

**A study on whether the Australian regime  
of income tax on capital gains  
causes widespread violation of horizontal equity**

Maheswaran Sridaran

CA, Master of Taxation (UNSW)

(Student number: 40029255)

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I confirm that this doctoral thesis of mine has not been submitted by me for a higher degree to any other university or institution.

Maheswaran Sridaran

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## **Publications based on my thesis**

Most principal elements of this thesis have already been published by me, as follows:

### Articles published in refereed journals

- “Taxation of capital gains and horizontal equity: a review of the Australian perception”, (2005) *Australian Tax Forum* Volume 20 No 1, p 41
- “An evaluation of whether the Australian regime of income tax on capital gains satisfies the policy objective of horizontal equity”, (2007) *Macquarie Journal of Business Law* Volume 4, p 213
- “What reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity”, (2009) *International Journal of Liability and Social Enquiry*, Volume 2, No 3, p 332

### Articles published in non-refereed tax journals

- “Is Australian currency property for CGT purposes?” (9 January 2003) *CCH Tax Week*, Issue 1, p 1
- “CGT: Is confidential information of a business property?” (1 May 2003) *CCH Tax Week*, Issue 16, p 269

- “Some arguments for not having a flat personal income tax” (9 December 2004)

*CCH Tax Week*, Issue 48, p 793

## Abbreviations used and definitions

In this thesis:

- the Income Tax Assessment Act 1936 (Cth) is referred to as “the 1936 Act”;
- the Income Tax Assessment Act 1997 (Cth) is referred to as “the 1997 Act”;
- all legislative provisions referred to are those of the 1997 Act, unless otherwise stated;
- the (Federal) Commissioner of Taxation is referred to as “the Commissioner”;
- Taxation Rulings, Taxation Determinations, Interpretative Decisions, and Law Administration Practice Statements issued by the Commissioner are collectively referred to as “rulings”, though Interpretative Decisions and Law Administration Practice Statements strictly do not represent rulings which are binding on the Commissioner;
- “horizontal equity” means taxpayers in an equal economic situation being taxed equally, and, by extension, taxpayers not in an equal economic situation not being taxed equally;
- “economic efficiency” means a state that pertains where scarce resource use occurs such that there is no possibility of making a change (of scarce resource use) which helps one person without hurting anyone else;

- “significant” or cognate expressions mean “of consequence”;
- “widespread” means “occurring in many situations”;
- the system in Australia for subjecting capital gains to income tax is referred to as “the CGT regime”; and
- the Australian income tax on capital gains is referred to as “CGT”.

## **Abstract**

The research problem addressed in this thesis is:

Does the Australian regime of income tax on capital gains cause widespread violation of horizontal equity?

The conclusion drawn in this thesis is that there is reason to expect that the Australian regime of income tax on capital gains (“the CGT regime”) can cause widespread violation of horizontal equity. That conclusion is reached by seeking answers to five questions:

### Question 1

- Was the enactment of the CGT regime, and the continuance of it after enactment, actuated by a perception (of respectively the government which enacted it, and subsequent governments which yielded to its continuance) that the regime will satisfy the policy objective of horizontal equity?, and, if it was,

### Question 2

- Is that perception largely correct?, and, if it is,

### Question 3

- What reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity (that is, outcomes that violate horizontal equity)?, and, if such reasons exist,

#### Question 4

- Do those reasons (or any other) in practice cause the CGT regime to produce outcomes that violate horizontal equity?, and, if they do,

#### Question 5

- Is there reason to expect those outcomes to be widespread?

This thesis argues that only any one of four reasons can (in theory) cause the CGT regime to potentially produce outcomes that violate horizontal equity. Those four reasons (designated as respectively Reason A, Reason B, Reason C and Reason D) are:

#### Reason A

- The best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions can result in outcomes that violate horizontal equity.

#### Reason B

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Australian judiciary's interpretation of those legislative provisions, not being compatible with the best interpretation of those legislative

provisions (pursuant to the current approach of the Australian judiciary), can result in outcomes that violate horizontal equity.

### Reason C

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity. That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their best interpretation (pursuant to the current approach of the Australian judiciary).

### Reason D

- Though the Australian judiciary's interpretation of relevant legislative provisions (despite not being the best interpretation of those legislative provisions, based on the current approach of the Australian judiciary) does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity. That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their interpretation by the Australian judiciary (albeit, based on the current approach of the Australian judiciary, such interpretation of the Australian judiciary not being compatible with the best interpretation of those legislative provisions).

In the arrangements pursuant to which legislative provisions imposing CGT are enacted and implemented, there is an absence of systematic sensitivity to those four reasons. In those arrangements, there is also an absence of institutionalised processes (mandated by legislation or otherwise) for the identification of outcomes that violate horizontal equity, and effecting legislative amendments to prevent such outcomes. Due to those absences, in this thesis, the conclusion is reached that there is reason to expect outcomes from the detailed working of the CGT regime that violate horizontal equity to be widespread.

Those four reasons can be effectively addressed through: a consequentialist approach to interpreting legislative provisions imposing CGT, buttressed by legislative directives to the Australian judiciary and other means necessary for making such an approach practicable; post-implementation reviews of CGT measures enacted to ensure that those measures do not cause violation of horizontal equity; and enacting explicit legislative directives essentially precluding the Commissioner from issuing rulings (or any like pronouncements) which are inconsistent with judicial authority.

A status quo where there is reason to expect widespread violation of horizontal equity caused by the CGT regime may be perpetuated if those four reasons are not addressed. Such an outcome will retard sound tax administration because the public's willingness to optimally comply with a tax will not be fostered unless the public views that tax as one which satisfies horizontal equity. An absence of optimal compliance will make a tax inefficacious. The CGT may become a tax relegated to such a status if those four reasons are not addressed.

## **Chapter 1: Introduction**

### **Overview of the scope of this chapter and this thesis**

In this chapter, the research problem is stated, as is how that research problem is answered. At the end of this chapter, some presentational aspects that require to be highlighted are described.

In Chapter 2, the methodology employed is described. That methodology involves finding answers to five questions. Each of those five questions is addressed in a succeeding chapter.

In the last chapter (Chapter 8), the overall conclusions from the research recorded in this thesis are stated, as are the policy implications arising from those conclusions. In that chapter, delimitations of the research recorded in this thesis are also outlined, based upon which directions for future research are identified.

### **Research problem**

The research problem dealt with in this thesis is:

Does the Australian regime of income tax on capital gains cause widespread violation of horizontal equity?

In this thesis, it is concluded that there is reason to expect that the Australian regime of income tax on capital gains (“the CGT regime”) can cause widespread violation of horizontal equity.

In Chapter 5, four reasons are identified which alone can cause the CGT regime to potentially produce outcomes that violate horizontal equity.

There is (as canvassed in Chapter 7) no sensitivity, in a systemic sense, to those for reasons in the processes employed to enact and implement provisions imposing CGT. There are also no institutionalised processes (warranted by legislation or otherwise) aimed at identifying outcomes that violate horizontal equity, and implementing legislative amendments to avoid them. Those absences led to the conclusion drawn in this thesis that there is reason to expect outcomes from the detailed working of the CGT regime that violate horizontal equity to be widespread.

### **Some presentational aspects of this thesis that require highlighting**

Each abbreviation used in this thesis is fully described in the passage where that abbreviation is first referred to. At the beginning of this thesis, those descriptions are detailed in a complete enumeration of abbreviations used in this thesis, where definitions of key expressions used are also detailed.

There is a large number of citations in this thesis of source materials that can be accessed on the internet. In all those citations, the website address of the respective source material is given, together with the date on which that source material was accessed on the internet. A printed copy of each of those source materials is held on file by me.

This thesis is based on the law and other relevant affairs as at 31 December 2009.

## **Chapter 2: Methodology**

### **Overview of the scope of this chapter**

In this chapter, the methodology employed in this thesis is described. There is also a discussion of the two broad methodological approaches that can be potentially adopted in a doctoral thesis such as this, and why the methodology employed in this thesis involves a combination of those two approaches. Thereafter, there is a description of the research through which each step of the methodology is addressed.

### **Methodology employed**

#### Introduction

The methodology employed involves finding answers to the following five questions:

##### Question 1

- Was the enactment of the CGT regime, and the continuance of it after enactment, actuated by a perception (of respectively the government which enacted it, and subsequent governments which yielded to its continuance) that the regime will satisfy the policy objective of horizontal equity?, and, if it was,

##### Question 2

- Is that perception largely correct?, and, if it is,

### Question 3

- What reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity (that is, outcomes that violate horizontal equity)?, and, if such reasons exist,

### Question 4

- Do those reasons (or any other) in practice cause the CGT regime to produce outcomes that violate horizontal equity?, and, if they do,

### Question 5

- Is there reason to expect those outcomes to be widespread?

There appears to be large consensus—but not unanimity—that the methodology adopted in a doctoral thesis such as this should be based on one of two broad methodological approaches. Those two broad methodological approaches are the positivist approach and the phenomenological approach.<sup>1</sup>

The positivist approach is predicated on a capability (by humans) to describe every social phenomenon, measure the effects of that phenomenon, and predict its occurrence in an absolute, scientific and objective manner.<sup>2</sup> The purpose of research undertaken pursuant to the

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<sup>1</sup> Perry C, “A structured approach to presenting PhD theses: Notes for candidates and their supervisors”, *paper presented to the ANZ Doctoral Consortium, University of Sydney*, 1994 (Sydney, 1995), p 23.

<sup>2</sup> Coventry University, *Research Approaches*, accessible at [http://www.stile.coventry.ac.uk/cbs/staff/g\\_urwin/Research\\_Approach.htm](http://www.stile.coventry.ac.uk/cbs/staff/g_urwin/Research_Approach.htm) (15 December 2004).

positivist approach, therefore, is to construct theories, which constitute general statements that validly explain social phenomena.<sup>3</sup>

The phenomenological approach (also known as a social constructionist approach) is predicated on the world being a social construct, and humans interpreting every social phenomenon not uniformly but rather in many different ways.<sup>4</sup> The aim of the phenomenological approach thus is more to understand the complexity and variety of social phenomena than to measure the effects or predict the occurrence of those social phenomena.<sup>5</sup> The purpose of research undertaken pursuant to the phenomenological approach, therefore, is to gain sufficient understanding of social phenomena so as to be able to roughly anticipate future outcomes with respect to any social phenomenon.<sup>6</sup>

This thesis favours the phenomenological approach, as that approach (relative to the positivist approach) has more rigour in the ascertainment of the true dynamics with respect to a given social phenomenon (such as a tax system). This thesis does, nevertheless, acknowledge that a research methodology can involve a combination of the positivist approach and the phenomenological approach (and does not have to necessarily involve exclusively one of those two approaches).<sup>7</sup>

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<sup>3</sup> Ibid.

Under the positivist approach, accordingly, the research involved is generally undertaken through the following methods: experiments, structured surveys and questionnaires, birth and death statistics, and official records (University of Leicester, *Summary Of positivist and anti-positivist positions*, accessible at <http://www.le.ac.uk/education/resources/SocSci/possum.html>) (15 December 2004).

<sup>4</sup> Above, note 2.

<sup>5</sup> Above, note 2.

<sup>6</sup> Above, note 2.

Under the phenomenological approach, accordingly, the research involved is generally undertaken through the following methods: observation of participants, unstructured interviews, diaries, and letters (University of Leicester, *Summary of positivist and anti-positivist positions*, accessible at <http://www.le.ac.uk/education/resources/SocSci/possum.html>) (15 December 2004).

<sup>7</sup> Above, note 2.

The research in this thesis required for finding answers to the five questions largely conforms to the phenomenological approach.

There is some literature that describes that the methodology adopted for the research required for a doctoral thesis such as this as involving two approaches, where those two approaches have not been explicitly articulated (in that literature) as conforming to either the positivist approach or the phenomenological approach.<sup>8</sup> Those two approaches (as described in that literature) are one that involves the testing of theories,<sup>9</sup> and another that involves the construction of theories.<sup>10</sup> In terms of those descriptions, the research in this thesis required for finding answers to the five questions involve a combination of both those approaches, for the following reasons.

Questions 1 and 2 (taken together) test a theory, as those questions involve testing the theory that the CGT regime (largely) does satisfy the policy objective of horizontal equity.

Question 3 involves the construction of a theory, as it involves the development of the reasons (a theory) that could cause the CGT regime to cause outcomes that fail to satisfy horizontal equity.

Question 4 involves testing the theory constructed in Question 3.

Question 5, like Question 4, involves testing the theory constructed Question 3. The result of the testing carried out in Question 4 was affirmation of the theory that the CGT regime does

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<sup>8</sup> Lewins F, *Social Science Methodology* (Melbourne: Macmillan Education Australia Pty Limited, 1992), p 68.

<sup>9</sup> Id, p 44.

<sup>10</sup> Above, note 8, p 68.

produce outcomes that violate horizontal equity. Question 5 tests that theory further in seeking to establish whether there is reason to expect those outcomes to be widespread.

Each of the five questions is addressed in a succeeding chapter, as outlined below.

### Question 1

Question 1 is addressed in Chapter 3, which contains an overview of the history of taxation of capital gains in Australia. Based on that history, Question 1 is answered in the affirmative. It is, accordingly, concluded that the enactment of the CGT regime, and its continuance after enactment, were actuated by a perception (of respectively the government which enacted it, and subsequent governments which yielded to its continuance) that the regime will satisfy the policy objective of horizontal equity. To set the context for that overview, in Chapter 3, at the outset, there is a comprehensive discussion of what constitute respectively capital gains and horizontal equity.

### Question 2

Question 2 is addressed in Chapter 4, which records the results of analyses carried out to conclude that the perception (of respectively the government which enacted the CGT regime, and subsequent governments which yielded to its continuance) that the regime will satisfy the policy objective of horizontal equity is a perception that is largely correct. The analyses required for drawing that conclusion represent a discussion of policy objectives other than horizontal equity the CGT regime has to satisfy. That discussion was warranted as those policy objectives and horizontal equity are not necessarily wholly co-extensive, so the satisfaction of horizontal equity by the CGT regime can potentially be compromised due to the regime also having to satisfy those other policy objectives.

### Question 3

Question 3 is addressed in Chapter 5, where it is argued that only one of four reasons can theoretically cause the CGT regime to potentially produce outcomes that violate horizontal equity. Those four reasons are outlined. The approaches taken by the Australian judiciary as well as the (Federal) Commissioner of Taxation (“the Commissioner”) to the interpretation of legislative provisions imposing CGT are also outlined. That is necessary as the four reasons are based on those approaches.

It is noted in Chapter 5 that, based on the research carried out for this thesis, there is no existing material which has identified those four reasons as the potentially only causes why the CGT regime may theoretically produce outcomes that violate horizontal equity.

### Question 4

Outcomes that violate horizontal equity, which are potentially caused by the CGT regime, can be grouped into the following three categories:

- Situations which result in an incidence of tax either greater or less than that placed on other taxpayers in a like economic situation
  
- Situations which result in an incidence of tax greater than that placed on other taxpayers in a like economic situation
  
- Situations which result in an incidence of tax less than that placed on other taxpayers in a like economic situation

Chapter 6 (in which Question 4 is addressed) analyses 15 case studies, each of which representing a situation that can potentially be encountered in real life. Those 15 situations, which represent potential outcomes, encompass the three categories. The 15 case studies serve two purposes. First, they readily exemplify outcomes that can, in real life, cause violation of horizontal equity due to the CGT regime. Second, they serve to demonstrate that the only reasons that could cause the regime to produce outcomes that violate horizontal equity are the four reasons identified in this chapter (and no other).

Each case study is described under a separate heading. Under each heading, there is a description (by reference to relevant legislative provisions, judicial interpretation of relevant legislative provisions, and relevant rulings) of a situation where horizontal equity is violated by the detailed workings of the CGT regime. That description includes an explanation as to why that situation is appropriate to be dealt with under the respective category (of the three categories of outcomes violating horizontal equity that can potentially result from the detailed working of the CGT regime). Under each heading, at the end, there is a recommendation of what should be done to avoid horizontal equity being violated.

That recommendation is made to demonstrate that that violation of horizontal equity is possibly capable of remediation without exposure to being “capricious”, to “excessive administrative costs or other adverse effects”, or to them both. Those criteria are as formulated in a work (cited in Chapter 6) by the respected American public finance professor Louis Kaplow.

Why it was stated that those recommendations are “possibly” capable of remediation without exposure to those three criteria was in recognition that horizontal equity is only one of many

policy objectives (which are not necessarily wholly co-extensive) that the CGT regime has to satisfy.

### Question 5

Question 5 is addressed in Chapter 7, where it is asserted that a basis is established to articulate a preliminary argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread. That basis is established through the analysis (in Chapter 6) of 15 case studies representing situations that can potentially be encountered in real life where the detailed workings of the CGT regime do violate horizontal equity.

In Chapter 7, that preliminary argument is then tested through the research described below. Through a description of the arrangements adopted to enact and implement legislative provisions imposing CGT, it is demonstrated that there is an absence of systematic sensitivity to the four reasons that alone can cause the CGT regime to potentially produce outcomes that violate horizontal equity. It is also demonstrated that there are no institutionalized processes (mandated by legislation or otherwise) for identifying outcomes that violate horizontal equity and enacting legislative amendments to avoid such outcomes.

Due to those absences, the conclusion is drawn that the argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread is justified.

## Overall conclusions

In the last chapter (Chapter 8), the overall conclusions from the research recorded in this thesis are summarised. The policy implications of those conclusions are also identified. Delimitations of the research recorded in this thesis are outlined, based upon which directions for further research are identified.

## **Chapter 3: Was the enactment of the CGT regime actuated by a perception that it will satisfy the policy objective of horizontal equity?**

### **Overview of the scope of this chapter**

This chapter addresses the question of whether the enactment of the CGT regime, and the continuance of it after enactment, were actuated by a perception (of respectively the government which enacted it, and subsequent governments which have yielded to its continuance) that it will satisfy the policy objective of horizontal equity. That question, in this chapter, is answered in the affirmative.

In order to reach that answer, in this chapter, there is a comprehensive discussion of what constitute capital gains and what constitutes horizontal equity, so as to set the context for an overview of the history of taxation of capital gains in Australia. On the basis of that history, the conclusion is drawn that the enactment of the CGT regime was actuated by a perception (of the government which enacted it) that the regime will satisfy horizontal equity, a perception which has continued to be held by subsequent governments.

### **What are capital gains?**

#### Introduction

In Australia, presently, there is a regime that subjects capital gains to income tax (commonly referred to as “the CGT regime”). In truth, however, the CGT regime subjects to income tax not only capital gains, but rather gains generally of any nature (whether those gains are capital

gains or not). Quite apart from the CGT regime, gains that are not capital gains are generally subject to income tax in Australia in terms of several other regimes.

Any one gain, accordingly, can be potentially subject to Australian income tax twice (once under the CGT regime, and again under another regime). In order to avoid such an outcome, gains that are subject to income tax under a regime other than the CGT regime are essentially excluded from being subject to the CGT regime.<sup>11</sup> Therefore, one may rightly generalise that the CGT regime, in its ultimate outcome, subjects to Australian income tax only capital gains.

### The origins of the distinction between capital gains and income gains

In a tax context (in England, and in all other countries that adopt a common law judicial system), the judicial practice has evolved to categorise all gains accruing to an entity mainly into two mutually exclusive categories.<sup>12</sup> Those two categories are capital gains, and income gains.<sup>13</sup> In that evolution of judicial practice, the determination of what constitute “capital gains” has largely turned on the distinction between “capital” and “income” as popularly understood, as understood in economic theory, and as understood in branches of law other than tax.<sup>14</sup> Each of those understandings was not the outcome of reasoning pursuant to a coherent conceptual framework.<sup>15</sup> And each of those understandings often informed and influenced the others.<sup>16</sup> In terms of those understandings, “capital gains” were regarded as being comprehended by “capital”, in contrast to “income”.<sup>17</sup>

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<sup>11</sup> Income Tax Assessment Act 1997 (Cth) s 118 - 20.

<sup>12</sup> Woellner R & others, *Australian Taxation Law 2001* (Sydney: CCH Australia Limited, 2001), p 350.

<sup>13</sup> *Ibid.*

<sup>14</sup> Kreyer R & Brooks N, *A Capital Gains Tax for New Zealand* (Wellington: Victoria University Press, 1990), p 1.

<sup>15</sup> Above, note 14, p 9.

<sup>16</sup> Above, note 14, p 9.

<sup>17</sup> Above, note 14, p 9.

The popular understanding of the distinction between “capital” and “income” appears to have originated, more than two centuries ago, in England (and perhaps some other northern hemisphere countries with a temperate climate), whose economy as of then was largely based on agriculture, where income was regarded as the agricultural produce annually harvested from the land (or the worth of that harvest in money) and capital was regarded as predominantly the land which yielded that harvest.<sup>18</sup> Accordingly, until into the 20<sup>th</sup> century, in the context of a prudent man deriving a gain, income was popularly understood to mean gains which that person would spend on routine consumption, and capital was popularly understood to mean gains which that person would save.<sup>19</sup>

What was understood to be “income” in economic theory, in the 19<sup>th</sup> and early 20<sup>th</sup> centuries, was essentially firmly grounded on the popular understanding of what “income” was.<sup>20</sup> Accordingly, in economic theory at that time, income gains were understood to be the yield of what necessarily warranted some purposeful economic activity (such as farming) by the person deriving those gains, where necessarily those gains recurred fairly regularly (like with the passage of harvesting seasons).<sup>21</sup> Income gains, accordingly, were understood to be such that, if they were withdrawn for consumption by the person deriving those gains, their withdrawal did not cause a permanent impairment of the source that yielded those gains (like the annual harvest that can be separated from the land that yielded that harvest, and consumed or disposed of without depleting the productive potential of that land).<sup>22</sup>

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<sup>18</sup> Seltzer L H & others, *The Nature and Tax Treatment of Capital Gains and Losses* (New York: National Bureau Of Economic Research, Inc., 1951), p 25.

<sup>19</sup> Above, note 18, p 25.

<sup>20</sup> Above, note 18, p 25.

<sup>21</sup> Above, note 18, p 25.

<sup>22</sup> Above, note 18, p 25.

What has been so described has, elsewhere,<sup>23</sup> been appositely placed in context, in the following terms:

... Strongest of all these traditional earmarks of income is the tendency to recur at more or less regular intervals.

Casual, sporadic, and unexpected gains, whether from the sale of land, other property not ordinarily dealt in by the recipient, gifts, or otherwise derived, did not fit into this concept of income. They appeared to be the result of good luck, not the usual product of purposeful activity. Lacking a continuing source, such as a farm or business enterprise, they arose from discrete events. Hence they could not reliably be expected to recur at regular intervals. A prudent man, the conclusion was, will therefore regard them differently from ordinary income. He will treat them as additions to his capital, not available for ordinary consumption. Capital gains in this view included all unexpected receipts.

During the 17<sup>th</sup> and 18<sup>th</sup> centuries, a practice emerged (with increasing frequency) for testators to give to their immediate heirs a life interest in their estate, and to leave to succeeding generations an interest in remainder in their estate. In that light, for trust and property law purposes, “income” was taken to mean the yield of the estate which those with a life interest in the estate were entitled to; and, correspondingly, “capital” was taken to mean the yield of the estate that would accumulate for the benefit of those with an interest in the remainder of the estate.<sup>24</sup>

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<sup>23</sup> Above, note 18, p 25.

<sup>24</sup> Above, note 14, p 2.

Per above, note 18, p 25: Those with a life interest were merely entitled to a life interest in specific items of physical property, and not in any specific capital value. Those with a life interest, therefore, did not have an entitlement to sell any part of the estate of the testator, and consequently could never “realise” a gain in value in

The English courts interpreted the expression “capital gains” (in the context of income tax, which was first enacted in England in 1799) largely with reference to what constituted “capital” in terms of the description above.<sup>25</sup> They did so as they regarded capital gains as being comprehended by “capital”.<sup>26</sup> Accordingly, capital gains, not being “income”, generally were not deemed as being subject to income tax (as income tax was regarded as a tax only on income, not on capital).<sup>27</sup>

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any part of that estate (if such a gain were to occur). Accordingly, an appreciation in the value of that estate could not, in any useful sense, be considered income (of those with a life interest). Nor could (correspondingly) a decline in value of that estate be considered a reduction in income (of those with a life interest).

The position noted in the paragraph just above was buttressed by the general immobility (that pertained at that time) of ownership of property.

<sup>25</sup> Above, note 14, p 9.

Ross Parsons had expressed the opinion that the English courts, in adjudicating early cases on income tax, adopted, for purposes of income tax, the meaning of the expression “income” (and hence the meaning of the expression “capital”) that was relevant for purposes of trust law (Parsons R, “Income tax—An institution in decay”, (1986) 3 *Australian Tax Forum*, p 223). That opinion is only partly correct, as the meaning of those expressions for purposes of trust law was (as noted in the main body of this chapter) not the sole source of influence on the English courts in their interpretation of those expressions for purposes of income tax (Prebble J, “Income taxation: A structure built on sand”, (2002) *Sydney Law Review* 24 (3) September 2002, pp 302).

<sup>26</sup> Above, note 14, p 9.

<sup>27</sup> As to how the English courts articulated that interpretation is summarised in Richardson S R & Moore K E, “Canadian experience with the taxation of capital gains”, (1995) *Canadian Public Policy* Volume 21 Issue s1, pp 77 – 99. There, there is an enumeration of the important cases in which the English courts developed that interpretation. Those cases are *Californian Copper Syndicate v. Harris (Surveyor of Taxes)* (1904) 5 TC 159 (Scot. Ct. of Ex.); *Pearn v. Miller* (1927) 11 TC 610; *Ryall v. Hoare* (1923) All ER 528; *Jones v. Leeming* (1930) 15 TC 355, HL; *Trustees of Earl Haig v. CIR* (1939) 22 TC 725. One more case should perhaps be added to that enumeration, and that case is *LGC v. AG* (1901) 4 TC 265, HL.

Per above, note 18, p 29: In England, income tax was imposed only on types of income comprehended by five schedules. Of those five schedules, four schedules (Schedules A, B, C and E) covered income from specific sources, and therefore only Schedule D could have potentially comprehended capital gains. Schedule D applied to ‘... *annual* profits or gains arising ... from any kind of property... and other *annual* profits or gains not charged under Schedule A, B, C, or E ...’ [Emphasis added]. The English courts interpreted the expression ‘annual’ to not include occasional isolated profits (which capital gains generally are).

A fundamental feature of the common law judicial system (which has always obtained in Australia) is the doctrine of precedent<sup>28</sup> (that doctrine compels a lower court to follow the relevant reasoning of a superior court with respect to any matter in contention<sup>29</sup>). At the time the federation of (Commonwealth) Australia was formed and at the time (subsequently) the Commonwealth income tax was first enacted (in 1916) in Australia, the most superior appellate court in Australia was not the High Court of Australia, but the Judicial Committee of the Privy Council<sup>30</sup> (which sat in England, and which generally comprised judges from the UK)<sup>31</sup>. Accordingly, the English courts' interpretation of the expression "capital gains" (as described above) was readily adopted by the Australian courts adjudicating income tax disputes (in relation to Commonwealth income tax).<sup>32</sup>

### Influence of *Eisner v Macomber*

Such an adoption by the Australian courts appears to have been buttressed (and sustained) by a reliance (by the Australian courts) on a single USA Supreme Court decision—*Eisner v Macomber*<sup>33</sup> (decided in 1920)—to the effect that "capital" is analogous to a "tree" and "income" is analogous to the 'fruit' of that tree.<sup>34</sup> Though that reliance appears to have been based on a misunderstanding (by the Australian courts) of the true import of that USA

<sup>28</sup> Krever R, "The ironic Australian legacy of *Eisner v. Macomber*", (1990) *Australian Tax Forum* Volume 7 Number 2, p 191.

<sup>29</sup> Fleming J, *Barbarism to Verdict: A History of the Common Law* (Sydney: Angus & Robertson, 1994), pp 129 – 135.

Spigelman J J, "Our common law heritage", *address To The 2004 Joint Study Institute of Law Librarians*, 21 February 2004 (Sydney: 2004), accessible at <[http://www.agd.nsw.gov.au/sc/sc.nsf/pages/spigelman\\_210204](http://www.agd.nsw.gov.au/sc/sc.nsf/pages/spigelman_210204)> (2 August 2004).

<sup>30</sup> The High Court of Australia website <[http://www.hcourt.gov.au/about\\_02.html](http://www.hcourt.gov.au/about_02.html)> (7 July 2004).

<sup>31</sup> Crisp L F, *Australian National Government* (Hawthorne, Victoria: Longman Australia Pty Limited, 1974), p 63.

<sup>32</sup> *Ibid.*

<sup>33</sup> *Eisner v. Macomber* (1920) 252 US 189.

<sup>34</sup> Above, note 28, pp 200, 202.

Supreme Court decision, the effect of that reliance by the Australian courts has been decisive.<sup>35</sup>

That USA Supreme Court decision, on a few occasions, has also been relied upon by the English courts.<sup>36</sup> Therefore, reliance on that USA Supreme Court decision by the Australian courts did not represent a radical departure by the Australian courts of its practice of almost exclusive reliance on the English courts' interpretation of the expression "capital gains".<sup>37</sup> The real import of the Australian courts' reliance on that USA Supreme Court decision is the legitimation, in Australia, of the following view. That view (which, as noted above, appears to have been based on a misunderstanding by the Australian courts) is that capital gains conceptually cannot be severed from the underlying capital asset, and therefore "capital gains" cannot constitute "income".<sup>38</sup>

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<sup>35</sup> Above, note 28, p 200 - 204. There (at p 200), it is explained that, in *Eisner v. Macomber*, the judgment of the USA Supreme Court stated '...Income may be defined as the gain derived from capital ... provided it [that is, income] be understood to include profit gained through a sale or conversion of assets ... ', a statement which represents an important qualification that the Australian courts appear not to have understood. Accordingly, there (at p 200), it is rightly concluded that *Eisner v. Macomber*, on a proper analysis, serves as authority only for the proposition that a capital gain that has not been realised cannot be assessed to income tax. And it does not serve as authority (as the Australian courts have treated it to be) for the proposition that a capital gain in all circumstances (even if realised) cannot be assessed to income tax.

<sup>36</sup> Above, note 28, p 199.

<sup>37</sup> Above, note 28, p 204.

<sup>38</sup> Above, note 28, p 199.

## What is horizontal equity?

### Introduction

In order to define “horizontal equity”, necessarily first there has to be a discussion as to what constitutes “equity” (in general, as well as specifically in the context of taxation).

A country’s tax system, if that country were to be viewed as a proper liberal democracy, is a most important economic, social and political institution of that country.<sup>39</sup> In such a country, its tax system has a quasi-constitutional character, in that that tax system is not transient, but endures usually without major change (as that country’s constitution does) over not one but a number of consecutive budgetary cycles (constitutionally imposed on the governments of that country).<sup>40</sup> The tax system of a country determines the manner in which the cost of governmental services should be borne by that country’s public.<sup>41</sup> The tax system of that country, therefore, in conjunction with that country’s (welfare) transfer system and other public expenditure programmes, has a critical impact on the distribution of income and wealth amongst the public of that country.<sup>42</sup>

The accomplishment of equity (or fairness) in a country’s tax system is widely (and rightly) considered as an ideal of significant economic, social and political importance.<sup>43</sup> That is so for the following reasons:

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<sup>39</sup> Head J G, “Tax fairness principles: A conceptual, historical and practical review”, (1992) *Australian Tax Forum* Volume 9 Number 1, p 65.

<sup>40</sup> Ibid.

<sup>41</sup> Above, note 39, p 65.

<sup>42</sup> Above, note 39, p 65.

<sup>43</sup> Above, note 39, p 66.

- A country's tax system, coupled with that country's public's attitude towards that tax system, is a major element of that country's public capital.<sup>44</sup>
- If a country's tax system is equitable, that tax system is likely to enjoy a level of acceptance by that country's public better than what would have been otherwise, which is likely to conduce decisions by that country's government on public expenditure that are better than what would have been otherwise (as that government will then not be constrained by the lack of adequate resources to undertake public expenditure programmes that it deems optimal).<sup>45</sup>
- Conversely, if a country's tax system is not equitable, compliance with that tax system by that country's public is likely to be low, possibly causing sub-optimal decisions by that country's government on public expenditure (as that government will then be constrained by the lack of adequate resources to undertake public expenditure programmes that it deems optimal).<sup>46</sup>

### What is equity?

On what constitutes "equity" in general (that is, not specifically in the context of taxation, but in general), the views of perhaps the greatest of seminal influence have been propounded in the work of each John Rawls and John Harsanyi.<sup>47</sup> The immediate parent discipline on which

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<sup>44</sup> Above, note 39, p 66.

<sup>45</sup> Above, note 39, p 66.

<sup>46</sup> Above, note 39, p 66.

<sup>47</sup> Above, note 39, p 67.

The views propounded by John Rawls and John Harsanyi are those that have perhaps had the greatest of seminal influence, but there has by no means been an acceptance of those views which is unanimous. For instance, for criticisms of Rawls work, see Nozick R, *Anarchy, State and Utopia* (New York: Basic Books, 1974). And for criticisms of Harsanyi's work, see Broome J, "Can there be a preference-based utilitarianism?" in Salles M &

Rawls's work was grounded in political philosophy. Harsanyi's (correspondingly) was economics.

Rawls, in his work<sup>48</sup> (Rawls's work is commonly referred to as forming part of "the modern contractarian tradition"<sup>49</sup>), concluded that an essential feature of a proper approach to a country's institutional design (or reform) is the application of an appropriately "impartial" perspective.<sup>50</sup> Impartiality (or equity, in other words), according to Rawls, is accomplished through the following means. That means is a "veil of ignorance", in terms of which those who decide (under constitutional processes) for a country's public institutions are mandated to rely exclusively on "general information" on the nature and operation of that country's society, and are denied "specific information" which may bear on those decision-makers' personal preferences.<sup>51</sup>

Through that "veil of ignorance", accordingly, a fundamental prerequisite of a country, in order for that country to be a liberal democracy, which is to accord everyone in that country equality, is accommodated. Aspects of equality such as equal liberty, equal respect, equality of opportunity, and non-discrimination on the basis of race, religion, gender, sexual preference etc. are all, for instance, thus accommodated.<sup>52</sup> Thereby, causes which may (left to their own) operate to divide a country's public are prevented from coming to pass.<sup>53</sup>

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Weymark J, eds, *Justice, Political Liberalism and Utilitarianism: Proceedings of the Caen conference in honour of John Harsanyi and John Rawls* (London: Cambridge University Press, 2003).

(Harsanyi, who was born in Hungary, taught in Australia from the early 1950s to the early 1960s, before migrating to the USA. In 1994, he was (jointly with two others) awarded the Nobel Prize in economic science.)

<sup>48</sup> Rawls J, *A Theory of Justice* (Oxford, UK: Oxford University Press, 1999), which is the revised edition; the original edition was first published in 1971.

<sup>49</sup> Above, note 39, p 67.

<sup>50</sup> Above, note 48, p 165 - 168.

<sup>51</sup> Above, note 48, p 118 - 123.

<sup>52</sup> Above, note 39, p 67.

<sup>53</sup> Above, note 39, p 67.

Rawls argued that rational persons (comprising a country's public), in choosing that country's institutional arrangements, will choose arrangements that will potentially result in the avoidance (in relation to those persons) of worst possible outcomes.<sup>54</sup> From that argument, Rawls concluded that institutional arrangements of a country must have paramount concern for worst-off persons of that country's public.<sup>55</sup>

Harsanyi, in his work<sup>56</sup> (Harsanyi's work is commonly referred to as forming part of "modern utilitarianism"<sup>57</sup>), concluded essentially not significantly dissimilarly to Rawls (as described above).<sup>58</sup> Harsanyi, however, did so on the argument that rational persons (comprising a country's public), in choosing that country's institutional arrangements, will choose arrangements that will potentially maximise the "utility" of those persons.<sup>59</sup> From that argument, Harsanyi concluded that institutional arrangements of a country should be arrangements that optimise "utility" of all persons of that country, where those arrangements are formulated (by those responsible for the government of that country) based on a choice "between conflicting preferences of different [persons] according to certain standards of impartial equity".<sup>60</sup>

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<sup>54</sup> Above, note 48, p 266 - 267.

<sup>55</sup> Above, note 48, p 266 – 267.

<sup>56</sup> Harsanyi J C, "Cardinal utility in welfare economics and in the theory of risk taking", (1953) *61 Journal of Political Economy*, p 434; Harsanyi J C, "Cardinal welfare, individualistic ethics and interpersonal comparisons of utility", (1955) *63 Journal of Political Economy*, p 309.

<sup>57</sup> Above, note 39, p 67.

<sup>58</sup> Above, note 39, p 67.

Quiggin J, "Expected Utility", accessible at <<http://quiggindictionary.blogspot.com>> (14 July 2004).

<sup>59</sup> Harsanyi J C, "Cardinal welfare, individualistic ethics, and interpersonal comparisons of utility", (1955) *63 Journal of Political Economy*, p 321.

<sup>60</sup> Ibid.

That conclusion of Harsanyi has been explained essentially to the same effect elsewhere,<sup>61</sup> as follows:

With the assumption that individuals all have the same utility function, the principle of horizontal equity requires nothing more than that individuals with the same consumption bundle (including leisure) should pay the same tax. ... Since violation of this condition would reduce aggregate social welfare, the equal taxation of equals is implied directly by utilitarianism and does not require a separate principle of horizontal equity.<sup>62</sup>

#### Relationship between equity and economic efficiency

To explore the concept of “equity” further, one has to offer some definitional comment on another concept, which is “economic efficiency”. That is so as “economic efficiency”, together with “equity”, is a critical policy objective a tax system has to satisfy.

In terms of economic theory applicable to a country that is a liberal democracy, for optimal use of scarce resources by that country (so that that country’s economic growth is optimised), those resources must be allocated amongst the public of that country in a manner that attains economic efficiency.<sup>63</sup> The attainment of economic efficiency, in that context, is defined as a

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<sup>61</sup> Feldstein M, “On the theory of tax reform” (1976) 6 *Journal of Public Economics* 77, p 82.

<sup>62</sup> Aspects of that explanation (but not the entirety of it) have been the subject of some criticisms. For instance, see Atkinson A B, “Horizontal equity and the distribution of the tax burden”, in Aaron H J & Boskin M J, eds, *The Economics of Taxation* (Washington, D C: The Brookings Institution, 1980), p 14. The essential validity of that explanation, however, does not detract from those criticisms.

<sup>63</sup> Musgrave R A & Musgrave P B, *Public Finance Theory & Practice* (Singapore: Singapore McGraw-Hill Book Co, 1984), p 82.

state that pertains where scarce resource use occurs such that there is no possibility of making a change (of scarce resource use) which helps one person without hurting anyone else.<sup>64</sup>

In practical terms, in a country which is a liberal democracy, the attainment of economic efficiency (in the use of scarce resources by that country) is generally ensured through permitting the operation of market forces with the least possible intervention.<sup>65</sup> That essentially means that those of the public who are most “efficient” (or “productive”) in that country will be allocated (through the unfettered operation of market forces) the largest share of that country’s scarce resources.<sup>66</sup> Such an allocation of (scarce) resources of a country may conflict with “equity”, as defined above (in terms of the work of Rawls) essentially to mean everyone in a country being regarded (by those constitutionally responsible for the government of that country) as equal.<sup>67</sup>

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<sup>64</sup> Id, p 67.

<sup>65</sup> Meade J E & others, *The Structure and Reform of Direct Taxation (Meade Committee Report)* (Chairman: Meade J E) (London: The Institute of Fiscal Studies, 1978), p 10.

<sup>66</sup> Ibid.

For a persuasive analysis of why the attainment of economic efficiency is best ensured through the unfettered operation of market forces, see Ball R, “Institutions of Innovation and Prosperity”, *the thirteenth annual John Bonython lecture* delivered at the Grand Hyatt, Melbourne (August 1996), accessible at <<http://www.cis.org.au/Events/JBL?JBL96.htm>> (18 September 2003); Wilson J Q, “The Morality of Capitalism”, *the fourteenth annual John Bonython lecture* delivered at the Hilton, Sydney (October 1997), accessible at <<http://www.cis.org.au/Events/JBL?JBL97.htm>> (18 September 2003); and Chipman L, “What governments can’t know: The knowledge economy and the market”, *the eighteenth annual John Bonython lecture* delivered at the Art Gallery of New South Wales, Sydney (October 2001), accessible at <<http://www.cis.org.au/Events/JBL?JBL01.htm>> (18 September 2003).

For an alternative analysis, see Nell E J, “The revival of political economy” in Argyrous G & Stilwell F, eds, *Economics as a Social Science* (Sydney: Pluto Press, 1996), p 189. There, Nell expresses the view that, though orthodox economics attempts to demonstrate that the unfettered operation of market forces allocates scarce resources according to relative efficiency, political economics demonstrate that that allocation occurs according to relative power (of market participants) (p 197). That analysis of Nell may have some merit, but is not one that has gained wide acceptance as yet. For that reason, that analysis of Nell has not been explored in this thesis to conclude whether it is appropriate for adoption in this thesis.

<sup>67</sup> Above, note 39, p 68.

Rawls's work accepted an unequal division of a country's national income amongst that country's public if (and only if) such a division (as noted above) promoted the well-being of the least well-off in that country.<sup>68</sup> Rawls, accordingly, did concede that a departure from an equal division of a country's national income can be warranted if by that departure economic efficiency was promoted.<sup>69</sup>

It is a state such as that (where there has been a departure from an equal division of a country's national income so as to promote economic efficiency) which generally pertains currently in all countries in the world which are liberal democracies. A decisive issue facing (government) policymakers of any country (that is a liberal democracy) then is, given that economic efficiency of that country's resources must be promoted, how is one to (at the same time) ensure there is "equity" (as defined above to mean everyone in that country being regarded as equal).<sup>70</sup>

The governments of most (if not all) countries which are liberal democracies (that is, democracies which aim to foster liberty of their peoples) seem to have (thus far) approached

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In Spigelman J J, "Economic Rationalism and the Law", *the fourteenth Lionel Murphy Memorial Lecture* delivered at the State Library of New South Wales, Sydney (October 2000), accessible at [http://www.agd.nsw.gov.au/sc/sc.nsf/pages/cj\\_261000](http://www.agd.nsw.gov.au/sc/sc.nsf/pages/cj_261000) (2 August 2004), there is a discussion of some conclusions reached in North D C, *Institutions, Institutional Change and Economic Performance* (Cambridge, UK: Cambridge University Press, 1990). Those conclusions essentially are to the following effect. "Allocative efficiency" represents a traditional comparative static approach of neoclassical economics. The primary determinant of economic welfare is not "allocative efficiency". Rather, the primary determinant of economic welfare is "adaptive efficiency", which represents a dynamic approach of economics. Adaptive efficiency refers to the way an economy evolves through time. In that evolution, "institutions" define "the rules of the game" (both formal rules and informal rules), and, through those rules, institutions reduce uncertainty (and hence risk) by providing a structure to the numerous transactions that occur in an economy. Accordingly, institutions (that incorporate notions of equity, thus ensuring fairness in processes, in access to opportunities, and in outcomes) significantly influence economic welfare as they generally facilitate experiment and innovation.

<sup>68</sup> Above, note 48, p 266 - 267.

<sup>69</sup> Above, note 48, p 266 - 267.

<sup>70</sup> Above, note 61, p 83.

that (decisive) issue pragmatically by attempting to ensure that there is an equitable distribution of the scarce resources of those countries amongst their publics. Such an equitable distribution has never been an “equal” distribution, since, as explained above, an “equal” distribution may cause a too severe impairment of the promotion of those countries’ economic efficiency.<sup>71</sup> Such an equitable distribution, in the case of any one of those countries, has been accomplished through intervention by that country’s government to reallocate that country’s scarce resources (otherwise allocated through unfettered operation of market forces) amongst that country’s public.<sup>72</sup> Such government intervention has taken the form of taxation (that is,

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<sup>71</sup> For an impassioned analysis of why such an “equal” distribution may never cause a too severe impairment of economic efficiency, see Stilwell F, “Economic inequality”, in Argyrous G & Stilwell F, eds, *Economics as a Social Science* (Sydney: Pluto Press, 1996), p 25. There, Stilwell argues as follows. There is no systematic evidence of a positive connection between economic inequality and superior macroeconomic performance (p 27). Economic inequality exacerbates class conflict, which undermines the conditions requisite for economic efficiency (p 27). Therefore, a violation of equity endangers economic efficiency (p 27). Economic inequality engenders adverse social effects related to crime, ill health, threats to social cohesion, and impediments to ecological sustainability (pp 97 - 98). All those adverse social effects translate to economic costs (p 97). Economic inequality also undermines the potential for the complete realisation of democratic political ideals (p 98). That is so as those with greater wealth, in reality, wield more power in most affairs of society than those with relatively less wealth (p 98). Some may find that analysis of Stilwell consistent with their own passion. However, it is an analysis that is inadequate for the reason that it is not borne out in practice in any of the countries which has attained economic prosperity. (For instance, economic equality does not pertain in Australia as of now, and never has since it was colonised by European settlers. If economic equality were to be achieved in Australia now, the policies required to achieve that outcome is most likely to be viewed by most Australians as radical, if not revolutionary.) For that reason, that analysis of Stilwell has not been adopted in this thesis.

<sup>72</sup> Above, note 65, p 12.

In Stein H, “Reflections on an early libertarian” (1996) *Cosmos Journal*, accessible at <<http://www.cosmos-club.org/journals/1996/stein.html>> (22 September 2004), there is a useful discussion of how Henry Simons (a single work of whose is cited in note 77 below) perceptively articulated why a country’s government should intervene to reallocate that country’s scarce resources (otherwise allocated through unfettered operation of market forces) amongst that country’s public. That articulation is to the following effect.

There are two kinds of justice—commutative justice and distributive justice.

Commutative justice dictates that each person is rewarded according to what that person contributes (or, in other words, according to the productivity of that person’s property, capital, or capacity). The case for commutative justice, accordingly, is a case for two things: one is the case for liberty, and the other is the case for economic efficiency. The case for liberty exists because any radical alteration of distribution of rewards resulting from voluntary exchange among persons would require a degree of centralised power that would be inconsistent with liberty. The case for economic efficiency exists because redistributing rewards away from a system in which

the extraction of scarce resources from that public by government) and expenditure programmes (that is, programmes through which government essentially distributes amongst that public the resources extracted by government through taxation).<sup>73</sup>

### An Australian perspective of equity

In 2004, Peter Saunders published a work,<sup>74</sup> in which he advanced the view that, in Australia, “fairness” (or “equity”) is perceived as all of the following three notions:

- First, the assurance that outcomes enjoyed by everyone in the public are so distributed that the outcomes afforded each of them are the same (or equal).<sup>75</sup>

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each gets rewarded the value of her or his product impairs incentives, disorganises production, and so reduces total output.

Distributive justice dictates equality, including equality of income. As to the distribution of power (on the one hand) and the distribution of economic goods or income (on the other), “there is something unlovely, to modern as against medieval minds, about marked inequality of either kind. A substantial measure of inequality may be unavoidable or essential for motivation; but it should be recognised as evil and tolerated only so far as dictates of expediency are clear” (as quoted from Simons’s “A Positive Program for Laissez Faire”). Redistribution of income is to be achieved in a two-level process. At the first level, production is organised in a free-market system that yields a primary distribution of income that is highly unequal. At the second level, that primary distribution of income is changed by transfer programmes, taxation, and investment in the education of those who would otherwise be least productive. Progressive mitigation of inequality of incomes can be achieved by government policy at the second level, whilst (at the first level) the free-market system could be preserved to yield both liberty and economic efficiency.

Distinguishing between those two levels reduces the conflict between liberty-cum-economic growth (on the one hand) and redistribution of incomes (on the other). Those two levels, however, cannot be entirely isolated from each other. The tax system, for instance, should be “neutralised” so that it did not distort the pattern of production that would emerge in a free-market. The system for redistribution of incomes (including the tax system) will inevitably affect incentives to work and save, and thus will affect the rate of economic growth. The question of whether those effects are desirable, and to what extent, will, therefore, remain.

<sup>73</sup> Above, note 65, p 12.

<sup>74</sup> Saunders P, “What is fair about a ‘Fair Go’”, *a monograph published by The Centre for Independent Studies, Sydney*, accessible at <<http://www.cis.org.au>> (8 July 2004).

<sup>75</sup> Ibid.

- Second, the assurance that everyone in the public is afforded the same (or equal) chance to compete for outcomes (even if, as a result, the eventual distribution of such outcomes amongst that public is not equal).<sup>76</sup>
- Third, the assurance that everyone in the public is able to carry out their affairs freely subject only to a uniformly applicable rule of law (how outcomes are distributed amongst the public, or what chances those of the public are afforded to compete for those outcomes, are, accordingly, irrelevant).<sup>77</sup>

Saunders concluded that, in Australia, as of now, “fairness” (or “equity”) is perceived as encompassing all of those three notions (and not just any one or two of them).<sup>78</sup>

The first and the third notions of “fairness” (or “equity”) advanced by Saunders are comprehended by a conclusion reached in the work of Rawls (as described above). That conclusion was to the effect that an essential feature of a proper approach to a country’s institutional design (or reform) is the application of an appropriately “impartial” perspective, with the consequence that everyone in that country’s public is regarded as equal.

The second notion of “fairness” (or “equity”) advanced by Saunders is comprehended by the concept of “economic efficiency” defined above. As explained in that definition of the concept of “economic efficiency”, Rawls did conditionally concede that a departure from an equal division of a country’s national income can be warranted if by that departure economic efficiency was promoted.

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<sup>76</sup> Above, note 74.

<sup>77</sup> Above, note 74.

<sup>78</sup> Above, note 74.

Accordingly, all three notions of “fairness” (or “equity”) advanced by Saunders are comprehended by the conclusions reached in the work of Rawls (as described above), upon which the analysis adopted in this thesis on equity (as recorded above) has to a considerable extent been developed. That analysis, therefore, does accommodate all three notions of “fairness” (or “equity”) advanced by Saunders.

### Equity in the context of taxation: Introduction

What then is “equity” specifically in the context of taxation? There is perhaps universal agreement that, in a country which is a liberal democracy, each one in that country’s public should contribute (by way of taxes) her or his “equitable share” to meet the cost of that country’s government (expenditure) programmes.<sup>79</sup> However, there is no like agreement as to how what constitutes such “equitable share” should be defined.<sup>80</sup> In formulating that definition, two approaches predominate,<sup>81</sup> which are commonly described as “the benefit principle” and “the ability to pay principle”.<sup>82</sup>

### Equity in the context of taxation: The benefit principle

The benefit principle postulates that, in a country which is a liberal democracy, each one in that country’s public should contribute (by way of taxes) according to how she or he benefits

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<sup>79</sup> Above, note 63, p 227.

<sup>80</sup> Above, note 63, p 227.

<sup>81</sup> Above, note 63, p 227.

Per above, note 39, pp 73 – 97: The other approaches are the sacrifice doctrines (as advocated by J S Mill, A J Cohen-Stuart, F Y Edgeworth, and A C Pigou), the public choice doctrines (as advocated by J M Buchanan, H J Aaron, and M McGuire), and the optimal tax doctrines (as advocated by M Feldstein, N H Stern, and R A Musgrave). Those approaches have not gained any degree of universal acceptance as they do not lend themselves to ready practical application.

<sup>82</sup> Above, note 63, p 227.

from the expenditure programmes of that country's government.<sup>83</sup> Accordingly, the benefit principle (unlike the ability to pay principle) involves a simultaneous consideration of taxation (by government) as well as public expenditure (by government).<sup>84</sup>

There are significant practical difficulties in measuring how each and every one in a country benefits (relative to others of that country) from the large number of expenditure programmes of that country's government (especially, of any developed country such as Australia).<sup>85</sup> That is especially so in the case of "pure or near pure public goods" provided by government (such as, say, national security).<sup>86</sup>

Therefore, generally, the benefit principle has been repudiated as an approach that is, in a country which is a liberal democracy, capable of generally affording a practical definition of what constitutes the equitable share of taxes that each one in that country's public should pay.

<sup>87</sup> The benefit principle, however, continues to be useful (if not indispensable) in those limited situations where it can be applied; that is, in situations where government expenditure programmes provide benefits to groups of the public that are specifically identifiable (such as, say, elements of health care or education).<sup>88</sup>

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<sup>83</sup> Above, note 63, p 228.

<sup>84</sup> Above, note 39, p 70.

<sup>85</sup> Above, note 39, p 228.

<sup>86</sup> Above, note 39, p 71.

<sup>87</sup> Simons H, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p 17.

<sup>88</sup> Above, note 39, p 71.

For a comprehensive discussion of the benefit principle, see Cooper G S, "The Benefit Theory of Taxation", (1994) *Australian Tax Forum* Volume 11 Number 4, p 397. There, it is argued that an income tax can be justified in terms of the benefit principle as the "benefit" that the government provides, in the context, is "the act of ordering, regulating and maintaining civil society and its private markets and providing the legal and regulatory framework within which individuals can transact and derive income" (p 495). Accordingly, there, it is argued (in rather general terms, and fatally not pursuant to close reasoning) that "the amount of income derived by an individual is a good reflection of the value of the benefits received by an individual", and consequently an income tax represents taxation according to the benefit principle (p 501). In terms of those arguments, the benefit

The benefit principle, accordingly, operates in a manner not essentially dissimilar to the unfettered operation of market forces, in that it results in a fair price being demanded from those in a country's public who consume specific public services provided by that country's government.<sup>89</sup> The benefit principle, therefore, by its very design, cannot, in a country which is a liberal democracy, accomplish an equitable distribution of that country's scarce resources among that country's public.<sup>90</sup> To accomplish that (at least, to a better extent), resort has been had to the ability to pay principle.<sup>91</sup>

#### Equity in the context of taxation: The ability to pay principle

The ability to pay principle postulates that each member of society should contribute (by way of taxes) according to her or his "ability to pay".<sup>92</sup> Accordingly, the ability to pay principle involves a consideration only of taxation (by government), and does not (like the benefit principle) involve a simultaneous consideration of taxation (by government) as well as public expenditure (by government).<sup>93</sup>

Taxation according to "ability to pay" comprises two components: horizontal equity, and vertical equity.<sup>94</sup> Horizontal equity requires those in an equal economic situation to pay an equal amount of taxes, and, by extension, those not in an equal economic situation not to pay an equal amount of taxes.<sup>95</sup> Vertical equity requires those in a more advantageous economic

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principle and the ability to pay principle lose their respective distinctions as two separate approaches to taxation, and consequently merge.

<sup>89</sup> Above, note 39, p 70.

<sup>90</sup> Above, note 39, p 71.

<sup>91</sup> Above, note 39, pp 72 -73.

<sup>92</sup> Above, note 63, p 232.

<sup>93</sup> Above, note 39, p 73.

<sup>94</sup> Above, note 63, p 232.

<sup>95</sup> Above, note 63, p 232.

situation to pay a greater amount of taxes (relative to those in a less advantageous economic situation).<sup>96</sup>

### The ability to pay principle: Horizontal equity

Horizontal equity, accordingly, finds a basis in the work of Rawls (as described above), which concluded that, in a country which is a liberal democracy, everyone in that country's public should be regarded as equal. A basis for horizontal equity can also be found in work preceding that of Rawls. John Stuart Mill, for instance, asked "For what reason ought equality be the rule in matters of taxation?," and answered "For the reason that it ought to be so in all matters of government."<sup>97</sup>

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Such a definition of horizontal equity, of course, assumes that all persons of a country have identical abilities and identical tastes. That is so as the economic capacity of a person reflects that person's ability as well as that person's tastes. Such an assumption, though it strictly does not reflect reality, is, however, necessary for horizontal equity to be made capable of practical implementation. For a discussion of the necessity of such an assumption, see generally the work by Feldstein M, cited in note 51; Stiglitz J E, "Utilitarianism and horizontal equity: The case for random taxation" (1982) 18 *Journal of Public Economics*, p 1; and Brennan G, "Horizontal equity: An extension of an extension", (1971) *Public Finance*, p 437.

There has been some discussion in the literature on whether "equality", in the context of horizontal equity, refers to equality of taxpayers' pre-tax situation or taxpayers' post-tax situation. On a robust and pragmatic view, it can refer to them both, and must be taken to be referring as such. (See Musgrave R A, "The Nature of horizontal equity and the principle of broad-based taxation: A friendly critique" in Head J G, ed, *Taxation Issues Of The 1980s* (Sydney: Australian Tax Research Foundation, 1983), p 30.)

<sup>96</sup> Above, note 63, p 232.

<sup>97</sup> Mill J S, *Principles of Political Economy* (London: Longmans, Green & Co, 1939), p 804.

John Stuart Mill (perhaps the best known disciple of the philosophical school pioneered by Jeremy Bentham) coined (in the nineteenth century) the expression "utilitarianism" to denote the philosophical position of those attached to the doctrine of utility as a measure of the adequacy of both laws and institutions (pp 317 – 318). In relation to that philosophical position, Mill adopted Bentham's dictum on "equality" that "everybody to count for one, and nobody for more than one", from which he developed the view that the claim of everybody to happiness:

... involves an equal claim to all the means of happiness, except in so far as the inevitable conditions of human life, and the general interest, in which that of every individual is included, set limits to the maxim; and those limits ought to be strictly construed ... All persons are deemed to have a right to

The implementation of horizontal equity (as well as vertical equity) requires, with respect to each and every one in a country, a quantitative measure of her or his “ability to pay”.<sup>98</sup> Ideally, that measure would reflect the entire economic welfare that she or he can derive from all options available to her or him, including consumption (present and future), holding of wealth, and enjoyment of leisure.<sup>99</sup> The formulation of such a quantitative measure, however, is not practicable.<sup>100</sup> That is so, particularly, as the value of leisure cannot be measured.

Income of a person is a second-best quantitative measure of that person’s “ability to pay” that has received wide acceptance.<sup>101</sup> There are, however, some who (with considerable force) regard a person’s consumption as a second-best quantitative measure of that person’s “ability to pay” that is superior to that person’s income.<sup>102</sup> Most countries (including Australia)

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equality of treatment, except when some recognised social expedience requires the reverse. ... (Mill’s writing, at pp 58 – 59, in *Utilitarianism*, Acton H, ed (London: 1972), quoted at p 319)

From that view, Mill developed the following perceptive interpretation:

... And hence all social inequalities which have ceased to be considered expedient, assume the character not of simple inexpediency, but of injustice, and appear so tyrannical, that people are apt to wonder how they ever could have been tolerated; forgetful that they themselves perhaps tolerate other inequalities under an equally mistaken notion of expediency, the correction of which would make that which they approve seem quite as monstrous as what they have at last learnt to condemn. The entire history of social improvement has been a series of transitions, by which one custom or institution after another, from being a supposed primary necessity of social existence, has passed into universally stigmatised injustice and tyranny. So it has been with the distinctions of slaves and freemen, nobles and serfs, patricians and plebeians; and so it will be, and in part already is, with the aristocracies of colour, race, and sex. ... (Mill’s writing, at p 59, in *Utilitarianism*, Acton H, ed (London: 1972), quoted at pp 319 – 320)

<sup>98</sup> Above, note 63, p 233

<sup>99</sup> Above, note 63, p 233.

<sup>100</sup> Above, note 63, p 233.

<sup>101</sup> Above, note 63, p 233.

<sup>102</sup> Above, note 63, p 233.

Fisher I, “Income in theory and income taxation in practice”, (1937) 5 *Econometrica*, p 1; Fisher I, “Double taxation of savings”, (1939) 29 *American Economic Review*, p 16; Fisher I & Fisher H W, *Constructive Income Taxation* (New York: Harper Brothers, 1942).

For a useful discussion of the relative pros and cons of each of the two measures—a person’s “income” and a person’s “consumption”—see Musgrave R A cited in note 95 above.

impose taxes based on a person's income (income tax in Australia, for instance) as well as based on a person's consumption (goods and services tax in Australia, for instance).

Accordingly, it is the ability to pay principle which furnishes the ethical justification for a country's government to impose an income tax on that country's public (which is the extraction of tax by government from each person of that public based on that person's income).<sup>103</sup>

#### Horizontal equity: The Schanz-Haig-Simons definition of income

In traditional tax policy analysis and in recent tax reform worldwide, the Schanz-Haig-Simons definition of income has been widely accepted as the best operational index of a person's income (in the context of imposing a tax on a person based on that person's income).<sup>104</sup> The Schanz-Haig-Simons definition of income of a person for a period is the result obtained by adding that person's consumption during that period to her or his wealth at the end of that period and then subtracting her or his wealth at the beginning of that period.<sup>105</sup> Thus defined, capital gains derived by a person during a period will clearly constitute income of that person for that period.

Accordingly, a tax that is ostensibly imposed on a person's income, but where income for that purpose is (contrary to the Schanz-Haig-Simons definition) legislated or judicially interpreted

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<sup>103</sup> Above, note 14, p 43.

<sup>104</sup> Above, note 14, p 43; Per above, note 29, p 204: The work was pioneered by G Schanz, a work which was published in 1896 (in Germany), but which was not widely read in the English-speaking world. R M Haig's relevant work was published in 1921 (in the USA). And H Simons's in 1938, a work which is cited in note 87 above.

<sup>105</sup> King J R, "The Concept of income", in Shome P, ed, *Tax Policy Handbook* (Washington, DC: International Monetary Fund, 1995), p 117.

to exclude capital gains, will seriously violate horizontal equity.<sup>106</sup> A widespread perception amongst those on whom a tax is imposed that the incidence of that tax falls unequally on those whose economic situation is essentially equal can undermine the enforcement of the tax.<sup>107</sup> That is especially so where the tax is administered on a self-assessment basis,<sup>108</sup> as CGT in Australia largely is. The attainment of horizontal equity is accordingly a most significant policy objective in the taxation of capital gains.

### Detractors of horizontal equity

The research carried out for purposes of this thesis did not reveal anyone as having authoritatively advocated that horizontal equity is not a policy objective a tax system should satisfy, though Boris Bittker and Louis Kaplow have expressed qualified doubt (as described below) on whether horizontal equity can be viewed as such a policy objective that can be absolutely optimally satisfied in practice.

Bittker<sup>109</sup> has argued that horizontal equity can perhaps never be absolutely optimally satisfied by any tax system, because of (say) the difficulty in defining a comprehensive tax base without ambiguity. And, therefore, as what should or should not be comprehended in that tax base will have to be decided necessarily somewhat arbitrarily, that arbitrariness will inevitably cause horizontal inequities (in practice) in the imposition of the tax (imposed by that tax system).

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<sup>106</sup> Above, note 14, p 43.

<sup>107</sup> Pederick W H, "Fair and square taxation for Australia", (1984) Vol 19 *Taxation in Australia*, p 575.

<sup>108</sup> Above, note 14, p 43; Ibid.

<sup>109</sup> Bittker B I, "A 'Comprehensive Tax Base' as a goal of income tax reform", (1967) *Harvard Law Review* 80, pp 925 – 985; Bittker B I, "Income tax 'loopholes' and political rhetoric", (1973) *Michigan Law Review* 71, pp 1099 – 1128.

Kaplow has argued that the satisfaction (or otherwise) of horizontal equity can never be reliably assessed, as such satisfaction (or otherwise) can never be measured with scientific precision. And that inability to measure coupled with the fact that the satisfaction of horizontal equity is “in conflict with the very core of welfare economics, the Pareto principle” (which essentially means that horizontal equity is not wholly co-extensive with economic efficiency) detracts from the utility of horizontal equity as “an independent evaluative principle”, though (Kaplow concedes) horizontal equity remains indeed relevant in a tax policy context, as “most of us feel that equal treatment of equals is important”.<sup>110</sup>

#### Reconciling the arguments of detractors of horizontal equity

The arguments of Bittker and Kaplow, as described above, have rigour (as those arguments do reflect reality), but those arguments do not detract from the position adopted in this thesis that horizontal equity is a policy objective that a tax system (such as the CGT regime) should satisfy, for the following reasons.

The analysis developed above resulted in two relevant and material conclusions (as follows):

- It was concluded “if a country’s tax system is equitable, that tax system is likely to enjoy a level of acceptance by that country’s public better than what would have been otherwise, which is likely to conduce decisions by that country’s government on public expenditure that are better than what would have been otherwise (as that government will then not be constrained by the lack of adequate resources to undertake public expenditure programmes that it deems optimal).”

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<sup>110</sup> Kaplow L, “Horizontal equity: New measures, unclear principles”, *Working Paper 7649* (Cambridge, Massachusetts: National Bureau of Economic Research, 2000), accessible at <<http://www.nber.org/papers/w7649>> (27 September 2004), p 22.

- It was concluded that, through the accommodation of “equality” among a country’s public, “causes which may (left to their own) operate to divide a country’s public are prevented from coming to pass.”

Those two conclusions demonstrate that horizontal equity is a policy objective that a country’s public (in practice) expects a tax system of that country to vitally satisfy, if that tax system is to remain efficacious (through optimal compliance with that tax system by that public). That expectation (of that country’s public) is generally formed on a pragmatic (relatively readily comprehensible) basis of what constitutes “horizontal equity” (as defined above as those in an equal economic situation paying an equal amount of taxes, and, by extension, those not in an equal economic situation not paying an equal amount of taxes).<sup>111</sup>

Accordingly, a tax system (which imposes a tax based on a comprehensive tax base, such as the income tax in Australia), if it is to remain efficacious, must necessarily satisfy horizontal equity (at least, with respect to the larger part of the operation of that tax system, as comprehended by the public on whom that tax system imposes a tax). Absent that satisfaction of horizontal equity, that tax system will not be efficacious.

This thesis, accordingly, does not adopt the position that a tax system (such as the CGT regime) can (in practice) satisfy the policy objective of horizontal equity absolutely optimally; the position that it does adopt (rather) is that, taking the CGT regime as a whole, there has to be such satisfaction in sufficiently large part, such that that satisfaction is perceived to be credible by the public on whom that tax system imposes a tax.<sup>112</sup> That position (adopted in

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<sup>111</sup> Above, note 110, p 22.

<sup>112</sup> Above, note 110, p 22; and above, note 12, p 14, which cites Kinsey K A & Smith K W, “Income tax cheating: Opportunities, preferences and sanctions”, *American Bar Foundation Working Paper Series # 8,718*, presented at the 1986 meeting of the Midwestern Sociological Society, Des Mines, Iowa to the effect that a belief that a tax system is unfair has a “strong positive effect on the acceptability of tax cheating”.

this thesis), therefore, is not inconsistent with the arguments of Bittker or Kaplow, as outlined above.

There will, however, not be such satisfaction in sufficiently large part, if violations of horizontal equity caused by the detailed working of the CGT regime are widespread. Whether there are indeed such widespread violations is the research problem that is addressed in this thesis.

How to identify which of the outcomes where the CGT regime does violate horizontal equity are capable of remediation?

As demonstrated below, the enactment of the CGT regime was actuated by a perception (of the government which enacted it) that the regime will satisfy the policy objective of horizontal equity, and the continuance of the regime (after enactment) was actuated by the same perception. Despite that, in practice, the detailed workings of the CGT regime do result in outcomes that violate horizontal equity.

In that context, an authoritative standard is required for identifying which of such outcomes can be remediated so that the violation of horizontal equity caused by the detailed working of the CGT regime can be avoided. Such an authoritative standard is required as one may contend (and perhaps rightly so) that those violations result because of the need for the CGT regime to satisfy policy objectives other than horizontal equity (which are not co-extensive with horizontal equity). That authoritative standard can be derived from a work by the distinguished American public finance professor Louis Kaplow,<sup>113</sup> a work in which that standard is formulated in the following terms:

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<sup>113</sup> Kaplow L, "Horizontal equity: Measures in search of a principle", (1989) 42 *National Tax Journal*, p 139.

... Much unequal treatment is, however, more incidental. Yet, so long as such inequality is not capricious and is justified—often by the excessive administrative costs or other adverse effects of attempting to remedy it—there is no obvious affront to the principles of justice originally offered to motivate [horizontal equity]. After all, [horizontal equity] demands equal treatment only when there is no legitimate basis for inequality ...<sup>114</sup>

Accordingly, in terms of the standard formulated in that passage, those outcomes (caused by the detailed workings of the CGT regime) that potentially violate horizontal equity (which represent departures from equal treatment of taxpayers whose economic situation is essentially similar) are possibly capable of remediation where they are:

- “capricious”;
- not justified by “excessive administrative costs or other adverse effects of attempting to remedy” them; or
- both.

Those outcomes are mentioned above as “possibly” capable of remediation. The use of the word “possibly” was necessary for two reasons: first, one cannot conclude with absolute certitude that those outcomes are capable of remediation in practice (so as to avoid the violation of horizontal equity) because the CGT regime does have to satisfy policy objectives other than horizontal equity (which are not co-extensive with horizontal equity); and, second, the scope of this thesis does not permit undertaking an evaluation of whether horizontal equity must be accorded priority over those other competing policy objectives.

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<sup>114</sup> Id, p 149.

Some outcomes of significance that compound the violation of horizontal equity

The violation of horizontal equity which is caused if capital gains are excluded from income subject to tax (as described above) is compounded by a number of potential outcomes. Three of such outcomes, which are of appreciable significance, are described below:

- The number of taxpayers who own assets that may yield capital gains is relatively small.<sup>115</sup> Such taxpayers are generally able to consult professional tax advisers to convert their income gains (income gains from capital or from labour) into capital gains (which would be tax-free if capital gains were not comprehended by income subject to income tax).<sup>116</sup> Accordingly, not only do capital gains escape income tax, but income gains which by legislative design are subject to income tax also escape income tax. The violation of horizontal equity is thus compounded.
- A taxpayer who finances the acquisition of an asset (which is capable potentially of generating income gains as well as capital gains) through debt can (for purposes of income tax) claim the interest payable on such debt as fully tax-deductible from aggregate income (generated by that asset plus other sources). Accordingly, if any capital gain generated by that asset is not subject to income tax (due to capital gains not being comprehended by income subject to income tax), the taxpayer, in effect, benefits from a “negative” income tax.<sup>117</sup> That benefit (of a “negative” income tax) occurs where a taxpayer acquires, through an equal amount of debt, an asset that generates only income gains and no capital gains. The violation of horizontal equity is thus compounded.

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<sup>115</sup> Above, note 14, p 44.

<sup>116</sup> Above, note 14, p 44.

<sup>117</sup> Above, note 14, p 44.

- If capital gains are not comprehended by income liable to income tax, capital losses will generally not be tax-deductible for purposes of income tax. But a taxpayer's "ability to pay" is reduced by capital losses just as by non-capital losses incidental to income generation.<sup>118</sup> The exclusion of capital gains from income subject to income tax thus compounds the violation of horizontal equity.

#### An aspect of horizontal equity not addressed in this thesis

The taxation of capital gains is predicated on the formulation of a proper quantitative measure of a taxpayer's "ability to pay" (that is, the tax base), which thus is (as explained above) an aspect of horizontal equity. Who the taxpayer (that is, the tax unit) should be (that is, whether the tax unit should be the singular individual, as is so in Australia currently,<sup>119</sup> or the family, as is essentially so in some other countries), likewise, is an aspect of horizontal equity.<sup>120</sup> That aspect, too, has prompted much discussion,<sup>121</sup> but is not an aspect that is addressed in this thesis. In this thesis, the singular individual is accepted as the tax unit (without any critical evaluation of the appropriateness of that acceptance), as the tax unit for purposes of income tax in Australia currently is the singular individual.<sup>122</sup>

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<sup>118</sup> Above, note 14, p 44.

<sup>119</sup> CCH Australia Limited, *2004 Australian Master Tax Guide* (Sydney: CCH Australia Limited, 2004), p 22.

<sup>120</sup> Above, note 39, p 76.

<sup>121</sup> Sullivan L, "Tax injustice: Keeping the family cap-in-hand", *CIS Issue Analysis No 3 July 10 1998* (Sydney: The Centre For Independent Studies, 1998), accessible at <<http://www.cis.org.au>> (8 July 2004); Dwyer T, "The taxation of shared family incomes", *CIS Policy Monograph 61* (Sydney: The Centre for Independent Studies, 2004), accessible at <<http://www.cis.org.au>> (8 July 2004); and Covick O, "Put not your trust in tax reform: Rather, do the opposite", *Economic Papers September 2004* (Sydney: Economic Society of Australia, 2004), accessible at <[http://www.findarticles.com/p/articles/mi\\_m0PAO/is\\_3\\_23/ai\\_n6201944/print](http://www.findarticles.com/p/articles/mi_m0PAO/is_3_23/ai_n6201944/print)> (10 December 2004).

<sup>122</sup> Above, note 119, p 22.

## **An overview of the history of taxation of capital gains in Australia**

### Introduction

As to what constitute capital gains and what constitutes horizontal equity were comprehensively discussed in the preceding pages so as to provide a context for an overview of the history of taxation of capital gains in Australia. That overview (which is set out below) provides the factual basis for the analysis warranted to answer the question of whether the enactment of the CGT regime was actuated by a perception (of the government which enacted it, and subsequent governments) that the regime will satisfy horizontal equity.

### The origins of Australian income tax

Income tax was first imposed in Australia not by the Commonwealth but by the states.<sup>123</sup> South Australia started imposing income tax in 1884, New South Wales and Victoria in 1895, Queensland and Tasmania in 1902, and Western Australia in 1907.<sup>124</sup> The Commonwealth imposed income tax first in 1916.<sup>125</sup>

In 1942, as a war-time measure, the Commonwealth effectively exclusively assumed all functions connected with the collection and imposition of income tax.<sup>126</sup> That position has since remained unchanged, and, as of now, only the Commonwealth (and not any state) imposes an income tax.<sup>127</sup>

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<sup>123</sup> CCH Australia Limited, *2002 Australian Master Tax Guide* (Sydney: CCH Australia Limited, 2002), p 2.

<sup>124</sup> *Ibid.*

<sup>125</sup> Above, note 123, p 2.

<sup>126</sup> Above, note 123, p 3.

<sup>127</sup> Above, note 123, p 3.

The Commonwealth imposes income tax essentially in terms of two enactments: the *Income Tax Assessment Act 1936* (“the 1936 Act”), and the *Income Tax Assessment Act 1997* (“the 1997 Act”). The 1997 Act now contains substantial parts that were contained in the 1936 Act (including the CGT regime) as rewritten in terms purported to be user-friendly (as noted below).

When income tax was first enacted in Australia (both by states as well as the Commonwealth), there was, in terms of the relevant legislative enactments, no explicit inclusion of any forms of capital gain as income subject to income tax.<sup>128</sup> And it was assumed that the Australian courts would interpret those legislative enactments in accordance with the English courts (as noted above) so as to exclude capital gains from income subject to income tax.<sup>129</sup>

### The 1920 Royal Commission

A Royal Commission appointed in 1920 was the first to consider, in Australia, the issue of whether some forms of capital gain should be taxed.<sup>130</sup> The commission considered whether profits arising from the sale of property that was purchased primarily for the purpose of re-selling at a profit should be subject to income tax.<sup>131</sup> And it concluded that they should not, without any detailed consideration of relevant horizontal equity implications. It was so concluded as it was considered that it will be difficult to enforce the imposition of income tax on such profits, as well as to ensure that any tax-deductions claimed in respect of losses from

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<sup>128</sup> Above, note 14, p 31.

<sup>129</sup> Above, note 14, p 31.

<sup>130</sup> Above, note 14, p 31.

<sup>131</sup> Aust, *Report of Royal Commission on Taxation, Reports 1 – 5* (Chairman: Kerr W W) (Canberra: Commonwealth of Australia, Government Printer, 1921 – 23), paras 403 – 411.

such sales were not excessive.<sup>132</sup> No legislative changes were made to subject any form of capital gains to income tax as a result of the commission's report.<sup>133</sup>

#### Enactment of section 26 a) of the 1936 Act

In 1930, the equivalent of section 26 a) of the 1936 Act was enacted in the predecessor to the 1936 Act.<sup>134</sup> Section 26 a) of the 1936 Act subjected to income tax “any profit arising from the sale by [a] taxpayer of any property acquired by [the taxpayer] for the purpose of profit making by sale, or from the carrying on or carrying out of any profit making undertaking or scheme”. The purport of section 26 a) of the 1936 Act appears to have been to codify those judicial tests that had evolved in the English courts up to then which were considered to be good authority in Australia for distinguishing income gains from capital gains.<sup>135</sup> Such codification was seemingly considered necessary so as to avoid the applicability in Australia of an apparent anomalous decision by an English court to narrow the scope of what constitute income gains.<sup>136</sup>

The enactment of section 26 a) of the 1936 Act, accordingly, was the very first legislative effort to reinforce a definition of income liable to income tax that is broader than what it would otherwise have been. It was, consequently, an effort which represented a general motion (even if modest) towards greater horizontal equity.

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<sup>132</sup> Ibid.

<sup>133</sup> Above, note 14, p 32.

<sup>134</sup> Above, note 14, p 32.

<sup>135</sup> Priestly L J, “Section 26 a)—Is the law changing?” (1976) Vol 11 *Taxation In Australia*, p 2.

<sup>136</sup> Ibid.

## 1922 – 1960s: Three major Commission reports

Between 1922 and the early 1960s, there were three major reports by commissions dealing with taxation in Australia. None of those reports seriously considered the issue of whether capital gains (apart from those subject to income tax under section 26 a) of the 1936 Act) should be taxed,<sup>137</sup> or how such taxation (or the absence of it) affects horizontal equity.

### Downing report in 1964

The Social Science Research Council of Australia appointed a group of academics (chaired by Professor R I Downing) in 1964 to report on taxation in Australia.<sup>138</sup> The group published a report entitled *Taxation In Australia: An Agenda For Reform*.<sup>139</sup> The report was influential,<sup>140</sup> but the Commonwealth government at the time did not respond to it, as the report was not one commissioned by the Commonwealth government. The report contained the following relevant conclusions:

- The case for taxing capital gains was strong on grounds of equity.<sup>141</sup> Nevertheless, capital gains should not be taxed (as income is) as taxing so would cause significant administrative problems (as outlined in the two points just below).<sup>142</sup>

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<sup>137</sup> The three Commissions are referred to in Driesen I V & Fayle R, “History of income tax in Australia” in Krever R, ed, *Australian Taxation: Principles And Practice* (Melbourne: Longman, 1987), p 27.

<sup>138</sup> Above, note 14, pp 22 – 23.

<sup>139</sup> Downing R I & others, *Taxation in Australia: An agenda for reform* (Chairman: Downing R I) (Melbourne: Melbourne University Press, 1964).

<sup>140</sup> Above, note 14, p 33.

<sup>141</sup> Above, note 14, p 33.

<sup>142</sup> Above, note 14, p 33.

- Taxing capital gains on an accruals basis was administratively problematic due to the difficulty in annually valuing capital assets.<sup>143</sup>
- Taxing capital gains on a realisation basis was administratively problematic due to the following. It may cause taxpayers to lock into particular capital investments. It may necessitate capital losses to be made deductible only from capital gains. It may require capital gains subject to tax to be adjusted for inflation. And it may call for concessionary treatment of capital gains generated by sales of homes and corporate reorganisations.<sup>144</sup>
- The inequities caused by the non-taxation of capital gains would be somewhat reduced if the group's proposals for an "undistributed profits tax" on companies and an annual wealth tax was adopted.<sup>145</sup>

### Asprey Committee

A committee was appointed, in 1972, by the Liberal Party Commonwealth government to carry out a comprehensive review of taxation in Australia.<sup>146</sup> The chairman of the committee was Justice K W Asprey,<sup>147</sup> and the committee came to be known as the Asprey Committee. Though, in late 1972, an Australian Labor Party Commonwealth government replaced the

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<sup>143</sup> Above, note 14, p 33.

<sup>144</sup> Above, note 14, p 33.

<sup>145</sup> Above, note 14, p 33.

<sup>146</sup> Above, note 14, p 33.

<sup>147</sup> Above, note 14, p 33.

Liberal Party Commonwealth government, the remit of the Asprey Committee continued.<sup>148</sup>

The Asprey Committee published a *Preliminary Report* in June 1974.<sup>149</sup>

#### Enactment of section 26AAA of the 1936 Act

Before the publication of the Asprey Committee's *Preliminary Report*, the Australian Labor Party Commonwealth government, in 1973, enacted section 26AAA of the 1936 Act.<sup>150</sup>

Section 26AAA of the 1936 Act subjected to income tax any profit arising from the sale of property within twelve months of the purchase of that property.<sup>151</sup> Profits arising from the sale of a taxpayer's home resulting from a change in the taxpayer's place of employment or business were, however, excluded from the ambit of section 26AAA of the 1936 Act.<sup>152</sup>

The Australian Labor Party Commonwealth government's announced purport of enacting section 26AAA of the 1936 Act was to increase certainty and reduce abuse.<sup>153</sup> In that light, section 26AAA of the 1936 Act appears to have been intended to provide greater certainty (relative to section 26 a) of the 1936 Act, which was explained above) as to what specific forms of capital gain would be subject to income tax. Such greater certainty was provided because section 26AAA of the 1936 Act prescribed a taxing criterion that called for little subjective judgment in its application. That taxing criterion was a fixed time frame (of twelve months, within which the sale of the property, from the time of its purchase, must occur).

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<sup>148</sup> Above, note 14, p 33.

<sup>149</sup> Aust, *Taxation Reform Committee Preliminary Report* (Chairman: Asprey KW) (Canberra: AGPS, 1974).

<sup>150</sup> Above, note 14, p 33.

<sup>151</sup> Australian Tax Practice, *Australian Tax Handbook 2002* (Sydney: Australian Tax Practice, 2002), pp 155 – 157.

<sup>152</sup> *Ibid.*

<sup>153</sup> Above, note 14, p 33.

The enactment of section 26AAA of the 1936 Act (just as the enactment of section 26 a) of the 1936 Act did) reinforced a definition of income liable to income tax that is broader than what it would otherwise have been. Accordingly, the enactment of section 26AAA of the 1936 Act represented a general motion (even if modest) towards greater horizontal equity.

### Asprey Committee: Preliminary Report

The Asprey Committee's *Preliminary Report* (published in June 1974) recommended the introduction of a comprehensive tax on capital gains on grounds of horizontal equity and economic efficiency.<sup>154</sup> The *Preliminary Report* recommended only some portion of capital gains be taxed.<sup>155</sup> It recommended so as the high rate of inflation was a major concern in the mid-1970s (reaching an annual rate of over 20% in Australia).<sup>156</sup> And also as the Asprey Committee had concluded that it was not practicable to quantify inflation-adjusted capital gains (as a base for imposing tax) through indexation.<sup>157</sup>

In response to the *Preliminary Report*, the month following its publication, the Australian Labor Party Commonwealth government announced that it intended to enact a comprehensive tax on capital gains whereby over one half of any capital gain would be taxed.<sup>158</sup> The then Commonwealth Treasurer, in his September 1974 budget, provided an outline of that tax, which was to be effective from the date of the budget.<sup>159</sup> However, that tax was not enacted, and, in January 1975, the Commonwealth government announced that it was postponing the

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<sup>154</sup> Above, note 14, p 33.

<sup>155</sup> Above, note 14, p 33.

<sup>156</sup> Above, note 14, p 33.

<sup>157</sup> Above, note 14, p 33.

<sup>158</sup> Above, note 14, p 33.

<sup>159</sup> Above, note 14, p 33.

introduction of that tax.<sup>160</sup> The Commonwealth government's decision to not enact that tax was significantly influenced by widespread criticism which the Commonwealth government's announcement to enact that tax attracted.<sup>161</sup> That decision was also significantly influenced by the widespread belief that the high rates of inflation that were then prevailing made it difficult to measure what the real gain of any nominal gain was.<sup>162</sup>

### Asprey Committee: Final Report

The Asprey Committee published its *Final Report* in June 1975.<sup>163</sup> The *Final Report* maintained the recommendation in the *Preliminary Report* for the introduction of a comprehensive tax on capital gains on grounds of horizontal equity and economic efficiency (as noted above).<sup>164</sup> The Asprey Committee considered the grounds of equity to be the strongest so as to be overwhelming, which it rationalised in the following terms:

...It is on the ground of equity that, in the Committee's view, the arguments for capital gains tax may reasonably be held to be so strong to overwhelm the admittedly strong case against it on grounds of simplicity.

...The fundamental argument here is that a taxation system in which the ability to pay is a primary test of liability, capital gains, whether accrued or realised, constitute increase in ability to pay in so much the same way as receipts of wage, salaries,

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<sup>160</sup> Above, note 14, p 33.

<sup>161</sup> Above, note 14, p 33.

<sup>162</sup> Above, note 14, p 33.

<sup>163</sup> Aust, *Taxation Reform Committee Full Report (Asprey Committee Report)* (Chairman: Asprey K W) (Canberra: AGPS, 1975).

<sup>164</sup> Above, note 14, p 34.

interest, and rents to make it inequitable for them not to be brought to tax. Failure to tax them gives rise to inequity...<sup>165</sup>

The *Final Report* recommended that there should be wide public consultation to resolve the treatment of many complex issues relating to taxing capital gains.<sup>166</sup> In that light, the *Final Report* recommended the publication of a green paper on the taxation of capital gains, and also recommended further study on the means of recognising the effects of inflation in the taxation of capital gains.<sup>167</sup> The *Final Report* recommended that capital gains be taxed when realised.<sup>168</sup> And also only part of the capital gain be subjected to tax, with the proportion of the part to be so taxed to the whole of the capital gain varying inversely with the rate of inflation.<sup>169</sup> Such a method, it recommended, due to the absence of a better means of recognising the effects of inflation in the taxation of capital gains.<sup>170</sup>

The recommendations of the *Final Report*, overall, represented the most authoritative basis for the comprehensive taxation in Australia of capital gains that had been promulgated up to then. Those recommendations (as noted below) did indeed prove influential in the eventual enactment of the CGT regime.

After the publication of the *Final Report*, the Australian Labour Party Commonwealth government lost power (in 1975), before a green paper on the taxation of capital gains (as recommended in the *Final Report*) could be issued.<sup>171</sup> The Australian Labour Party supported

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<sup>165</sup> Above, note 163, p 414, paras 23.12 – 23.13.

<sup>166</sup> Above, note 14, p 34.

<sup>167</sup> Above, note 14, p 34.

<sup>168</sup> Above, note 14, p 34.

<sup>169</sup> Above, note 14, p 34.

<sup>170</sup> Above, note 14, p 34.

<sup>171</sup> Above, note 14, p 34.

the introduction of a comprehensive tax on capital gains in the federal elections in 1977 and 1980, which it lost.<sup>172</sup>

### Campbell Committee report

The Liberal Party – National Party coalition Commonwealth government, in January 1979, established a Committee of Inquiry (chaired by Mr J K Campbell, a committee which came to be known as the Campbell Inquiry) to report on the Australian financial system.<sup>173</sup> The Campbell Inquiry commissioned some papers that dealt with business taxation.<sup>174</sup> The authors of two of such papers argued that a separate tax on capital gains would be unnecessary if taxation of companies and taxation of shareholders were integrated.<sup>175</sup> That argument, however, was strongly disputed by some commentators.<sup>176</sup>

In its final report (delivered in September 1981), the Campbell Inquiry did not make any recommendations relating to the need for a comprehensive tax on capital gains, but noted:

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<sup>172</sup> Above, note 14, p 34.

<sup>173</sup> Above, note 14, p 34.

<sup>174</sup> Above, note 14, p 34.

<sup>175</sup> Aust, Swan P L, “Is there a case for complete integration of corporate and personal income taxes?”, in *Australian Financial System Inquiry, Commissioned Studies and Selected Papers: Part 3 – Business Taxation and the Financing of Industry* (Canberra: AGPS, 1982), pp 18 – 19; Aust, Officer R R, “Company tax and company financing”, in *Australian Financial System Inquiry, Commissioned Studies and Selected Papers: Part 3 – Business Taxation and the Financing of Industry* (Canberra: AGPS, 1982), pp 137 – 142.

<sup>176</sup> Aust, Head J G, “Company tax in Australia”, in *Australian Financial System Inquiry, Commissioned Studies and Selected Papers: Part 3 – Business Taxation and the Financing of Industry* (Canberra: AGPS, 1982), pp 160 – 163; Aust, Groenewegen P D, “Company finance and company tax”, in *Australian Financial System Inquiry, Commissioned Studies and Selected Papers: Part 3 – Business Taxation and the Financing of Industry* (Canberra: AGPS, 1982), pp 186 – 187.

...if the Committee's proposal for an integrated system of company taxation were adopted...some portion of share gains – viz. that portion arising from retained earnings – would, in effect, be assessed for tax at the time of realisation.<sup>177</sup>

### Draft White Paper

In the federal election in 1983, the Australian Labor Party campaigned on the promise that it would not enact a comprehensive tax on capital gains.<sup>178</sup> It did so seemingly in the belief that its defeat at the elections in 1977 and 1980 were (at least, partly) due to the non-acceptance by the electorate of its platform for tax reform (which included the introduction of a comprehensive tax on capital gains).<sup>179</sup> At the federal election in 1984, however, the Australian Labor Party campaigned expressly on a promise of tax reform (including the introduction of a comprehensive tax on capital gains).<sup>180</sup> It was seemingly influenced to do so by a series of tax scandals that occurred (in Australia) in the late 1970s and early 1980s, including the so-called “bottom-of-the-harbour” schemes.<sup>181</sup>

After its re-election at the federal election in 1984, the Australian Labor Party Commonwealth government appointed the Economic Planning & Advisory Committee to prepare a *Draft White Paper*<sup>182</sup> on tax reform. The Economic Planning & Advisory Committee reviewed the reports of the Asprey Committee and elicited numerous submissions before preparing the

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<sup>177</sup> Aust, *Australian Financial System: Final Report of the Committee of Inquiry (Campbell Inquiry Report)* (Chairman: Campbell J K) (Canberra: AGPS, 1981), p 274.

<sup>178</sup> Above, note 14, p 34.

<sup>179</sup> Above, note 14, p 34.

<sup>180</sup> Above, note 14, p 34.

<sup>181</sup> Above, note 14, p 34.

<sup>182</sup> Dirkis M, “Australian income tax policy and income tax law development—past, present, and future: A personal critique”, *paper presented at Australasian Tax Teachers' Association Conference 2002* (10 January 2002), p 6.

*Draft White Paper*,<sup>183</sup> which was released in June 1985.<sup>184</sup> The *Draft White Paper* recommended a comprehensive tax on capital gains, in terms of which capital gains (as adjusted for inflation by indexation) were to be taxed at ordinary rates of income tax.<sup>185</sup> That recommendation was rationalised on grounds of horizontal equity, as follows:

...Because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income. The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of objectives of equity, efficiency and combating tax avoidance.<sup>186</sup>

...The lack of general capital gains tax represents a structural defect in the income tax system which lies at the core of many avoidance arrangements: if income can be converted into or dressed up as capital gains, income tax can be avoided completely. The imposition of a capital gains tax would, therefore, strike at one of the foundations of tax avoidance in Australia.<sup>187</sup>

### Enactment of the CGT regime

The then Commonwealth Treasurer, in a statement made on 19 September 1985, announced the Commonwealth government's intention to introduce a comprehensive tax on capital gains

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<sup>183</sup> Ibid.

<sup>184</sup> Aust, *Reform of the Australian Tax System: Draft White Paper (Draft White Paper)* (Canberra: AGPS, 1985).

<sup>185</sup> Above, note 14, p 35.

<sup>186</sup> Above, note 184, p 77.

<sup>187</sup> Above, note 184, p 78.

broadly in terms of the recommendations of the *Draft White Paper*.<sup>188</sup> On 28 November 1985, the Commonwealth Treasurer announced that the design of the comprehensive tax on capital gains would depart in some respects from that recommended in the *Draft White Paper*.<sup>189</sup> Those departures were conceded by the Commonwealth government to secure, in the Commonwealth senate, the support of the Australian Democratic Party to ensure passage of legislation to impose a comprehensive tax on capital gains.<sup>190</sup> Legislation for the introduction of a regime of income tax on capital gains (that is, the CGT regime) was enacted on 22 May 1986.<sup>191</sup>

The broad features of the CGT regime were as follows:<sup>192</sup>

- Capital gains are subject to CGT only when they are realised, rather than as they accrue.
- Only capital gains realised in the 1986-87 income year and income years subsequent to it are subject to CGT. But capital gains realised on the disposal of assets acquired before 20 September 1985 are not subject to CGT.
- Capital gains are taxed at ordinary rates of income tax, subject to a requirement for averaging, so as to prevent “bunching” of capital gains. Such averaging had the effect of taxing a capital gain realised in any one income year at rates of

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<sup>188</sup> Aust, Statement by the Commonwealth Treasurer, the Hon. Paul Keating, “Reform of the Australian Tax System” (Canberra: AGPS, 1985), pp 41 – 49.

<sup>189</sup> Head J G, “Capital gains tax and capital income taxation”, (1987) Vol 4 No 1 *Australian Tax Forum*, p 35.

<sup>190</sup> *Ibid.*

<sup>191</sup> Income Tax Assessment (Capital Gains) Act 1986 (Cth).

<sup>192</sup> Bengé M, “Capital gains and the reform of the tax base” in Head J G & Krever R, eds, *Taxation Towards 2000* (Sydney: Australian Tax Research Foundation, 1997), p 353 – 354.

income tax that would apply had that capital gain been realised over five income years.

- Only real capital gains (that is, nominal capital gains inflation-adjusted by reference to the Consumer Price Index) are subject to CGT. The entitlement to so inflation-adjust capital gains was limited to assets owned by a taxpayer for at least 12 months.
- Nominal capital losses may be deducted from real capital gains realised in the same income year in which those capital losses are incurred or be carried forward to be deducted from real capital gains realised in future income years. Capital losses cannot be deducted, in any income year, from assessable income other than capital gains.
- A change of ownership of an asset arising from the owner of it dying or bequeathing it does not give rise to a capital gain subject to CGT. Instead, the beneficiary receiving that asset is deemed to have acquired it at the cost its previous owner acquired it (inflation-adjusted up to the time of that owner's death).
- A capital gain realised on the disposal of a personal-use asset (apart from land acquired primarily for personal use) is subject to CGT only to the extent of the excess of proceeds from such disposal over the greater of the inflation-adjusted purchase price of such asset and \$5,000.

- The position noted just above did not apply to certain personal-use assets that were “listed personal-use assets”. Capital gains on the disposal of listed personal-use assets (including works of art, jewellery, and antiques) acquired for more than \$1,000 are subject to CGT.
- Capital losses incurred on the disposal of listed personal-use assets can be deducted only from capital gains realised on the disposal of listed personal-use assets. Capital losses incurred on the disposal of personal-use assets that are not listed personal-use assets are wholly disregarded.
- Certain capital gains are exempt from CGT. Examples of such exemptions are a capital gain realised on the disposal of a taxpayer’s principal residence (now referred to as the main residence), and part of the capital gain realised on the disposal of business goodwill.

Did significant concessions contained in the CGT regime violate horizontal equity?

The CGT regime, as enacted, contained a number of concessions (in that some capital gains were legislated to be either wholly or partly not liable to income tax). The most significant of those concessions, and the reasons that led to their enactment, are canvassed below.

Only capital gains realised on the disposal of assets acquired on or after 20 September 1985 were subject to CGT. That was a concession that the Commonwealth government conceded to accommodate opposition from the Australian Democratic Party in the Commonwealth senate (opposition which seemingly was mistakenly predicated on a fear of retrospective

taxation).<sup>193</sup> It was a concession that, in the view of some, introduced severe horizontal inequities (as it favoured those who had acquired assets prior to 20 September 1985) and economic inefficiencies (as it provided a strong incentive to refrain from the sale of assets acquired prior to 20 September 1985).<sup>194</sup>

Twenty percent of any capital gain realised on the sale of business goodwill was exempt from CGT up to a maximum of \$1 million. That concession was rationalised by the Commonwealth government as being targeted to benefit small businesses.<sup>195</sup> That was so since business goodwill normally has no cost base.<sup>196</sup> Therefore, the provision for inflation adjustment through indexation by reference to the Consumer Price Index would (in the view of the Commonwealth government) seemingly operate to discriminate against those who realise capital gains on the sale of business goodwill.<sup>197</sup> Thus rationalised, that concession did not seemingly cause a significant violation of horizontal equity. That is so as that concession seemed to restore the loss of horizontal equity attending those unable to access inflation adjustments through indexation in relation to capital gains realised by them from the sale of non-purchased business goodwill.

On the death of a taxpayer, the deceased's assets were not deemed disposed of at market value at the time of the deceased's death. Rather, those assets were deemed to have been acquired by those who inherit those assets at the deceased's cost base of those assets.<sup>198</sup> That concession was made by the Commonwealth government to accommodate pressure from

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<sup>193</sup> Evans C, "The Australian capital gains tax: Rationale, review, and reform" (1998) Vol 14 No 3 *Australian Tax Forum*, p 300.

<sup>194</sup> Above, note 14, p 35.

<sup>195</sup> Above, note 14, pp 35 – 36.

<sup>196</sup> Above, note 14, pp 35 – 36.

<sup>197</sup> Above, note 14, pp 35 – 36.

<sup>198</sup> Above, note 14, p 36.

farmers and other small business owners.<sup>199</sup> They were seemingly concerned of the liquidity problems that would ensue, if CGT were payable on their death with respect to their assets, where their wills provided for a transmission of all their assets to their family, and those assets were largely not in liquid form.<sup>200</sup> They were also concerned that, if not for that concession, CGT would amount to a covert re-introduction of death duty, which had been abolished.<sup>201</sup> Given that death inevitably happens to everyone, that concession seemingly does not represent a significant violation of horizontal equity.

Capital gains realised by individuals were subject to CGT (at progressive rates of tax) effectively averaged over five income years. That concession was afforded by the Commonwealth government in recognition of the seeming horizontal inequity that may arise due to a capital gain that had accrued over a number of income years being taxed at progressive rates of income tax in one income year (in which that capital gain was realised).<sup>202</sup> (The latter income year being the income year in which that capital gain is realised.) Thus rationalised, that concession seems to restore a loss of horizontal equity inherent in the CGT regime taxing capital gains on a realisation—and not on an accruals—basis. Therefore, that concession did not seem to represent a significant violation of horizontal equity.

Capital gains subject to CGT were to be adjusted for inflation through indexation by reference to the Consumer Price Index, where the assets whose disposal realised such capital gains were owned for at least 12 months.<sup>203</sup> That concession was necessitated by the widespread perception at the time that, given the high rates of inflation prevalent then, the taxation of

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<sup>199</sup> Above, note 14, p 37.

<sup>200</sup> Above, note 14, p 37.

<sup>201</sup> Above, note 193, p 300.

<sup>202</sup> CCH Australia Limited, *1987 Australian Master Tax Guide* (Sydney: CCH Australia Limited, 1987), p 445.

<sup>203</sup> *Id.*, p 418.

nominal capital gains without any adjustments for the loss in purchasing power caused by inflation will cause horizontal inequity as well as distortion in economic behaviour.<sup>204</sup>

Whether that concession promoted greater satisfaction of horizontal equity than what it would otherwise have been is moot. That is so as adjustments for the effects of inflation (through indexation) only under the CGT regime, but generally not under any other regime imposing income tax, was seemingly of itself discriminatory, and thus violated horizontal equity.

There has been persuasive criticism that to exempt from CGT capital gains realised on the disposal of a taxpayer's principal residence (now referred to as the main residence) violates horizontal equity, as that exemption favours owner-occupiers of homes over those that are not.<sup>205</sup> And that that exemption, moreover, compounds the violation of horizontal equity arising from the failure in Australia to subject to income tax owner-occupiers of homes on imputed (economic) income in respect of their homes.<sup>206</sup>

However, strong pragmatic reasons did perhaps exist for the enactment of that exemption.

Three of those reasons are significant, which are outlined below:

- As at the time the CGT regime was enacted, there was apparently only one member of the OECD—Switzerland—that did tax the entire capital gain realised from the disposal of a taxpayer's principal residence.<sup>207</sup> Apart from Switzerland, at the time, all members of the OECD exempted from tax the entire capital gain realised from the disposal of a taxpayer's principal residence, with the exception of Spain, Sweden and the USA.<sup>208</sup> In those latter three countries, such an

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<sup>204</sup> Above, note 189, pp 52 – 53.

<sup>205</sup> Above, note 14, p 93.

<sup>206</sup> Above, note 14, p 93.

<sup>207</sup> Above, note 14, p 93.

<sup>208</sup> Above, note 14, p 93.

exemption was conferred only if the taxpayer realising such a capital gain acquired another principal residence within a prescribed period from the time of such disposal.<sup>209</sup>

- That exemption was warranted as home ownership possibly generated positive (social) “externalities”.<sup>210</sup> Such positive ‘externalities’ are social stability, reduced physical illness, greater economic security for families, and (as owner-occupied homes tend to be maintained better than those that are not) increase in values of properties in the neighbourhood of owner-occupied homes.<sup>211</sup>
- There has always been a general perception amongst Australian politicians that “[h]ome was a castle in which a citizen was barricaded against the avaricious tax commissioner and his assessors”.<sup>212</sup>

The violation of horizontal equity which that exemption is likely to cause may be limited in extent. That is especially so as, in Australia, as it is a developed country, home-ownership is relatively widespread such that the proportion of taxpayers (in Australia) who are not owner-occupiers of homes is relatively low.

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<sup>209</sup> Above, note 14, p 93.

<sup>210</sup> Above, note 14, p 98.

<sup>211</sup> Above, note 14, p 98.

<sup>212</sup> Stokes R, “Taxing family homes: An autopsy of the premium property tax in New South Wales”, *paper presented at the Australasian Tax Teachers’ Association 17<sup>th</sup> Annual Conference in Wellington (26 – 28 January 2005)*, p 8.

### Comparable position in other developed countries in relation to taxation of capital gains

At the time CGT was enacted in Australia, of those developed countries which have tax systems generally comparable to those of Australia, the USA, the UK and Canada had already enacted regimes for the comprehensive taxation of capital gains.<sup>213</sup> The terms of legislation used to enact CGT in Australia were largely modelled on the legislation that imposed capital gains tax in the UK.<sup>214</sup>

### Abolishment of sections 25A and 26AAA of the 1936 Act

With the introduction of the CGT regime, section 25A of the 1936 Act ceased to apply to profits arising from the sale by a taxpayer of any property acquired by that taxpayer on or after 20 September 1985.<sup>215</sup> (Section 25A of the 1936 Act was the successor to section 26 a) of the 1936 Act) And section 26AAA of the 1936 Act ceased to apply to any profits arising from the sale of property acquired after 25 May 1988.<sup>216</sup> Those cessations were enacted as, with the introduction of the CGT regime, gains that would be comprehended by each section 25A of the 1936 Act and section 26AAA of the 1936 Act (had those sections not ceased to be operative) were essentially comprehended by the CGT regime, thus making those sections otiose.

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<sup>213</sup> Above, note 14, p 8.

<sup>214</sup> Cominos D G, "Capital Gains Tax", (1986) Vol 21 *Taxation In Australia*, p 322.

<sup>215</sup> Above, note 151, p 156.

<sup>216</sup> Taxation Laws Amendment Act (No 3) 1994 (Cth) s 67.

The rewritten CGT regime embodied in the 1997 Act

In November 1993, the Joint Committee of Public Accounts (of the Commonwealth parliament) published a report (entitled *Inquiry into the Australian Taxation Office*), which recommended that the provisions of the 1936 Act be rewritten by a broadly based taskforce.<sup>217</sup> To give effect to that recommendation, the Commonwealth government announced the formation of the Tax Law Improvement Project, whose work was to commence on 1 July 1994 and span the three following years.<sup>218</sup> That project comprised a multi-disciplinary team of some 40 individuals, the bulk of whom drawn from the Australian Taxation Office, and the balance from the Commonwealth Treasury and the Office of Parliamentary Counsel.<sup>219</sup>

The objectives of the Tax Law Improvement Project were to restructure, renumber, and rewrite existing law pertaining to income tax, so that it could be more easily understood.<sup>220</sup> In rewriting existing law, the Tax Law Improvement Project was to not make any changes to the policy underlying existing law, apart from changes that easily can correct obvious deficiencies in a particular provision in existing law.<sup>221</sup>

The Tax Law Improvement Project rewrote bulk of the provisions pertaining to the CGT regime that were contained in the 1936 Act.<sup>222</sup> Those rewritten provisions, following their

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<sup>217</sup> Aust, Parliament (Cth), *Tax Law Improvement Project: The Quiet Achiever in Tax Reform*, Research Note 16 1996-97, accessible at <<http://www.aph.gov.au/library/pubs/rn/1996-97/97rn16.htm>> (16 August 2004).

<sup>218</sup> Ibid.

<sup>219</sup> Above, note 217.

<sup>220</sup> Above, note 217.

<sup>221</sup> Above, note 217.

<sup>222</sup> Tax Law Improvement Project, *Capital Gains Tax: Part 1*, Exposure Draft No 10 (June 1997) (Sydney: CCH Australia Limited, 1997); Tax Law Improvement Project, *Capital Gains Tax: Part 2*, Exposure Draft No 11 (September 1997) (Sydney: CCH Australia Limited, 1997).

progressive release in draft form, were enacted to take effect from 1 July 1998 as part of the 1997 Act.<sup>223</sup>

Section 1 – 3 of the 1997 Act provides:

(1) This Act contains provisions in the *Income Tax Assessment Act 1936* in a rewritten form.

(2) If:

(a) that Act expressed an idea in a particular form of words; and

(b) this Act appears to have expressed the same idea in a different form of words in order to use a clearer or simpler style;

the ideas are not to be taken to be different just because different forms of words were used.

Note: A public or private ruling about a provision of the *Income Tax Assessment Act 1936* is taken to be a ruling about the corresponding provision of this Act, so far as the 2 provisions express the same ideas...

The explanatory memorandum to the bill that introduced s 1 – 3 of the 1997 Act states:

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<sup>223</sup> Act No 46 of 1998 (Cth) s 3 and Sch 1 item 1.

The *Income Tax Assessment Act 1936* is complemented by a large body of judicial precedent and Commissioner rulings that have evolved over almost 60 years, since the Act was introduced. It is important that the value of this material not be lost, especially as most provisions are being rewritten without any intention of changing their effect.

This issue has already been addressed, at a general level for all Commonwealth legislation, by the introduction of s 15AC of the *Acts Interpretation Act 1901*. That section provides that, if:

- legislation is rewritten; and
- the rewritten law appears to express the same ideas as the old law; and
- the rewriting of the law is done to use a simpler or clearer style;

then the meaning is not to be taken to have changed merely because different words are used in the new law.

### Ralph Review

The Liberal Party – National Party coalition Commonwealth government, on 13 August 1998, released proposals, in a document entitled *Tax Reform—Not A New Tax—A New Tax System*, for revamping the Australian tax system.<sup>224</sup> Following the release of that document, on 14

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<sup>224</sup> Aust, *Tax Reform—Not A New Tax—A New Tax System* (Canberra: AGPS, 1998).

August 1998, the Commonwealth government established the Business Review of Taxation (chaired by Mr J Ralph) that came to be known as the Ralph Review.<sup>225</sup>

The Ralph Review published its final report in July 1999.<sup>226</sup> The Commonwealth government relatively swiftly announced its responses to the recommendations contained in the final report of the Ralph Review.<sup>227</sup> And following which enacted legislation to implement those announced responses, some of which of significance pertained to CGT.<sup>228</sup> The resulting major changes to the CGT regime are canvassed below.

Did significant changes to the CGT regime resulting from the Ralph Review violate horizontal equity?

Averaging was abolished with effect from 21 September 1999.<sup>229</sup> That abolition was rationalised by the Ralph Review due to averaging contributing little to “encouraging investment or removing inflexibilities in the capital markets”.<sup>230</sup> And being susceptible to use “by a section of asset-holding community to reduce capital gains taxation to zero, or near to zero”, thus causing “considerable [horizontal] inequity”.<sup>231</sup>

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<sup>225</sup> Aust, *Review of Business Taxation: A Tax System Redesigned (Ralph Review Report)* (Chairman: Ralph J) (Canberra: AGPS, 1999), p v.

<sup>226</sup> *Ibid.*

<sup>227</sup> Aust, Treasurer’s Press Release No 58 (21 September 1999); Aust, Treasurer’s Press Release No 74 (11 November 1999).

<sup>228</sup> New Business Tax System (Capital Gains Tax) Bill 1999 (Cth), which received Royal assent on 10 December 1999.

<sup>229</sup> Evans C, “CGT after Ralph—The new regime”, *paper presented at the Taxation Institute Of Australia Conference (Western Australia)* (January 2000), p 5.

<sup>230</sup> Above, note 225, p 599.

<sup>231</sup> Above, note 225, p 599.

Whether that rationalisation is wholly tenable is moot, in view of averaging (as noted above) having been enacted to seemingly restore a loss of horizontal equity inherent in the CGT regime taxing capital gains on a realisation (and not accruals) basis. However, any violation of horizontal equity resulting from the abolishment of averaging may somewhat be attenuated by the enactment of the discount (as noted below) applicable to the disposal by a taxpayer of assets owned by that taxpayer for at least 12 months.

Indexation was made possible only up to 30 September 1999.<sup>232</sup> That change was rationalised by the Ralph Review as follows. Though indexation, in fact, reduced the rate of tax on capital gains, such reduction is not readily transparent.<sup>233</sup> Hence, especially among foreign investors, the perception has been that Australia subjects capital gains to income tax at full rates.<sup>234</sup> The avoidance of such a perception, so as to be effective in attracting greater investors to Australian assets, can be achieved by replacing indexation with a concession akin to the types of concession available abroad (such as the discount referred to below).<sup>235</sup>

The abolishment of indexation after 30 September 1999 may, overall, promote the satisfaction of horizontal equity, as (with that abolishment) generally all regimes (including the CGT regime) imposing income tax do not incorporate adjustments for the effects of inflation. (That is so despite any violation of horizontal equity that may be caused by the discount, as referred to below.)

Capital gains realised from the disposal (after 21 September 1999) of assets were to be reduced by a discount (the percentage of the discount was, with respect to individuals and

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<sup>232</sup> Above, note 229, p 6.

<sup>233</sup> Above, note 225, p 600.

<sup>234</sup> Above, note 225, p 600.

<sup>235</sup> Above, note 225, p 600.

trusts, 50%, and, with respect to superannuation funds, 33 1/3%).<sup>236</sup> To be eligible for that discount, the asset disposed of must have been owned for at least 12 months.<sup>237</sup>

The Ralph Review rationalised that concession as one necessary to negate the inherent preference for owners of capital assets to refrain from the sale of those assets where capital gains are only taxed upon realisation (and not accrual).<sup>238</sup> That concession, the Ralph Review rationalised, therefore will “enliven and invigorate the Australian equity markets to stimulate greater participation by individuals, and to better achieve a better allocation of the nation’s capital resources”, as well as appeal to foreign investors (as noted above).<sup>239</sup>

The enactment of that concession (of the discount), as noted above, somewhat attenuated the violation of horizontal equity resulting from the abolishment of averaging. However, that concession also causes most capital gains to effectively be taxed at a rate of income tax much lower than the rate at which other forms of taxable income are taxed, and thus violates horizontal equity.

The exemption that could be availed of with respect to any capital gain realised from the sale of business goodwill was abolished with effect from 21 September 1999, and replaced with three concessions available to small businesses.<sup>240</sup> Those three concessions were:<sup>241</sup>

- a 50% reduction of any capital gain made on the sale of business assets;

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<sup>236</sup> Above, note 229, p 7.

<sup>237</sup> Above, note 229, p 7.

<sup>238</sup> Above, note 225, p 598.

<sup>239</sup> Above, note 225, p 598.

<sup>240</sup> Above, note 229, p 18.

<sup>241</sup> Above, note 229, p 18.

- an exemption of any capital gain made on the sale of business assets where the taxpayer selling those assets retires after such sale (the exemption cannot exceed \$500,000 per individual over her or his lifetime); and
- an exemption of any capital gain made on the sale of business assets where those assets had been owned (by the taxpayer selling those assets) for at least 15 years.

The Ralph Review rationalised those three concessions as necessary “to provide small business people with access to funds for retirement and expansion”.<sup>242</sup> Those three concessions are discriminatory, as capital gains realised from the sale of assets of small businesses are (pursuant to those three concessions) effectively taxed at a rate of income tax much lower than that at which other forms of capital gains (or any other taxable income) are taxed. Those three concessions thus violate horizontal equity.

However, the violation of horizontal equity caused by those three concessions is likely to be limited in extent. That is so as two of those three concessions are unlikely to be availed of by any one taxpayer frequently. The first of those two concessions—the concession described second—can be availed of by any one taxpayer only on that taxpayer’s retirement. The second of those two concessions—the concession described third—can be availed of by any one taxpayer only in relation to a business asset owned by that taxpayer for as long as 15 years.

## **Conclusion**

This chapter answers in the affirmative the question of whether the enactment of the CGT regime, and the continuance of it after enactment, were actuated by a perception (of

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<sup>242</sup> Above, note 225, p 587.

respectively the government which enacted it, and subsequent governments which yielded to its continuance) that it will satisfy the policy objective of horizontal equity.

Comments in the *Draft White Paper*, which provided the immediate basis for the enactment of the CGT regime, unequivocally evince that the enactment of the regime was significantly actuated by a perceived need to satisfy the policy objective of horizontal equity.

In the enactment of the CGT regime, a number of concessions were incorporated in that regime. Some of those concessions (such as the concession of making capital gains made from the sale of assets acquired by a taxpayer before 20 September 1985 exempt from CGT payable by that taxpayer) do represent departures from satisfying the policy objective of horizontal equity.<sup>243</sup> That is so as a concession of those sorts (by its very nature) may mean that one segment of taxpayers (which is potentially able to avail of that concession) is being (favourably) discriminated relative to other taxpayers (despite the segment of taxpayers which could potentially avail of that concession possibly essentially being in an equal economic situation as the other taxpayers).

However, the incorporation of those concessions in the CGT regime was something that the government which enacted the CGT regime was largely forced to accede to for reasons of political expedience. Those concessions therefore did not detract from the perception (of the government which enacted the CGT regime) that the regime will satisfy the policy objective of horizontal equity.

As was so in relation to concessions that were incorporated in the CGT regime when it was first enacted, concessions (and “negative” concessions) incorporated in it through

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<sup>243</sup> Above, note 14, p 35.

amendments to it since its enactment can be viewed as representing departures from satisfying the policy objective of horizontal equity. The three concessions exclusively applicable to capital gains realised from the disposal of assets of small businesses represent an example of such concessions.

Amendments of that sort that have been made to the CGT regime since its enactment, however, do not demonstrate that they were actuated by a perception (of the governments which enacted those amendments) that the regime cannot (or should not) satisfy the policy objective of horizontal equity. For instance, the final report of the Ralph Review did explicitly acknowledge that the accomplishment of horizontal equity was a “central concern”<sup>244</sup> underpinning all recommendations contained in it (including those pertaining to the CGT regime).<sup>245</sup>

It is thus concluded that the enactment of the CGT regime was actuated by a perception (of the government which enacted it) that it will satisfy the policy objective of horizontal equity, and that its continuance (after enactment) was actuated by the same perception of subsequent governments. As to whether that perception is a perception that is largely correct is a question which is addressed in the next chapter. That question is pertinent as horizontal equity is only one of many policy objectives a tax system (such as the CGT regime) should satisfy, and those policy objectives not necessarily being wholly co-extensive. Consequently, the satisfaction of horizontal equity by a tax system (such as the CGT regime) can potentially be compromised due to that tax system also having to satisfy other policy objectives.

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<sup>244</sup> Above, note 225, p 15.

<sup>245</sup> The cogency of that acknowledgement is not detracted by the absence of any pointed comment in the final report of the Ralph Review that the attainment of horizontal equity is a policy objective the CGT regime should satisfy.

For instance, the policy objectives of horizontal equity and economic efficiency may not be wholly co-extensive. As well, any tax measure, for its enactment and continuance, must secure the acceptance of all relevant political parties and other institutional stakeholders (such as, say, business or industry federations, and trade unions). Securing that acceptance is a policy objective that a tax measure (such as the CGT regime) should satisfy, which is a policy objective that is often not wholly co-extensive with other policy objectives (including horizontal equity).

## **Chapter 4: Is the perception that the CGT regime will satisfy the policy objective of horizontal equity a perception that is largely correct?**

### **Overview of the scope of this chapter**

Whether the perception (of respectively the government which enacted the CGT regime, and subsequent governments which have not repealed it) that the regime will satisfy the policy objective of horizontal equity is a perception that is largely correct is the question to which this chapter seeks an answer. That question, in this chapter, is answered in the affirmative.

This chapter contains a comprehensive discussion of each of the policy objectives a tax system (such as the CGT regime) should satisfy. That discussion demonstrates that: each of those policy objectives may not be necessarily wholly co-extensive with horizontal equity; and, therefore, that the satisfaction by the CGT regime of the policy objective of horizontal equity can potentially be compromised due to that regime also having to satisfy those other policy objectives.

At the end of the discussion of each of those policy objectives, one of the following two conclusions is essentially drawn:

- The satisfaction of that policy objective by the CGT regime did not perhaps affect the correctness of the perception (of the government which enacted the regime) that the regime (upon enactment) will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since its enactment have perhaps not affected the correctness of that perception.

- The satisfaction of that policy objective by the CGT regime did compromise the capacity of the regime to also satisfy the policy objective of horizontal equity, but that compromise was perhaps not of such significance as to displace the correctness of the perception (of the government which enacted the regime) that the regime (upon enactment) will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since the enactment of it have not perhaps affected that position.

### **Policy objectives a tax system (such as the CGT regime) should satisfy**

#### Introduction

From a review of the literature, one is not able to discern any firm consensus on what may constitute an exhaustive enumeration of policy objectives a tax system (such as the CGT regime) should satisfy. The bulk of the literature limits that enumeration to a small number of such policy objectives (that small number of policy objectives being those in terms of which analyses of tax policy analysts are generally carried out).<sup>246</sup> In this thesis, an attempt has been

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<sup>246</sup> For instance, see McKerchar M, *The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers* (Sydney: Australian Tax Research Foundation, 2003) and Evans C, *Taxing Personal Capital Gains: Operating Cost Implications* (Sydney: Australian Tax Research Foundation, 2003).

McKerchar canvassed three sets of policy objectives that a tax system should satisfy. Those three sets were not mutually exclusive; rather each of those sets was seemingly purported to cover the same ambit as the other two, though each was articulated differently to the other two. First, McKerchar, based on the work of Adam Smith (written as far back as 1776, when circumstances impinging on public finance were, at the least in some respects, markedly different to those as of now), canvassed four policy objectives that a tax system should satisfy, which were equality, certainty, convenience of payment, and economy in collection (p 24). Second, McKerchar, based on the work of the *Asprey Committee* (referred to on pages 51 to 56 of this thesis), canvassed three policy objectives that a tax system should satisfy, which were efficiency, equity, and simplicity (p 24). And, third, based on the work of Cedric Sanford, McKerchar canvassed four policy objectives that a tax system should satisfy, which were equity, ability to pay, efficiency, and simplicity (p 27).

made to formulate such an enumeration as exhaustively as possible, so as to ensure that the analysis developed in this chapter is comprehensive. The following is an enumeration (which is not in any order of importance) of policy objectives a tax system (such as the CGT regime) should satisfy that has been thus formulated:

- A tax system should satisfy horizontal equity.<sup>247</sup>
- A tax system should satisfy vertical equity.<sup>248</sup>
- A tax system should cause the least of interference with economic efficiency.<sup>249</sup>
- A tax system should be compatible with tax systems of other countries, as well as be in conformity with Australia's international treaty and other like obligations.<sup>250</sup>
- A tax system should be sufficiently simple, so that the costs of administering it (by government) and the costs of complying with it (by taxpayers) are tolerably low.<sup>251</sup>
- A tax system should be stable, so as to enable those potentially affected by it to anticipate its incidence with certainty.<sup>252</sup>

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Evans, similar to McKerchar, canvassed policy objectives that a tax system should satisfy based on the work of Adam Smith (pp 36 -37), and concluded that all those policy objectives were effectively comprehended by the following three policy objectives that a tax system should satisfy: equity, efficiency, and simplicity (p 37).

<sup>247</sup> Above, note 65, p 12.

<sup>248</sup> Above, note 65, p 12.

<sup>249</sup> Above, note 65, p 7.

<sup>250</sup> Above, note 65, p 16.

<sup>251</sup> Above, note 65, p 18.

<sup>252</sup> Above, note 65, p 21.

- A tax system should be flexible, in that it should provide the government with the means to effectively and timely accomplish macro-level economic and social objectives (such as, say, management of aggregate demand, or management of aggregate supply).<sup>253</sup>
- A tax system should properly cohere with other related tax systems.<sup>254</sup>
- A tax system should practicably cater for transitional problems that its enactment may cause those who are potentially affected by it.<sup>255</sup>
- A tax system should yield (to the government) the net revenue that that tax system is expected to yield.<sup>256</sup>
- A tax system should secure the acceptance of all relevant political parties and other institutional stakeholders (such as, say, business or industry federations, and trade unions), so that that tax system can be enacted, and (once enacted) remains enacted (without being repealed).<sup>257</sup>

All documentation that exists (for example, the *Draft White Paper*) is to the effect that only some (and not all) of the policy objectives enumerated above were considered in enacting the CGT regime by the government which enacted it. Despite that, in this chapter, all of the policy objectives enumerated above have been canvassed. That has been done mindful of the possibility that, in enacting the CGT regime, the government which enacted it may have

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<sup>253</sup> Above, note 12, p 41.

<sup>254</sup> Above, note 65, p 4.

<sup>255</sup> Above, note 65, p 22.

<sup>256</sup> Above, note 12, p 41.

<sup>257</sup> Above, note 12, p 41.

actually also considered, in addition those policy objectives whose consideration by that government is documented, other policy objectives. That is so as the substance of the items of documentation that exist (of which those that are relevant are referred to below, under each relevant policy objective) is such that the omission in them of consideration of a policy objective by the government which enacted the CGT regime cannot be regarded as conclusive proof that the omission amounts to an absence of consideration of that policy objective by that government.

A discussion, in turn, of each of the eleven policy objectives enumerated above follows.

### Horizontal equity

A comprehensive discussion of the policy objective of horizontal equity was set out in Chapter 2. That discussion, therefore, is not repeated in this chapter. That discussion is supplemented by addressing, in this chapter, a single proposition that impinges on horizontal equity (in the context of comprehensive taxation of capital gains), a proposition which the scope of Chapter 2 did not afford the opportunity to be addressed in that chapter.

That proposition, which is to the effect that, if capital gains are comprehensively taxed, there is a double taxation of income (thereby causing a violation of horizontal equity), has been described thus:

The value of an asset is equal to the discounted value of the expected future cash flow generated by that asset. Therefore, any increase in the value of the asset must be attributable to an increase in the expected future cash flow. Since this increased cash flow will be taxed when it is actually realised, it is equivalent to double taxation to

also tax it, in effect, when it is anticipated by the market by being reflected in the increased value of the asset.<sup>258</sup>

That proposition (thus described) is not one that is tenable, for the following reasons:

- With respect to an asset (such as that described above), the economic power of the owner of that asset is augmented in two ways: first, through the increase in the market value of that asset; and, second, on the receipt by that owner (in the future) of income from that asset.<sup>259</sup>
- If the owner of that asset sells it, that owner (if capital gains were comprehensively taxed) will be taxed on the capital gain realised from that sale. And the buyer of that asset will be taxed (in the future) on the income from that asset, but that buyer will be eligible to deduct from the proceeds realised from a sale of that asset in the future what that buyer paid to acquire that asset.<sup>260</sup>
- As the amount that that buyer will be eligible to deduct from the proceeds realised from a sale of that asset in the future is what that buyer paid to acquire that asset, no double taxation as such will result (if capital gains are comprehensively taxed). That is so since that amount is the same as the proceeds realised by the previous owner of that asset, proceeds which were taken account for calculating the capital gain realised by that previous owner from the sale of that asset that was comprehensively taxed.<sup>261</sup>

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<sup>258</sup> Above, note 14, pp 57 – 58.

<sup>259</sup> Above, note 14, p 58.

<sup>260</sup> Above, note 14, p 58.

<sup>261</sup> Above, note 14, p 58.

The proposition that, if capital gains are comprehensively taxed, there is a double taxation of income (thereby causing a violation of horizontal equity) is, accordingly, not a proposition that is tenable. That proposition, therefore, does not affect the conclusion (drawn in Chapter 2) that the enactment of the CGT regime, and the continuance of it, were actuated by a perception (of respectively the government which enacted the CGT regime, and subsequent governments) that the regime will satisfy the policy objective of horizontal equity. That proposition, consequently, also does not affect the question addressed in this chapter, which is whether that perception—that the CGT regime will satisfy the policy objective of horizontal equity—is a perception that is largely correct.

### Vertical equity

In Chapter 3, “vertical equity” was defined as the requirement that those in a more advantageous economic situation pay a greater amount of taxes (relative to those in a less advantageous economic situation).<sup>262</sup>

At the time the CGT regime was enacted, and also well before that time, Australia imposed income tax on individuals at progressive rates. That, therefore, was a manifestation that Australia, at the time the CGT regime was enacted, did regard vertical equity as a policy objective a tax system (such as the CGT regime) should satisfy.

The appropriateness of “vertical equity” as a policy objective a tax system should satisfy is, at best, open to conflicting views. That position has been well summarised in the following passage:

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<sup>262</sup> Above, note 63, p 232.

The case for progression, after a long critical look, thus turns out to be stubborn but uneasy. The most distinctive and technical arguments advanced in its behalf are the weakest. It is hard to gain much comfort from the special arguments, however intricate their formulations, constructed on notions of benefit, sacrifice, ability to pay, or economic stability. The case has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. But the case for more economic equality, when examined directly, is itself perplexing. And the perplexity is greatly magnified for those in the quest for greater equality are unwilling to argue for radical changes in the fundamental institutions of the society.<sup>263</sup>

The conflicting views that pertain in Australia over whether vertical equity is an appropriate policy objective that a tax system should satisfy are evidenced by a work (published in 2004) by Lauchlan Chipman<sup>264</sup> and a work (published in 2004) by me<sup>265</sup> as a response to that work of Chipman.

Chipman, in his work, concluded that, in Australia, income tax on individuals should be imposed at a flat rate, and not at progressive rates (as currently happens).<sup>266</sup> Chipman formed that conclusion based on the following eight arguments, as documented in that work:

- A flat tax is simpler.<sup>267</sup>

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<sup>263</sup> Blum W J & Kalven H, "The uneasy case for progressive taxation", (1952) *The Chicago Law Review* Volume 19 Number 3, p 519.

<sup>264</sup> Chipman L, "The very idea of a flat tax", *CIS Policy Monograph 66* (Sydney: The Centre For Independent Studies, 2004), accessible at <<http://www.cis.org.au>> (8 December 2004).

<sup>265</sup> Sridaran M, "Some arguments for not having a flat personal income tax", (2004) *CCH Tax Week* (Issue 48) 9 December 2004, p 793.

<sup>266</sup> Above, note 264, p 18.

<sup>267</sup> Above, note 264, p 4.

- A flat tax will preclude scope for tax avoidance by diversion of income from a high taxpaying individual to a low taxpaying individual.<sup>268</sup>
- A flat tax is consistent with vertical equity (primarily as, even with a flat tax, a tax-free threshold applicable to income tax imposed on individuals should exist).<sup>269</sup>
- The additional income of the rich does not have less value to them than the value that same income has to those less rich.<sup>270</sup>
- Disparities in income between individuals do not necessarily mean that the lowest of incomes is not able to support a life of reasonable sufficiency.<sup>271</sup>
- If a policy of progressive income tax rates imposed on individuals is designed to ameliorate feelings of envy caused by inequality of income between individuals, respecting and reinforcing such feelings is an unacceptable basis for such a policy.<sup>272</sup>
- If a policy of progressive income tax rates imposed on individuals is designed to ameliorate feelings of resentment caused by inequality of income between individuals, respecting and reinforcing such feelings is not an acceptable basis for such a policy.<sup>273</sup>

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<sup>268</sup> Above, note 264, p 4.

<sup>269</sup> Above, note 264, p 7.

<sup>270</sup> Above, note 264, p 8.

<sup>271</sup> Above, note 264, p 10.

<sup>272</sup> Above, note 264, p 12.

<sup>273</sup> Above, note 264, p 14.

- One's moral obligation to assist the poor is an obligation that is assumed by one, and therefore has nothing to do with distributive justice (distributive justice deals with the manner in which wealth is distributed amongst those in a country: see footnote 62, under Chapter 3).<sup>274</sup>

Significantly, those eight arguments, as documented in Chipman's work, did not include an argument to the effect that a flat tax is (relative to a policy of progressive income tax rates imposed on individuals) conducive to the attainment of economic efficiency. Chipman, in his work, extensively canvassed the appropriateness of such an argument, but was not able, on balance, to conclude that such an argument was tenable.<sup>275</sup>

I, in the work that I published as a response to the work of Chipman, contended that those eight arguments do not represent an exhaustive enumeration of arguments that should be addressed in concluding whether a flat tax is to be preferred over a policy of progressive income tax rates imposed on individuals.<sup>276</sup> I outlined (in my work) the main arguments (as

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<sup>274</sup> Above, note 264, p 15.

<sup>275</sup> Above, note 264, pp 4 – 6.

For a view that the redistribution of income resulting from progressive fiscal policies is not causative of economic distortions (thus impairing economic efficiency), but rather (government induced) economic distortions (which impair economic efficiency) are causative of progressive fiscal policies, see Mulligan C B & Philipson T J, "Merit motives and government intervention: Public finance in reverse" , *Working Paper 7698* (Cambridge, Massachusetts: National Bureau Of Economic Research, 2000), accessible at <<http://www.nber.org/papers/w7698>> (26 December 2004). There (at pp 1 – 5), it is argued that the bulk of the assistance granted by government to the less-wealthy is not unconditional but rather constitute "merit goods" (such as health care), which are granted to the wealthy as well. The wealthy consume those merit goods at a level more than that at which is granted by government, and pay for that excess consumption through their (private) incomes. The less wealthy consume those merit goods up to the level granted by government, which is a level higher than the level at which they would have consumed those merit goods had those merit goods not been granted by government. Financing that excess level of consumption by the less wealthy (which is an economic distortion, as that excess would not have occurred had there not been a government grant of those merit goods) necessitates progressive taxes (imposed on the wealthy by government).

<sup>276</sup> Above, note 265, p 794.

advanced by others before) why a flat tax cannot be regarded as being superior to a policy of progressive income tax rates imposed on individuals that had not been addressed in Chipman's work.<sup>277</sup> Those arguments (nine in number, as outlined in my work) are as follows:

- A flat tax cannot be justified on the basis that a policy of progressive rates of income tax imposed on individuals is effectively an oppression of the minority (whose levels of income are high to warrant exposure to income tax at the higher rates) by the majority (whose levels of income are low to warrant exposure to income tax at the lower rates). That is so as, even with a flat tax, a government can effectively redistribute wealth through the use of its powers to undertake expenditure programmes.<sup>278</sup>
- The case for simplicity of a flat tax (relative to progressive rates of income tax imposed on individuals) may be overstated (due to the fact that the calculation of personal income tax is now done largely through automated computing devices).<sup>279</sup>
- The case for a flat tax as a means for precluding scope for tax avoidance by diversion of income from a high taxpaying individual to a low taxpaying individual is not as strong as it is made out to be for two reasons. First, the scope for such diversion will continue to remain even with a flat tax so long as a tax-free

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<sup>277</sup> Above, note 265, p 794.

<sup>278</sup> Above, note 265, p 794.

Galvin C O & Bittker B I, *The Income Tax: How Progressive should it be* (Washington, D C: American Enterprise Institute For Public Policy Research, 1974), p 33.

<sup>279</sup> Above, note 265, p 794.

Galvin C O & Bittker B I (cited in note 278), p 33.

threshold (applicable to income tax imposed on individuals) exists (which Chipman, in his work, on balance, concedes should exist, even with a flat tax).<sup>280</sup> Second, such diversion (in the broadest sense) can never be avoided altogether so long as different types of entity (including individuals) are not taxed at the same income tax rate (as is currently so in Australia).<sup>281</sup>

- For a proper evaluation of the fairness (or otherwise) of the rates of personal income tax, one has to consider not just income tax but also all other taxes imposed by government as well as the benefits conferred on individuals by all government expenditure programmes. On that basis, progressive rates of income tax imposed on individuals may be viewed as necessary to counter regressive effects ensuing from other taxes as well as government expenditure programmes.<sup>282</sup>
- If the tax-free threshold (applicable to income tax imposed on individuals) is fixed below the level of income required for minimum subsistence (as is so in Australia currently), progressive income tax rates imposed on individuals are necessarily required to mollify the effect of income tax on the genuinely poor. If, on the other hand, the tax-free threshold (applicable to income tax imposed on individuals) is fixed above the level of income required for minimum subsistence, for pragmatic fiscal and political reasons, progressive income tax rates imposed on individuals

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<sup>280</sup> Above, note 265, p 794.

Galvin C O & Bittker B I (cited in note 278), p 42.

<sup>281</sup> Above, note 265, p 794.

<sup>282</sup> Above, note 265, p 794.

Galvin C O & Bittker B I (cited in note 278), pp 34, 39.

are necessarily required to ensure a sufficient number of individuals is captured as taxpayers by the income tax system.<sup>283</sup>

- In a developed country like Australia, “minimum subsistence” may be rightly viewed as a concept which is cultural, rather than physiological. In that light, it is not difficult to conceive a different income requirement on the part of different individuals to sustain a living standard at different intermediate levels in (Australian) society (that is, levels of living standard of, say, “modest” and “comfortable” progressively above the level of “minimum subsistence”). And to, consequently, recognise each of those levels of living standard through a policy of progression in income tax rates imposed on individuals. Admittedly, such recognition does call for the application of discretion, but that is inevitable (in as much as fixing a flat tax rate calls for the application of discretion).<sup>284</sup>
- The greater an individual’s income is, generally, the larger portion of that income is not potentially impaired by illness or destroyed by death. That is especially so of income derived from capital. It is also so of income derived from labour, as the larger the income from labour an individual has, the more likely it is that that individual (relative to an individual with a smaller income from labour) enjoys greater security of tenure and is able to add to her or his capital a greater share of that income from labour. In the absence (as currently in Australia) of an income tax system for taxing an individual differentially based on that individual’s sources

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<sup>283</sup> Above, note 265, p 794.

Galvin C O & Bittker B I (cited in note 278), p 43.

<sup>284</sup> Above, note 265, p 795.

Galvin C O & Bittker B I (cited in note 278), pp 43-45.

of income, a policy of progressive rates of income tax imposed on individuals represents a proxy for accomplishing the effects of such a system.<sup>285</sup>

- Based on anecdotal evidence, one may plausibly conclude that the greater an individual's wealth proportionally greater is the governmental services (say, in areas of international affairs, national security etc.) that individual will benefit from. That conclusion supports a policy of progressive rates of income tax imposed on individuals (instead of a flat tax).<sup>286</sup>
- Pragmatically, it is difficult to sustain the argument that the additional income of the rich does not have less value to them than the value that same income has to those less rich. An average Australian is likely to respond that the value of additional income of \$1,000 to someone who already earns an annual income of \$1 million is less than it is for someone who already earns an annual income of \$40,000. The state of affairs that pertains in Australia (and all other developed countries which are liberal democracies) is a not a free-market economy, but a partially free-market economy and a collection of half-measures to reduce income equality (that necessarily results from a free-market economy) amongst its residents. And Australians are seemingly disposed to live in a state of compromise between those two poles, rather than abandon one altogether in order to wholly migrate to the other. A policy of progressive rates of income tax imposed on individuals is consistent with such a state of affairs.<sup>287</sup>

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<sup>285</sup> Above, note 265, p 795.

Galvin C O & Bittker B I (cited in note 278), pp 45-46.

<sup>286</sup> Above, note 265, p 795.

Galvin C O & Bittker B I (cited in note 278), pp 48-49.

<sup>287</sup> Above, note 265, p 795.

Galvin C O & Bittker B I (cited in note 278), p 57.

By reason of those nine arguments outlined in my work, I summed up (in my work) as follows:

- The case for a flat tax in preference to a policy of progressive rates of income tax imposed on individuals is by no means clear-cut.<sup>288</sup>
- The preference for a policy of progressive rates of income tax imposed on individuals over a flat tax is guided very much viscerally, by instinct, than by philosophical reason.<sup>289</sup>
- A policy of progressive rates of income tax imposed on individuals, which has stood the test of time (not just in Australia, but in all other countries comparable to Australia) should, therefore, not be abandoned lightly (even if the political will to do so can be found, which is perhaps doubtful).<sup>290</sup>

Those conclusions resulting from the work of respectively Chipman and mine evidence the conflicting views that pertain in Australia over whether vertical equity is an appropriate policy objective that a tax system should satisfy. Each of those two sets of conflicting views is, considered in isolation, plausibly articulated, such that it is difficult to conclusively form an opinion that one of them is superior to the other.<sup>291</sup>

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<sup>288</sup> Above, note 265, p 795.

<sup>289</sup> Above, note 265, p 795.

<sup>290</sup> Above, note 265, p 795.

<sup>291</sup> Similar conflicting views have been expressed in other countries with respect to income taxation that obtains in those countries. For instance, in the context of income tax imposed in the USA and in Canada, see: Hamond M J, “The Failings of the Flat Tax”, accessible at <http://www.ndol.org/print.cfm?contentid=2471> (10 December 2004); Hoover Institution, “The Flat Tax”, accessible at <http://www-hoover.stanford.edu/PRESSWEBSITE/FlatTax/chpt2.html> (10 December 2004); and Younkins E W, “Taxation and Justice”, accessible at <http://www.quebecoislibre.org/000930-11.htm> (10 December 2004).

The inability to form such an opinion, however, does not affect the following conclusion that, in the context of vertical equity and comprehensively taxing capital gains in Australia, was of the highest material import. That conclusion is that the failure to comprehensively tax capital gains in Australia will have preponderantly benefited the wealthy (as the bulk of capital gains in Australia is realised by the wealthy).<sup>292</sup> The failure to comprehensively tax capital gains in Australia will thus have caused a significant violation of vertical equity.<sup>293</sup> That is so as, even on conceding that conflicting views (each articulated equally plausibly) do pertain in Australia over whether vertical equity is an appropriate policy objective that a tax system should satisfy, there is no justification that the wealthy should pay a lesser proportion of their income as tax than the less-wealthy.<sup>294</sup>

A recognition of that conclusion—which is that the failure to comprehensively tax capital gains in Australia will have nearly exclusively benefited the wealthy—can be found in the *Draft White Paper* in the following terms:

... The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of objectives of equity ...<sup>295</sup>

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The work of Blum W J & Kalven H, cited in note 18, represents a most comprehensive (if somewhat dated) analysis of the pros and cons of a policy of progressive rates of income tax imposed on individuals as relevant to the USA. There (at p 520), it is appositely concluded:

...in the end it is the implications about economic inequality which impart significance and permanence to the issue and institution of progression. Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem.

<sup>292</sup> Above, note 14, p 44.

<sup>293</sup> Above, note 14, p 44.

<sup>294</sup> Above, note 14, p 45.

<sup>295</sup> Above, note 184, p 77.

That conclusion—which is that the failure to comprehensively tax capital gains in Australia will have preponderantly benefited the wealthy—underlay the enactment of the CGT regime so as to satisfy the policy objective of vertical equity. That same conclusion also underlay the enactment of the CGT regime so as to satisfy the policy objective of horizontal equity (as, if income that is made liable to income tax is legislated or judicially interpreted to exclude capital gains, a serious violation of horizontal equity does result).

In Chapter 3, significant changes made to the CGT regime (following the final report of the Ralph Review) were discussed. Those changes were: the abolition of averaging; making indexation possible only up to 30 September 1999; introduction of the CGT discount; and the replacement of the exemption of capital gains made from the sale of business goodwill with three concessions available to small businesses (commonly referred to as “small business CGT relief”).

All of those changes (except the second one) violated horizontal equity. That violation of horizontal equity, however, did not occur because those changes satisfying the policy objective of vertical equity. Rather, the third change (to the extent that it does not negate the effects of the first change) and the fourth change also violate vertical equity, as those changes are likely to benefit a segment of taxpayers who are relatively more wealthy.

The requirement that the CGT regime satisfies the policy objective of vertical equity did not, accordingly, affect the correctness of the perception (of the government which enacted it) that it will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since its enactment have not affected the correctness of that perception.

Economic efficiency

As noted in Chapter 3:

- The attainment of economic efficiency is defined as a state that pertains where scarce resource use occurs such that there is no possibility of making a change (of scarce resource use) which helps one person without hurting anyone else.<sup>296</sup>
- And, in practical terms, in a country which is a liberal democracy, the attainment of economic efficiency (in the use of scarce resources by that country) is generally ensured through permitting the operation of market forces with the least possible intervention.<sup>297</sup>

In comparison with other economic systems humankind has adopted throughout its history, a free-market economy must be regarded as one with a high (if not the one with the highest) performance rating, if that performance were to be judged in terms of the level of wealth produced due to the economic system.<sup>298</sup> Accordingly, the choice of a free-market economic system as the optimal means for accomplishment of economic efficiency is a choice hard to impugn.

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<sup>296</sup> Above, note 63, p 82.

<sup>297</sup> Above, note 65, p 10.

It has been stated that the attainment of economic efficiency is “generally” ensured through permitting the unfettered operation of market forces because the unfettered operation of market forces will not result in economic efficiency where (exceptionally) there is “market failure”, “externalities”, or both. For a useful discussion of the need for taxation to remedy such “market failure”, “externalities”, or both, see Gandhi V P & others, *Supply-side Tax Policy: Its Relevance to Developing Countries* (Washington, D C: International Monetary Fund, 1987), p 225.

<sup>298</sup> Okun A M, *Equity and Efficiency: The Big Trade-off* (Washington, DC: Brookings Institute, 1975), p 51.

An income tax can affect the operation of a free-market economy in two ways. First, an income tax can cause an “income effect”.<sup>299</sup> Or, second, it can cause a “substitution effect”.<sup>300</sup>

An income effect is caused where a tax on income, as that tax reduces the spendable income of the taxpayer on whom that tax is imposed, induces that taxpayer to either work harder, save more, or employ that taxpayer’s capital better, so as to restore that taxpayer’s post-tax income to negate that reduction.<sup>301</sup>

And a substitution effect is caused where a tax on income, as that tax reduces, with respect to a taxpayer on whom that tax is imposed, the spendable income that that taxpayer can earn from either working an additional unit of time or employing that taxpayer’s capital better, induces that taxpayer to prefer leisure to work<sup>302</sup>, to save less, or be indifferent as to how that taxpayer’s capital is employed.<sup>303</sup> Accordingly, a substitution effect is compounded where one type of income is taxed differently (or not taxed at all) relative to other types of income. That is so as then a taxpayer will be induced to convert income that is highly taxed to income that is taxed less.<sup>304</sup> A substitution effect may thus result if capital gains are not taxed, whilst other forms of income are taxed.<sup>305</sup>

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<sup>299</sup> Above, note 65, p 8.

<sup>300</sup> Above, note 65, p 8.

<sup>301</sup> Above, note 65, p 8.

<sup>302</sup> For an empirical finding that high marginal rates of income tax may not necessarily cause those deriving labour income to work less, see Break G F, “Income taxes and incentives to work: An empirical study”, (1957) *The American Economic Review* Vol 47 No 5 (September 1957), pp 529 – 549.

<sup>303</sup> Above, note 65, p 8.

Conversely, for empirical findings essentially to the effect that marginal rates of income tax may not have a significant influence on how taxpayers employ their capital, see Stiglitz J E, “The corporation tax”, (1976) *Journal Of Public Economics* 5, pp 303 – 311, and Bradford D F, “The incidence and allocation effects of a tax on corporate distributions” (1981) *Journal of Public Economics* 15, pp 1 – 22.

<sup>304</sup> Above, note 298, p 61.

<sup>305</sup> Above, note 298, p 61.

An income effect does not impair (but rather promotes) economic efficiency.<sup>306</sup> Conversely, a substitution effect does impair economic efficiency, unless that substitution effect is offset by the impact of income effects.<sup>307</sup> Accordingly, the avoidance (or, at least, the minimisation) of substitution effects that an income tax causes is conducive to the unfettered operation of a market economic system.

The unfettered operation of a market economic system essentially means that those of the public of a country that operates such a system who are most “efficient” (or “productive”) are allocated the largest share of that country’s scarce resources. There will, thus, be caused inequalities in income and wealth amongst those in that country, as well as collateral inequalities amongst them in social status and power (that accompany income and wealth).<sup>308</sup> Two (of potentially many) significant manifestations of such inequalities in social status and power are exemplified below:

- The less-wealthy (relative to the wealthy) will in reality not enjoy equality before the law. That is so as the less-wealthy will be less educated, and therefore be less informed as to how they can take full advantage of the legal system, as well as lack the financial means to secure optimal legal representation to assert their position at law.<sup>309</sup>
- The less-wealthy (relative to the wealthy) will have limited (if any) means to influence political outcomes (other than through voting at elections), as (unlike the

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<sup>306</sup> Above, note 65, p 8.

<sup>307</sup> Above, note 65, p 8.

<sup>308</sup> Above, note 298, p 51.

<sup>309</sup> Above, note 298, p 23.

wealthy) they will not be able to make significant financial contributions to political parties or engage political lobbyists.<sup>310</sup>

Accordingly, the effects of an unfettered operation of a market economic system (and therefore economic efficiency) will generally not be wholly co-extensive with horizontal equity.

Despite that, there are those (some of considerable authority) who assert that the maintenance of an unfettered market economic system by any country is sacrosanct.<sup>311</sup> That assertion is generally principally based on the following grounds:

- A free-market economic system is consistent with the conferment on individuals the broadest possible scope of private property and rights, thereby facilitating amongst individuals the broadest range of choice, and thus personal freedom.<sup>312</sup>
- A free-market economic system helps to safeguard individuals' political rights against encroachment by government.<sup>313</sup>
- A free-market economic system represents the only ethical method of rewarding one for her or his contribution, as what one receives as a reward for one's contribution is what someone else is freely prepared to pay.<sup>314</sup>

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<sup>310</sup> Above, note 298, pp 24 – 26.

<sup>311</sup> Friedman M, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), p 158.

<sup>312</sup> Above, note 298, p 36.

<sup>313</sup> Above, note 298, p 38.

<sup>314</sup> Above, note 298, p 40.

- A free-market economic system is the economic system that best promotes economic efficiency (or economic growth).<sup>315</sup>

All of those grounds (except the last one) are, on close review, not wholly tenable, for the following reasons.<sup>316</sup>

In practice, in all countries that are liberal democracies that essentially adopt a free-market economic system, private property and rights of individuals of those countries are necessarily (in some respects) circumscribed by government action. For instance, an individual is not allowed the freedom to engage in any occupation that she or he likes (in Australia, for instance, an individual must possess certain qualifications prescribed by government if she or he is to engage in the occupation of a medical practitioner).<sup>317</sup> And a large part of private property (such as company shares) is created by government action (legislation, in other words), whose ownership and resulting rights cannot be asserted by any individual generally without recourse to (government initiated) legislation.<sup>318</sup>

The ground that a free-market economic system helps to safeguard individuals' political rights against encroachment by government has more substance, but that ground too is not wholly

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<sup>315</sup> Above, note 298, p 51.

<sup>316</sup> See Gray J, *False Dawn: The Delusions of Global Capitalism* (London: Granta Books, 1998), pp 1 -21 for a perceptive, thorough and persuasive analysis as to why a “free-market economic system” is not as “free” as many claim it is. The following passage from there sums up that analysis:

Free market governments model their policies on the era of *laissez-faire*—the mid-nineteenth century period [in the UK] in which government claimed that it did not intervene in economic life. In reality a *laissez-faire* economy—that is to say, an economy in which markets are deregulated and put beyond the possibility of political and social control—cannot be reinvented. Even in its heyday it was a misnomer. It was created by state coercion, and depended on every point in its workings on the power of government. By the First World War the free market had ceased to exist in its most extreme form because it did not meet human needs—including the need for personal freedom. (p 5)

<sup>317</sup> Above, note 298, p 36.

<sup>318</sup> Above, note 298, p 36.

tenable. For instance, Scandinavian governments have generally exercised significant control over the economies of their respective countries, but they have done so without compromising the democratic institutions of those countries.<sup>319</sup> In contrast, previous fascist governments in Italy and Germany have, in those countries, suppressed democratic institutions, whilst largely maintaining a free-market economic system.<sup>320</sup>

The reward one receives (in a free-market economic system) for one's contribution may not necessarily be ethical for a number of reasons, such as the following. One's contribution can be influenced by factors such as one's family background, privilege or status, factors which do not evenly apply to everyone in a country.<sup>321</sup> One's contribution may also be influenced by physical or mental deformities.<sup>322</sup> And one's contribution may be influenced (even significantly) by the contribution of others<sup>323</sup> (for instance, Bill Gates can never contribute the effort he did contribute to Microsoft, an effort which was highly valued by Microsoft as it rewarded that effort to the tune of several million dollars, if not for the efforts of the entire workforce of Microsoft, most of whom are rewarded by Microsoft modestly relative to the reward Microsoft offered Bill Gates).

The ground that a free-market economic system is the economic system that best promotes economic efficiency (or economic growth) is, as noted earlier, a ground that is hard to impugn.<sup>324</sup> Accordingly, it is that ground which furnishes the most cogent basis for regarding economic efficiency (or, in other words, the causation of minimal disruption to the unfettered operation of the free-market economic system) as a policy objective that a tax system (such as

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<sup>319</sup> Above, note 298, p 40.

<sup>320</sup> Above, note 298, p 40.

<sup>321</sup> Above, note 298, p 43.

<sup>322</sup> Above, note 298, p 44.

<sup>323</sup> Above, note 298, p 46.

<sup>324</sup> In note 66, a number of works (by respectively Ball R, Wilson J Q, Chipman L, and Nell E J) is cited that canvass the pros and cons of a free-market economic system as a means for accomplishing economic efficiency.

the CGT regime) should satisfy. That is so despite economic efficiency generally not being wholly co-extensive with horizontal equity.<sup>325</sup>

The satisfaction of the policy objective of economic efficiency, accordingly, as explained above, essentially means that substitution effects that an income tax causes should be avoided (or, at least, minimised), for which (as explained above) all forms of income (including capital gains) should be made liable to income tax similarly. A failure to capture capital gains as being liable to income tax, accordingly, may compound the substitution effects that an income tax causes.

There is a view that the capture of capital gains as being liable to income tax (as the CGT regime does), rather than contributing to the avoidance (or minimisation) of substitution effects that an income tax causes, compounds such substitution effects, as such capture may disincline owners of assets to dispose of those assets, thereby inhibiting the free movement of capital from a less productive use to a more productive one.<sup>326</sup> That seeming disinclination of owners of assets to dispose of those assets is generally referred to as “the lock-in effect”.<sup>327</sup>

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<sup>325</sup> In note 71, a work (by Stilwell F) is cited that articulates an analysis as to why an “equal” distribution of a country’s scarce resources may never cause a too severe impairment of economic efficiency. In note 62 (under Chapter 1), a work (by Stein H) is cited that discusses why (in terms articulated by Henry Simons) a country’s government should intervene to reallocate that country’s scarce resources (otherwise allocated through unfettered operation of market forces) amongst that country’s public.

For a general survey of practical techniques for striking a balance between income equality and economic efficiency, see Lindbeck A, “How can economic policy strike a balance between economic efficiency and income equality?”, *papers presented at the 1998 Symposium of the Federal Reserve Bank of Kansas City on ‘Income Inequality’*, accessible at <<http://www.kc.frb.org/PUBLICAT/SYMPOS/1998/s98Lindbeck.pdf>> (26 December 2004).

<sup>326</sup> Above, note 14, p 63.

<sup>327</sup> Above, note 14, p 63.

That view has seemingly never been confirmed or contradicted by conclusive empirical research.<sup>328</sup> That view has been countered by the following arguments (none of which, as well, has been confirmed or contradicted by conclusive empirical research):

- The seeming “lock-in effect”, if it in fact does obtain, does not affect the aggregate level of investment in a country, as, whilst the capital of the owner of “locked-in” assets remains immobile, the capital of an investor who may have (if not for the “lock-in effect”) purchased those “locked-in” assets remains mobile (free to be invested in other assets).<sup>329</sup>
- The seeming “lock-in effect”, if it in fact does obtain, in the case of company shares quoted on a stock exchange, does not cause steep fluctuations in the prices of such shares, as, often, those who sell such shares (which are “locked-in”) use the proceeds realised from those sales to buy other such shares, rather than withdrawing those proceeds altogether from investment in such shares.<sup>330</sup>
- The seeming “lock-in effect”, if it in fact does obtain, may render some stability to the periods for which owners of assets invest in those assets by discouraging those owners from frequently disposing of those assets for speculative purposes.<sup>331</sup>
- The seeming “lock-in effect”, if it in fact does obtain, will cause owners of assets to retain those assets, rather than to dispose of those assets and expend the

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<sup>328</sup> Above, note 14, p 72.

<sup>329</sup> Above, note 14, p 73.

<sup>330</sup> Above, note 14, p 73.

<sup>331</sup> Above, note 14, p 73.

proceeds realised from such disposal on consumption.<sup>332</sup> Such an inducement on owners of assets to retain those assets will negate the inherent bias of an income tax (relative to a consumption tax) against saving.<sup>333</sup>

- The seeming “lock-in effect”, if it in fact does obtain, will cause greater mobility of capital during an economic downturn, as owners of assets may dispose of their assets (during an economic downturn) so as to realise capital losses, as those capital losses will be deductible on the capture of capital gains as being liable to income tax (but not otherwise).<sup>334</sup>

The *Draft White Paper* stated that:

... The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of objectives of equity, efficiency and combating tax avoidance ...<sup>335</sup>

The meaning of that statement (in the *Draft White Paper*), as concerns economic efficiency and horizontal equity, is best explained to the following effect:

- The CGT regime, upon enactment, will promote the satisfaction of horizontal equity.

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<sup>332</sup> Above, note 14, p 74.

<sup>333</sup> Above, note 14, p 74.

<sup>334</sup> Above, note 14, p 74.

<sup>335</sup> Above, note 184, p 77.

- Whilst income tax in general does cause substitution effects (that impair economic efficiency), those substitution effects will be reduced upon the enactment of the CGT regime, as, (as noted above) upon the enactment of the CGT regime, the scope (as was then obtaining) for a taxpayer to substitute highly taxed income with untaxed capital gains is foreclosed.

Accordingly, in the enactment of the CGT regime, the requirement for satisfying the policy objective of economic efficiency was perceived (by the government which enacted it) to be significant, as was the requirement for satisfying the policy objective of horizontal equity. And that first requirement did not cause that second requirement to be compromised.

Of the significant changes made to the CGT regime following the final report of the Ralph Review, one change is of significance in relation to economic efficiency and horizontal equity. That change is the CGT discount that was made applicable with respect to capital gains realised by taxpayers (except companies) after 21 September 1999.

That CGT discount was rationalised by the Ralph Review (as noted in Chapter 3) as necessary (amongst others) in order to negate the “lock-in effect”, without offering any empirical analysis to support that rationale. Accordingly, in the view of the Ralph Review, that CGT discount was necessary in order that the CGT regime satisfies (amongst others) the policy objective of economic efficiency.

That CGT discount violates horizontal equity, as those capital gains that are eligible to that CGT discount (and most capital gains would) become taxed effectively at a rate of income tax much lower than the rate at which other forms of taxable income are taxed. The effect of that violation of horizontal equity, however, is somewhat attenuated, as that violation negates the

violation of horizontal equity resulting from the abolition of averaging. Accordingly, on balance, the net violation of horizontal equity which that CGT discount does cause may not be significant.

The requirement that the CGT regime (upon enactment) does satisfy the policy objective of economic efficiency did not, accordingly, affect the correctness of the perception (of the government which enacted the regime) that the regime will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since its enactment may have not affected the correctness of that perception.

Compatibility with tax systems of other countries, and conformity with Australia's treaty and other like obligations

At the time CGT was enacted in Australia, of those developed countries which have tax systems generally comparable to those of Australia, the USA, the UK, and Canada had already enacted regimes for the comprehensive taxation of capital gains.<sup>336</sup> As of 1990 (that is, just about four years after the CGT regime was enacted in Australia), all of Australia's major trading partners (bar New Zealand) were (in one form or another) taxing capital gains.<sup>337</sup>

That fact—which is that all Australia's major trading partners (bar New Zealand) were (in one form or another) taxing capital gains—cannot by itself be taken as necessarily having required that Australia enacts a regime for the comprehensive taxation of capital gains. However, that fact did mean that, if Australia did choose to enact a regime for the comprehensive taxation of capital gains (as Australia did, by way of the CGT regime), that choice would not have been

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<sup>336</sup> Above, note 14, p 8.

<sup>337</sup> Above, note 14, p 40.

incompatible with the tax systems of Australia's major trading partners. (Any lack of compatibility of the tax systems of Australia applicable to taxation of capital income (which includes capital gains) with corresponding tax systems of Australia's major trading partners does possibly affect the level of Australia's inbound and outbound capital flows.<sup>338</sup>)

The *Draft White Paper* stated that:

... The lack of general capital gains tax represents a structural defect in the income tax system which lies at the core of many avoidance arrangements: if income can be converted into or dressed up as capital gains, income tax can be avoided completely. The imposition of a capital gains tax would, therefore, strike at one of the foundations of tax avoidance in Australia. ...<sup>339</sup>

Accordingly, the CGT regime was (rightly) perceived (by the government which enacted the CGT regime) as being necessary to complement the income tax regime that was then obtaining (that is, before the enactment of the CGT regime).<sup>340</sup> That was so because, with the enactment of the CGT regime, revenue lost by the Australian government through the avoidance of income tax (by taxpayers converting income gains liable to income tax to untaxed capital gains) will cease to be lost (as taxpayers will then cease to have an incentive to so convert income gains to capital gains).<sup>341</sup>

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<sup>338</sup> See generally Grubert H, "Source rules, trade and income taxes, and electronic commerce: Designing rules for the taxation of cross-border income", (2003) *Economic Analysis & Policy* Volume 33 No 2, p 237; and Burn P, "How highly taxed are we?: The level and composition of taxation in Australia and the OECD", *CIS Policy Monograph 67* (Sydney: The Centre for Independent Studies, 2004), accessible at <<http://www.cis.org.au>> (28 December 2004).

<sup>339</sup> Above, note 184, p 78.

<sup>340</sup> Above, note 14, p 70.

<sup>341</sup> Above, note 14, p 70.

Absent the CGT regime, therefore, unlike its major trading partners (bar New Zealand), Australia lacked a basis (and therefore an entitlement) to exact income tax on a gain that is characterised as a capital gain, but which, if not for the absence the CGT regime, will have been characterised in its true form as an income gain. Australia was thus (in a fiscal sense) at a competitive structural disadvantage vis-à-vis its major trading partners (before the CGT regime was enacted), as those countries (bar new Zealand) will have exacted tax from that gain irrespective of its form (that is, irrespective of whether it is a capital gain or an income gain) where either that gain is sourced in those countries or the entity deriving that gain is a resident of those countries (for purposes of income tax, or any other tax in those countries corresponding to Australian income tax).

If the CGT regime was not enacted, with respect to Australian sourced capital gains derived by entities that were not residents of Australia (for purposes of Australian income tax), therefore, Australia will have not had a basis (and therefore an entitlement) to exact any taxes. The country of residence of those entities, however, will have exacted taxes on those capital gains, as (as noted above) all of Australia's major trading partners (bar New Zealand) were (in one form or another) taxing capital gains. Australia was thus (in a fiscal sense) at a competitive structural disadvantage vis-à-vis its major trading partners (before the CGT regime was enacted).

At the time the CGT regime was enacted, Australia had concluded a number of double tax avoidance treaties with other countries, but had not entered into any other like obligations (bilaterally or multi-laterally) that potentially impinged on the CGT regime.<sup>342</sup>

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<sup>342</sup> *Taxation Ruling*, TR 2001/12 (2001), para 5.

With respect to those double tax avoidance treaties, Australia's official position (as promulgated by the Commissioner)—a position that has yet not been contested in court, but which has been the subject of some criticism<sup>343</sup>—was as follows:

- None of those double tax avoidance treaties (except the double tax avoidance treaty Australia had concluded with Austria) applied to the taxation of capital gains (pursuant to the CGT regime), as the types of taxes to which those treaties were explicitly made applicable did not encompass a tax (even if it is nominally described as an income tax, as the CGT is) on capital gains.<sup>344</sup>
- In any event, none of those double tax avoidance treaties contained provisions that in any way limited Australia's right to tax (pursuant to the CGT regime) Australian sourced capital gains derived by entities who are not residents of Australia (for purposes of Australian income tax) and capital gains wherever sourced derived by entities who are residents Australia (for purposes of Australian income tax).<sup>345</sup>

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<sup>343</sup> The position promulgated by the Commissioner has, however, been the subject of authoritative criticism. For instance, see Gzell I, "International tax: Current issues", (2001) *The Tax Specialist* Volume 4 No 3 February 2001, p 114. There, essentially, it is argued that the Commissioner's position that the types of taxes to which double tax avoidance treaties concluded by Australia before the enactment of the CGT regime were explicitly made applicable did not encompass a tax (even if it is nominally described as an income tax, as the CGT is) on capital gains is not tenable. That is so, it is argued there, as the CGT is, through its introduction to the 1936 Act and subsequently the 1997 Act, indisputably comprehended by income tax.

Arguments consistent with those of Gzell (described just above) are found in Hamilton R L, Deutsche R L & Raneri JC, *Guidebook to Australian International Taxation* (Sydney: Prospect Media Pty Ltd, 2001), pp 6-33 – 6-36.

<sup>344</sup> Above, note 342, para 5.

<sup>345</sup> Above, note 342, para 5.

Accordingly, the enactment of the CGT regime did not cause a breach of conformity (on Australia's part) of Australia's treaty and other like obligations.

Of the significant changes made to the CGT regime following the final report of the Ralph Review, one change is of significance in relation to (on the one hand) satisfying the policy objective of Australia's tax systems being compatible with tax systems of other countries and Australia maintaining conformity with its treaty and other like obligations, and (on the other) horizontal equity. That change is the CGT discount that was made applicable with respect to capital gains realised by taxpayers (except companies) after 21 September 1999.

That CGT discount was rationalised by the Ralph Review as necessary (amongst others) in order to ensure that the concession offered in Australia to negate the "lock-in effect" (discussed above) be akin to corresponding concessions available abroad. Accordingly, in the view of the Ralph Review, that CGT discount was necessary in order that the CGT regime satisfies (amongst others) the policy objective of Australia's tax systems being compatible with tax systems of other countries.

The CGT discount violates horizontal equity, which, though, is somewhat extenuated due to the abolition of averaging. Accordingly, on balance, the net violation of horizontal equity which that CGT discount does cause may not be significant.

Thus, with the enactment of the CGT regime, tax systems of Australia will have become more compatible (than they would have been otherwise) with tax systems of its major trading partners (bar New Zealand), and Australia will have not breached its conformity with its treaty and other like obligations. Accordingly, the requirement for satisfying the policy objective of Australia's tax systems being compatible with tax systems of other countries and

Australia maintaining conformity with its treaty and other like obligations did not affect the correctness of the perception (of the government which enacted the CGT regime) that the regime will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since its enactment may not have affected the correctness of that perception.

### Simplicity

The simplicity of a tax system causes three possible effects:<sup>346</sup>

- Substantive simplicity

If the legislative provisions pertaining to that tax system are drafted in a manner that is comprehensible with ease and certainty, administration of that tax system and compliance with that tax system are made easier.<sup>347</sup>

- Transactional simplicity

If the legislative provisions pertaining to that tax system are drafted in a manner that the scope of those legislative provisions is cohesive, the potential for manufacturing

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<sup>346</sup> In 2004, Chris Evans published a work (Evans C, *Taxing Personal Capital Gains: Operating Cost Implications* Research Study No 40 (Sydney: Australian Tax Research Foundation, 2003), cited in note 246), which addressed the question of whether the manner in which capital gains are taxed influence the operating costs of the CGT regime. That work was reviewed as part of the research undertaken for this thesis. But that work is not considered to be of relevance to the issue of whether, in the enactment of the CGT regime, the satisfaction of the policy objective of simplicity warranted a significant compromise of the perception (of the government which enacted the CGT regime) that the CGT regime (upon enactment) will satisfy the policy objective of horizontal equity. That is so as that work is not an empirical study that canvasses the motivations that underlay the enactment of the CGT regime.

<sup>347</sup> Above, note 14, p 138.

transactions of such form that those transactions are not comprehended by those legislative provisions is minimised.<sup>348</sup> Therefore, administration of that tax system and compliance with that tax system are made easier where legislative provisions pertaining to that tax system are drafted in a manner that the scope of those legislative provisions is cohesive.<sup>349</sup>

- Administrative and compliance simplicity

If a tax system is so designed that the record keeping and information processing required for the administration of that tax system and the compliance with that tax system are not elaborate, administration of that tax system and compliance with that tax system are made easier.<sup>350</sup>

In its *Final Report*, the Asprey Committee stated:

...It is on the ground of equity that, in the Committee's view, the arguments for capital gains tax may reasonably be held to be so strong to overwhelm the admittedly strong case against it on grounds of simplicity.<sup>351</sup>

The recommendations in the *Final Report* of the Asprey Committee proved influential in the eventual enactment of the CGT regime, as that report was reviewed by the Economic Planning & Advisory Committee in the preparation of the *Draft White Paper*.

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<sup>348</sup> Above, note 14, p 138.

<sup>349</sup> Above, note 14, p 138.

<sup>350</sup> Above, note 14, p 138.

<sup>351</sup> Above, note 163, p 414.

Accordingly, in the enactment of the CGT regime, the government (which enacted the CGT regime) did concede that the satisfaction of the policy objective of simplicity will have to be compromised so as to satisfy the policy objective of horizontal equity. That concession, however, was made subject to a single significant exception, as described below.

In the interest of satisfying the policy objective of simplicity, the CGT regime (as enacted) taxed capital gains only when those capital gains are realised (rather than when they accrued). There is considerable authority for the view that the CGT regime, for it to optimally satisfy horizontal equity, should tax capital gains as they accrue.<sup>352</sup> Those authorities essentially reason that a taxpayer who has realised a capital gain and a taxpayer who has an accrued but unrealised capital gain of equal value are in a similar economic situation, and therefore taxing the former taxpayer (merely because that taxpayer has chosen to realise that capital gain) but not the latter taxpayer violates horizontal equity. However, not a single country, as at the time

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<sup>352</sup> Andrews W D, “The Achilles heel of the comprehensive income tax”, in Walker C E & Bloomfield M A, eds, *New Directions in Federal Tax Policy for The 1980s* (Cambridge, Massachusetts: Ballinger, 1983); Auerbach A J, “Retrospective Capital Gains Taxation”, *Working Paper 2792*, (Cambridge, Massachusetts: National Bureau Of Economic Research, 1988), accessible at <<http://papers.nber.org/papers/w2792.pdf>> (27 December 2004); Auerbach A J, “Capital gains taxation and tax reform” (1989) *National Tax Journal* Volume 42 Issue 3, p 391; Brinner R, “Inflation, deferral and the neutral taxation of capital gains” (1973) *National Tax Journal* Volume 26 Issue 4, p 565; Bucovetsky M W, “Inflation and the personal tax base: The capital gains issue”, (1977) 25 *Canadian Tax Journal*, p 79; and Shakow D J, “Taxation without realisation: A proposal for accrual taxation” (1986) 134 *University of Pennsylvania Law Review*, p 1111.

A comprehensive analysis as to why taxing capital gains as they accrue (“accruals basis”) is to be preferred over taxing capital gains as they realise is given in the source cited in note 14 (pp 131 -150). There, it is argued as follows. The accruals basis better satisfies horizontal equity (as, under the accruals basis, a taxpayer who has realised a capital gain and a taxpayer who has an accrued but unrealised capital gain of equal value, are both taxed similarly) (p 137). The accruals basis better satisfies economic efficiency (as, under the accruals basis, there is no possibility that a “lock-in” effect will arise) (p 138). The accruals basis better satisfies simplicity (as, under the accruals basis, the scope for postponement of tax payments through a contrived deferral of the realisation of a capital gain is absent) (p 139). The argument that, under the accruals basis, a taxpayer’s liquidity is burdened as the tax on capital gains has to be paid before those gains are realised in liquid form is overstated (p 141).

CGT regime was enacted (or as of now), taxes all capital gains as they accrue.<sup>353</sup> That is so for the following two main reasons:

- Taxing capital gains as they accrue will require annual valuations by a taxpayer of that taxpayer's capital assets, a requirement that will necessarily result in considerable complexity to the legislative provisions imposing a tax on capital gains.<sup>354</sup>
- Taxing capital gains as they accrue will impose a burden on the liquidity of taxpayers who own capital assets, as those taxpayers will have to pay the tax on capital gains annually (based on accrued values) despite not having realised those capital gains in liquid form.<sup>355</sup>

Those reasons have strong pragmatic relevance. The enactment of the CGT regime, in deference to those reasons, was to tax capital gains only when those capital gains are realised (rather than when they accrue). Taxing so, however, did not amount to a significant compromise of the perception (of the government which enacted the CGT regime) that the regime will satisfy the policy objective of horizontal equity. That is so as, even if capital gains are not taxed when those capital gains accrue, taxing capital gains when those capital gains are realised (as the CGT regime does) is an option that better satisfies horizontal equity than not taxing capital gains at all.

Accordingly, the requirement that the CGT regime satisfies the policy objective of simplicity did compromise the capacity of the CGT regime to also satisfy the policy objective of

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<sup>353</sup> Above, note 14, p 132.

<sup>354</sup> Above, note 14, p 105.

<sup>355</sup> Above, note 14, p 105.

horizontal equity. That compromise, though, was not of such significance as to displace the correctness of the perception that the regime will satisfy the policy objective of horizontal equity. No changes to the CGT regime have occurred since the enactment of it to affect that position.

### Stability

A tax system should satisfy the policy objective of stability, so as to enable those potentially affected by that tax system to anticipate the incidence of that tax system with certainty.<sup>356</sup>

Stability of a tax system, accordingly, comprises two features:

- The tax which that tax system imposes must be imposed in such manner as to be capable of being ascertained with certainty by a taxpayer who may potentially be liable to that tax.<sup>357</sup>
- The tax system, once enacted, remains enacted, with minimal change.<sup>358</sup>

The first of those two features is comprehended by “substantive simplicity”, addressed under the heading “Simplicity”. Only the second of those features, therefore, will be addressed under this heading.

The second of those two features of stability of a tax system (such as the CGT regime) is a policy objective whose satisfaction can be assessed as such only in hindsight (that is, after that tax system has been enacted).

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<sup>356</sup> Above, note 65, p 21.

<sup>357</sup> Above, note 65, p 39.

<sup>358</sup> Above, note 65, p 39.

Having been enacted, the CGT regime has (though it has been subject to some amendment) largely remained intact. And currently it is not the official policy of any prominent political party in Australia that the CGT regime should either completely or substantially be abolished.

What is pertinent, however, is the question of whether, in the enactment of the CGT regime, in order to ensure that the regime will remain enacted (with minimal change), features that were incorporated in that regime amount to a significant compromise of the perception (of the government which enacted the regime) that the regime will satisfy the policy objective of horizontal equity.

The CGT regime (as enacted) did contain a number of concessions, concessions which in large part were conceded by the government (which enacted the CGT regime) for reasons of political expedience. That is, if those concessions were not conceded by that government, it is unlikely that the CGT regime will have been enacted, or, even if it did get enacted, it is unlikely that it will have remained enacted without change.

As noted in Chapter 3, three of those concessions were of such nature that they violated horizontal equity. Those three concessions were: exemption of capital gains realised from the disposal of assets acquired by a taxpayer before 20 September 1985; indexation of capital gains; and exemption of capital gains realised from the disposal of a taxpayer's principal residence.

There has not been any empirical research to establish how significant the violation of horizontal equity caused by each of those three concessions is. Accordingly, the conclusions noted below as to the significance of the violation of horizontal equity caused by each of those three concessions are based on anecdotal observation.

The first concession, in effect, is narrower in scope when one considers the applicability of CGT event K6<sup>359</sup> and Subdivision 149-B, two provisions which (in certain circumstances) operate to deem assets acquired by a taxpayer before 20 September 1985 to be assets acquired by that taxpayer on or after 20 September 1985.

CGT event K6 effectively treats shares in a company or interests in a trust, which a taxpayer acquired before 20 September 1985, as having been acquired by that taxpayer on or after 20 September 1985, where the total assets of that company or trust comprise assets acquired by that company or trust on or after 20 September 1985 to the extent of at least 75% of the value of net assets of that company or trust.<sup>360</sup> CGT event K6 does not generally apply to companies whose shares, or trusts whose interests, are listed for quotation in the official list of an approved stock exchange.<sup>361</sup>

Subdivision 149-B effectively treats assets of a company or trust, which were acquired by that company or trust before 20 September 1985, as having been acquired by that company or trust on or after 20 September 1985, where the ultimate ownership of that company or trust has, to the extent of more than 50%, changed since 20 September 1985.<sup>362</sup> Subdivision 149-B does not generally apply to companies whose shares, or trusts whose interests, are listed for quotation in the official list of an approved stock exchange.<sup>363</sup>

The first concession may not have caused a significant violation of horizontal equity for two reasons. First, that concession, in effect, is narrower in scope when one considers the

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<sup>359</sup> S 104 – 230.

<sup>360</sup> S 104 – 230 (2).

<sup>361</sup> S 104 – 230 (7).

<sup>362</sup> S 149 – 30.

<sup>363</sup> S 149 – 50.

applicability of CGT event K6<sup>364</sup> and Subdivision 149-B. Second, any violation of horizontal equity caused by that concession abates as time passes as, with the passage of time, the stock of assets acquired by a taxpayer before 20 September 1985 reduces, due to a change of ownership of those assets (on or after 20 September 1985) having to (often) necessarily occur.

The second concession may not have caused a significant violation of horizontal equity as, over the past decade or so, the rates of inflation in Australia have considerably reduced, and have remained at low levels.<sup>365</sup> Thus, the adjustments for inflation (through indexation by reference to the Consumer Price Index) in calculating a capital gain assessable to CGT realised from the disposal of assets that taxpayers had owned for at least 12 months are likely to have been correspondingly low in value.

The violation of horizontal equity caused by the third concession is hard to refute. However, strong pragmatic reasons did perhaps exist for the enactment of that concession. Three of those reasons, which are significant, were outlined above.

The third concession, though it does violate horizontal equity, is unlikely to cause such violation to an extent of such significance as to compromise the capacity of the CGT regime (overall) to satisfy the policy objective of horizontal equity. That is especially so as, in Australia, as it is a developed country, home-ownership is relatively widespread such that the proportion of taxpayers (in Australia) who are not owner-occupiers of homes is relatively low.

Accordingly, the effects of those three concessions are unlikely to constitute a significant compromise of the perception (of the government which enacted the CGT regime) that the regime will satisfy the policy objective of horizontal equity.

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<sup>364</sup> S 104 – 230.

<sup>365</sup> Above, note 229, p 6.

Therefore, the requirement that the CGT regime (upon enactment) satisfies the policy objective of stability did compromise the capacity of the regime to also satisfy the policy objective of horizontal equity. That compromise was, though, perhaps not sufficiently significant to displace the correctness of the perception (of the government which enacted the CGT regime) that the regime will satisfy the policy objective of horizontal equity. The fact that the CGT regime has largely remained intact and that currently it is not the official policy of any prominent political party in Australia that the regime should either completely or substantially be abolished means that nothing has occurred since the enactment of the regime to affect that position.

### Flexibility

Flexibility of a tax system has three aspects: one is economic, another is social, and the third is political.<sup>366</sup> The economic aspect warrants that a tax system is such by design that it confers on the government of a country the ability to use that tax system to manage that country's economy.<sup>367</sup> The social aspect warrants that a tax system is such by design that it confers on the government of a country the ability to use that tax system to manage certain social outcomes of that country.<sup>368</sup> The political aspect warrants that a tax system is such by design that it has the ability to endure despite the government which enacted that tax system being replaced with one of a different political persuasion.<sup>369</sup>

Of those three aspects, only two aspects—the economic aspect and the social aspect—are addressed under this heading (entitled “Flexibility”), as the political aspect is addressed under

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<sup>366</sup> Above, note 65, p 21.

<sup>367</sup> Above, note 65, p 21.

<sup>368</sup> Faria A G A, “Tax reform in market economies ... :Principles and experience”, in Shome P, ed, *Tax Policy Handbook* (Washington D C: International Monetary Fund, 1995), p 275; above, note 12, p 28.

<sup>369</sup> Above, note 65, p21.

the penultimate heading of this chapter (entitled “Securing acceptance of all relevant political parties and other relevant stakeholders”).

In the management of a country’s economy, a government of that country can potentially use a tax system of that country to either manage that country’s aggregate demand, or manage that country’s aggregate supply.<sup>370</sup> Until the early 1980s, inspired by the work of J M Keynes, a tax system of a country was regarded as useful for only the former (that is, management of a country’s aggregate demand).<sup>371</sup> Since the early 1980s, an influential school has emerged (referred to as “supply-side economics”) which advocates that a country’s tax system is useful for the latter (that is, management of a country’s aggregate supply).<sup>372</sup>

As to how a country’s tax system can be potentially useful for management of that country’s aggregate demand has been described thus:

... [Macroeconomic theories] develop a model of national income determination based on the circular flow of income between firms and households. Additions to the circular flow include government expenditures, investment by ... [firms] and export earnings. Withdrawals from the circular flow include taxation, savings by firms and households and expenditures on imports. If additions to the circular flow are greater than withdrawals from it the national output expands to meet the increased spending, leading to the recruitment of more workers. Hence, by varying the levels of

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<sup>370</sup> For an authoritative analysis of the role of fiscal policy in the management of a country’s economy, see Fatas A and Mihov I, “The case for restricting fiscal policy discretion”, *Insead Working Papers*, accessible at <<http://ged.insead.edu/fichiersti/inseadwp2002/2002-38.pdf>> (27 March 2005). There, it is argued that fiscal policy (in countries with political systems similar to those of Australia) is often used by politicians to political ends rather than to ends dictated by sound economic management, a use that which should therefore be disciplined through appropriate institutional controls.

<sup>371</sup> Bailey S J, *Public Sector Economics: Theory, Policy and Practice* (London: Macmillan Press Limited, 1995), pp 116 – 118.

<sup>372</sup> Id, pp 118 – 120.

government spending and taxation (discretionary fiscal policy) the government can control the levels of aggregate demand and so control the level of employment and unemployment. ...<sup>373</sup>

The context in which “supply-side economics”, which advocates that a country’s tax system is useful for the management of that country’s aggregate supply, gained influence (in the early 1980s) has been described thus (though the following description applies specifically to the UK, the position described in it accurately represents the general context in which “supply-side economics” gained influence in not just the UK, but also the USA and other parts of the world):

Supply-side policies seek to remove constraints or impediments on output. In Keynesian analysis the greatest impediment on supply is lack of aggregate demand. Hence [under Keynesian analysis] the most effective supply-side measure is the demand-side measure of expansionary fiscal policy to boost aggregate demand. ...

For four decades after 1945 [in the UK] macroeconomic policy was directed at the control of output and employment and microeconomic policy at the control of inflation (e.g. the control of credit creation by commercial banks). This was reversed [in the UK] during the 1980s, when macroeconomic policy was to control inflation and microeconomic policy was used to remove supply constraints. Control of inflation and improvements on the supply side of the economy became the two main objectives of the [UK] government’s economic strategy during the early 1980s. Control of inflation was not so much a faithful application of monetarist rules to control the money supply as a refusal to adopt Keynesian reflationary policies in response to dramatic rises [in the UK] in unemployment ... Supply-side measures involved the

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<sup>373</sup> Above, note 371, pp 116 – 117.

removal of impediments preventing people and firms responding quickly to changing market conditions.

The economic strategy reflected the dispute [between demand-side policies and supply-side policies] over the relative significance of demand and supply factors in determining output and employment. The dispute concerned whether stagnant or falling output and rising unemployment was due to restrictive fiscal and monetary policies or due to supply constraints (especially labour market rigidities). ...<sup>374</sup>

As to how a country's tax system can be potentially useful for management of that country's aggregate supply (that is, under "supply-side economics") has been described thus:

... income tax is inherently biased against work effort (on the ground that work is taxed but leisure is not), as well as against savings (since income saved is taxed twice, while income consumed is taxed only once) and investment (since productive investment is taxed but unproductive investment is not) and that high marginal income tax rates exacerbates these biases significantly; reducing marginal income tax rates would, therefore, increase labour supply, savings, and investment. ...<sup>375</sup>

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<sup>374</sup> Above, note 371, pp 118 – 119.

<sup>375</sup> Gandhi V P & others, cited in note 297, p 5.

Conversely, for an empirical finding that high marginal rates of income tax may not necessarily cause those deriving labour income to work less (so as to significantly influence the supply of labour), see the work of Break G F, cited in note 302. And, for empirical findings essentially to the effect that marginal rates of income tax may not have a significant influence on how taxpayers employ their capital, see the works of each Stiglitz J E and Bradford D F, cited in note 303.

The emphasis which each of the two approaches to economic management of a country—an approach of managing a country's aggregate demand, or an approach of managing a country's aggregate supply—places on an income tax (as a tool for economic management) is thus different (as described below).

Under an approach of managing a country's aggregate demand, the only emphasis placed on an income tax (as a tool for economic management) is the means afforded to the government to directly affect the level of after-tax incomes of the taxpayers on whom that income tax is imposed, through a variation (by that government) of the level of that income tax. Beyond that, under that approach, there is no emphasis placed on an income tax, as the level of an income tax cannot (at least, by itself) affect how taxpayers on whom that income tax is imposed spend their after-tax incomes (and thus contribute to that country's aggregate demand).

Therefore, under an approach of managing a country's aggregate demand, if an income tax is to serve as an effective tool for economic management, that income tax must possess the necessary feature of having a direct effect on the after-tax incomes of the taxpayers on whom that income tax is imposed. That feature an income tax will best possess if it is imposed on a tax base which represents economic income proper (the most widely accepted best operational index of which, as noted in Chapter 3, is the Schanz-Haig-Simons definition of income). Accordingly, the comprehensive taxation of capital gains in Australia through the CGT (which is comprehended by the income tax) offers optimal flexibility for the management of the Australian economy, if such management were based on an approach of managing Australia's aggregate demand.

Under an approach of managing a country's aggregate supply, the emphasis placed on an income tax (as a tool for economic management) as a means afforded to that country's government to raise tax revenues (necessary for sustaining those functions of that government that it must necessarily carry out) causing the least disruption to the unfettered operation of that country's market economic system.<sup>376</sup> Accordingly, that emphasis is co-extensive with the requirement that an income tax, by being so designed to cause the least substitution effects, should satisfy the policy objective of economic efficiency.

A failure to capture capital gains as being liable to income tax compounds the substitution effects an income tax causes. The comprehensive taxation of capital gains in Australia through the CGT (which is comprehended by the income tax), accordingly, offers optimal flexibility for the management of the Australian economy, if such management were based on an approach of managing Australia's aggregate supply.

In the interest of satisfying the policy objective of simplicity, the CGT regime (as enacted) taxed capital gains only when those capital gains are realised (rather than when they accrued). Therefore, in the context of either managing a country's aggregate demand or managing a country's aggregate supply, the CGT may not constitute a tool (for use by the government) that can yield an immediate impact, as the incidence of the CGT will not be immediate but rather be somewhat delayed, corresponding to the interval of time from the accrual of a capital gain to the realisation of that capital gain.<sup>377</sup>

Of the significant changes made to the CGT regime following the final report of the Ralph Review, one change is of possible significance in relation to each of the two policy objectives

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<sup>376</sup> Gandhi V P & others, cited in note 297, p 3.

<sup>377</sup> Above, note 12, p 40.

of horizontal equity and (the economic aspect of) flexibility. That change is the replacement of indexation with the CGT discount.

That change was rationalised by the Ralph Review (as noted in Chapter 3) as necessary (amongst others) in order to ensure that the essential concession offered by way of indexation was made more “readily transparent” by replacing indexation with the CGT discount. That expression “readily transparent” (as used in the final report of the Ralph Review) would appear to connote ready comprehensibility of the CGT discount (relative to the concession represented by indexation) by taxpayers, and not any ability of the CGT discount (relative to the concession represented by indexation) to have a ready impact on either the aggregate demand of Australia or the aggregate supply of Australia.

The social aspect (of the flexibility of a tax system) has a number of sources. One of those sources that is commonly encountered, “market failure”, can overlap with the economic aspect (of the flexibility of that tax system), and has been described well as follows:

Where ... “market failure” is manifested because of public goods, externalities, natural monopoly, and asymmetric information, state intervention [through the tax system] is ... warranted.<sup>378</sup>

Other sources of the social aspect (of the flexibility of a tax system) are so various that they cannot be exhaustively enumerated. An example of one such other source is the expressed preference on the part of the immediately previous Australian (Commonwealth) government to encourage parents to have more children, and an example of another is the expressed

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<sup>378</sup> Faria A G A, cited in note 368, p 275.

preference on the part of that same government to encourage employees to retire later in their lives.

When the CGT regime was enacted, two types of capital gain were made exempt from CGT: capital gains realised on the disposal of a taxpayer's principal residence (now referred to as the main residence), and part of the capital gain realised on the disposal of business goodwill. The latter exemption (applicable to part of the capital gain realised on the disposal of business goodwill) was abolished with effect from 21 September 1999, and replaced with three concessions available to small businesses.

Both those exemptions do violate horizontal equity. However, there has not been any empirical research to establish how significant the violation of horizontal equity caused by each of those two exemptions. Accordingly, the conclusions noted below as to the significance of the violation of horizontal equity caused by each of those two exemptions are based on anecdotal observation.

The exemption from CGT of capital gains realised on the disposal of a taxpayer's principal (or main) residence (as noted under the heading entitled "Stability") does violate horizontal equity. However, strong pragmatic reasons did perhaps exist for the enactment of that exemption. Three of those reasons are significant. Those three reasons are not comprehended by "market failure", but by other sources of the social aspect (of the flexibility of a tax system).

The exemption from CGT of capital gains realised on the disposal of a taxpayer's principal (or main) residence does violate horizontal equity. Such a violation, however, is unlikely to be of an extent of such significance as to compromise the capacity of the CGT regime (overall)

to satisfy the policy objective of horizontal equity. That was especially so as, in a developed country such as Australia, home-ownership is relatively widespread such that the proportion of taxpayers who are not owner-occupiers of homes is relatively low.

The three concessions available to small businesses (that was enacted with effect from 21 September 1999, on the abolition of the exemption from CGT of part of the capital gain realised on the disposal of business goodwill) were rationalised by the Ralph Review as necessary “to provide small business people with access to funds for retirement and expansion”.<sup>379</sup> That rationalisation, in part, may be comprehended by “market failure” that causes difficulty for small businesses to raise finance due to “asymmetric information, for example on markets or products, [and] monopoly power of large firms”.<sup>380</sup>

Those three concessions do violate horizontal equity. However, the violation of horizontal equity caused by those three concessions is unlikely to be of such significance as to compromise the overall capacity of the CGT regime to satisfy the policy objective of horizontal equity. That is so as two of those three concessions are unlikely to be availed of by any one taxpayer frequently. One of them is the exemption from CGT of any capital gain made on the sale of business assets where the owner of those assets retires after such sale—that is, the concession can be availed of by any one taxpayer only on that taxpayer’s retirement. Another of them is the exemption from CGT of any capital gain made on the sale of business assets where those assets had been owned (by the taxpayer selling those assets) for at least 15 years—that is, the concession can be availed of by any one taxpayer only in relation to a business asset owned by that taxpayer for as long as 15 years.

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<sup>379</sup> Above, note 225, p 587.

<sup>380</sup> Freedman J, “Small business taxation: Policy issues and the UK”, *paper presented at the Small Business Tax Symposium 22 August 2003* (Sydney: University of New South Wales, 2003), p2.

Accordingly, with respect to both “market failure” and other sources of the social aspect (of the flexibility of a tax system), the comprehensive taxation of capital gains in Australia through the CGT (which is part of the income tax)—due to that comprehensiveness—does offer optimal flexibility to the Australian (Commonwealth) government to manage social outcomes. That is so as that comprehensiveness means that a proportion of taxpayers larger than what it would have been otherwise can be reached through the Australian federal tax system.

In sum, the requirement that the CGT regime does satisfy the policy objective of flexibility did compromise the capacity of the CGT regime to also satisfy the policy objective of horizontal equity. That compromise, however, was perhaps not of such significance as to displace the correctness of the perception of the government which enacted the CGT regime that the regime will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since its enactment have perhaps not affected that position.

#### Coherence with other related tax systems

The policy objective that a tax system should cohere with other related tax systems essentially means that that tax system, when that tax system is considered with all other tax systems of that country as well as all other tax systems of that country’s major trading partners as a whole, must be such that that tax system is consistent with each of those other tax systems.<sup>381</sup>

Under this heading, what will be addressed (so far as practicable) is whether the CGT regime is such that, when it is considered with all other tax systems of Australia as a whole, it is consistent with each of those tax systems. The issue of whether the CGT regime is such that,

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<sup>381</sup> Above, note 65, p 19.

when that regime is considered with all other tax systems of Australia's major trading partners as a whole, that regime is consistent with each of those tax systems was addressed (so far as practicable) under an earlier heading (entitled "Compatibility with tax systems of other countries, and conformity with Australia's treaty and other like obligations").

When it is considered with all other tax systems of Australia as a whole, whether the CGT regime is such that it is consistent with each of those tax systems is not an issue that can be practicably addressed. That is so as, in Australia (given the federated form of government that applies), taxes are imposed at two tiers of government.<sup>382</sup> For historical reasons (including reasons dictated by the Australian constitution), each tier of government imposes taxes generally independent of the other tier of government.<sup>383</sup> Therefore, the taxes imposed by each tier of government (including the Commonwealth, which exclusively imposes income tax that comprehends CGT) have not, either relative to those taxes only or relative to those taxes as well as taxes imposed by the other tier of government, conformed to a coherent framework.<sup>384</sup>

All that is practicable, therefore, is to address whether the CGT regime is such that it is consistent with all other aspects of Australia's income tax system.

The *Draft White Paper* stated that:

... The lack of capital gains tax represents a structural defect in the income tax system which lies at the core of many avoidance arrangements: if income can be converted into or dressed up as capital gains, income tax can be avoided completely. The

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<sup>382</sup> Above, note 12, pp 74 – 96.

<sup>383</sup> Above, note 12, pp 74 – 96.

<sup>384</sup> Above, note 12, pp 74 – 96.

imposition of a capital gains tax would, therefore, strike at one of the foundations of tax avoidance in Australia.<sup>385</sup>

That opinion expressed in the *Draft White Paper* is consistent with opinion expressed by others to the effect that, absent comprehensive taxation of capital gains, there will result a loss of revenue raised by way of income tax because of the contrived conversion of income gains (which are liable to income tax) to capital gains (which are not liable to income tax or any other tax).<sup>386</sup>

Accordingly, the CGT regime necessarily complemented (and thus cohered with) the income tax system (of which the CGT regime, upon enactment, was to be part).

The requirement that the CGT regime does satisfy the policy objective of coherence with other related tax systems did not, therefore, affect the correctness of the perception (of the government which enacted the regime) that the regime will satisfy the policy objective of horizontal equity. No changes to the CGT regime have occurred since its enactment to affect that perception being largely correct.

#### Catering for transitional problems

A new tax system should satisfy the policy objective of catering for transitional problems that the enactment of that tax system may cause those who are potentially affected by that tax system.<sup>387</sup>

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<sup>385</sup> Above, note 184, p 78.

<sup>386</sup> See generally, above, note 14, p 74; and Evans C, cited in note 193, p 307.

<sup>387</sup> Above, note 65, p 22.

The CGT regime (as enacted) did contain a number of concessions, one of which was a most significant concession made to cater for transition problems that the enactment of the CGT regime may cause those who are potentially affected by that regime. That concession was to the effect that capital gains realised from the disposal of assets acquired by a taxpayer before 20 September 1985 were not subject to the CGT regime (that is, those capital gains were effectively not liable to any tax). The effect of that concession on horizontal equity was analysed above (under the heading “Stability”), where it was concluded that it does violate horizontal equity, but not to a significant extent.

Four significant changes made to the CGT regime (following the final report of the Ralph Review) were discussed above. All of those changes (except one) violated horizontal equity. None of those changes were subject to any “grandfathering” relief, and therefore the violation of horizontal equity was not caused by any such relief.

Accordingly, the requirement that the CGT regime does satisfy the policy objective of catering for transitional problems that the enactment of it may cause did compromise the perception (of the government which enacted it) that the regime will satisfy the policy objective of horizontal equity. That compromise, though, was perhaps not of such significance as to displace the correctness of that perception. Those changes to the CGT regime that have occurred since its enactment have not affected that position.

### Yielding expected net revenue to the government

A tax system should satisfy the policy objective of yielding to the government the net revenue that that tax system is expected to yield.<sup>388</sup>

The net revenue that a tax system yields to a government is the gross tax revenue that tax system yields minus the administrative costs borne by that government in relation to that tax system.<sup>389</sup> In relation to the CGT regime, there are no statistics as to what administrative costs are borne by the government in relation to that regime.<sup>390</sup> Therefore, the analysis under this heading is limited to a review of the gross tax revenue that the CGT regime yields to the government.

The *Draft White Paper* estimated that a comprehensive tax on capital gains “could generate tax liabilities around \$450 million in the fifth year of operation”.<sup>391</sup> That estimate was seemingly based on what a comprehensive tax on capital gains yielded the Canadian government, when such a tax was first enacted in Canada.<sup>392</sup> Following the government’s announcement that the regime of comprehensive tax on capital gains that was to be enacted will depart in some respects from that recommended in the *Draft White Paper* (as canvassed above), the then Commonwealth Treasurer announced that that amount of \$450 million estimated in the *Draft White Paper* had been revised to be \$25 million.<sup>393</sup> In the event, the actual gross tax revenue yielded by the CGT regime has considerably exceeded that revised

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<sup>388</sup> Above, note 12, 41.

<sup>389</sup> Above, note 193, p 306.

<sup>390</sup> Above, note 193, p 306.

<sup>391</sup> Above, note 184, p 85.

<sup>392</sup> Above, note 193, p 306.

<sup>393</sup> Above, note 193, p 306.

estimate announced by the then Commonwealth Treasurer,<sup>394</sup> and also has, as a proportion of the (Commonwealth) government's total gross tax revenue, been rising.<sup>395</sup>

Further, with the enactment of the CGT regime, tax revenue lost by the government through avoidance of income tax (by taxpayers converting income gains liable to income tax to untaxed capital gains) generally ceased to be lost (as taxpayers then ceased to have an incentive to so convert income gains to capital gains). The resulting increase in income tax (an increase which is correctly attributable to the enactment of the CGT regime) is not included in the gross tax revenue actually yielded by the CGT regime referred to in the paragraph just above, as there is currently no measure of that resulting increase in income tax.<sup>396</sup>

Accordingly, the CGT regime does satisfy the policy objective of yielding to the government the net revenue that the regime is expected to yield. Whether that satisfaction did compromise the perception (of the government which enacted the CGT regime) that the regime (upon enactment) will satisfy the policy objective of horizontal equity becomes moot only in the following situation.

That situation is where the government (which enacted the CGT regime) was forced to incorporate in the CGT regime features that fail to satisfy horizontal equity, so as to ensure that that regime satisfies the policy objective of yielding to the government the net revenue that that regime is expected to yield. In the event, no such features were incorporated in the CGT regime; rather, what came to pass was the opposite. That is, the form in which the government (which enacted the CGT regime) was forced to enact the regime was such that, as

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<sup>394</sup> Above, note 193, p 306.

<sup>395</sup> Above, note 193, p 306.

<sup>396</sup> Above, note 193, p 307.

that regime in that form represented a departure in some respects from the regime for comprehensive taxation of capital gains which was recommended in the *Draft White Paper*, that regime caused not a gain but a loss of gross tax revenue (yielded by it) to the government.

Of the significant changes made to the CGT regime following the final report of the Ralph Review, all (except one) violated horizontal equity (as analysed in Chapter 3). That violation of horizontal equity, however, did not occur due to the government being forced to incorporate (in the CGT regime) those changes, so as to ensure that the regime satisfies the policy objective of yielding to the government the net revenue that that regime is expected to yield. That is so as the remit of the Ralph Review was explicitly to the effect that its recommendations should be “revenue neutral”<sup>397</sup>.

Accordingly, the requirement that the CGT regime (upon enactment) does satisfy the policy objective of yielding to the government the net revenue that the regime is expected to yield did not affect the correctness of the perception (of the government which enacted it) that the regime will satisfy the policy objective of horizontal equity. No changes to the CGT regime have occurred since its enactment to affect the correctness of that perception.

#### Securing acceptance of all relevant political parties and other institutional stakeholders

A tax system should satisfy the policy objective of securing the acceptance of all relevant political parties and other institutional stakeholders (such as, say, business or industry federations, and trade unions), so that that tax system can be enacted, and (once enacted) remains enacted (without being repealed).<sup>398</sup>

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<sup>397</sup> Above, note 225, p vii.

<sup>398</sup> Above, note 12, p 41.

The CGT regime (as enacted) did contain a number of concessions, concessions which in large part were conceded by the government (which enacted the CGT regime) for reasons of political expedience. Three of those concessions were of such nature that they violated horizontal equity, and the effects of the violations of horizontal equity caused by those three concessions have already been analysed (in Chapter 3). Based on that analysis, it was concluded that those effects of those three concessions are unlikely to constitute a significant compromise of the perception (of the government which enacted the CGT regime) that the CGT regime will satisfy the policy objective of horizontal equity.

Having been enacted, the CGT regime (though it has been subject to some amendment, as outlined in Chapter 3) has largely remained intact. Currently, it is not the official policy of any prominent political party in Australia that the CGT regime should either completely or substantially be abolished.

Accordingly, the requirement that the CGT regime (upon enactment) does satisfy the policy objective of securing the acceptance of all relevant political parties and other institutional stakeholders did not affect the correctness of the perception (of the government which enacted it) that the regime will satisfy the policy objective of horizontal equity. No changes to the CGT regime have occurred since its enactment to affect the correctness of that perception.

## **Conclusion**

The previous chapter addressed the question of whether the enactment of the CGT regime, and the continuance of it after enactment, were actuated by a perception (of respectively the government which enacted it, and subsequent governments which yielded to its continuance) that it will satisfy the policy objective of horizontal equity. And that question, in that chapter,

was answered in the affirmative. This chapter addressed the question of whether that perception is largely correct. A question which, based on the analysis recorded in this chapter, is answered in the affirmative.

This chapter contained a comprehensive discussion of each of the policy objectives a tax system (such as the CGT regime) should satisfy. That discussion was necessary in order to conclude whether, in the CGT regime having to satisfy each of those policy objectives (which are not necessarily wholly co-extensive with horizontal equity), the satisfaction of horizontal equity (as a policy objective) by the regime was significantly compromised. That discussion resulted in, with respect to each of those policy objectives, one of the two following conclusions essentially being drawn:

- The requirement to satisfy that policy objective by the CGT regime did not perhaps affect the correctness of the perception (of the government which enacted the regime) that the regime will satisfy the policy objective of horizontal equity. Those changes to the CGT regime that have occurred since the enactment of it have perhaps not affected the correctness of that perception.
- The requirement to satisfy that policy objective by the CGT regime did compromise the capacity of the regime to also satisfy the policy objective of horizontal equity, but that compromise was perhaps not of such significance as to displace the correctness of the perception (of the government which enacted the regime) that the regime will satisfy the policy objective of horizontal equity. Changes to the CGT regime that have occurred since its enactment have not perhaps affected that position.

The first conclusion was drawn with respect to the following policy objectives:

- Vertical equity
  
- Economic efficiency
  
- Compatibility with tax systems of other countries, and conformity with Australia's treaty and other like obligations
  
- Coherence with other related tax systems
  
- Yielding expected net revenue to the government
  
- Securing acceptance of all relevant political parties and other institutional stakeholders

The second conclusion was drawn with respect to the following policy objectives:

- Simplicity
  
- Stability
  
- Flexibility
  
- Catering for transitional problems

With respect to the policy objective of horizontal equity, which was comprehensively discussed in Chapter 2, in this chapter, just one proposition was addressed, a proposition

which the scope of Chapter 2 did not afford the opportunity to be addressed. That proposition, it was concluded, in this chapter, does not affect the conclusion drawn in Chapter 2 that the enactment of the CGT regime, and the continuance of it after enactment, were actuated by a perception (of respectively the government which enacted it, and subsequent government which yielded to its continuance) that it will satisfy the policy objective of horizontal equity.

## **Chapter 5: What reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity?**

### **Overview of the scope of this chapter**

The question addressed in this chapter is: what reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy the policy objective of horizontal equity? That question is answered through arguing that any one of four reasons (and no other) can (in theory) cause the CGT regime to potentially produce outcomes that violate horizontal equity. Those four reasons are described in this chapter.

The research carried out for the preparation of this thesis has not found any existing material that has identified as such the four reasons that this chapter has as the only causes why the CGT regime theoretically may potentially produce outcomes that violate horizontal equity. The lack of such a finding does not detract from the identification of those four reasons in this chapter.

Those four reasons largely turn on the approaches taken by the Australian judiciary, as well as the Commissioner, to the interpretation of legislative provisions imposing CGT. Accordingly, in this chapter, the approaches taken by the Australian judiciary and the Commissioner to the interpretation of legislative provisions imposing tax in general are described, and how those approaches should be changed so as to address each of those four reasons is canvassed.

**The four reasons that could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity**

The four reasons (and no other) that could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity are the following:

Reason A

- The best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions can result in outcomes that violate horizontal equity.

Reason B

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Australian judiciary's interpretation of those legislative provisions, not being compatible with the best interpretation of those legislative provisions (pursuant to the current approach of the Australian judiciary), can result in outcomes that violate horizontal equity.

Reason C

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity.

That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their best interpretation (pursuant to the current approach of the Australian judiciary).

#### Reason D

- Though the Australian judiciary's interpretation of relevant legislative provisions (despite not being the best interpretation of those legislative provisions, based on the current approach of the Australian judiciary) does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity. That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their interpretation by the Australian judiciary (albeit, based on the current approach of the Australian judiciary, such interpretation of the Australian judiciary not being compatible with the best interpretation of those legislative provisions).

Fundamental to an appreciation of the four reasons identified above is an understanding of the approaches taken by the Australian judiciary as well as the Commissioner to the interpretation of legislative provisions imposing CGT. Those approaches are described next.

**What is the Australian judiciary's current approach to the interpretation of legislative provisions imposing CGT?**

Status quo

Legislative directives to the Australian judiciary as to the interpretation of legislative provisions in general are relevantly found in sections 15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*. Those two sections are reproduced below:

15AA In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

15AB (1) Subject to subsection (3), in the interpretation of a provision of an Act, if any material not forming part of the Act is capable of assisting in the ascertainment of the meaning of the provision, consideration may be given to that material:

(a) to confirm that the meaning of the provision is the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act; or

(b) to determine the meaning of the provision when:

i) the provision is ambiguous or obscure; or

- ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.

15AB (2) Without limiting the generality of subsection (1), the material that may be considered in accordance with that subsection in the interpretation of an Act includes:

- (a) all matters not forming part of the Act that are set out in the document containing the text of the Act as printed by the Government Printer;
- (b) any relevant report of a Royal Commission, committee of inquiry or other similar body that was laid before either House of the Parliament before the time when the provision was enacted;
- (c) any relevant report of a committee of the Parliament or of either House of the Parliament that was made to the Parliament or that House of the Parliament before the time when the provision was enacted;
- (d) any treaty or other international agreement that is referred to in the Act;
- (e) any explanatory memorandum relating to the Bill containing the provision, or any other relevant document, that was laid before, or furnished to the members of, either House of the Parliament by a Minister before the time when the provision was enacted;

- (f) the speech made to a House of the Parliament by a Minister on the occasion of the moving by that Minister of a motion that the Bill containing the provision to be read a second time in that House;
- (g) any document (whether or not a document to which a preceding paragraph applies) that is declared by the Act to be a relevant document for the purposes of this section; and
- (h) any relevant material in the Journals of the Senate, in the Votes and Proceedings of the House of Representatives or in any official record of debates in the Parliament or either House of the Parliament.

15AB (3) In determining whether consideration should be given to any material in accordance with subsection (1), or in considering the weight to be given to any such material, regard shall be had, in addition to any other relevant matters, to:

- (a) the desirability of persons being able to rely on the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act; and
- (b) the need to avoid prolonging legal or other proceedings without compensating advantage.

The Australian judiciary, generally, complies with the legislative directives in sections 15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*.<sup>399</sup> That compliance, in the context of legislative provisions applicable to a tax (such as the CGT), yields an approach that has been authoritatively described as follows:

*There can be no doubt that the task of a judge in interpreting any statute is to endeavour to ascertain the meaning of the words used. ... Of the ... rules ..., the one which has the greatest impact on a court is probably the need to consider the meaning of the words used by reference to the context in which they appear.*<sup>400</sup> [Emphasis added.]

... [E]ven without legislative intervention it became clear that regard could be had to extrinsic materials, at least for a limited purpose. ... Legislative intervention came with the insertion into the Acts Interpretation Act 1901 of ss 15AA and 15AB. ... It is commonplace today to have regard to extrinsic material, but less commonplace for that material to be of any great assistance.<sup>401</sup>

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<sup>399</sup> See generally Gleeson M (serving chief justice of the High Court of Australia at the time the speech was delivered), “Legality – spirit and principle”, *The second Magna Carta Lecture*, New South Wales Parliament House, 20 November 2003 (Sydney: 2003); Kirby M (then serving justice of the High Court of Australia), “Judicial activism”, *The Hamlyn Lectures*, University of Exeter, 19 – 20 November 2003 (Exeter, UK: 2003); McHugh M H (serving justice of the High Court of Australia as at the time the speech was delivered), “The judicial method”, *The Australian Bar Association conference on “Democracy and the law”*, 5 July 1998 (London, 1998); McHugh M H (serving justice of the High Court of Australia as at the time the article was published), “The law making function of the judicial process”, (1988) 62 *Australian Law Journal*, p 15; Hill DG (serving justice of the Federal Court of Australia as at the time the paper was presented), “How is tax to be understood by courts”, *Taxation Institute of Australia South Australian convention papers 2001* (Sydney: 2001); Spigelman J J (serving chief justice of the Supreme Court of New South Wales at the time the speech was delivered), “Statutory interpretation: identifying the linguistic register”, *Sir Ninian Stephen Lecture*, University of Newcastle, 23 March 1999 (Newcastle, Australia: 1999).

<sup>400</sup> Hill DG, cited in note 399, p 112.

<sup>401</sup> Hill DG, cited in note 399, p 113.

The rules of statutory interpretation which guide the courts in interpreting taxation laws ensure that overly technical interpretations of tax laws will be less likely to be adopted than in the past. But while these rules leave considerable latitude to the courts *it is accepted that judicial decision making should not proceed by reference to judicial conscience or political philosophy but principled decision.*<sup>402</sup> [Emphasis added.]

... [I]t is important to know what it was that the legislature was concerned to do in the section which requires interpretation. In general terms legislation is of two kinds. First, there may be legislation which has been enacted to deal with a particular problem by changing the law – so called “remedial legislation”. Second, the legislation may be new legislation, either introducing a totally new tax, ... or introducing within the context of an old tax some new set of provisions ...<sup>403</sup>

It will be important to ascertain when interpreting remedial legislation what the mischief was which parliament sought to remedy. Even if the legislation itself is ambiguous, it can usually be assumed that the courts will attempt to give effect to parliament’s intention and will give to it an interpretation which enables the mischief to which it was directed to be overcome. This will usually entail reading the Second Reading Speech and the Explanatory Memorandum and may, as well, entail some reading of the previous law in order to better understand the mischief.<sup>404</sup>

The interpretation of new legislation is more of a challenge. ... Particularly helpful in this exercise will be both the initial explanatory memorandum (or, if the provision to be interpreted is one of the numerous amendments made after the introduction of the

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<sup>402</sup> Hill DG, cited in note 399, p 116.

<sup>403</sup> Hill DG, cited in note 399, p 116.

<sup>404</sup> Hill DG, cited in note 399, p 116.

legislation, the explanatory memorandum accompanying the particular amendments)<sup>405</sup> ...

In such an approach to interpreting legislative provisions applicable to a tax (such as the CGT), there are two principles of significant import. Those two principles (as represented by the italicised statements in the passages quoted just above) are:

- “[T]he task of a judge in interpreting any statute is to endeavour to ascertain the meaning of the words used.”<sup>406</sup>
- “[I]t is accepted that judicial decision making should not proceed by reference to judicial conscience or political philosophy but principled decision.”<sup>407</sup>

Those two principles seem to be mutually reinforcing, in that the perception appears to be that the satisfaction of each principle is necessarily required in order to satisfy the other principle. Those two principles, sometimes described in different terms, are found not only amongst pronouncements by Australian judges but also amongst pronouncements by eminent judges of other countries, which (like Australia) have a common law judicial system.<sup>408</sup>

Both of those principles have been the subject of authoritative, substantial criticisms. The most far-reaching and sustained of those criticisms has been by Neil Brooks (a distinguished Canadian tax law professor). In Australia, the most comprehensive of those criticisms has been by Dr Mark Burton. The criticisms by each Brooks and Burton are canvassed below.

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<sup>405</sup> Hill DG, cited in note 399, p 116.

<sup>406</sup> Above, note 400.

<sup>407</sup> Above, note 402.

<sup>408</sup> See generally all works cited in note 399; Lord Radcliffe, “Law and order”, (1964) 61 *Law Society’s Gazette*, p 821; Lord Reid, “The judge as lawmaker”, (1972) *Journal of the Society of Public Teachers of Law*, p 22.

Given that those criticisms are markedly at variance with the well-entrenched, received position in Australia (a received position as evinced by the two principles identified above), passages from the work of respectively Brooks and Burton crucial to sustain the cogency of those criticisms have been quoted below verbatim, as paraphrasing those passages was considered likely to make one's grasp of those criticisms less reliable.

### Criticisms of status quo by Neil Brooks

#### *Brooks's summation*

Brooks sums up his criticisms (on the prevailing judicial approaches to interpretation of legislative provisions) as follows:

... [T]he plain meaning approach ... is based on the premise that words have plain meanings and argues that a judge's task is to simply interpret, or more accurately straightforwardly apply, the words of the statute. ... [T]he intentionalist approach and variations of it ... concedes that words only have meaning to the extent they reflect the intention of the user, and therefore, the judge's task is to determine the intention of the legislation in enacting the statute by reading the words in their context. Neither of these approaches is coherent.<sup>409</sup>

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<sup>409</sup> Brooks N, "Statutory interpretation as incremental policy-making: illustrated by reference to Canadian GST cases", paper presented at the conference "Interpreting the GST Law" (convened by the Taxation Law and Policy Research Institute of Monash University) 5 August 2005 (Coogee, Australia: 2005), p 8.

*Brooks's criticisms of the plain meaning approach*

Brooks justifies that summation, as to the plain meaning approach, as follows:

[The plain meaning approach] assumes that words have meanings independent of the intentions of the author. Wrong. By itself a word or even a sentence has no meaning whatsoever. Someone has to give it meaning and in ordinary discourse it is the intention of the speaker that gives a word or sentence meaning.<sup>410</sup>

... Judges in most jurisdictions recognize the exception to the plain meaning rule frequently referred to as the absurdity rule (the golden rule) and the exception for drafting ... errors. Both of these exceptions are justified by judges by reference to the presumed intent of the legislature: the legislature could not have intended to achieve an absurd result or an obvious drafting error. When judges determine that one of these exceptions applies, they freely re-write the legislation to conform to the legislature's presumed intention. Thus the exceptions would appear to be inconsistent with the plain meaning approach itself, which holds that the words have plain meanings and the legislature's intentions are irrelevant. If the courts are prepared to rely upon a presumed legislative intent in these instances, why not consider all evidence of legislative intent?<sup>411</sup>

*Brooks's criticisms of the intentionalist approach*

As to the intentionalist approach, Brooks justifies his summation as follows:

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<sup>410</sup> Above, note 409, p 8.

<sup>411</sup> Above, note 409, p 12.

Having argued that the meaning of words depend solely upon the intention of the author, and that the task of the interpreter is to determine that intent in giving meaning to words, one might suppose that I would now argue that in interpreting statutes judges should use all available and reliable means of determining the legislature's intention in using the contested words. Instead, of course, I am going to argue that there is no such thing as legislative intent and even if there were it would be impossible to verify; therefore, since interpretation is impossible, the task of a judge in applying a statute to a particular factual situation is to re-write the legislation to achieve the most sensible policy result.<sup>412</sup>

*Brooks's recommended (consequentialist) approach*

Brooks describes the approach to interpretation of legislative provisions that he advocates as follows:

... Words do not have plain meanings, and legislatures do not have discernible intentions. The larger point that follows from this conclusion is that a sensible theory of statutory interpretation cannot be based on semantic or epistemic grounds; it must be justified on political and institutional grounds.<sup>413</sup> ...

The political and institutional grounds upon which a theory of statutory construction must be justified might be contested; however, the following list of criteria would be acceptable to most analysts. The approach should be consistent with prevailing notions of democracy; the values underlying the rule of law such as the need for accessibility, certainty and predictability; and the relative institutional competence of legislatures

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<sup>412</sup> Above, note 409, pp 12 -13.

<sup>413</sup> Above, note 409, p 15.

and courts. In addition the approach should have beneficial effects on the legislative process, should be efficient, should lead to acceptable results, and should allow for the frank acknowledgement of the role of judges.<sup>414</sup> ...

The difference between what I am referring to as the consequentialist approach [which is the approach that Brooks advocates] and the purposive approach is only a matter of degree. Basically, under the consequentialist approach the judges' reasoning is less formal and deductive and judges are more candid about their law-making function. Instead of purporting to deduce their conclusion from the discovered purpose of the legislation, judges weigh the consequences of the application of the statute. Purposivists search through the legislative record to attempt to find explicit reference to the purposes and aims that the legislators had in mind; consequentialists are more likely to derive the purpose of the statute from the structure of the legislation and use information from the legislative record to assist in analysing the consequences of alternative interpretations. The consequentialist approach places much more emphasis on facts and policy analysis in judicial decision-making. In deciding cases, judges have to consider not only the broad purposes of the legislation, but also all of the factors that would be considered by a policy analyst in the Revenue department in formulating a rule to answer the adjudicated question: the ease with which the implicit rule can be administered; the consequences of the holding for the achievement of horizontal and vertical equity, the likely effect of the holding on individual incentives, the effect of the holding on the government's ability to raise revenue, and the effect of the rule on tax avoidance and evasion behaviour.<sup>415</sup> ...

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<sup>414</sup> Above, note 409, p 15.

<sup>415</sup> Above, note 409, p 17.

Brooks justifies as follows the superiority of the consequentialist approach to interpreting legislative provisions that he advocates, in relation to the evaluative criteria that he refers to in the second paragraph of the passages quoted just above:

### **Democratic legitimacy**

... Textualists argue that it is undemocratic for unelected judges to engage in law-making. ... [I]n fashioning the common law judges have developed most of the significant bodies of law that regulate modern market economies; yet no one has ever suggested that judicial decision-making in common law cases is somehow undemocratic.<sup>416</sup> ...

Many textualists view the legislative process through the lens of public choice theory. This theory sees politics not as an effort to carry out coherent public purposes but as a process rife with unprincipled compromises and deal making. ... Thus they argue that judges should interpret statutes strictly, by looking primarily at the text, in order to avoid upsetting the deals struck. There are two responses to this argument. First, as an empirical matter, most cases do not appear to involve interpreting statutes that have been the result of deal making or unprincipled compromises. ... Second, even if the details of some legislation reflects the political power of special interest groups or the failure of legislatures to agree on a more precise statement, as a normative matter,

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<sup>416</sup> Above, note 409, p 19.

legislation would be improved if judges interpret language whose application is debatable as designed to promote public purposes.<sup>417</sup> ...

**Consistency with values underlying the rule of law: Accessibility, predictability, and objectivity**

... First, it is naive to imagine that any lay person, or even any lawyer who is unfamiliar with the subject area of the law covered by a statute could read it and resolve tricky interpretive problems, no matter what approach to statutory interpretation is taken. Second, textualists' approaches leave room for a great deal of unpredictability. In my view, reasonable interpreters are much more likely to agree on the most appropriate consequences of alternative interpretations than they are on the plain meaning of the words in a provision.<sup>418</sup>

**Recognition of comparative institutional competence of legislatures and courts**

... In policy analysis it is widely agreed that those who are assigned the responsibility of implementing public policy have obvious advantages over the policy drafters in formulating the precise policy that should apply. First, they are able to consider the concrete consequences of the provision in the context of having to decide specific cases, in many instances these consequences might have been overlooked or could not have been foreseen by those drafting the policy. For this reason, it often makes sense for the legislative drafters to draft somewhat general provisions and allow judges to work out the matrix of rules that will be needed to fully implement the policy. Second, through the operation of the adversarial system, principles that lie beneath the surface

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<sup>417</sup> Above, note 409, pp 19 – 20.

<sup>418</sup> Above, note 409, p 20.

of the law or anomalies in the application of the law might be more likely brought to the attention of judges than to the attention of legislative policy makers. Third, in applying the policy to subsequent cases judges will be able to consider new social and legal circumstances.<sup>419</sup>

### **Effect on efficiency of adjudication**

... Textualists argue that issues of statutory interpretation can be resolved quicker with less effort using the plain meaning approach than a consequentialist approach. This is obviously an empirical question that might be difficult to resolve. ... Certainly, my general impression is that judgments written by judges applying a textualist approach seem to be as long and as involved as those written by judges who take a more consequentialist approach.<sup>420</sup> ...

### **Effect on the legislative process**

The approach judges take to the interpretation of statutes might have an effect on the style of legislative drafting and on the legislative process more generally. Some commentators have argued that these types of dynamic ex ante effects are important considerations in arriving at a conclusion about the most appropriate method of statutory interpretation.<sup>421</sup> ...

... Drafters face a number of incentives to draft carefully, and it would seem highly doubtful if an inappropriate judicial decision made many years after they had drafted

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<sup>419</sup> Above, note 409, pp 20 – 21.

<sup>420</sup> Above, note 409, p 21.

<sup>421</sup> Above, note 409, p 21.

the relevant legislation would weigh heavily in a rational calculation of the time and effort they put into their job. ... Moreover, to the extent that the court's approach to statutory interpretation might affect drafting styles, many commentators have hypothesized that the application of the plain meaning approach has the adverse effect on drafting of requiring drafters to draft legislation in mind-numbing, incomprehensible detail. Finally, most cases arise not because the policy makers were short-sighted or the actual legislation was not well-crafted but because so many problems on interpretation simply cannot be foreseen.<sup>422</sup> ...

Consequentialists also dispute the claim that a textualist approach will cause legislators to spend more time researching, deliberating and enacting updated statutory policies. The reality is that the legislative process is cumbersome and complex. The nature of the legislative process makes it very difficult to amend legislation, particularly when there are powerful interest groups aligned against change.<sup>423</sup> ...

### **Effect on the legal system**

... Since reaching the best result is the central focus of the judge's attention under consequentialist approaches, on this account it would appear to be clearly preferable to the plain meaning approach.<sup>424</sup> ...

It is a commonplace observation among tax commentators that a plain meaning approach fosters the attitude among taxpayers and advisors that tax laws and planning

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<sup>422</sup> Above, note 409, p 22.

<sup>423</sup> Above, note 409, p 22.

<sup>424</sup> Above, note 409, p 22.

are largely a game in which the clever, not necessarily those with the most just cause, are entitled to win.<sup>425</sup> ...

... The problem with formulistic approaches is that they do not permit statutes to evolve over time. A more sensible, consequentialist approach to statutory interpretation would allow judges to account for changing values and new circumstances in the application of the statute.<sup>426</sup> ...

### **Realistic expectations about the role of the judge**

... Even adherents of the plain meaning approach admit that there is nothing mechanical about deciding the plain meaning of words. It involves judgment and, therefore, discretion. However, the plain meaning approach leaves the judge's discretion unexamined and buries in his or her discretion. The consequentialist approach actually reduces judicial discretion by providing an explicit framework within which it must be exercised. Further, unlike textualist approaches, it does not allow them to conceal the choice they made, but requires the basis for the exercise of their discretion to be fully revealed.<sup>427</sup>

### *Conclusion on Brooks's criticisms*

To conclude on whether the justifications Brooks offers for the superiority of the consequentialist approach to interpreting legislative provisions that he advocates are tenable, one has to necessarily comprehensively survey all major schools of legal theory on the

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<sup>425</sup> Above, note 409, p 22.

<sup>426</sup> Above, note 409, p 23.

<sup>427</sup> Above, note 409, p 23.

approaches to interpreting legislative provisions. That survey (in chronological order) is undertaken immediately below.

### *Legal realists*

In the 1930s, a group of jurists, who later came to be regarded as the pioneers of the school of “legal realists”, launched a serious attack on the “plain meaning” approach to interpreting legislative provisions.<sup>428</sup> Their attack maintained that, as language can never be wholly unambiguous, an interpretation of legislative provisions strictly limited to the language employed in those legislative provisions can never result in the proper adjudication of specific cases.<sup>429</sup> To contend otherwise, the legal realists maintained, was specious, a contention which, they argued, merely allowed judges the scope to camouflage the true reasons that underlay judicial decisions.<sup>430</sup>

The legal realists also launched an equally serious attack on the “intentionalist” approach to interpreting legislative provisions.<sup>431</sup> Their attack maintained that it was wrong to perceive a unity of intention, when there was not, in a disparate group of individuals, who comprised the legislature, as being manifest in legislation enacted by that legislature.<sup>432</sup> Accordingly, even if there in fact was such a unity of intention, there were not reliable means (that the judiciary can resort to) for discovering what that intention was.<sup>433</sup> And, even if that intention was reliably discoverable by the judiciary, there was not, in the context of every specific case (whose relevant circumstances, more often than not, are not likely to have been anticipated by

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<sup>428</sup> Frickery PP, “From big sleep to the big heat: the revival of theory in statutory interpretation” (1992) 77 *Minnesota Law Review*, p 241.

<sup>429</sup> *Ibid.*

<sup>430</sup> Above, note 428.

<sup>431</sup> Radin M, “Statutory interpretation”, (1930) 43 *Harvard Law Review*, p 863.

<sup>432</sup> *Ibid.*

<sup>433</sup> Above, note 431.

the legislature as at the time of enacting legislation), the scope for the judiciary to properly conclude that that intention comprehends that case.<sup>434</sup>

One of the best-known legal realists, Karl Llewellyn, in a most effective attack on the “plain meaning” approach and “intentionalist” approach to interpreting legislative provisions maintained that the “canons of construction” historically employed by the judiciary under those approaches are self-contradictory, in that, for any one of those “canons”, one can identify another of those “canons” that has the opposite effect.<sup>435</sup> And, those approaches, therefore, in effect, do no more than offer a judge with a menu of rationalisations that can be employed by that judge to dispose of a case whichever way that judge thought fit (quite apart from any of the ostensible justifications of those approaches by the proponents of those approaches).<sup>436</sup>

Despite their serious attack on the “plain meaning” approach and the “intentionalist” approach, the legal realists failed to offer a coherent alternative to those approaches, an alternative which robustly addressed the shortcomings (as identified by the legal realists) of those approaches. Llewellyn, for instance, was able to offer, as an alternative, no more than a recommendation that legislation “must be read in the light of some assumed purpose”, so that judicial decision turned on “the sense of the situation as seen by the court”, where the judiciary “must strive to make sense as a whole out of our law as a whole”.<sup>437</sup>

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<sup>434</sup> Above, note 431.

<sup>435</sup> Llewellyn K, “Remarks on the theory of appellate decision and the rules or canons about how statutes are to be construed”, (1950) *Vanderbilt Law Review*, p 395.

<sup>436</sup> *Ibid.*

<sup>437</sup> Above, note 435, p 399.

*Legal process school*

The most substantial rebuttal to the legal realists emerged, in the 1950s, from a group of jurists who later came to be regarded as the “legal process school”. The best-known proponents of the legal process school were Henry Hart and Albert Sacks (both of the Harvard Law School), who advocated a purposive approach to interpreting legislative provisions, an approach which they justified as follows. The legislature comprises individuals who are reasonable, who therefore pursue the enacting of legislation for reasonable purposes.<sup>438</sup> The purpose of any legislation, therefore, is an essential part of the context of that legislation, a purpose which, accordingly, must be had regard to in giving meaning to that legislation, as that meaning depends upon the context of that legislation.<sup>439</sup> The judiciary should thus reach its verdict, in relation to any legislation, through “a process of reasoned elaboration”.<sup>440</sup>

The purposive approach to interpreting legislative provisions (as advocated by Hart and Sacks), which quickly gained widespread acceptance throughout countries which have a common law judicial system, has prevailed in those countries almost unchallenged since, so that it has now become entrenched in those countries as the received approach for interpreting legislative provisions.<sup>441</sup> That is exemplified by the two principles of significant import to interpreting (in Australia) legislative provisions applicable to a tax (such as the CGT), as represented by statements in passages quoted above from a paper presented by DG Hill, who was a serving justice of the Federal Court of Australia as at the time that paper was presented,

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<sup>438</sup> Hart HM & Sacks AM, *The Legal Process: The Basic Problems in the Making and Application in Law* (New York: Foundation Press, 1958), p 1,200.

<sup>439</sup> *Ibid.*

<sup>440</sup> Above, note 438.

<sup>441</sup> Brooks N, “The responsibility of judges in interpreting tax legislation”, in Cooper G S (ed) *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publication BV, 1997), p 93.

as those two principles are manifestations of that purposive approach to interpreting legislative provisions.

### *Public choice theorists*

In the late 1960s, that purposive approach to interpreting legislative provisions (as advocated by the legal process school) was attacked by a school which later came to be regarded as the “public choice theorists”.<sup>442</sup> The main focus of public choice theorists was the use of methodology grounded in economics to study political institutions.<sup>443</sup> Based on such studies, they argued that the true motive which actuates the enacting of legislation is not public interest, but (rather) the furtherance of personal interests of legislators (including the improvement of the prospects of re-election of those legislators).<sup>444</sup> The public choice theorists, accordingly, maintained that the assumption (crucial to a purposive approach to interpreting legislative provisions) that legislation represents purposive acts by the legislature enacting that legislation, acts which are motivated by the furtherance of public interest, was fallacious.<sup>445</sup>

### *Critical legal studies movement*

In the early 1970s, the purposive approach to interpreting legislative provisions (as advocated by the legal process school) was attacked also by a school which later came to be regarded as the “critical legal studies movement”.<sup>446</sup> The critical legal studies movement, which drew inspiration from post-modern discourses, essentially maintained that the perspective on

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<sup>442</sup> Id, p 113.

<sup>443</sup> Above, note 441, p 113.

<sup>444</sup> Above, note 441, p 113.

<sup>445</sup> Above, note 441, p 113.

<sup>446</sup> Above, note 441, p 113.

anything formed by any individual is inseparably conditioned by that individual's cultural, linguistic and experiential identity.<sup>447</sup> Therefore, the critical legal studies movement argued that, though the purposive approach to interpreting legislative provisions was asserted (by the legal process school) to be “neutral” in the interpretive outcomes that approach yielded, in reality, that assertion never comes to pass, as what comes to pass is an interpretive outcome based on the particular personal preferences of the judge responsible for that interpretation.<sup>448</sup> The interpretation by the judiciary of legislation, accordingly, maintained the critical legal studies movement, was not “neutral” but political, as political, in the event, as the enactment of that legislation by the legislature.<sup>449</sup>

*Richard Posner's “consequentialist” approach*

Two respected judges in the USA, Richard Posner and Frank Easterbrook, in the 1980s, published influential works which fortified as the proper approach to interpreting legislative provisions a purposive approach (albeit, a purposive approach not identical to that advocated by Hart and Sacks of the legal process school). Posner argued that a judge, in interpreting legislation, should give effect, as closely as possible, to the compromises (made by the legislature) which that legislation represents.<sup>450</sup> And, if the scope of those compromises is not evident, a judge should interpret that legislation by “imaginatively reconstructing” what the legislature would have incorporated in that legislation had the legislature been aware, as at the time of enacting that legislation, the case confronting that judge.<sup>451</sup>

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<sup>447</sup> Above, note 441, p 113.

<sup>448</sup> Above, note 441, p 113.

<sup>449</sup> Above, note 441, p 113.

<sup>450</sup> Posner RA, “Statutory interpretation—in the classroom and in the court”, (1983) 50 *University of Chicago Law Review*, p 800.

<sup>451</sup> *Ibid.*

Easterbrook argued that any legislation will rarely represent the position willed by the majority of the legislature enacting that legislation, due to circumstances such as “strategic voting”, “agenda manipulation”, and “cycling majorities”.<sup>452</sup> Easterbrook maintained, therefore, that legislatures may never have the intention to “imaginatively reconstruct”, as argued by Posner.<sup>453</sup> Accordingly, Easterbrook asserted that the only approach to interpreting legislative provisions is to adopt a “plain meaning” approach, as, under that approach, as a judge will not interpret legislation more expansively than what the text of that legislation unequivocally states, the legislature will be forced to enact legislation with clarity.<sup>454</sup> Easterbrook justified that assertion on the grounds that “a principle that statutes are in applicable unless they either plainly supply a rule of decision or delegate the power to create such a rule is consistent with the liberal principles underlying our political order”, which is that “most social relations would be governed by private agreements, customs, and understandings, not resolved in the halls of government”.<sup>455</sup> The variation of the purposive approach (essentially, a “plain meaning” approach) to interpreting legislative provisions thus advocated by Easterbrook is now largely referred to as “new textualism”, an approach which is vigorously espoused by the current USA Supreme Court justice Antonin Scalia.<sup>456</sup>

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<sup>452</sup> Easterbrook FH, “Statutes’ domains”, (1983) 50 *University of Chicago Law Review*, p 533.

<sup>453</sup> *Ibid.*

<sup>454</sup> Above, note 452.

<sup>455</sup> Above, note 452, p 549.

<sup>456</sup> Scalia A, “The rule of law as a law of rules”, (1989) 56 *University of Chicago Law Review*, p 1175.

*Liberal purposive approach*

Three authors—Reed Dickerson, Willard Hurst, and Guido Calabresi—published influential works which advocated a more liberal purposive approach to interpreting legislative provisions, in contrast to “new textualism”.

Dickerson, a leading legislative draftsman and legal academic in the USA, asserted, consistent with a purposive approach to interpreting legislative provisions, that a proper approach to interpret legislative provisions comprehends two distinct functions: a cognitive function, and a creative function.<sup>457</sup> That cognitive function involves the search for the true meaning of the legislative provision being interpreted, a meaning “carried by [the] language when it is read in its proper context by a typical member of the audience to which it is addressed”.<sup>458</sup> When such a meaning cannot be found by a judge that effectively addresses the case being adjudicated by that judge, that judge should then engage in the creative function, a function which strictly is not an “interpretative function” but (rather) is “law making”.<sup>459</sup>

Hurst, a well-known legal historian in the USA, advocated a liberal purposive approach to interpreting legislative provisions.<sup>460</sup> He advocated so on the grounds that the institutional attributes of legislatures were such that it was inherently impossible for legislatures to enact as legislation laws that were wholly coherent, primarily as legislatures felt impelled (only when political pressure is brought to bear) to address issues of policy piecemeal (that is, not comprehensively, but piecemeal).<sup>461</sup> Hurst reasoned that the institutional attributes of the judiciary, conversely, were dissimilar to those of the legislature, as the judiciary was not

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<sup>457</sup> Dickerson R, *The Interpretation and Application of Statutes* (Boston: Little Brown, 1975), p 71.

<sup>458</sup> *Id.*, p 286.

<sup>459</sup> Above, note 456, p 286.

<sup>460</sup> Hurst W, *Dealing with Statutes* (New York: Columbia University Press, 1982), p 52.

<sup>461</sup> *Ibid.*

subject to the same political pressure that the legislature is.<sup>462</sup> And, therefore, the judiciary was well placed, through its interpretation of legislation pursuant to a liberal purposive approach, to make legislation more coherent, thus compensating for corresponding inherent inability of the legislature to enact legislation that is wholly coherent.<sup>463</sup>

Calabresi advocated the view that the judiciary, through a liberal purposive approach to interpreting legislative provisions, judge legislation to be “obsolete” if the judiciary finds that legislation “out of phase with the legal framework”, as such legislation cannot assert a strong claim to contemporary majority support in the legislature.<sup>464</sup> Such an approach to interpreting legislative provisions, Calabresi concluded, will enhance the overall coherence of the “legal landscape”.<sup>465</sup>

#### *Ronald Dworkin’s “chain novel” approach*

The best-known, leading contemporary proponent of a liberal purposive approach to interpreting legislative provisions is Ronald Dworkin. Dworkin reasons that the judiciary and the legislature essentially act in conjunction in making law by legislation.<sup>466</sup> A judge, Dworkin asserts, must, accordingly, in interpreting legislation, ask: “What coherent system of political convictions would best justify what [the legislature] has done?”<sup>467</sup> A judge should, Dworkin reasons, therefore, find and adopt as the proper interpretation of any legislative provisions whose interpretation is in dispute an interpretation which is “the best justification

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<sup>462</sup> Above, note 460.

<sup>463</sup> Above, note 460.

<sup>464</sup> Calabresi G, *A Common Law for the Age of Statutes* (Cambridge, Massachusetts: Harvard University Press, 1982), p 164.

<sup>465</sup> *Ibid.*

<sup>466</sup> Dworkin R, *Law’s Empire* (Cambridge, Massachusetts: Belknap, 1986), p 313.

<sup>467</sup> *Id.*, p 335.

... of a past legislative action.”<sup>468</sup> Dworkin thus expresses the view that the judiciary and the legislature, analogically, are successive (institutional) co-authors of a chain novel.<sup>469</sup> Dworkin opines that, although deference to “textual integrity” requires the judiciary to have regard to the clear meaning of words used in a legislative provision being interpreted, the overriding duty of the judiciary is to ensure that any legislation is so interpreted that that legislation is consistent with coherent schemes of principle that comprehend all legislations and other laws, and that that legislation satisfies the higher-order democratic principles of political integrity, fairness, and procedural due process.<sup>470</sup>

In interpreting legislation, Dworkin argues, a judge must rely on that judge’s own judgment, but Dworkin does not argue so because that judge’s judgment is necessarily correct, but (rather) because “no one can properly answer any question except by relying at the deepest level on what he himself [or she herself] believes.”<sup>471</sup> Dworkin, however, emphatically concludes that, in interpreting any legislation, the duty of a judge is not to reach the best “substantive result”, but rather construct a result that best justifies that legislation.<sup>472</sup> That is, Dworkin explicitly disclaims a “consequentialist” approach to interpreting legislative provisions pursuant to which a judge may, in interpreting any legislation, choose the interpretation which that judge regards as yielding the “best substantive result”; what Dworkin, conversely, advocates is that such a judge should choose an interpretation that is “the best justification he can of a past legislative event”.<sup>473</sup>

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<sup>468</sup> Above, note 466, p 338.

<sup>469</sup> Above, note 466, p 342.

<sup>470</sup> Above, note 466, pp 164 – 167.

<sup>471</sup> Above, note 466, p 313 – 314.

<sup>472</sup> Above, note 466, p 313.

<sup>473</sup> Above, note 466, p 313.

Over the last decade, a group has emerged (which has now come to be regarded as the school of “new pragmatism”) that has advocated a “new pragmatism” in the interpretation of legislative provisions. The leading exponents of that group are William Eskridge, Daniel Farber, and Philip Frickey.<sup>474</sup> The “new pragmatists” essentially argue that all “foundational” approaches to interpreting legislative provisions—that is, those approaches that are premised on identifying a single legitimate source, such as the legislative text or legislative intent, to guide the interpretative task—must be abandoned, in favour of an approach that involves the employment of practical reasoning in interpreting legislative provisions. The following passage summarises well the approach generally advocated by the “new pragmatists”:

The positive metaphors of our analysis—the web of beliefs idea, the cable-versus-chain contrast, the hermeneutical circle—suggest the contours of a practical reasoning model of statutory interpretation that roughly captures the Court’s practice. Our model holds that an interpreter will look at a broad range of evidence—text, historical evidence, and the text’s evolution—and thus form a preliminary view of the statute. The interpreter then develops that preliminary view by testing various possible interpretations against the multiple criteria of fidelity to text, historical accuracy, and conformity to contemporary circumstances and values. Each criterion is relevant, yet none necessarily trumps the other. Thus while an apparently clear text, for example, will create insuperable doubts for a contrary interpretation if other evidence reinforces it ... an apparently clear test may yield if other considerations cut against it ...<sup>475</sup>

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<sup>474</sup> Eskridge WN, *Dynamic Statutory Interpretation* (Cambridge, Massachusetts: Harvard University Press, 1994), p12.

<sup>475</sup> Eskridge WN & Frickey PP, “Statutory interpretation as practical reasoning” (1990) 42 *Stanford Law Review*, p 352.

*Public policy approach*

Cass Sunstein has, not dissimilar to the “new pragmatists”, argued that the approach for interpreting legislative provisions should not turn on merely the text or the historical context of those provisions, but (rather) should defer to issues of public policy (as those issues emerge and evolve).<sup>476</sup> Sunstein, however, unlike the “new pragmatists”, postulated a systematic framework for such an approach (whereas, the “new pragmatists” stressed that their approach is essentially ad-hoc to each case calling for the adjudication of an interpretive issue with respect to legislation).<sup>477</sup> That framework of Sunstein was not based on linguistic concerns, but was (rather) based on substantive constitutional and institutional concerns (such as promoting public deliberation, and protecting traditionally disadvantaged groups), concerns that essentially represent dysfunctions of regulation (any one or a combination of excessive regulation, inadequate regulation, or absence of regulation).<sup>478</sup>

*Rationalising the major schools of legal theory on the approaches to interpreting legislative provisions with the summation of Brooks*

From the survey undertaken above, it will be evident that there does exist some good authority for the “consequentialist” approach to interpreting legislative provisions imposing tax (such as the CGT) that Brooks advocates. That authority is represented by the “consequentialist” approach to interpreting legislative provisions advocated by Posner, and the “practical reasoning” approach to interpreting legislative provisions advocated by the “new pragmatists”. Brooks has acknowledged the former, but repudiated the latter. Brooks has stated, in the following terms, his acknowledgement of the former:

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<sup>476</sup> Sunstein CR, “Interpreting statutes in the regulatory state” (1989) 103 *Harvard Law Review*, p 405.

<sup>477</sup> *Ibid.*

<sup>478</sup> Above, note 476.

... [T]he commentator on statutory interpretation who I have taken the most comfort from is Richard Posner, the Chief Judge of the US Court of Appeals for the Seventh Circuit, pioneer of the law and economics movement, and prolific author on almost every legal subject and many public policy issues, including statutory interpretation. He is the leading advocate of the view that consequences should matter to a theory legal interpretation. He has suggested that statutory interpretation might proceed by examining consequences alone: “Maybe the best thing to do when a statute is invoked is to examine the consequences of giving the invoker what he wants and then estimate whether those consequences will on the whole be good ones.”<sup>479</sup>

Brooks has stated, in the following terms, his repudiation of the “practical reasoning” approach to interpreting legislative provisions advocated by the “new pragmatists”:

... Although I suspect that most cases would be decided in the same way whether a judge purported to take a pragmatic or a consequentialist approach, the difficulty I have with the pragmatic approach is that it seems ad hoc. Pragmatists often assert that the responsibility of the judge is to reach an appropriate result. But appropriate in relation to what? How is the judge to weigh the individual factors in a particular case in determining whether the outcome is appropriate? Or to put it another way, what is the judge supposed to be pragmatic about? Usually, we have some overriding goal or objective and then seek pragmatic means to achieve it. What is the goal of statutory interpretation when the judge takes a pragmatic approach? If the goal is to achieve the best policy outcome, then there is no difference between the pragmatic and the consequentialist approaches. But if the goal is something else, and if there are circumstances under the pragmatic approach where the text or subjective legislative

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<sup>479</sup> Above, note 409, p 7.

intent can trump the best answer in terms of tax policy then what are those cases and why should the best result be sacrificed and for the achievement of what other goals? I have read a good deal of the literature on pragmatic interpretation, and I am not yet sure how the pragmatists answer questions such as these. One possible answer is that if the text is absolutely clear and the words to be applied have never borne the usage that a consequentialist approach would attribute to it then the text should prevail over an assessment of consequences. Or, similarly, if there is strong and reliable evidence of the subjective legislative intent then it should trump the preferred policy result. But if this is what is meant then since these circumstances seldom arise in practice there would appear to be little difference between the pragmatic and consequentialist approaches. However, given the significance that pragmatists attach to the consideration of all factors and the necessity of moving back and forth between them, I suspect they are thinking of something more profound.<sup>480</sup>

Without reference to Brooks's work or the survey (documented above) of all major schools of legal theory on the approaches to interpreting legislative provisions, those with authoritative expertise in Australian tax have concluded similar to Brooks's criticisms (as quoted above) on the prevailing approaches (in Australia) to interpreting legislative provisions. Thomas Reid (former Second Parliamentary Counsel, Commonwealth Office of Parliamentary Counsel), for instance, concludes:

The doctrine that statutory interpretation is about discerning the "intention of Parliament" seems to me rather artificial even when a question comes up which the

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<sup>480</sup> Above, note 409, p 18.

actual framers of a measure might be expected to have considered. It is pure fiction when one is trying to apply the law to a situation that no one could have foreseen.<sup>481</sup>

If the “consequentialist” approach to interpreting legislative provisions imposing tax (such as the CGT) that Brooks recommends is to become practicable, two obstacles—potentially, quite stubborn obstacles—will have to be surmounted:

- First, that “consequentialist” approach must, most preferably, be an approach that applies to interpreting all legislative provisions, not only legislative provisions imposing tax, as otherwise that approach may, as a reform proposal, lack the breadth of relevance required to command the attention (and, therefore, support) of the legal community at large (the practitioner community, the judicial community, as well as the academic community).
- Second, that “consequentialist” approach has to displace a very firmly, and widely, entrenched preference on the part of the Australian judiciary for adopting a purposive (essentially, an “intentionalist”) approach to interpreting legislative provisions.

Whilst both of those obstacles will have to be surmounted for the “consequentialist” approach to interpreting legislative provisions imposing tax (such as CGT) that Brooks recommends to become practicable, one can, at an abstract level, conceive, especially with respect to the second of those obstacles, that the Australian judiciary can be required to heed such a “consequentialist” approach through explicit legislative directives (analogous to, say, sections

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<sup>481</sup> Reid T, “Tax law based on coherent principles: for it to work, what do the designers and interpreters need to do differently”, *paper presented at the conference “Interpreting the GST law” (convened by the Taxation Law and Policy Research Institute of Monash University) 5 August 2005 (Coogee, Australia: 2005), p 2.*

15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*, quoted above) but with the application of those legislative directives limited to laws imposing income tax (which comprehends CGT). And, if the Australian judiciary so heeds (because it is required to, or otherwise), the other segments of the legal community (certainly, the practitioner community, and, perhaps to a somewhat lesser extent, the academic community) will necessarily follow suit.

The Australian judiciary is unlikely to heed those criticisms by Brooks (and adopt a consequentialist approach to interpreting legislative provisions, as Brooks advocates), absent explicit legislative directives that it should, as the Australian judiciary's entrenched position seems to be that it is necessarily required to observe the two principles quoted above (from a paper presented by G Hill, who was a serving justice of the Federal Court of Australia as at the time that paper was presented), which are:

- “[T]he task of a judge in interpreting any statute is to endeavour to ascertain the meaning of the words used.”<sup>482</sup>
- “[I]t is accepted that judicial decision making should not proceed by reference to judicial conscience or political philosophy but principled decision.”<sup>483</sup>

Brooks's criticisms (quoted above) make a sustainable case for regarding the first of those principles as not being valid, and modify the second of those principles so as to provide a basis for “principled decision” by the judiciary which properly incorporates (amongst others) aspects of “conscience” and “political philosophy” of the judiciary.

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<sup>482</sup> Above, note 400.

<sup>483</sup> Above, note 402.

Criticisms of status quo by Mark Burton*Burton's summation*

In 1999, Mark Burton, in a doctoral thesis,<sup>484</sup> essentially addressed the following question:

Formal accounts (as presently understood), both in descriptive terms and in normative terms, of how the British and the Australian courts interpreted tax legislation (from the inception to the present) are to the effect that such interpretation involved an application of determinate law in accordance with the literal meaning of the language of legislative provisions or the intention of legislature enacting legislative provisions. Are those formal accounts accurate?

Burton concluded that that question should be answered in the negative. He concluded so as the interpretation of tax legislation has, in Britain and in Australia, from the inception up to now, been “indelibly stamped with judicial pragmatism”.<sup>485</sup>

*Analytical approach adopted by Burton*

Burton reached that conclusion through an analysis of the following four case studies:

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<sup>484</sup> Burton M A, “The interpretation of tax legislation in Great Britain and Australia – a study of the indeterminacy of law”, a doctoral thesis submitted to Australian National University (July 1999), a thesis which is unpublished, but a copy of which I have obtained.

<sup>485</sup> Id, p 331.

Case study 1

- The window tax in Britain (in the eighteenth century)<sup>486</sup>

Case study 2

- The interpretation of the expression “income”, in the context of the income tax, in Britain (in the nineteenth century)<sup>487</sup>

Case study 3

- The requirement for companies to make a “sufficient distribution”, in the context of income taxation of companies and shareholders in Australia (prior to 1987)<sup>488</sup>

Case study 4

- The general anti-avoidance provisions in the context of income tax in Australia (from the 1980s to the present)<sup>489</sup>

*Case study 1*

With respect to case study 1, Burton concluded that, in the seventeenth century, there were constitutional conflicts in Britain, and “the English psyche ... [was] deeply imbued with a

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<sup>486</sup> Above, note 484, p 80.

<sup>487</sup> Above, note 484, p 137.

<sup>488</sup> Above, note 484, p 214.

<sup>489</sup> Above, note 484, p 261.

rights rhetoric.”<sup>490</sup> But, despite that, “the apparent contradiction between individual and state was resolved by accepting that in some cases individual rights might have to be compromised in order to assure the existence of what was understandably perceived at the time to be a fragile political order.”<sup>491</sup>

### *Case study 2*

With respect to case study 2, Burton concluded that, during the period 1875 to 1900, “the interpretation of income tax was founded upon anything but a mechanical application of the literal meaning of the legislation ... [as exemplified by the] several differing conceptions of income used in differing contexts” during that period.<sup>492</sup> However, despite that, “the strict construction rule” is accepted by a significant number of contemporary commentators as the “interpretive methodology” that was prevalent during that period.<sup>493</sup> That acceptance is likely due to the following reasons:

- Given “the significance to the Victorian mind of modern science as the source of solutions to all sorts of social and physical problems, ... the courts and lawyers had developed the objectivist theory of law in analogising law to science.”<sup>494</sup> That is, “the law was ‘out there’ awaiting discovery by the application of appropriate legal scientific method.”<sup>495</sup>

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<sup>490</sup> Above, note 484, p 80.

<sup>491</sup> Above, note 484, p 79.

<sup>492</sup> Above, note 484, p 137.

<sup>493</sup> Above, note 484, p 139.

<sup>494</sup> Above, note 484, p 140.

<sup>495</sup> Above, note 484, p 140.

- The greater acceptance of the rhetoric (sponsored by John Stuart Mill) of equal sacrifice (relative to the benefit theory of taxation) meant that “taxes were no longer seen in terms of a purchase of a social good (ie the survival of the liberal political order) but rather were perceived as confiscatory.”<sup>496</sup> This “was considered to require a reconfiguration of the judicial role in terms of the protectors of individual rights from encroachment by the executive arm of government.”<sup>497</sup>
- “The ‘rule of law’ seemed to emphasise the importance of the courts in protecting the rights of individuals to retain private property from the grasp of the state, presumably on the assumption that private property was more productive than public expenditure.”<sup>498</sup>
- “The rhetoric of respect for the democratically based sovereign power of parliament was ... another vital element in contemporary portrayals of the law applying, as opposed to law creating, function of the courts.”<sup>499</sup>

### *Case study 3*

With respect to case study 3, Burton concluded that the “repeated judicial references to the methodology of literalism”, in the context of interpreting the “sufficient distribution” requirement, is not correct as, “in each case the interpretation ultimately adopted by the courts

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<sup>496</sup> Above, note 484, pp 142 – 143.

<sup>497</sup> Above, note 484, p 144.

<sup>498</sup> Above, note 484, p 144.

<sup>499</sup> Above, note 484, p 144.

was merely one of several quite plausible interpretations, rather than the one ‘right’ interpretation.”<sup>500</sup>

Also, even if the “repeated judicial references to the methodology of literalism” are taken to be descriptively correct, in the adherence to that methodology, the “courts variously purported to adopt a literal construction, a purposive construction, a business or commercial understanding of the statutory terms and at other times a technical reading of relevant provisions.”<sup>501</sup>

The reasons why the Australian judiciary’s portrayal of its “methodology of literalism” was generally accepted by the Australian judiciary as well as by others are the same as those applicable to case study 2.<sup>502</sup>

#### *Case study 4*

With respect to case study 4, Burton concluded that, from the beginning of the 1980s to the present, it is “commonly accepted that there had been a fundamental shift in the methodology of statutory interpretation in favour of the discovery and application of legislative intention.”<sup>503</sup> However, there has “been pervasive reluctance on the part of the judiciary to overtly contemplate the legislative purpose in weighing competing interpretations of” the general (income tax) anti-avoidance legislative provisions.<sup>504</sup> The most plausible explanation

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<sup>500</sup> Above, note 484, p 214.

<sup>501</sup> Above, note 484, p 214.

<sup>502</sup> Above, note 484, p 215.

<sup>503</sup> Above, note 484, p 261.

<sup>504</sup> Above, note 484, p 263.

of that reluctance is that “express recourse to the legislative intention is perceived to be an admission of legal pluralism which is anathema to the determinacy thesis.”<sup>505</sup>

*Burton’s recommended approach*

Based on those four case studies, overall, Burton concluded that, “by accepting that all knowledge is ‘grounded’ in some social context, contemporary determinacy theorists have conceded that all knowledge is to some extent pragmatic.”<sup>506</sup> If that pragmatism is to be accepted by liberal legal theorists, their attempts to theorise legal determinacy is disturbed.<sup>507</sup> The acceptance (as a matter of legal theory) of a pragmatic (pluralist) approach to statutory interpretation may prove impossible due to the “political” effects (that is, the perceived infringement of the rule of law)<sup>508</sup> as well as “anarchic” effects<sup>509</sup> of such an approach. Accordingly, “nothing can be done but acquiesce in the status quo.”<sup>510</sup>

*Conclusion on Burton’s criticisms*

As noted above, the Australian judiciary’s entrenched position seems to be that it is necessarily required to observe the two principles quoted above (from a paper presented by G Hill, who was a serving justice of the Federal Court of Australia as at the time that paper was presented).<sup>511</sup>

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<sup>505</sup> Above, note 484, p 264.

<sup>506</sup> Above, note 484, p 327.

<sup>507</sup> Above, note 484, p 327.

<sup>508</sup> Above, note 484, p 328.

<sup>509</sup> Above, note 484, p 328.

<sup>510</sup> Above, note 484, p 329.

<sup>511</sup> Above, note 400.

Burton's criticisms (quoted above) do not refute the validity of both of those principles,<sup>512</sup> but rather essentially conclude that the adherence by the Australian judiciary to the first of those principles is more rhetorical than real. With respect to the second of those principles, Burton's criticisms are essentially to the effect that "nothing can be done but acquiesce in the status quo."<sup>513</sup> The overall essence of Burton's criticisms, therefore, is not dissimilar to that of the "legal realists" (as canvassed above).

Brooks's criticisms, conversely, essentially make a sustainable case for regarding the first of those principles as not being valid, and modify the second of those principles so as to provide a basis for "principled decision" by the judiciary which properly incorporates (amongst others) aspects of "conscience" and "political philosophy" of the judiciary.

Burton's recommendation—which is to accept the status quo, where the Australian judiciary adopts what Burton describes as a "pragmatic" approach to the interpretation of legislative provisions—was essentially anticipated and countered by Brooks, in terms quoted above, to the effect that that approach was inadequate, as it was too "ad hoc".

The essential difference between the criticisms of respectively Brooks and Burton, accordingly, is that Burton (unlike Brooks) does not venture to recommend a change to the status quo (as to the interpretation by the Australian judiciary of legislative provisions imposing a tax, such as the CGT), as Burton does not consider such a recommendation to be practicable. The two obstacles—which are, potentially, quite stubborn obstacles—that will have to be surmounted for the recommendation by Brooks (for the adoption of a consequentialist approach by the Australian judiciary to the interpretation of legislative

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<sup>512</sup> Above, note 402.

<sup>513</sup> Above, note 510.

provisions imposing a tax, such as the CGT) to become practicable have been canvassed above.

**What is the Commissioner's current approach to the interpretation of legislative provisions imposing CGT?**

Status quo

The Commissioner has not issued any formal pronouncements as such as to how the Australian Taxation Office approaches the interpretation of legislative provisions imposing any tax (such as the CGT) that the Commissioner administers. That is so perhaps as to what the Commissioner's approach to the interpretation of legislative provisions should be is self-evident, given that all taxes the Commissioner administers are necessarily imposed by legislative provisions, and any dispute as to the interpretation by the Commissioner of those legislative provisions is appealable by any affected taxpayer to the Australian judiciary. It therefore follows that the Commissioner should adopt the same approach that the Australian judiciary adopts to the interpretation of legislative provisions imposing taxes (such as the CGT) that the Commissioner administers, though in practice often the Commissioner does not adopt such an approach (as will be evident from some of the 15 case studies analysed in Chapter 6).

Changes to the status quo recommended by the Commissioner

The most authoritative (albeit, not formal) description of the Commissioner's preferred approach to the interpretation of legislative provisions imposing taxes (such as the CGT) that

the Commissioner administers is a work<sup>514</sup> published by the current Commissioner Michael D'Ascenzo (who at the time of that publication was Second Commissioner). In that work, D'Ascenzo argued:

... it is a proper judicial function to seek to develop a coherent body of law that reflects the underlying policy of relevant legislative provisions, and that such an approach is consistent with the separation of executive, legislative and judicial powers.<sup>515</sup> ...

D'Ascenzo reasoned that argument as follows:

... Resignment to the proposition that effective implementation of the tax law is possible only with an all-knowing and infallible legislator (which does not exist in reality), ... is likely to lead to a sub-optimal, and in some cases dysfunctional operation of the community's tax laws.<sup>516</sup>

The goal should of course be well developed and principle based legislation providing greater integrity, simplicity and certainty. ... However, this has to be supported by a coherent and rational application of the law. The tax administration bears a heavy responsibility in this regard. There is also much to be said for the view that “[j]udges, as final arbiters in the implementation process, should thus assume responsibility for ensuring that legislation is as coherent as possible.”<sup>517</sup> ...

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<sup>514</sup> D'Ascenzo M, “Along the road to Damascus: a framework for interpreting tax law”, (2000) 6 *Journal of Australian Taxation* , p 384.

<sup>515</sup> Above, note 514, p 384.

<sup>516</sup> Above, note 514, p 385.

<sup>517</sup> Above, note 514, p 385.

... Accordingly, the words in an Act should be interpreted in the light of the legislative purpose ascertained having regard to the context in its widest sense so as to prefer a competing interpretation which is more in accord with logic and policy.<sup>518</sup> ...

It has been said that under “s 15AA [of the *Acts Interpretation Act 1901 (Cth)*] a court may consider the purpose and object of [a] statute in order to determine whether there is more than one construction. But if there is only one possible construction, then it is the construction that must be given to the statute.” ... However, while caution is required, ... even in such a case there may still be scope for departure from the words, either by ignoring the words in the statute or by reading into the statute words which are not there.<sup>519</sup> ...

D’Ascenzo’s statements quoted above do not represent the Commissioner’s current approach to interpreting legislative provisions imposing taxes (such as the CGT) that the Commissioner administers. Rather, those statements represent the Commissioner’s preferred approach to interpreting legislative provisions imposing taxes (such as the CGT) that the Commissioner administers. Accordingly, those statements represent an exhortation (by D’Ascenzo, on behalf of the Commissioner) to the Australian judiciary to modify its current approach to interpreting legislative provisions imposing taxes (an approach which the Commissioner is necessarily obliged to adopt) so as to adopt an approach to interpreting legislative provisions imposing taxes that “accord[s] with logic and policy”<sup>520</sup>, which, “while caution is required, ... [allow] scope for departure from the words, either by ignoring the words in the statute or by reading

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<sup>518</sup> Above, note 514, p 389.

<sup>519</sup> Above, note 514, p 389.

<sup>520</sup> Above, note 518.

into the statute words which are not there”<sup>521</sup> (such that the Commissioner can then, as well, adopt the same approach).

That exhortation to the Australian judiciary by D’Ascenzo (on the Commissioner’s behalf) is not essentially dissimilar to the recommendation by Brooks (as noted above) that the judiciary should adopt a “consequentialist” approach to interpreting legislative provisions imposing taxes.

**How should the four reasons that could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity be addressed?**

The four reasons (and no other) that could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity (as identified earlier in this chapter) should be addressed as follows, so that the potential for the CGT regime producing outcomes that fail to satisfy horizontal equity is reduced.

How should Reason A be addressed?

The approach to addressing Reason A comprises two points:

- If it is not practicable that the relevant legislative provisions can be re-written so as to ensure that the best interpretation (pursuant to a consequentialist approach) of those legislative provisions does not result in outcomes that violate horizontal equity, an interpretation should be adopted of those legislative provisions (pursuant to a consequentialist approach) that does not result in such outcomes. That should be so

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<sup>521</sup> Above, note 519.

despite that interpretation not being consistent with the best interpretation of those legislative provisions, pursuant to the current approach of the Australian judiciary.

- Otherwise, the relevant legislative provisions should be re-written so as to ensure that their best interpretation (pursuant to a consequentialist approach) does not result in outcomes that violate horizontal equity.

In order to ensure that the approach outlined in the first point prevails, explicit legislative directives to the Australian judiciary (analogous to, say, sections 15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*) should be enacted, reflecting the substance of the following terms:

Legislative provisions imposing income tax on capital gains should be interpreted in such manner that taxpayers in a similar economic situation are subject to income tax similarly. Such an interpretation is to be adopted, even if the terms of those legislative provisions are capable of being interpreted differently, or even if there is authority by way of decisions of the Australian judiciary (delivered in relation to cases heard by the Australian judiciary before the enactment of this provision) that those legislative provisions should be interpreted differently. Such an interpretation is not to be adopted only if it is clearly discernible that those legislative provisions ought to satisfy a policy objective that is not consistent with taxpayers in a similar economic situation being subject to income tax similarly, and that that policy objective ought to be given precedence over ensuring that taxpayers in a similar economic situation are subject to income tax similarly.

In order to ensure that the approach outlined in the second point prevails, legislative provisions should be drafted reflecting the following considerations:

Instead of trying to “micromanage” application of the law in practice, the Parliament should enact principles that clearly reflect the policy outcome it intends, and that create a framework within which that outcome can be achieved through a process we call “unfolding” the principles.<sup>522</sup>

... [I]f the law expresses principles, these can be used to resolve an unforeseen question, even if they do not produce a unique or obvious answer. It is the principles, not the specific outcome, that can be meaningfully be said to manifest the Parliament’s intention.<sup>523</sup>

From this point of view, it is the role of the Treasury, in advising the Government on tax policy, and preparing drafting instructions for a tax measure:

- first, to develop workable policy based on sound principles
- second, to articulate the intended policy outcome for the measure, and the policy means for achieving it, well enough so that Parliamentary Counsel can frame the draft legislation as operative principles giving effect to the policy outcome and means

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<sup>522</sup> Above, note 481, p 2.

<sup>523</sup> Above, note 481, p 2.

- thirdly, to consider what unfolding the legislative principles may need in practice, and to decide what form it should take.<sup>524</sup>

To make coherent principles work in practice, we need more of an interdisciplinary approach, and to encourage participants in the tax policy, legislation, and administration process to leave the shelter of their silos and see things from others' point of view.<sup>525</sup>

I don't mean that policy makers, drafters, administrators and judges all have to think the same way, but they need to understand each other's methods of working within their respective spheres, and to reconcile these methods so as to produce workable outcomes. Obviously, mutual understanding of methods is a desirable goal in itself. It is particularly important for principle-based law ...<sup>526</sup>

In addition to the considerations represented by the passages quoted just above, in order to ensure that the approach outlined in the second point prevails, there must be legislatively-mandated post-implementation reviews of legislative provisions imposing CGT. Those post-implementation reviews are necessary:

- so as to establish whether those legislative provisions, in their actual operation, have achieved the policy objectives (including horizontal equity) that those legislative provisions were designed to achieve;

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<sup>524</sup> Above, note 481, pp 2 – 3.

<sup>525</sup> Above, note 481, p 11.

<sup>526</sup> Above, note 481, p 11.

- and, where they have not, to remedy that failure through re-written legislative provisions.

The position that currently pertains in Australia as to such post-implementation reviews (which are not legislatively-mandated) has been authoritatively described as follows:

... [D]esign is an iterative process. It is important to learn by experience and to use that knowledge to refine administrative processes and/or advise Treasury of possible improvements to the system in operation. Accordingly, the methodology used by the ATO [that is, the Australian Taxation Office] to implement a measure includes process reviews and requires a post implementation review.<sup>527</sup>

In addition, the PIF [that is, the Policy Implementation Forum, which is high level committee within the Australian Taxation Office] selects a small number of projects for more detailed post implementation reviews (independent of any reviews undertaken by the project team). ... In selecting measures for review, ... [the Australian Taxation Office] take account of what others are doing – the Board of Taxation ..., the Treasury, the Cabinet Implementation Unit in the Department of Prime Minister and Cabinet, other agencies, [the Australian National Audit Office] and other review bodies such as the Inspector-General of Taxation and the Commonwealth Ombudsman.<sup>528</sup>

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<sup>527</sup> D'Ascenzo M, "Designing the delivery of legislative measures", *paper presented at the International Quality and Productivity Conference* (17 May 2004), (Canberra: 2004), p 6.

<sup>528</sup> *Id.*, p 6.

In contrast, the position that currently pertains in New Zealand as to post-implementation reviews (which are mandated administratively, but not legislatively) has been authoritatively described as follows:

The second feature for present purposes is the systematic review of legislation and the identification of remedial measures. It is budgeted for and carried out as part of the work program [which is a “rolling three-year work program”, undertaken by the Inland Revenue Department of New Zealand].<sup>529</sup>

Even under the approach outlined in the second point, as a back-stop, explicit legislative directives such as that described above in relation to the approach outlined in the first point (analogous to, say, sections 15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*) should be enacted.

#### How should Reason B be addressed?

The enactment (under the approach outlined in the first point, in addressing Reason A) of explicit legislative directives to the Australian judiciary (analogous to, say, sections 15AA and 15AB of the *Acts Interpretation Act 1901 (Cth)*) will effectively address Reason B. That is so as, even if lower-level Australian judiciary (for whatever reason) does not heed those legislative directives in reaching a decision, that decision will (properly) be displaced (on the authority of those legislative directives) by an appellate Australian judiciary (ultimately the High Court of Australia) on that decision being appealed.

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<sup>529</sup> Richardson I L M, “Reducing tax avoidance by changing structures, processes and drafting””, in Cooper G S (ed) *Tax Avoidance And The Rule Of Law* (Amsterdam: IBFD Publication BV, 1997), p 336.

How should Reason C be addressed?

Reason C should be addressed by enacting explicit legislative directives essentially precluding the Commissioner from issuing rulings (or any like pronouncements) which are inconsistent with judicial authority. That is, the only recourse that the Commissioner should be allowed to address the Commissioner's disagreement with a decision of the Australian judiciary is to appeal against that decision. The Commissioner's unexceptionable compliance with those legislative directives should be ensured through pointed, continuous reviews by the Australian National Audit Office.

How should Reason D be addressed?

The approach pursuant to which Reason C should be addressed (as described above) will address Reason D as well.

**Conclusion**

This chapter addressed the question of what reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy the policy objective of horizontal equity. That question was answered in this chapter through arguing that only any one of four reasons can (in theory) cause the CGT regime to potentially produce outcomes that violate horizontal equity. Those four reasons were described in this chapter, followed by a formulation of why those reasons can be effectively addressed through a consequentialist approach to interpreting legislative provisions imposing CGT, buttressed by legislative directives to the Australian judiciary and other means necessary for making such an approach practicable.

## **Chapter 6: What reasons in practice cause the CGT regime to produce outcomes that violate horizontal equity?**

### **Overview of scope of this chapter**

Fifteen case studies are analysed in this chapter. Each of those case studies represents a situation that can potentially be encountered in real life, resulting in outcomes (caused by the CGT regime) that violate horizontal equity. Those case studies also exemplify that only the four reasons (and no other) identified in the previous chapter could cause the CGT regime to produce outcomes that violate horizontal equity.

Outcomes that violate horizontal equity, which are potentially caused by the CGT regime, can be grouped into the following three categories:

- Situations which result in an incidence of tax either greater or less than that placed on other taxpayers in a like economic situation
- Situations which result in an incidence of tax greater than that placed on other taxpayers in a like economic situation
- Situations which result in an incidence of tax less than that placed on other taxpayers in a like economic situation

The analysis of case studies in this chapter is based on an approach to statutory interpretation that accords with that currently adopted by the Commissioner (as canvassed in Chapter 5). That approach, therefore, does not accord with the “consequentialist” approach to interpreting

legislative provisions imposing taxes, which this thesis has argued as the approach that must be adopted.

**Situations which result in an incidence of tax either greater or less than that placed on other taxpayers in a like economic situation**

Case study 1: Is Australian currency property?

Case study 1 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed either greater or less, by reason of Australian currency owned by a taxpayer not constituting “property” in the context of the CGT regime. A taxpayer will be taxed relatively either greater or less in the context of determining whether the maximum net asset value test is passed to become eligible to access small business CGT relief. A taxpayer will be taxed relatively either greater or less in the context of determining whether the tests prescribed in section 115 – 45 are passed to become eligible for the CGT discount. A taxpayer will be taxed relatively either greater or less also in the context of determining whether CGT event K6 is attracted to a capital gain made on the sale of shares in a company or interests in a trust. (CGT event K6 is engaged essentially if two conditions apply. First, the shares in a company or interests in a trust were acquired before 20 September 1985. Second, a prescribed proportion of the property of the company or trust, as at the time of the sale of shares in the company or interests in the trust, was acquired after 20 September 1985.)

The expression “Australian currency” is used in this case study to mean Australian currency physically in the possession of a taxpayer, and therefore does not include Australian currency held in a bank account of a taxpayer.

The expression “CGT asset” is defined in section 108 –5 as “...any kind of *property*; or...a legal or equitable right that is not property.” [Emphasis added.]

The expression “property” used in the definition of the expression “CGT asset” is not defined, and accordingly has its meaning at common law. The establishment of the meaning of the expression “property” at common law requires reference to the literal meaning of that expression.

*The Macquarie Dictionary*<sup>530</sup> defines the expression “property” as “...that which one owns; the possession or possessions of a particular owner”.

The question of whether or not Australian currency is a CGT asset has pointed practical relevance in two situations:

- In order to become eligible to access small business CGT relief, one has to determine whether the maximum net asset value test (as prescribed in section 152 – 15 a)) is passed. In that determination, one has to conclude whether to include (as part of the CGT assets) Australian currency of the taxpayer (and generally certain entities connected or affiliated with the taxpayer).
- In order to become eligible for the CGT discount with respect to a capital gain made on the sale of certain shares in a company or interests in a trust, one has to determine whether the tests prescribed in section 115 – 45 are passed. In that determination, one has to conclude whether to include Australian currency of the company or the trust

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<sup>530</sup> *The Macquarie Dictionary*: Third Edition (Sydney: The Macquarie Library Pty Ltd, 1998), p 1711.

(whose shares or interests respectively have been sold by the taxpayer) as CGT assets of such company or trust.

A third situation of practical relevance is in the context of determining whether CGT event K6 is engaged. In that situation, the question of whether or not Australian currency is “property” (not a CGT asset, but property) becomes moot, where Australian currency is held by a company or trust as at the time shares in such company or interests in such trust are sold. That would be so where the capital gain resulting from such sale may potentially attract CGT event K6. For CGT event K6 to potentially apply essentially two conditions must apply. First, the shares in the company or interests in the trust (which are sold) must have been acquired before 20 September 1985. Second, a prescribed proportion of the property of the company or the trust, as the time of sale of shares or interests in the trust, must have been acquired after 20 September 1985.

If section 108 – 5 were to be considered in isolation, Australian currency owned by an entity would constitute a CGT asset of that entity. That would be so as Australian currency would (in accordance with the literal meaning of the expression “property” in terms of *The Macquarie Dictionary*, as referred to above) constitute property of that entity.

However, a purposive interpretation (as currently adopted by the Australian judiciary) of the definition of the expression “CGT asset” would lead to the conclusion (for the reasons outlined below) that that expression does not comprehend Australian currency.

Section 109 – 5 contains the rules relevant to determining when a CGT asset is deemed to be acquired by its owner. Section 109 – 5 provides, in the context of CGT event A1, that the owner acquires the CGT asset “when the disposal contract is entered into, or, if none, when

the entity [that is, the entity disposing of the CGT asset] stops being the [CGT] asset's owner". The CGT event that will generally apply for the acquisition of Australian currency (if it were a CGT asset) by its owner is CGT event A1.

In the great majority of cases, there will be no contracts as such pursuant to which Australian currency is disposed of by one entity to another. And, in those cases, establishing in practice as to when the disposal of Australian currency from one entity to another occurred would be virtually impossible as no records will exist to enable such establishment. This would be so because no entity generally maintains records of the dates on which specific quantities of Australian currency (with each unit of quantity bearing a unique identity) are acquired or disposed of.

Section 104 – 10 contains the rules relevant to determining when a CGT asset is disposed of in the context of CGT event A1, which is the CGT event pursuant to which Australian currency (if it were a CGT asset) will generally be disposed of by its owner. Section 104 – 10 provides that the owner of the CGT asset disposes of it “when [such owner] enters into a contract for the disposal; or...if there is no contract—when the change of ownership occurs”.

It will be impossible in practice to establish the date on which (for purposes of section 104 – 10) a change of ownership of (specific quantities of) Australian currency (with each unit of quantity bearing a unique identity) from one entity to another occurs. That is so for the same reasons explained above (with respect to section 109 – 5) in the context of determining as to when Australian currency is acquired by its owner.

Australian currency is not a CGT asset (for the reasons explained above), and therefore the disposal of Australian currency does not result in a capital gain or a capital loss. Also (for the

reasons explained below), Australian currency does not constitute “property” in the context of CGT event K6. Accordingly, Division 121 (which prescribes the record keeping requirements relevant to the CGT regime) cannot mandate the maintenance by taxpayers of records of the dates on which specific quantities of Australian currency (with each unit of quantity bearing a unique identity) are acquired or disposed of.

Section 109 – 5, section 104 – 10 and Division 121 (all of which as referred to above) together represent the relevant legislative context for purposively interpreting whether the expression “property” used in the definition of the expression “CGT asset” in section 108 – 5 was intended by the legislature to comprehend Australian currency. As explained above, an analysis of section 109 – 5, section 104 – 10 and Division 121 leads to a purposive interpretation that the expression “property” used in the definition of the expression “CGT asset” in section 108 – 5 does not comprehend Australian currency. And there are no other legislative provisions or extrinsic material, which could potentially also form part of the relevant legislative context, that displace or even impugn such an interpretation.

Note 1 to section 108 – 5 gives “foreign currency” as an example of a CGT asset. That explicit reference to foreign currency as an example of a CGT asset removes uncertainty as to whether foreign currency is a CGT asset. That explicit reference, due to the absence of a similar reference to Australian currency in note 1 to section 108 – 5, is consistent with the purposive interpretation noted above that Australian currency is not a CGT asset.

Hill J, as the single judge forming the minority in *FCT v Cooling*,<sup>531</sup> concluded (at p 4488): “...it would seem Australian currency may not be an asset as defined.” This conclusion of Hill J has not, since it was expressed, been contradicted or qualified by any Australian court.

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<sup>531</sup> *FCT v Cooling* (1990) 90 ATC 4472.

Hill J's judgment does not record an analysis that led to this conclusion. Accordingly, whether Hill J's respective analysis (unrecorded in his judgment) was the same as that explained above is open to conjecture. Nevertheless, the fact that Hill J's respective conclusion is consistent with the purposive interpretation noted above that Australian currency is not a CGT asset is significant.

The Commissioner has issued two rulings which bear on the position noted above: IT 2584 and TD 2002/25.

In ruling IT 2584, at paragraph 9, the Commissioner opines:

In the case of the disposal of money winnings, no capital gain or capital loss will normally accrue because the consideration in respect of the disposal is the same as the deemed consideration in respect of the acquisition of the money.

The Commissioner's opinion in ruling IT 2584 (as quoted just above) accordingly essentially is to the effect that Australian currency is a CGT asset. For the reasons explained earlier, this opinion of the Commissioner may be incorrect.

In ruling TD 2002/25, at paragraph 1, the Commissioner opines:

...Australian currency is not a CGT asset under section 108 – 5 of the ITAA 1997 when it is used as legal tender.

There is perhaps no legal basis (in terms of the legislative provisions relevant to the CGT regime or otherwise) for the Commissioner to form an opinion (as expressed in ruling TD

2002/25, quoted above) that Australian currency is not a CGT asset in just one circumstance. That one circumstance is when Australian currency is used as legal tender. This is so as the definition of the expression “CGT asset” (in section 108 – 5) is a definition which uniformly applies to all of the legislative provisions relevant to the CGT regime. It is not a definition that is (expressly or implicitly) made applicable to one or more circumstances differently relative to others.

The conclusion has been drawn above that Australian currency is not a CGT asset as Australian currency is not comprehended by the expression “property” used in the definition of the expression ‘CGT asset’ in section 108 – 5. That conclusion does not automatically lead to the conclusion that Australian currency (in the context of CGT event K6) is not “property”.

The expression “property” used in section 104 – 230 (which deals with CGT event K6) is not defined. If such expression were to be considered in isolation, Australian currency would (in accordance with the literal meaning of the expression “property”, in terms of *The Macquarie Dictionary*, as referred to above) constitute “property”.

However, a purposive interpretation would not lead to the conclusion that Australian currency to constitute “property” in the context of CGT event K6.

Section 104 – 230 (2) refers to “...property...acquired on or after 20 September 1985...” Therefore, the expression “property” used in section 104 – 230 seems to have intended by the legislature to comprehend only items of property whose date of acquisition was capable of establishment with accuracy. As explained above (in the context of section 109 –5), the date of acquisition of specific quantities of Australian currency (with each unit of quantity bearing

a unique identity) cannot, in practice, be established with accuracy, as no entity generally maintains records to enable such establishment. Accordingly, a purposive interpretation would not lead to the conclusion that the expression “property” used in section 104 – 230 to comprehend Australian currency.

Division 121 prescribes the record keeping requirements relevant to the CGT regime. Division 121 cannot mandate the maintenance by taxpayers of records of the dates on which specific quantities of Australian currency (with each unit of quantity bearing a unique identity) are acquired or disposed of. That is so for the reason explained above and also because Australian currency (for the reasons explained earlier) is not a CGT asset.

Section 104 – 230 (2) and Division 121 (all of which as referred to in the two paragraphs just above) together represent the relevant legislative context for interpreting whether Australian currency constitutes “property” in the context of CGT event K6. As explained above, an analysis of section 104 – 230 (2) and Division 121 leads to a purposive interpretation Australian currency is not comprehended by the expression “property” in the context of CGT event K6. And there are no other legislative provisions or extrinsic material, which could potentially also form part of the relevant legislative context, that displace or even impugn such an interpretation.

In ruling TR 2004/18, at paragraph 58, the Commissioner opines:

[W]hile there is debate whether Australian currency notes and coins (“cash”) is a GST asset, it is clearly a chattel and therefore “property”.

For the reasons explained above, the Commissioner's opinion expressed in ruling TR 2004/18 (as quoted just above) may not be correct.

The question of whether Australian currency is "property" for purposes of the definition of the expression "CGT asset" and for purposes of CGT event K6 has implications with respect to horizontal equity, as exemplified below.

Consider the maximum net asset value test, which a taxpayer must pass to access small business CGT relief. In the context of, say, two taxpayers with an equal amount of wealth, one taxpayer who (relative to the other) holds a larger proportion of her wealth in Australian currency may pass the maximum net asset value test (and become eligible to access CGT small business relief). Whereas the other taxpayer may fail the maximum net asset value test (and not be eligible to access CGT small business relief). The dissimilarity of these outcomes proves a violation of horizontal equity. The reason for such dissimilar outcomes is cash is not taken account of in determining whether the maximum net asset value test is passed. That is so as cash is properly deemed (in terms of the reasons explained above) not to be "property" for purposes of the definition of the expression "CGT asset".

In order to become eligible for the CGT discount, the tests prescribed in section 115 – 45 must be passed. Consider two companies, Company A and Company B. Each of them started business at the same time, 24 months ago, each with an equal contribution of capital (of \$1,000 each), received in cash. The two companies had used its capital as follows (as at the end of their first 24 months of business):

	<i>Assets acquired during first 12 months</i>	<i>Assets acquired during second 12 months</i>	<i>Unused cash</i>
Company A	\$80	\$120	\$800
Company B	\$880	\$120	\$0

If the test prescribed in section 115 – 45 (3) were to be applied as at the end of the first 24 months of business of each company, Company A will fail the test, and Company B will pass the test. The dissimilarity of these outcomes proves a violation of horizontal equity. The reason for such dissimilar outcomes is cash, as it is properly deemed not to be a “CGT asset” (in terms of the reasons explained above), cannot be treated as a “CGT asset” owned by Company A for more than 12 months.

In the context of CGT event K6, consider two companies, Company C and Company D. Each of them was incorporated, and they issued all of their share capital, before 20 September 1985. The shareholders of each of them have remained unchanged since the incorporation of each company. The cash (of \$1,000 each) received by each company through the issue of shares had been applied, as at 30 June 2009, as follows:

	<i>Assets acquired before 20 September 1985</i>	<i>Assets acquired on or after 20 September 1985</i>	<i>Unused cash</i>
Company C	\$80	\$120	\$800
Company D	\$880	\$120	\$0

If the test prescribed in section 104 – 230 (2) were to be applied as at 30 June 2009, Company C will fail the test, and Company D will pass the test. A sale of shares of Company C may, therefore, potentially attract CGT event K6 (despite those shares having been acquired by their seller before 20 September 1985). The dissimilarity of these outcomes proves a violation of horizontal equity. The reason for such dissimilar outcomes is cash, as it is properly deemed not to be “property” (in terms of the reasons explained above), cannot be treated as “property” acquired by Company C before 20 September 1985.

In order to avoid the occurrence of such outcomes that violate horizontal equity, the following should happen:

*Maximum net asset value test (as prescribed in section 152 – 15 a))*

- By legislative amendment, it should be essentially provided that, for purposes of the test, the assets to be taken account of must be CGT assets plus Australian currency.

*Eligibility for the CGT discount (pursuant to the tests prescribed in section 115 – 45)*

- By legislative amendment, it should be essentially provided that, for purposes of the tests, the assets to be taken account of must be CGT assets plus Australian currency (with the date of acquisition of Australian currency established on a last-in-first-out or LIFO basis). Accordingly, Australian currency held by the company or trust as at the date of sale of shares of the company or interests in the trust should be regarded as Australian currency that was held by the company or trust as at just prior to 12 months before the date of such sale. It should be so regarded

unless the former has increased relative to the latter (where there has been an increase, the increment must be regarded as not forming part of the latter). Such a method of establishing the date of acquisition of Australian currency on a LIFO basis admittedly is somewhat arbitrary and weighted in favour of the taxpayer. However, such a method is the only practicable one that can be implemented which is reasonable and which does not also compromise simplicity.

*CGT event K6 (as provided for in section 104 – 230)*

- No change is required to the status quo, as it is most unlikely that significant amounts of Australian currency acquired by a taxpayer before 20 September 1985 are currently held in that same form by the taxpayer. And the Commissioner's opinion expressed in ruling 2004/18 (as quoted above) should perhaps be retracted.

Case study 2: Is confidential information of a business property?

Case study 2 would demonstrate that the CGT regime does violate horizontal equity. This so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed either greater or less, by reason of confidential information of a business owned by a taxpayer not constituting "property" in the context of subjecting capital gains to Australian income tax. A taxpayer will be taxed relatively less in the context of determining whether the maximum net asset value test is passed to become eligible to access small business CGT relief. A taxpayer will be taxed relatively less also because proceeds from the disposal of confidential information of a business may not be assessed to income tax at all (where confidential information of a business is properly characterised, at common law, as a capital asset of that business). A taxpayer will be taxed relatively either greater or less in the context

of determining whether the tests prescribed in section 115 – 45 are passed to become eligible for the CGT discount. A taxpayer will be taxed relatively greater or less also in the context of determining whether CGT event K6 is attracted to a capital gain made on the sale of shares in a company or interests in a trust. (CGT event K6 is engaged essentially if two conditions apply. First, the shares in a company or interests in a trust were acquired before 20 September 1985. Second, a prescribed proportion of the property of the company or trust, as at the time of the sale of shares in the company or interests in the trust, was acquired after 20 September 1985.)

The question of whether or not confidential information of a business is a CGT asset has practical relevance particularly when one has to conclude whether to include as “property” confidential information of a business where the business has not yet commenced generating any revenue (and, hence, has no goodwill as such, as it still lacks the capacity to attract any custom) but has created confidential information of considerable value (by reason of research and development activity undertaken).

As explained in case study 1, the expression “property” used in the definition of the expression “CGT asset” is not defined. The respective expression “property” accordingly has its meaning at common law.

In *Hepples v FCT*,<sup>532</sup> at the full Federal Court, Gummow J (as one of the two judges forming the majority) categorically opined (at pp 4520 – 4521) that confidential information of a business (subsuming trade connections and trade secrets) was, considered separately from goodwill of the business, “of a proprietary character and therefore ‘assets’ within the meaning of the definition in section 160A”. The equivalent of section 160A of the 1936 Act in the

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<sup>532</sup> *Hepples v FCT* (1990) 90 ATC 4497.

1997 Act is section 108 – 5, which contains the definition of the expression “CGT asset”. In explaining the reasons for this opinion, Gummow J stated (at p 4520):

In *Smith Kline & French Laboratories (Australia) Limited & Ors v The Secretary to the Department of Community Services & Health* (16 May 1990, unreported), I concluded that the degree of legal protection afforded by the legal system (especially in equity) to confidential information (and this would be true particularly of trade secrets) makes it appropriate to describe such confidential information as having a proprietary character, not because this is the basis on which that protection is given, but because this is the effect of that protection...

That opinion of Gummow J has not, since it was expressed, been contradicted or qualified by any Australian court.

That opinion of Gummow J relies on a conclusion reached by Gummow J in *Smith Kline & French Laboratories (Australia) Limited & Ors v The Secretary to the Department of Community Services & Health* (16 May 1990, unreported), a conclusion which (after detailed analysis) was reasoned in the following terms:<sup>533</sup>

In *National Provincial Bank Ltd v Ainsworth* (1965) AC 1175 at 1247-1248, Lord Wilberforce said that before a right or interest can be admitted into the category of property, it must be definable, identifiable by third parties, have some degree of permanence or stability, and be capable in its nature of

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<sup>533</sup> *Smith Kline & French Laboratories (Australia) Limited & Ors v The Secretary to the Department of Community Services & Health* 16 May 1990 Unreported Federal Court decision, accessible at: <[http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal\\_ct/unrep4220.html](http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal_ct/unrep4220.html)>, para 168 (13 January 2003).

assumption by third parties. This dictum has been applied in Australian decisions, for example, *R v Toohey*; *Ex parte Meneling Station Proprietary Ltd* supra, at 342-343; *Sonenco (No 77) Pty Ltd v Silvia* (1989) 89 ALR 437 at 455, 457. The degree of protection afforded by equitable doctrines and remedies to what equity considers confidential information makes it appropriate to describe it as having a proprietary character. This is not because property is the basis upon which that protection is given, but because of the effect of that protection; cf. *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525 at 548 per Williams J; *Boardman v Phipps*, supra at 127-129 per Lord Upjohn.

That opinion of Gummow J was consistent with the opinion of Lockhart J (the other of the two judges of the full Federal Court forming the majority in *Hepples v FCT*<sup>534</sup>) which was expressed (at p 4508) in the following terms:

‘The asset which section 160M (7) (a) speaks (i.e. the asset in relation to which the relevant asset or transaction is said to have taken place) consists of *the trade secrets and trade connections* and the goodwill attaching to the business...’ [Emphasis added.]

Hill J, who delivered the sole minority judgment at the full Federal Court in *Hepples v FCT*,<sup>535</sup> did not make any comment in his judgment on whether confidential information of a business constitutes property.

In *Hepples v FCT*,<sup>536</sup> on appeal to the High Court, two judges (Dawson J, at p 4823; and Toohey J, at p 4825) expressly stated in their respective judgments, and two judges (McHugh

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<sup>534</sup> Above, note 532.

<sup>535</sup> Above, note 532.

J, at p 4837; and Mason CJ, at p 4810) implied in their respective judgments, that trade secrets and trade connections can (in the context) be “assets” (that is, CGT assets), with the other three judges not making any relevant comment in their respective judgments. And Toohey J (of the High Court) expressly stated in his judgment (at p 4825) his concurrence with the opinions of Gummow J and Lockhart J of the full Federal Court (as quoted above).

In terms of Gummow J’s reasons for his opinion (as quoted above), confidential information of a business is, at common law, “property”. Hence, confidential information of a business is also a “CGT asset” (in terms of the definition of the expression “CGT asset” noted above). This is so not because confidential information of a business is “a legal or equitable right that is not property”, but because confidential information of a business is “property”.

The Commissioner has, in 1999 (that is, much after the decision of the High Court in *Hepples v FCT*<sup>537</sup> was delivered), in ruling TR 1999/16, opined categorically (at paragraph 101):

Scientific, technical, industrial or commercial knowledge or information (such as know-how, mining, quarrying or prospecting information, a trade secret, secret process or formula) are not goodwill. This knowledge or information is not property. Nor is it a CGT asset...

That opinion expressed in ruling TR 1999/16 is maintained by the Commissioner in ruling TD 2000/33, as expressed (at paragraph 1) in the following terms: “...Know-how is not a CGT asset because it is neither a form of property nor a legal or equitable right.”

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<sup>536</sup> *Hepples v FCT* (1991) 91 ATC 4808.

<sup>537</sup> *Ibid.*

Accordingly, interpreting the definition of the expression “CGT asset” in section 108 – 5 consistent with the opinion expressed by Gummow J (as noted above), as one (as of now, and indeed at any time after the High Court decision in *Hepples v FCT* was delivered) necessarily must, as a matter of proper statutory interpretation, confidential information of a business must be taken to be “property”. Such an outcome, however, is incompatible with the position which the Commissioner has opined as correct (as noted above) which is that confidential information of a business is not “property”. The Commissioner’s failure to reconcile, in any ruling or otherwise, the respective position with the opinion expressed by Gummow J (as noted above) represents a material dereliction of duty on the part of the Commissioner. This is especially so as the respective opinion of Gummow J was, at the full Federal Court, explicitly approved by one judge and not disapproved by the other, and, at the High Court, (explicitly or implicitly) approved by four judges and not disapproved by the other three.

If the position which the Commissioner has opined as correct (as noted above) is to prevail in practice (which is likely, as the Australian Taxation Office generally regards, of all sources of authority on the proper interpretation of legislative provisions, the Commissioner’s rulings as the most authoritative), an outcome could result which violates horizontal equity. Such an outcome could result because confidential information of a business (being a resource which its owner could use to generate positive cash flows in the future) in essential substance is an asset which is not different to all other assets which are deemed “CGT assets”. Thus, affording no basis, with respect to two businesses (each with an equal value of total assets, with confidential information of each business being taken as an asset), where one of which is a business that, for instance, has not yet commenced generating any revenue (and, hence, has no goodwill as such, as it still lacks the capacity to attract any custom) but has created confidential information of considerable value (by reason of research and development activity undertaken) but the other is not. Each of those businesses will, accordingly, be

exposed on a capital gain made on the sale of those businesses or ownership interests in entities owning those businesses to an incidence of tax which is not alike due to the proportion of those businesses' respective assets that is represented by confidential information not being the same.

In order to avoid the occurrence of such an outcome which violates horizontal equity, the Commissioner's opinions expressed in rulings TR 1999/16 and TD 2000/33 (as quoted above) should perhaps be retracted. And the Commissioner should, in terms of Gummow J's reasons for his opinion (as quoted above), treat confidential information of a business as "property", and hence a "CGT asset".

Case study 3: Is the result of the apportionment of capital proceeds to a CGT event always right?

Case study 3 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed either greater or less, by reason of capital proceeds received in a lump sum which do not exclusively pertain to a single CGT event being allocated amongst its constituent items in a manner which is not fair.

Section 116 – 40 gives two examples, the strict application of both of which (in a practical sense) may produce outcomes which violate horizontal equity.

The first example (given in section 116 – 40 (1)) reads as follows:

You sell a block of land and a boat for a total of \$100,000. The transaction involves 2 CGT events.

The \$100,000 must be divided among 2 events. The capital proceeds from the disposal of the land are so much of the \$100,000 as is reasonably attributable to it. The rest relates to the boat.

In this example, there are two CGT events: the sale of the land, and the sale of the boat. Accordingly, in terms of section 116 – 40 (1), the capital proceeds reasonably attributable to each of the two respective CGT events must be determined. The example, rather than doing so, purports to determine the capital proceeds reasonably attributable to one (of the two) CGT events (being the sale of the land) and concludes that the balance of the total capital proceeds (that is, the total capital proceeds minus the capital proceeds determined as reasonably attributable to the sale of the land) is referable to the sale of the boat. It is accordingly implicit from the treatment adopted in the example that capital proceeds reasonably attributable to a CGT event must be determined only where the CGT event involves a CGT asset which is not a personal use asset.

Consequently, at the very extreme, assuming that the boat is a personal use asset, the capital proceeds deemed referable to the sale of the boat may be smaller than what ought to be the proper share of the total capital proceeds reasonably attributable to the sale of the boat, generating a capital loss which cannot be subtracted from any capital gain made on the sale of the land. An outcome could therefore result which violates horizontal equity. Such an outcome could result because attribution of capital proceeds, derived as a composite sum, amongst different CGT events turns on whether the CGT events involve CGT assets which are personal use assets or not. Accordingly, there is discrimination between, for instance, two taxpayers whose respective CGT assets are of the same value but where one of whose respective CGT assets do not comprise any personal use assets and where the other of whose respective CGT assets do comprise personal use assets.

The second example (given in section 116 – 40 (2)) reads as follows:

You are an architect. You receive \$70,000 for selling a block of land and giving advice to the new owner. This transaction involves one CGT event: the disposal of the land.

The capital proceeds from the disposal of the land is so much of the \$70,000 as is reasonably attributable to that disposal.

Whilst the position stated in the last paragraph of the second example as quoted in paragraph above accords with the terms of section 116 – 40 (2), the terms of section 116 – 40 (2) may produce outcomes which violate horizontal equity as described below.

Section 116 – 40 (2) requires only so much of the lump sum payment received as is reasonably attributable to the particular CGT event as capital proceeds to be determined. The balance of the lump sum payment received (that is, the total lump sum payment received minus what is reasonably attributable to the particular CGT event as capital proceeds), in the second example quoted above, as a matter of practice (though perhaps not strictly as a matter of law<sup>538</sup>), will be deemed by the Commissioner to constitute income (being compensation received for the provision of architectural advice). The amount so deemed to constitute income (since it is a residual figure) may not be what ought to be properly regarded as the share of the total lump sum payment reasonably attributable to the provision of architectural advice. And the taxpayer (the architect) may prefer the amount deemed to constitute income

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<sup>538</sup> Refer *Allsop v FCT* (1965) 9 AITR 724 for authority that, where a lump sum is received in respect of both items of a revenue nature and items of a capital nature and the lump sum receipt cannot be dissected into its constituent items, generally the entire lump sum is to be treated as a capital receipt.

to be less than what it properly should be if, say, the capital gain made on the sale of the land is eligible for the 50% CGT discount or is reduced by capital losses.

An outcome could therefore result which violates horizontal equity. Such an outcome could result because, for instance, two taxpayers, both in receipt of a composite sum of equal value for the disposal of land and the provision of architectural services, may have each chosen a different approach: one to provide architectural services at a discount and to dispose of the land at market value, and the other to provide architectural services at their market value and to dispose of the land at a discount. Despite this difference in approach, however, subsection 116 – 40 (2) and the example given in that subsection (as quoted above) are predicated only on the approach of the former, thus essentially causing an incidence of tax which is alike on two taxpayers who are not in a like economic situation.

In order to avoid the occurrence of the outcomes (as described above) which violate horizontal equity:

- the text of the first example provided in section 116 – 40 should be rephrased so that the respective example strictly conforms to the position prescribed in section 116 – 40 (1);
- the text of section 116 – 40 (2) should be rephrased to the effect that what is reasonably attributable to the CGT event (of the total lump sum payment received) should be determined with due regard to what is reasonably attributable to the CGT event as well as everything else apart from the CGT event (in respect of which the total lump sum payment is received); and

- the text of the second example provided in section 116 – 40 should then be rephrased so that the respective example strictly conforms to the position prescribed in section 116 – 40 (2), rephrased as noted in the point immediately above.

Case study 4: What happens when payment of part of the purchase price of an asset is contingent on a future event?

Case study 4 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater or less, by reason of the purchase price of a CGT asset, where the payment of that purchase price is contingent on a future event that occurs after the disposal of the CGT asset, and thus not being capable of inclusion wholly as part of the cost base of the CGT asset.

Often, a part of the purchase price of an asset is made payable by the purchaser in the future on the happening of a certain event (referred to as “contingent price” in this case study). For example, an entity may purchase the shares of a company on the payment of a sum at the time the shares are purchased and on the undertaking to pay a further sum in the future if the level of profits of the company for the year ending immediately after the purchase of the shares exceeding an agreed amount.

In terms of section 110-25 (2), the conferral by the purchaser of the shares on the seller of them an entitlement to the contingent price (payable by the purchaser to the seller in the future) amounts to the giving of “property” by the purchaser to the seller “in respect of acquiring” the shares. The contingent price, therefore, should be included by the purchaser in

the first element of the cost base of the shares at its “market value” established as at the time the shares are purchased.

That analysis is consistent with that promulgated by the Commissioner in draft ruling TR 2007/D10.

It is conceivable that the purchaser will, in the future, pay the seller an amount greater or less than the market value of the contingent price established as at the time the shares are purchased. When that happens, the resulting excess or deficit will respectively represent a capital loss or a capital gain of the purchaser in terms of CGT event C2. In other words, that capital loss or capital gain is not incorporated into the purchaser’s cost base of the shares, a treatment which can yield outcomes that violate horizontal equity.

Assume, for instance, CGT event C2 yields a capital gain, that is, the purchaser pays to the seller an amount in respect of the contingent price that is less than the market value of the contingent price established as at the time shares are purchased. The purchaser will be liable to CGT on that capital gain, despite it, in substance, being a reduction of the purchaser’s cost base of the shares purchased. Admittedly, to the extent of that capital gain, in substance, the purchaser’s cost base of the shares will be higher, which will result in a lower capital gain, to the same extent, on the disposal by the purchaser of those shares. That disposal, however, may not happen for several years, but the capital gain which CGT event C2 yields will be liable to CGT immediately.

Conversely, CGT event C2 may yield a capital loss, that is, the purchaser pays to the seller an amount in respect of the contingent price that is more than the market value of the contingent price established as at the time shares are purchased. The purchaser will be entitled to claim

an immediate tax-deduction in respect of that capital loss, provided the purchaser has sufficient capital gains in the income year in which that capital loss is incurred or in future income years, as that tax-deduction can only be claimed against capital gains (and not any other assessable income). That tax-deduction is claimable by the purchaser despite the excess of contingent price paid over its market value established as at the time the shares are purchased, in substance, being an increment to the purchaser's cost base of the shares purchased, and those shares remaining in the ownership of the purchaser.

Accordingly, horizontal equity is violated, as the disposal of an asset for a contingent price yields outcomes, as to the liability to CGT on capital gains, which are different to outcomes the disposal of an asset for a price which is not contingent yields. In order to avoid such outcomes, it must be legislated that, where a purchaser, in the future, pays the seller an amount greater or less than the market value of the contingent price established as at the time an asset is purchased, the resulting excess or deficit is to be incorporated into the purchaser's cost base of the asset.

**Situations which result in an incidence of tax greater than that placed on other taxpayers in a like economic situation**

Case study 5: How closely connected incidental costs must be to a CGT event for inclusion under the second element of the cost base?

Case study 5 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of costs incidental to the disposal of a CGT asset incurred in

certain circumstances by a taxpayer not being included in the cost base of the CGT asset disposed of.

In terms of section 110-25 (3) (b), the second element of the cost base comprises incidental costs incurred by a taxpayer “that relate to a CGT event that happens in relation to the [CGT] asset”. Accordingly, it appears that there must be a close connection between an item of incidental cost and a CGT event that happens in relation to a CGT asset for the respective item of incidental cost to be covered under the second element of the cost base. Such a close connection may not always exist in practice in very many cases.

For example:

- legal fees may be incurred by the owner of CGT asset with a view to selling a CGT asset, but such sale may not consummate; or
- with respect to the sale of a CGT asset, costs may be incurred by the owner of a CGT asset over a fairly long period in advertising for (or otherwise looking for) a buyer, and the buyer to whom the CGT asset is ultimately sold may be the last of many prospective buyers with whom the owner of the CGT asset may have had negotiations with for the sale of the CGT asset.<sup>539</sup>

In examples such as those, it would appear that the respective expenditure incurred by the owner of the CGT asset will not be covered by the second element of the cost base as such

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<sup>539</sup> Refer, for example, *FCT v Guy* (1996) 96 ATC 4520, where a contract for the sale of a CGT asset was not completed because the prospective buyer of the CGT asset defaulted (who, thereby, forfeited the deposit paid to the owner of the CGT asset at the time the contract was entered into and became liable to pay damages to the owner of the CGT asset).

expenditure lacks the requisite close connection to the CGT event that results in the disposal of the CGT asset. An outcome which violates horizontal equity could therefore result because the respective expenditure will effectively constitute non tax-deductible “black-hole” expenditure. Accordingly, causing (for instance) two taxpayers, one of whom incurs outgoings such as the respective expenditure and the other of whom does not incur outgoings such as the respective expenditure, but both of whom derive capital proceeds of the same value from the sale of the CGT asset (whose first element of the cost base is the same for both taxpayers), to be made liable to CGT on capital gains of unequal value (the first taxpayer’s capital gain made liable to CGT will be higher than that of the second).

In order to avoid the occurrence of such an outcome which violates horizontal equity, the terms of section 110-25 (3) (b) should be amended to make the second element of the cost base comprise incidental costs incurred by a taxpayer “in attempts to have a CGT event happen in relation to a CGT asset”, and section 110-35 (1) (b) should be amended consistently.

The analysis outlined above is not invalidated by the presence of section 40-880. That is so as that section may allow a tax-deduction for incidental costs not otherwise tax-deductible (as canvassed above) only where those incidental costs were incurred in the course of carrying on a business (and not all taxpayers who incur such incidental costs incur them in the course of carrying on a business).

Case study 6: Does all capital expenditure incurred to increase the value of a CGT asset form part of the fourth element of the cost base of a CGT asset?

Case study 6 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of capital expenditure incurred in certain circumstances by a taxpayer that increases the value of a CGT asset not being included in the cost base of the CGT asset.

In terms of section 110-25(2), capital expenditure incurred by a taxpayer to increase the value of a CGT asset of that taxpayer represents the fourth element of the cost base of the CGT asset provided that capital expenditure is “reflected in the state or nature of the [CGT] asset at the time of the CGT event”. It is difficult to comprehend as to how an item of capital expenditure (as such) can be reflected in the state or nature of an asset. Perhaps, the draftsman intended to say that the effects of the capital expenditure must be reflected in the state or nature of the CGT asset, but the terms of section 110-25(5), which seemingly have been largely modelled on comparable legislation in the UK,<sup>540</sup> does not state so. The terms of section 110-25(5) not stating so, coupled with one other factor (as described below), could result in outcomes that violate horizontal equity, as exemplified below.

Consider, for instance, the following situation:

An individual (Ms A) carries on, as a sole proprietor, the business of a recruitment agency. Ms A engages five employees in the business whose services represent the most

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<sup>540</sup> *Taxation Determination* TD 2004/2 (18 February 2004), para 10.

vital factor for the commercial success of the business. Ms A sells the business (whose only significant asset was goodwill) to another entity in return for:

- \$200,000 payable at the time the business is sold; plus
- a percentage of the excess of pre-tax profits of the business for the one year after its sale over an agreed threshold of \$75,000, which was payable to Ms A once the audit of the accounts of the business for that year was completed (referred to as “the additional price” in the rest of this case study).

As the satisfactory efforts of the five employees of the business are critical for the business to generate profits for the one year after its sale in excess of the agreed threshold of \$75,000, Ms A agrees with the employees to pay them a share of the additional price.

The amount of \$200,000 received at the time the business is sold plus the additional price will constitute capital proceeds of Ms A from the sale of the business. The question is whether the share of the additional price which Ms A agrees to pay (after the sale of the business) to her previous employees (referred to as “the employees’ share of the additional price” in the rest of this case study) is an item of expenditure forming part of the fourth element of the cost base of the goodwill of the business.

For the employees’ share of the additional price to form part of the fourth element of the cost base of the goodwill of the business, essentially, in terms of section 110-25(5), three conditions must be met:

- the employees’ share of the additional price must constitute capital expenditure;

- the employees' share of the additional price must have been incurred to increase the value of the CGT asset sold (being the goodwill of the business); and
- the employees' share of the additional price must be reflected in the state or nature of the goodwill of the business at the time the goodwill of the business is sold.

The employees' share of the additional price is an item of expenditure incurred by Ms A in connection with the disposal of a capital asset (being the goodwill of the business), and is hence capital expenditure.<sup>541</sup> Accordingly, the first condition is met.

The employees' share of the contingent price is an item of expenditure incurred by Ms A in order to increase the value of the CGT asset sold (being the goodwill of the business). Accordingly, the second condition is met.

The third condition, however, is unlikely to be met for two reasons:

- It will not be possible to establish that the employees' share of the additional price is reflected in the state or nature of the goodwill of the business at any time at all. This is particularly so as the goodwill of the business is an intangible asset, but, even in the case of a tangible asset (such as, say, a building), as explained earlier, it is difficult to comprehend as to how an item of expenditure (as such) can be reflected in the state or nature of the tangible asset at any time at all.
- Even if it were possible to establish that the employees' share of the additional price is reflected in the state or nature of the goodwill of the business at a certain time (which

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<sup>541</sup> *Case No G71 (1956) 7 TBRD 376.*

would not be possible as explained in the point just above), it will not be possible to establish that the employees' share of the additional price is reflected in the state or nature of the goodwill of the business at the time such goodwill is sold. This would be so as the increment to the goodwill of the business, through the efforts of Ms A's former employees who continue to serve the business after the business is sold by Ms A and who are remunerated by Ms A by way of the employees' share of the additional price, occurs during the one year after the sale of the business.

The failure to meet the third condition, as explained just above, could therefore result in an outcome which violates horizontal equity because the employees' share of the additional price will not be covered by the fourth element of the cost base of the CGT asset sold (being the goodwill of the business), thus effectively constituting non tax-deductible "black-hole" expenditure. In other words, for instance, if another taxpayer in the same situation as Ms A had chosen to pay the employees of the business which is to be sold before the business is sold an amount by way of a bonus equal to the value of the employees' share of the additional price, such bonus will (in practice) be tax-deductible by such other taxpayer. And, therefore, the incidence of tax on such other taxpayer and Ms A are not alike despite them both essentially being in like economic situations as the net cash flow (apart from the tax payable) each of them respectively derives from the sale of the business is of equal value.

That analysis is not affected by section 40-880 as, under that section, Ms A will have been eligible to claim a tax-deduction for the employees' share of the additional price not in the income year in which she realised the capital gain from the sale of the goodwill of the business but in the income year in which she became liable to pay the employees' share of the additional price and in the four succeeding income years (an equal part of that

expenditure being tax-deductible by Ms A in each of those five income years). It is not at all inconceivable that Ms A may, in those five income years (unlike in the income year in which she realises the capital gain on the sale of the goodwill of the business), not have sufficient assessable income to claim that tax-deduction.

In order to avoid the occurrence of such an outcome which violates horizontal equity, the second sentence of section 110-25(5) should be replaced with the following:

However, the effects of the expenditure must be reflected in the state or nature of the CGT asset:

- a) as at the time of the CGT event; or
- b) as at the time the capital proceeds (in full or in part) in respect of the CGT event are received or the entitlement to the receipt of which arises.

Case study 7: What is the cost base of a CGT asset acquired by a trustee in an arm's length transaction?

Case study 7 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of any CGT asset transferred to a trust (even where the CGT asset is acquired by the trust in an arm's length transaction) being deemed to have a cost base (from the standpoint of the trust) equal to the market value of such CGT asset as at the time it is transferred to the trust.

Section 104-60 is titled “Transferring a CGT asset to a trust: CGT event E2”. Section 104-60(4) reads as follows:

If you are the trustee of the trust and no beneficiary is absolutely entitled to the asset as against you (disregarding any legal disability), the first element of the asset’s \*cost base and \*reduced cost base in your hands is its \*market value when the asset is transferred.

In this case study, the expression “trust” is used to mean the trustee of a trust which is not a bare trust (in a bare trust, the beneficiary of the trust is absolutely entitled to the asset that is the subject of the trust as against the trustee of the trust).

Interpreted literally, section 104-60(4) would have the effect of deeming, with respect to any CGT asset transferred to a trust (irrespective of whether such transfer is the result of an arm’s length transaction or not), the market value of the CGT asset as at the time of transfer to be the cost base of the CGT asset from the standpoint of the trust.

Accordingly, where for good reason the cost at which a trust acquires a CGT asset in a genuine arm’s length transaction is different to the market value of the CGT asset as at the time of such acquisition, section 104-60(4) would appear to operate to deem the cost base of the CGT asset, from the standpoint of the trust, to be the market value of the CGT asset as at the time the CGT asset is acquired by the trust (and not the actual cost of acquisition).

Such an outcome violates horizontal equity because the market value substitution rule (in the context of the cost base of a CGT asset), in terms of section 112-20(1), applies only where the entity acquiring the CGT asset did not deal at arm’s length with the entity from whom the

CGT asset is acquired. Section 112-20(1), accordingly, evinces a general legislative policy intent to replace the actual cost of acquisition with market value as the cost base of the CGT asset acquired only where the acquisition is not the result of an arm's length transaction. However, any CGT asset transferred to a trust (even where such CGT asset is acquired by the trust in a genuine arm's length transaction) is deemed to have a cost base (from the standpoint of the trust) equal to the market value of such CGT asset as at the time it is transferred to the trust.

There is nothing in the relevant legislative context (including in the title to section 104-60, reproduced above) which, in unambiguous terms, requires the interpretation of section 104-60(4) as canvassed above to be qualified so as to exclude from the ambit of that subsection acquisitions by a trust of CGT assets in an arm's length transaction.

In order to avoid an outcome such as that described above which violates horizontal equity, by legislative amendment section 104-60(4) should be made inapplicable to acquisitions of CGT assets by a trust in arm's length transactions.

Case study 8: Does a transfer of a CGT asset devolved on the trustee of a testamentary trust to a beneficiary of that trust give rise to an assessable capital gain?

Case study 8 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of a transfer of a CGT asset of a deceased to a beneficiary of testamentary trust created by the deceased resulting in a capital gain assessable on the testamentary trust. Such an outcome does not correspond to the outcome which results when a

CGT asset of a deceased is transferred to a beneficiary of the estate of the deceased, which does not result in a capital gain assessable on the estate of the deceased.

It is not uncommon for a deceased, before that person's death, to, in terms of that person's will, create a testamentary trust (say, nominating as a beneficiary that person's child who is a minor at the time of that person's death, with such trust to last until that child reaches majority), and appoint the same individual who is the executor of that person's will as the trustee of such testamentary trust.

In the context of such a situation, the question arises as to whether a transfer by a trustee of the testamentary trust of a CGT asset (which was the property of the deceased before that CGT asset became the property of the testamentary trust) to a beneficiary of the testamentary trust gives rise to a capital gain assessable on the testamentary trust.

Section 128-15(3) provides as follows:

Any \*capital gain or \*capital loss the \*legal personal representative makes if the [CGT] asset \*passes to a beneficiary in your estate is ignored.

The expression "legal personal representative" (marked with an asterisk in section 128-15(3)) is defined in section 995-1 in exhaustive terms, and that definition does not include the trustee of a testamentary trust (created by the will of the deceased).

To put that conclusion in the context of the situation described earlier, in the case of a testamentary trust, the CGT asset which was the property of the deceased before the death of the deceased does not devolve on the legal personal representative as such but rather devolves

on the trustee of the testamentary trust. This conclusion is not affected by the fact that the same individual who is the legal personal representative of the estate of the deceased (that is, the executor of the will of the deceased) is also the trustee of the testamentary trust (created by the will of the deceased), a state of affairs which is purely coincidental.

Section 128-15(3) cannot apply to effectively ignore a capital gain resulting from a transfer by the trustee of a testamentary trust of a CGT asset (which was the property of the deceased before that CGT asset became the property of the testamentary trust) to a beneficiary of the testamentary trust. That is so as the trustee of the testamentary trust is, as explained above, not the legal personal representative of the estate of the deceased. Such an outcome violates horizontal equity because of the dissimilar treatment of a CGT asset of a deceased passing to respectively a beneficiary of the estate of the deceased and a beneficiary of a testamentary trust created by the will of the deceased.

The view<sup>542</sup> that section 128-15(3) may apply to a CGT asset transferred by a testamentary trust to a beneficiary of it as that CGT asset “passes to a beneficiary in the estate [of the deceased]” in terms of the definition of the expression “passes” (marked with an asterisk in section 128-5(3)), through a reference from section 995-1, in section 128-20(a) may not be correct (and, therefore, does not affect the conclusion drawn above). This is so as, for section 128-15(3) to apply, not only must a CGT asset “[pass] to a beneficiary in the estate [of the deceased]”, but the capital gain resulting from such passing of the CGT asset must be made by the “legal personal representative” of the estate of the deceased, which, as explained above, is not the case.

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<sup>542</sup> Coopers G S & Wolfers L R, *Coopers TLIP Capital Gains Tax* (Sydney: Australian Tax Practice, 1999), para 22,270.

The analysis outlined above is not affected by Law Administration Practice Statement PSLA 2003/12 issued by the Commissioner. That is so as, in that ruling, the Commissioner essentially adopts the same view canvassed in the paragraph just above, a view which (in that paragraph) has been demonstrated to be unsustainable as it is a view which is not underpinned by a proper interpretation of the relevant legislative provisions.

In order to avoid the occurrence of an outcome such as that described above which violates horizontal equity, the definition of the expression “legal personal representative” (in section 995-1) must be amended to include in such definition “the trustee of a trust created by the will of the person who has died”.

Case study 9: Does a life tenancy created by the will of a deceased give rise to an assessable capital gain?

Case study 9 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of there not being an increase of the cost base from the standpoint of either the life tenant or the remainderman, in relation to a CGT asset over which a life tenancy is created by the will of a deceased, corresponding to the market value of that life tenancy which may be deemed capital proceeds of the estate of the deceased.

It is not uncommon for a deceased, before that person’s death, to, in terms of that person’s will, create a life tenancy over a CGT asset owned by the deceased before that person’s death in favour of a life tenant, with the ownership of that CGT asset passing to a remainderman on the death of the life tenant.

In such a situation, the passing of ownership of the CGT asset to a remainderman (on the death of the life tenant) does not, by virtue of section 128-10, give rise to an assessable capital gain, as that CGT asset is one which the deceased owned just before that person's death. The remainderman is deemed to have acquired that CGT asset, in terms of section 128-15(2), on the day the deceased died,<sup>543</sup> with the first element of the cost base of that CGT asset, in terms of item 1 of the table in section 128-15(4), being the cost base of such asset (from the standpoint of the deceased) on the day the deceased died.

The creation of a life tenancy over a CGT asset owned by the deceased before that person's death in favour of a life tenant (as in the situation described above), from the standpoint of the estate of the deceased, causes CGT event D1 to happen (as that life tenancy constitutes a "right" created in favour of the life tenant) as at the time such life tenancy is created. The market value substitution rule (in the context of capital proceeds) will apply, in terms of section 116-25, to deem the capital proceeds from that CGT event to be the market value of that life tenancy as at the time such life tenancy is created. And the cost base of that CGT event, in terms of section 104-35(3), would be the incidental costs that relate to creating that life tenancy.

In summary, therefore, the creation of a life tenancy over a CGT asset owned by the deceased before that person's death in favour of a life tenant (as in the situation described above) would give rise to a capital gain assessable on the estate of the deceased.

Whether section 128-10 applies to essentially disregard that capital gain from being assessable turns on the interpretation of the word "for" as it appears in section 128-10 as, for that section to apply, the capital gain must be one "that results *for* a CGT asset [the deceased] owned just before dying." [Emphasis added.]

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<sup>543</sup> *Taxation Determination* TD 93/37 (11 March 1993), para 3.

One could interpret that word “for” to encompass a CGT event such as the creation of a life tenancy over a CGT asset owned by the deceased before that person’s death, with the result that a capital gain arising from the creation of a life tenancy over a CGT asset owned by the deceased just before that person’s death in favour of a life tenant is essentially disregarded from being assessable due to the application of section 128-10.

However, there is opinion expressed by well-regarded authority<sup>544</sup> that an interpretation such as that noted just above is not correct and consequently section 128-10 does not apply to disregard such a capital gain from being assessable. Such opinion is based on the reasoning that, though the CGT asset over which the life tenancy is created is a CGT asset owned by the deceased before that person’s death, that life tenancy itself is not a CGT asset which the deceased owned just before that person’s death.

If such an outcome were to prevail, it is an outcome that violates horizontal equity because of there not being an increase of cost base from the standpoint of either the life tenant or the remainderman, in relation to the CGT asset over which the life tenancy is created by the will of the deceased, corresponding to the market value of that life tenancy which (as explained above) is deemed to be capital proceeds of the deceased. This is so since such an outcome is contrary to the general scheme of the (present) legislative provisions pursuant to which what is deemed (from the standpoint of the entity disposing of a CGT asset) to be the capital proceeds from the disposal of the CGT asset is deemed (from the standpoint of the entity to whom the CGT asset is disposed of) to be the cost base of the CGT asset. A life tenant or remainderman (in the context of a CGT asset over which a life tenancy is created by the will of a deceased) is, accordingly, disadvantaged relative to an entity to whom a CGT asset is

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<sup>544</sup> Above, note 542, para 22,350.

disposed of other than through the creation of a life tenancy over a CGT asset (by the will of a deceased).

In relation to the position explained just above, the market value substitution rule (in the context of cost base), in terms of section 112-20(1)(a)(i), does not apply to a CGT asset (being the life tenancy) acquired (by the life tenant) as a result of CGT event D1 happening.

The occurrence of such an outcome that violates horizontal equity can be avoided if, by legislative amendment, any one of the three recommendations outlined below is given effect to:

- the terms of section 128-10 is expanded to disregard (from being assessable) any capital gain made by the estate of the deceased by reason of a life tenancy created over a CGT asset owned by the deceased before that person's death; or
- the cost base of the CGT asset over which the life tenancy is created, from the standpoint of the remainderman, is made equal to the cost base of such asset on the day the deceased died as increased by the amount of the capital proceeds of the life tenancy (from the standpoint of the estate of the deceased);
- the cost base of the CGT asset over which the life tenancy is created, from the standpoint of the remainderman, is made equal to the market value of that CGT asset as at the time the life tenant dies.

The rationale underpinning the first two of those three recommendations is as follows. In the scheme of the present legislative provisions, there is a recognition of the advantage accruing

to the life tenant by being entitled, over the life time of the life tenant, to the use of the CGT asset over which a life tenancy is created by deeming the market value of that life tenancy to be (from the standpoint of the estate of the deceased) the capital proceeds from the creation of such life tenancy. However, in the scheme of the present legislative provisions, such recognition of an advantage is not matched by a recognition of the disadvantage attending the remainderman by the remainderman being denied the use of the CGT asset over which a life tenancy is created until the death of the life tenant since the cost base of that CGT asset is deemed from the standpoint of the remainderman) to be the cost base of such asset on the day the deceased died. That remainderman is, accordingly, disadvantaged (as to the measurement of the cost base of CGT assets acquired) relative to an entity to whom a CGT asset is disposed of otherwise than through the creation of a life tenancy over a CGT asset (by the will of a deceased), an outcome which violates horizontal equity.

Case study 10: Are the terms of section 118-300 (dealing with the treatment of proceeds from insurance policies) coherent?

Case study 10 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of proceeds received by an insured under a general insurance policy potentially being exposed to be doubly taxed.

Section 118-300(1), in the context of proceeds received by an insured under a general insurance policy, essentially provides that any capital gain or capital loss made by a taxpayer (who is the insured) “in relation to a CGT asset that is [the taxpayer’s] interest in rights under a general insurance policy [is] disregarded” (in terms of item 2 of the table in section 118-300(1)) where the “general insurance policy [is] for property, where, if a CGT event happened in relation to the property, any capital gain or capital loss would be disregarded”.

Accordingly, to paraphrase the position noted just above, any capital gain referable to a taxpayer's rights under a general insurance policy is to be disregarded (from being assessable) where that insurance policy covers property whose disposal results in a capital gain that is disregarded (from being assessable). Generally speaking, the only property whose disposal results in a capital gain that is disregarded (from being assessable) is property acquired by a taxpayer before 20 September 1985. Therefore, a literal interpretation of section 118-300(1) (without reference to Example 1 given in that subsection) would appear to say no more than that the proceeds received by the insured under a general insurance policy would not give rise to an assessable capital gain in the hands of the insured where the property covered by that insurance policy is one which the insured acquired before 20 September 1985. Example 1 given in section 118-300(1), however, exemplifies a different outcome.

What Example 1 given in section 118-300(1) says is that, since the proceeds received by an insured under a general insurance policy covering property constitutes capital proceeds in relation to a CGT event that happens in relation to that property (in the context, CGT event C1), the capital gain resulting from the discharge of the rights of the insured under that insurance policy (due to the happening of CGT event C2) is to be disregarded (from being assessable). Accordingly, the outcome exemplified by Example 1 given in section 118-300(1) is consistent with the opinions expressed by the Commissioner in rulings TR 95/35 (at paragraphs 4 and 6) and TD 31.

The fact that a literal interpretation of the terms of section 118-300(1) (without reference to Example 1 given in that subsection) is not consistent with the outcome exemplified by that Example 1 violates horizontal equity. This is so because, if (as mandated by section 15AD of the *Acts Interpretation Act 1901* (Cth)) the terms of section 118-300(1) were to prevail

without reference to Example 1 given in that subsection, potentially proceeds received by an insured under a general insurance policy could be doubly subject to CGT: once as a capital gain arising on the happening of CGT event C1, and again as a capital gain arising on the happening of CGT event C2. Such an outcome causes an incidence of tax which is inconsistent with the norm, where the general scheme of present legislative provisions deem capital proceeds received by a taxpayer to be captured by not more than one CGT event.

In order to avoid the occurrence of such an outcome which violates horizontal equity, the terms of item 2 of the table in section 118-300(1) should be amended to reflect the outcome exemplified by Example 1 given in section 118-300(1).

Case study 11: Would the proceeds received under a life insurance policy held in the capacity of a trustee give rise to a capital gain assessable on such trustee?

Case study 11 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of proceeds under a life insurance policy received by someone owning that life insurance policy in the capacity of a trustee being assessable, whereas such proceeds would not be assessable if received by someone owning that life insurance policy in any other capacity.

Section 118-300(1), in the context of proceeds received under a life insurance policy, essentially provides, in terms of item 3 of that subsection, that any capital gain made by a taxpayer who is the “original beneficial owner” of that policy is disregarded (from being assessable).

That expression “original beneficial owner” is not legislatively defined. Accordingly, that expression has its meaning at common law.

The meaning at common law of the expression “original beneficial owner” would not encompass someone who owns the life insurance policy in the capacity of a trustee, as the trustee would be the legal owner of the life insurance policy owning such policy on trust (in accordance with the terms of the trust) for the benefit of the beneficiaries of the trust.

There is nothing in the relevant legislative context which requires such an interpretation to be qualified so as to regard someone owning a life insurance policy in the capacity of a trustee as being encompassed by that expression “original beneficial owner”.

Accordingly, where someone receives, in the capacity of a trustee, proceeds under a life insurance policy, item 3 of section 118-300(1) would not apply to disregard (from being assessable on that trustee) the resulting capital gain.

In ruling TD 94/31, at paragraph 4, the Commissioner expresses an opinion (as follows) consistent with the conclusions noted above:

It is generally accepted in trust law that the trustee of a trust estate is the legal owner, and not the beneficial owner, of rights, or any interest in rights, under a policy of life insurance taken out and held on trust for the beneficiaries of that trust.

However, in that same ruling, at paragraph 4, immediately after the sentence quoted just above, the Commissioner expresses the following opinion:

For the purpose of, and in the context of section 160ZZI [the equivalent of section 160ZZI of the 1936 Act in the 1997 Act is section 118-300], the trustee will be regarded as the “beneficial owner” of such rights or any interest in such rights if the trustee possesses all the normal incidents of beneficial ownership as referred to in paragraph 2(ii) above.

Paragraph 2(ii) (of ruling TD 94/31) referred to at the very end of the sentence quoted just above reads as follows:

... possesses all the normal incidents of beneficial ownership (for example, is entitled to the benefits of the policy proceeds **and** has the power of management and control over the policy as well as the power to transfer, grant as security, surrender or otherwise dispose of, the policy). [Emphasis as appears in ruling TD 94/31.]

The Commissioner does not, in ruling TD 94/31 or in any other pronouncement of his, indicate the basis upon which he has reached the second of his opinions noted in paragraph 4 of that ruling (quoted above), an opinion which is inconsistent with the first of his opinions noted in the same paragraph of that ruling (also quoted above).

Accordingly, if the second of the Commissioner’s opinions expressed in paragraph 4 of ruling TD 94/31 were to prevail in practice (which is likely, as the Australian Taxation Office regards, of all sources of authority on the proper interpretation of legislative provisions, the Commissioner’s rulings as the most authoritative), in terms of item 3 of section 118-300(1), where someone receives in the capacity of a trustee proceeds under a life insurance policy, the resulting capital gain would be disregarded (from being assessable).

Such an outcome, however, is not consistent with the outcome resulting from a best interpretation of the terms of item 3 of section 118-300(1), as noted above. Accordingly, horizontal equity is violated because, if the best interpretation of the terms of item 3 of section 118-300(1) were to prevail, proceeds under a life insurance policy received by someone in the capacity of a trustee would be assessable, whereas such proceeds would not be assessable if received by someone owning that life insurance policy in any other capacity.

In order to avoid the occurrence of such an outcome which violates horizontal equity, the terms of item 3 of section 118-300(1) should be amended so as to reflect the second of the opinions expressed by the Commissioner in paragraph 4 of ruling TD 94/31 (as quoted above) that essentially the expression “original beneficial owner” used in that item 3 would encompass someone who owns a life insurance policy in the capacity of a trustee.

Case study 12: Does the main residence exemption fairly apply when a taxpayer who owns two dwellings stops using one as that taxpayer’s main residence and starts using another as that taxpayer’s main residence?

Case study 12 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed greater, by reason of some part of the capital gain made on the disposal of a dwelling owned by a taxpayer not being eligible for the main residence exemption in some circumstances. Such an outcome does not correspond to the outcome which results when other taxpayers in essentially similar (but not identical) circumstances make a similar capital gain which is eligible for the main residence exemption.

Section 118-140(1) essentially provides for two dwellings of a taxpayer to be treated as the main residence of that taxpayer for a prescribed period where “[the taxpayer] acquires an ownership interest in a \*dwelling that is to become [the taxpayer’s] main residence and [the taxpayer] still has [the taxpayer’s] ownership interest in [the taxpayer’s] existing main residence”.

Accordingly, for section 118-140(1) to apply, the taxpayer must have acquired a (second) dwelling to be used by the taxpayer as the taxpayer’s main residence while the taxpayer already owns a (first) dwelling. Where a taxpayer owns two dwellings (Dwelling A and Dwelling B, with the taxpayer having acquired Dwelling B before Dwelling A) and currently uses Dwelling A as the taxpayer’s main residence, if the taxpayer stops using Dwelling A as the taxpayer’s main residence and starts using Dwelling B as the taxpayer’s main residence, section 118-140(1) will not apply (as the taxpayer had not acquired Dwelling B while already owning Dwelling A). This possible outcome is exemplified by the following situation:

Ms X owns a dwelling in Sydney, which she uses as her main residence for several years until 31 December 1990. On 31 December 1990, Ms X departs Australia for Spain, and, from thence, Ms ceases to be an Australian tax-resident. Ms X acquires ownership of a dwelling in Spain on 15 January 1991 which she uses as her main residence, and rents the dwelling she owns in Sydney (which was previously her main residence). On 2 July 2000, Ms X departs Spain for Australia, and, from thence, resumes being an Australian tax-resident. On her arrival in Australia, Ms X starts using the dwelling she owns in Sydney as her main residence. On 2 September 2000, Ms X sells the dwelling she owned in Spain and made a capital gain from such sale.

In that situation, the question is whether such part of the capital gain made by Ms X from the sale of her dwelling she owned in Spain referable to the few months for which that dwelling was not her main residence (that is, the period from 2 July 2000 to 2 September 2000) is eligible to be exempt from income tax in terms of the main residence exemption.

The answer to that question is in the negative, as section 118-140(1) does not apply to that situation (of Ms X). Such an outcome violates horizontal equity because of the lack of like treatment (with respect to the main residence exemption) of two taxpayers essentially in the same economic situation: one taxpayer commences to use as that taxpayer's main residence a dwelling which that taxpayer acquires while having another dwelling as that taxpayer's main residence, and another taxpayer who commences to use as that taxpayer's main residence a dwelling which that taxpayer had acquired before that taxpayer's acquisition of the dwelling which that taxpayer used as that taxpayer's penultimate main residence.

In order to avoid the occurrence of such an outcome which violates horizontal equity, the terms of section 118-140 should be wholly replaced with the following:

- (1) If you still have an \*ownership interest in a dwelling which was your main residence but you have commenced the use of another \*dwelling as your main residence, both dwellings are treated as your main residence for the shorter of:
  - a) 6 months ending when your ownership interest in the dwelling mentioned first in this subsection ends; or

- b) the period between the commencement of the use of the dwelling mentioned second in this subsection as your main residence and the time when the ownership interest referred to in paragraph a) ends.

(2) Subsection (1) only applies if:

- a) the dwelling mentioned first in that subsection was your main residence for a continuous period of at least 3 months in the 12 months ending when your ownership interest in it ends; and
- b) the dwelling mentioned first in that subsection was not used for purposes of producing assessable income in any part of the 12-month period when it was not your main residence.

Case study 12 is premised on the existence of the main residence exemption. Whether the very existence of the main residence exemption violates horizontal equity was commented upon in Chapter 3 (in the context of the incorporation of the main residence exemption in the design of the CGT regime when that regime was first enacted), and is an issue that will be addressed further in case study 14 (below).

**Situations which result in an incidence of tax less than that placed on other taxpayers in a like economic situation**

Case study 13: What happens when a CGT asset which was lost is found?

Case study 13 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed less, by reason of essentially being allowed a tax-deduction twice with respect to the cost base of the same CGT asset, where such CGT asset was lost by its owner and found thereafter before the disposal of it.

In terms of section 104-20(1), CGT event C1 happens when a CGT asset owned by a taxpayer is “lost” or “destroyed”. The expression “lost”, as used in section 104-20(1), is not legislatively defined, and accordingly has its meaning at common law. The establishment of the meaning at common law of the expression “lost” would require reference to the ordinary meaning of that expression.

According to *The Macquarie Dictionary*,<sup>545</sup> the expression “lost” (so far as relevant) has the following meaning:

1 no longer possessed or retained: *lost friends*. 2 no longer to be found: *lost articles* ...

[Emphasis as appears in *The Macquarie Dictionary*.]

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<sup>545</sup> Above, note 1, p 1271.

There is nothing in the relevant legislative context which indicates that the expression “lost” used in section 104-20(1), which is not legislatively defined, should be interpreted otherwise than in accordance with the ordinary meaning of that expression, as quoted above.

In terms of the ordinary meaning of the expression “lost”, as quoted above, CGT event C1 can happen if a CGT asset is “no longer to be found” (because, say, that CGT asset has been misplaced). In such a situation, generally, the outcome of CGT event C1 happening is that a capital loss equal to the cost base of the CGT asset (lost) will result, as the capital proceeds applicable to that CGT event will be nil (given that the market value substitution rule, in the context of capital proceeds, does not apply to CGT event C1<sup>546</sup>).

There is, however, no legislative provision which addresses what is to occur when a CGT asset that is “lost” (and which therefore caused CGT event C1 to happen) is found by its owner (the taxpayer). A subsequent disposal by the taxpayer of the CGT asset found will cause CGT event A1 to happen and, in calculating the resulting capital gain, the cost base of the CGT asset will be determined without any regard to the fact that CGT event C1 has previously happened in relation to that CGT asset. An outcome which violates horizontal equity could therefore result because the taxpayer will be allowed a tax-deduction twice (once in terms of CGT event C1, and again in terms of CGT event A1) for the cost base of the same CGT asset, whereas any other taxpayer disposing of a similar CGT asset, which that taxpayer had not previously “lost”, will be allowed a tax-deduction only once (in terms of CGT event A1).

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<sup>546</sup> Section 116-25.

In order to avoid the occurrence of such an outcome which violates horizontal equity, by legislative amendment, the cost base of a CGT asset which is found after having been lost (where CGT event C1 has been caused to happen) should be deemed to be nil.

Case study 14: Is the main residence exemption fair?

Case study 14 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed less, by reason of being eligible for the main residence exemption.

A capital gain made by a taxpayer from the disposal of a dwelling of that taxpayer which was that taxpayer's main residence is generally exempt from income tax and Medicare levy. That is so by virtue of section 118-100. Such an exemption violates horizontal equity, as canvassed below.

Assume two individuals, Ms A and Ms B, each of whom possesses cash of \$300,000.

Ms A, who does not own a dwelling for use as her home, uses her \$300,000 to buy a portfolio of shares in companies. For use as her home, she chooses to rent a dwelling. She derives income from her portfolio of company shares, income which is liable to income tax and Medicare levy payable by her. On the sale of those shares, where she makes capital gains from such sales, those capital gains are liable to income tax and Medicare levy payable by her. The rent which she pays in respect of the dwelling which is her home is not tax-deductible by her as that rent does not represent an outgoing of hers incurred by her in gaining her assessable income.

Ms B, who does not own a dwelling for use as her home, uses her \$300,000 to buy a dwelling for use as her home. On the sale of that dwelling, where she makes a capital gain from such sale, that capital gain is exempt from income tax due to the main residence exemption (that is, Ms B is not liable to income tax and Medicare levy payable by her in respect of that capital gain).

Ms A and Ms B are, in substance, in a like economic situation, but the tax incidence of each of them is not the same as the other, thus violating horizontal equity. Clearly, Ms A is taxed more than Ms B. That is so for two reasons: Ms B is not taxed in respect of her economic income from the ownership of her dwelling (which is her home), and Ms B is not taxed on the capital gain she makes on the sale of her dwelling (as that capital gain is exempt under the main residence exemption).

In order to avoid the occurrence of such an outcome which violates horizontal equity, by legislative amendment, the main residence exemption must be abolished, or, if such an abolishment is not politically feasible (which it is likely to prove), the main residence exemption must be capped with reference to the value of the dwelling (which is the main residence of the taxpayer selling it) sold by the taxpayer.

The existence of strong pragmatic reasons for the incorporation of the main residence exemption in the design of the CGT regime (when that regime was first enacted) was canvassed in Chapter 3. The analysis in case study 14 is not necessarily inconsistent with the position canvassed in Chapter 3.

The need for taxing an owner of a dwelling (which is that owner's home) in respect of the economic income from such ownership is a policy proposition which has considerable value,

but it is a proposition that will not be addressed further, since it is not germane to the research problem dealt with in this thesis.

#### Case study 15: Is the CGT discount fair?

Case study 15 would demonstrate that the CGT regime does violate horizontal equity. This is so as a taxpayer may not be taxed alike with others in a like economic situation, but rather may be taxed less, by reason of being eligible for the CGT discount.

Where a taxpayer (other than a company) makes a capital gain from the sale of a CGT asset, if that taxpayer has owned that CGT asset for at least 12 months, not the entirety but only a part of that capital gain is liable to income tax (and Medicare levy, where relevant) payable by that taxpayer. That is so because, in that situation, that taxpayer will be eligible to the CGT discount under sections 115-5 to 115-50.

Assume two individuals, Ms C and Ms D, each of whom possesses cash of \$100,000. They both propose to incorporate a company to carry on a business they propose to run. Each of them invests \$100,000 in the share capital of that company, which each of them regards as a long-term investment. Within two months of making that investment, Ms C's son takes seriously ill with a rare medical condition that requires him to be taken to the US for specialist medical treatment. In order to meet associated costs, Ms C is forced to sell her shares in the company, a sale which happens before the expiry of 12 months from the time she acquired those shares. She makes a capital gain of \$10,000 from that sale, on the entirety of which she is liable to pay income tax and Medicare levy, as she is not eligible for the CGT discount (as the shares sold were not owned by her for at least 12 months).

Fifteen months after the establishment of the company, its directors receive a takeover offer from a foreign multinational seeking to gain a foothold in Australia. That takeover offer is accepted by the shareholders of the company, pursuant to which Ms D sells her shares in the company, a sale from which she makes a capital gain of \$10,000. Ms D will be liable to income tax and Medicare levy on only \$5,000 of that capital gain, as she will be eligible for the CGT discount (at 50%), since the shares sold were owned by her for at least 12 months.

Ms C and Ms D are, in terms of the nature of the investment they made in the company (which, in each of their cases, was a long-term investment), in a like economic situation, but the tax incidence of each of them is not the same as the other, thus violating horizontal equity. Clearly, the tax incidence on Ms C is more than that on Ms D. That is so because Ms D is eligible for the CGT discount, which Ms C is not. Why Ms D is eligible for the CGT discount but not Ms C is due to the requirement that, in order to be eligible for the CGT discount, the CGT asset sold (which yields the capital gain potentially eligible for the CGT discount) must have been owned by the seller of it for at least 12 months. That requirement is arbitrary, as a genuine long-term investment (such as the investment in the share capital of the company made by Ms C) which has been owned for, say, 11 months and 20 days will fail to be eligible for the CGT discount as to any capital gain made from the sale of that investment by its owner, whereas it would had that sale happened 15 days later.

In order to avoid the occurrence of such an outcome which violates horizontal equity, by legislative amendment, the CGT discount must be applicable to capital gains made from the disposal of CGT assets owned for their potential to yield long-term returns, without any reference to the period of ownership of those CGT assets. Thus, the eligibility for the CGT discount will turn on the intrinsic nature of the CGT asset sold—that is, whether it is an asset

that was owned for its potential to yield long-term returns—not an arbitrary criterion such as the period of ownership of that asset.

Case study 15 is premised on the existence of the CGT discount. Whether the very existence of the CGT discount violates horizontal equity is an issue that was analysed in Chapter 3, and the analysis canvassed there is, accordingly, not repeated here.

## **Conclusion**

Fifteen case studies were analysed in this chapter. Two purposes were served by those case studies: they readily exemplified outcomes that can, in real life, cause violation of horizontal equity due to the CGT regime; and they served to demonstrate that the only reasons that could cause the CGT regime to produce outcomes that violate horizontal equity are the four reasons (and no other) identified in the previous chapter.

The recommendation formulated at the end of each case study in order to avoid the occurrence of violation of horizontal equity demonstrated by that case study has always (with the exception of case study 2) been a recommendation for legislative amendment, as legislative amendment represents the most robust mechanism for implementing a recommendation of that sort. That, however, must not be taken to mean that, of the four reasons identified in the previous chapter (described in that chapter as Reason A, Reason B, Reason C and Reason D), only Reason A prevails in practice. Case study 1, 8 and 11 exemplifies attempts by the Commissioner to (not in an altogether sustainable footing) address Reason A. And case study 2 is an example of the prevalence of Reason C.

The violations of horizontal equity, as revealed by each case study, are possibly capable of remediation without exposure to “excessive administrative costs or other adverse effects” (a criterion that was identified in Chapter 3 based on a standard formulated by the distinguished American public finance professor Louis Kaplow<sup>547</sup>). It is to demonstrate so that a recommendation was made with respect to each case study.

It was mentioned above that those recommendations are “possibly” capable of remediation without exposure to that criterion. That caveat was necessary as horizontal equity is only one of many policy objectives (which are not necessarily wholly co-extensive) that the CGT regime has to satisfy.

Kaplow, in his work referred to above, also did canvass a second criterion, which was “capriciousness”, as identified in Chapter 3. It is not necessary to demonstrate that the violations of horizontal equity, manifested in each case study, are “capricious” to sustain the recommendation made in relation to each case study, as those recommendations, as noted above, are sustained on the other criterion advocated by Kaplow, which is that, through each recommendation, the respective violation of horizontal equity can possibly be largely mitigated without exposure to “excessive administrative costs or other adverse effects”.

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<sup>547</sup> Above, note 113, p 139.

## **Chapter 7: Is there reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread?**

### **Overview of the scope of this chapter**

There is a basis, due to the 15 case studies canvassed in the previous chapter, to articulate a preliminary argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread. That preliminary argument is, in the rest of this chapter, tested through further research to establish whether it is justified.

### **Is there a basis for an argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread?**

Each of the 15 case studies identified in Chapter 6 cogently demonstrated that the detailed working of the CGT regime can cause outcomes that violate horizontal equity. The identification of those 15 case studies was not the result of a systematic, exhaustive investigation, as there is no scope in this thesis for the carrying out of such an investigation. Based on the experience of having carried out the somewhat limited investigation that was necessary for identifying those 15 case studies (as they comprised a necessary component of the research recorded in this thesis), and having regard to the nature of each of those case studies, one can very plausibly argue as follows. That is, one can argue that there can be little doubt, if a systematic, exhaustive investigation were to be carried out, many more (substantially many more) situations where the detailed working of the CGT regime causes violations of horizontal equity will be identified. Accordingly, there is a basis, due to the 15 case studies canvassed in Chapter 6, to articulate a preliminary argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be

widespread. That preliminary argument is next tested through further research to establish whether it is justified.

### **The arrangements pursuant to which legislative provisions imposing CGT are enacted and implemented**

In order to establish the arrangements pursuant to which legislative provisions imposing CGT are enacted and implemented, all relevant public speeches made by the Commissioner from 2005 onwards have been studied.<sup>548</sup> As to the arrangements pursuant to which legislative provisions imposing Commonwealth tax (including CGT) are enacted and implemented, the following advice of the Commissioner is authoritative and instructive:

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<sup>548</sup> Aust, Carmody M, “Revitalising the tax administration system: the Australian experience”, paper presented at the Tax Administration Advisory Board meeting at Phoenix, Arizona, USA, 11-12 January 2005; Aust, D’Ascenzo M, “The ATO’s approach to tax administration: working with the tax profession”, speech delivered to the Taxpayers Australia and Superannuation Australia annual conference at Sydney, Australia, 10 November 2006; Aust, D’Ascenzo M, “Australia’s approach to GST administration”, speech delivered to the “Twenty years of GST: the best path forward” conference at Wellington, New Zealand, 16-18 November 2006; Aust, D’Ascenzo M, “Consultation, collaboration and co-design”, speech delivered to the Australian Public Service SES Breakfast at Boathouse by the Lake, Canberra, Australia, 21 September 2006; Aust, D’Ascenzo M, “Impact of globalisation on tax administration”, speech delivered to the American Chamber of Commerce at Four Seasons Hotel, Sydney, Australia 26 September 2006; Aust, D’Ascenzo M, “It is the community’s tax system”, speech delivered to the Australasian Tax Teachers Association 18<sup>th</sup> annual conference at Melbourne, Australia, 30 January 2006; Aust, D’Ascenzo M, “Consultation, collaboration and co-design with the accounting profession”, speech delivered to the National Institute of Accountants at Canberra, Australia, 28 November 2007; Aust, D’Ascenzo M, “The rule of law: a corporate value”, speech delivered to the Law Council of Australia Rule of Law conference at Brisbane, Australia, 1 September 2007; Aust, D’Ascenzo M, “Simplifying tax administration in a complex world: the challenge of infinite variety”, speech delivered to the Australasian Tax Teachers Association 19<sup>th</sup> annual conference at Brisbane, Australia, 22-24 January 2007; and Aust, D’Ascenzo M, “Sustaining good practice tax administration”, speech delivered to the Australasian Tax Teachers Association 21<sup>st</sup> annual conference at Christchurch, New Zealand, 20 January 2009.

Whatever the merits of various reform proposals and the Government's responses or initiatives, and whatever the benchmarks against which they may be evaluated, the Tax Office's responsibility is to merely administer the tax and superannuation laws passed by Parliament. We are not the policy makers.

In translating Government policy into law, Treasury now plays the lead role as drafting instructor and the Office of the Parliamentary Counsel (OPC) writes the law. We work closely with Treasury and OPC on legislative design to ensure that the law when drafted gives effect to policy. However, the task of drafting is a difficult one because language often contains inherent ambiguities and at times can be subject to different interpretations, and it is not possible to anticipate the infinite variety of factual scenarios that may exist over time. Accordingly, our administration and interpretive skills can make a difference to the quality of the end product. We are strong supporters of "integrated tax design, where the process of drafting new laws or amendments has the seamless and combined benefit of policy, administrative, interpretive and drafting skills."<sup>549</sup>

That advice of the Commissioner yields two vital points, which are:

- the scope of the Australian Taxation Office's responsibility; and
- the scope of the process involved.

Those two points are canvassed below, in turn.

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<sup>549</sup> Aust, D'Ascenzo M, "Simplifying tax administration in a complex world: the challenge of infinite variety", speech delivered to the Australasian Tax Teachers Association 19<sup>th</sup> annual conference at Brisbane, Australia, 22-24 January 2007.

### The scope of the Australian Taxation Office's responsibility

Based on the Commissioner's advice, the responsibility for translating the policies of the Commonwealth government on Commonwealth tax into law is the responsibility of the Commonwealth treasury, which instructs the Commonwealth Office of Parliamentary Counsel to draft the law to give effect to that policy. While the Australian Taxation Office liaises with both those government agencies, its responsibility is to administer certain Commonwealth tax laws (as enacted by the Commonwealth legislature), not to formulate the policies that underpin those laws. That is, the exclusive responsibility of the Australian Taxation Office is the application of certain Commonwealth tax laws (including the CGT regime), based on a proper interpretation of those laws, regardless of the outcomes that ensue from that application.<sup>550</sup>

An appreciation of that position is quite important, as what it means is that the avoidance of outcomes (from the detailed working of the CGT regime) that cause violations of horizontal equity cannot, in principle, be made the responsibility of the Australian Taxation Office. That task must be made the responsibility of the Commonwealth treasury, or some other Commonwealth government agency (but not the Australian Taxation Office) designated for that purpose. There is no Commonwealth government agency currently with such a pointed responsibility.

### The scope of the process involved

The Commissioner's advice seems to describe a process that is aimed exclusively at new tax measures (that is, tax laws to be enacted), not at identifying and rectifying anomalies resulting

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<sup>550</sup> *Taxation Administration Act 1953 (Cth) Part IA.*

from laws already enacted. As the 15 case studies identified in Chapter 6 demonstrate, outcomes that violate horizontal equity result from the detailed working of the CGT regime (which comprises tax measures which have already been enacted). The process described in the Commissioner's advice (quoted above), accordingly, will not have identified those outcomes, as that process is not aimed at identifying such outcomes (stemming not from laws which are yet to be enacted but from laws already enacted). The absence of such a process is a telling institutional shortcoming.

It is highly germane that the Commissioner's advice did not describe that it was a feature in that process to be sensitive to the four reasons canvassed in Chapter 5 that alone can cause the CGT regime to potentially produce outcomes that violate horizontal equity. If such sensitivity was so systematic in that process one would expect that Commissioner's advice to have made mention of it. Accordingly, one can strongly surmise that there is no systematic sensitivity to those four reasons in that process.

**Is the argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread justified?**

The argument that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread is justified because, as canvassed above, there is no government agency that is pointedly responsible for identifying outcomes (resulting from the detailed working of the CGT regime) that violate horizontal equity (the Australian Taxation Office does not have such a responsibility) and there are no institutionalized processes (mandated by legislation or otherwise) for the identification of such outcomes.

## **Conclusion**

In this chapter, the arrangements pursuant to which legislative provisions imposing CGT are enacted and implemented were described. From that description, it was shown that, in those arrangements, there was no systematic sensitivity to the four reasons canvassed in Chapter 5 that alone can cause the CGT regime to potentially produce outcomes that violate horizontal equity. There were also no institutionalized processes (mandated by legislation or otherwise) for the identification of outcomes that violate horizontal equity and enacting legislative amendments to avoid such outcomes.

Due to those absences, the conclusion is drawn that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread.

## **Chapter 8: Overall conclusions, policy implications of them, and delimitations of the research**

### **Overview of the scope of this chapter**

In this last chapter, the analysis employed in this thesis and the resulting overall conclusions are summarized. The policy implications of those conclusions are then canvassed. Finally, delimitations of the research recorded in this thesis are outlined, from which directions for further research are identified.

### **Analysis employed and resulting overall conclusions**

This thesis addressed the following research problem:

Does the Australian regime of income tax on capital gains cause widespread violation of horizontal equity?

The overall conclusion reached in this thesis is that there is reason to expect that the Australian regime of income tax on capital gains (“the CGT regime”) can cause widespread violation of horizontal equity. That conclusion was reached based on answers to five questions:

#### Question 1

- Was the enactment of the CGT regime, and the continuance of it after enactment, actuated by a perception (of respectively the government which enacted it, and

subsequent governments which yielded to its continuance) that the regime will satisfy the policy objective of horizontal equity?, and, if it was,

### Question 2

- Is that perception largely correct?, and, if it is,

### Question 3

- What reasons could (in theory) cause the CGT regime to produce outcomes that fail to satisfy horizontal equity (that is, outcomes that violate horizontal equity)?, and, if such reasons exist,

### Question 4

- Do those reasons (or any other) in practice cause the CGT regime to produce outcomes that violate horizontal equity?, and, if they do,

### Question 5

- Is there reason to expect those outcomes to be widespread?

As reasoned in this thesis, only any one of four reasons can (in theory) cause the CGT regime to potentially produce outcomes that violate horizontal equity. Those four reasons are:

### Reason A

- The best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions can result in outcomes that violate horizontal equity.

### Reason B

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Australian judiciary's interpretation of those legislative provisions, not being compatible with the best interpretation of those legislative provisions (pursuant to the current approach of the Australian judiciary), can result in outcomes that violate horizontal equity.

### Reason C

- Though the best interpretation (pursuant to the current approach of the Australian judiciary) of relevant legislative provisions does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity. That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their best interpretation (pursuant to the current approach of the Australian judiciary).

### Reason D

- Though the Australian judiciary's interpretation of relevant legislative provisions (despite not being the best interpretation of those legislative provisions, based on the current approach of the Australian judiciary) does not result in outcomes that violate horizontal equity, the Commissioner's interpretation of those legislative provisions (generally, as evinced in rulings) can result in outcomes that violate horizontal equity. That would occur where the Commissioner's interpretation of relevant legislative provisions is not compatible with their interpretation by the Australian judiciary (albeit, based on the current approach of the Australian judiciary, such interpretation of the Australian judiciary not being compatible with the best interpretation of those legislative provisions).

It was demonstrated, in this thesis, that the arrangements pursuant to which legislative provisions imposing CGT are enacted and implemented lack systematic sensitivity to those four reasons. They also lack institutionalized processes (mandated by legislation or otherwise) for the identification of outcomes that violate horizontal equity and effecting legislative amendments to prevent such outcomes.

It was those shortcomings that led to the overall conclusion that there is reason to expect outcomes that violate horizontal equity (caused by the CGT regime) to be widespread.

## **Policy implications of the overall conclusions**

The principal policy implication of the overall conclusions from the research recorded in this thesis is that there must be institutionalized processes established to robustly address those four reasons.

As to how those four reasons should be addressed was articulated in this thesis: adopting a consequentialist approach to interpreting legislative provisions imposing CGT, which must be aided by legislative directives to the Australian judiciary and other means necessary for making such an approach practicable; mandating post-implementation reviews of CGT measures enacted to ensure that those measures do not cause violation of horizontal equity; and enacting explicit legislative directives prohibiting the Commissioner from issuing rulings (or any like pronouncements) which are inconsistent with judicial authority.

The failure to address those four reasons, and thus allowing the perpetuation of a status quo where there is reason to expect widespread violation of horizontal equity caused by the CGT regime, is highly inimical to good tax administration. That is so as a nation's public expects that a tax imposed by its government must necessarily satisfy horizontal equity in order for the public to feel persuaded to optimally comply with that tax. A lack of optimal compliance will render that tax to be inefficacious. The CGT may end up in that plight if those four reasons are not duly addressed.

## **Delimitations of the research recorded in this thesis, and directions for further research**

The delimitation of the research recorded in this thesis is alluded to at the end of in Chapter 6, which is that the conclusions drawn in this thesis as to the means for avoiding outcomes

(caused by the detailed working of the CGT regime) that violate horizontal equity are drawn necessarily tentatively. That is so in recognition that (as noted in Chapter 4) horizontal equity is only one of many policy objectives (which are not necessarily wholly co-extensive) that the CGT regime has to satisfy. Accordingly, while this thesis attempted to formulate the means for avoiding outcomes (caused by the CGT regime) that violate horizontal equity, implementing those means may not necessarily prove feasible in view of horizontal equity being regarded to be subordinate to one or more other policy objectives which the CGT regime also has to satisfy.

More research, therefore, is warranted to establish whether the means formulated in this thesis for avoiding outcomes (caused by the detailed working of the CGT regime) that violate horizontal equity may prove incapable of implementation due to horizontal equity being regarded to be subordinate to one or more other policy objectives which the CGT regime also has to satisfy.

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