought of Sir John Salmond" (1990) 30 *VUWLR* 159, 168.

I should note here two dangers of the fiction as a device for preventing the exploitation of legal forms to frustrate the intent of legal policy. First, use of the device *strengthens* the legitimacy and likely success of such exploitation in respect of those legal forms [that] are *not* specifically targeted – thus, if legal facts A, B, and C are specifically treated as if they were legal fact T (Taxable), then by implication legal fact X, which has not been designated, is not to be so treated, however artificial its existence may appear to be. Secondly, an ever-widening net of fictions may end in frustration and a despairing lunge towards legislation of the Danzig Decree type promulgated by the Nazi regime in the 1930s:

“Any person who commits an act which this law deems to be punishable or which is deserving of penalty according to the fundamental conceptions of penal law and sound popular feeling, shall be punished. If there is no penal law directly covering an act, it shall be punished under the law of which the fundamental conception applies most nearly to the said act.”

The current version of the New Zealand anti-avoidance rule, which reads, in effect, “An arrangement that has the effect of avoiding tax is void against the Commissioner for income tax purposes”,⁵⁵ is an uncanny echo of the Danzig Decree’s “Any ... act which is deserving of penalty ... shall be punished”.

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

The gap between tax law and fact that is the subject of this article means that there are perforce gaps in the formal coverage of an income tax statute. The statute needs a general, substance-over-form rule to protect the tax base.

In an income tax statute, a general anti-avoidance rule may be defended *in spite of* its parallel with the Danzig Decree. There is a distinction between criminal law (the context of the Decree) and income tax law. Criminal law both can and should be drafted in direct, transparent terms, without fictions. Indeed that characteristic of drafting is a quality to be desired of all law. But income tax law is constitutionally incapable of attaining the desideratum of fictionless transparency. As this

⁵⁵ This formulation is a concatenation of the general anti-avoidance provision, section BG 1 of the Income Tax Act 1994, and the definition of “tax avoidance arrangement” in section OB 1 of the same Act.

article has explained, income tax law is based on inherent fictions.

Income tax presents society with the Siberian dilemma: if you go fishing in Siberia and the ice breaks and you fall in you have twenty seconds to decide whether you want to drown or you prefer to freeze to death when you manage to climb out.⁵⁶ If society decides to have an income tax it has two choices. It can allow people to exploit the law's inherent imperfections and avoid tax; or it can minimise exploitation by the biggest tax law fiction of them all, a general anti-avoidance rule. I call such a rule the "biggest fiction" because a general anti-avoidance rule treats unspecified, non-taxable, transactions as if they were other unspecified, but taxable, transactions. Some anti-avoidance rules even give the Commissioner specific powers to reconstruct non-taxable arrangement X as if it were arrangement Y, and then to tax arrangement Y.⁵⁷

For people brought up to respect the rule of law and to despise the rule of the Nazis the very idea of a general anti-avoidance rule is anathema. But logic leads us to accept it. Society has chosen a tax base that is inherently flawed by fictions, a base that the law cannot describe accurately. Parliament does its best to repair these defects by enacting one analeptic fiction after another, but the task is never complete. Moreover, to rephrase Dr Frame's perceptive generalisation, enacting a fiction about one transaction inferentially invites taxpayers to switch their attention to a surrogate. Parliament may be forgiven for taking the rough with the rough: an income tax law without a general anti-avoidance rule is a law that is not only crippled but that lacks crutches.

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

⁵⁶ Analogy borrowed from Peter Munz "The Progression of Values, or Mankind's Siberian Dilemma" paper presented at the conference of the New Zealand Historical Association, Christchurch, 2 December 2001.

⁵⁷ Eg, Income Tax Act 1994, s GB 1 (NZ).