“Policy and fairness versus the Rule of Law in taxation matters”

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Introduction

It can be safely said that the ATO sets out to administer the tax laws by reference to the enacted laws themselves and the best evidence of the meaning of those enacted laws, being precedential judicial decisions. There can also be no doubt that the Commissioner implements judicial decisions against him in favour of taxpayers.

Whilst it makes salacious reading, none of us should be concerned with the rare overt errors of judgment by individuals within the ATO that are exposed and dealt with by the courts. That is an obvious danger within any organization and we are all well equipped to recognise it.

My concern is about the Commissioner’s approach to statutory interpretation. That approach presents an insidious danger to the Rule of Law, all the more so because it is well-meant, overt, and seems reasonable. One recalls the observation of Brandeis J:

Experience should teach us to be most on our guard to protect liberty when the government's purposes are beneficent. ... The greatest dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding.

As tax teachers, we have had to teach how the tax system should work fairly, and also try and understand (and explain) the various and ever-changing policies that underlie particular provisions.

But in advising a client about tax law, were I to approach a particular provision with a priori view about its meaning due to my understanding of the underlying “policy intent” – to use the Commissioner’s mantric expression – that could be very damaging to that client if I failed to pay proper attention to the actual words used by Parliament.

1 Olmstead v. United States, 277 U.S. 438 (1928)
The wrong approach to statutory construction

Griffith CJ, with respect, rang the alarm bells in Richardson v Austin:\(^2\):

“… there is nothing more dangerous and fallacious in interpreting a statute than first of all to assume that the legislature had a particular intention, and then, having made up one’s mind what that intention was, to conclude that that intention must necessarily be expressed in the statute, and then proceed to find it.”

Very strong words fell from the first Chief Justice – “nothing more dangerous and fallacious”.

The observations of Windeyer J in MP Metals v C of T\(^3\) should also be heeded:

“The policy of an enactment is what its words and phrases, read in their context and having regard to the subject matter, reveal it to be, and assumptions as to the general intent of a statute must be used cautiously in the interpretation of particular provisions.”

I give one example.

In Di Lorenzo Ceramics Pty Ltd v C of T\(^4\) the taxpayer – a private company – lent money to a unit trust in which it owned 75% of the units and another company owned the other 25%. The unit trust purchased business premises and leased those premises to the taxpayer.

The “policy intent” of Division 7A was to prevent disguised distributions of profits by private companies to non-corporate shareholders. Plainly the arrangement was not within the policy intent of the provisions, but that did not prevent the court finding that the company should pay tax on what was effectively a distribution of profits back to itself and that the other company should pay tax on a trust distribution even though had the funds been lent directly, there would be no problem.

Many advisors took a similar approach to Division 7A, relying fallaciously on what they understood it to mean without sufficient attention to its actual words.

This led to the amendment of Division 7A to allow the ATO a dispensing discretion (but in carefully defined circumstances).

From a tax advisor’s perspective, he or she would only be liable to be sued for negligence for suggesting a provision shouldn’t apply because it was not within the

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\(^2\) (1911) 12 CLR 463
\(^3\) (1967) 40 ALJR 538, 14 ATD 407
\(^4\) (2007) 161 FCR 198
policy intent. But if a Court were to take this “dangerous and fallacious” approach, the danger could be the unintended subversion of the Rule of Law itself.

In *Westraders v FCT*\(^5\) Deane J, when sitting in the Federal Court (and ruling favourably on a blatant tax avoidance scheme), said:

“For a court to arrogate to itself, without legislative warrant, the function of overriding the plain words of the Act in any case where it considers that overall considerations of fairness or some general policy of the Act would be best served by a decision against the taxpayer would be to substitute arbitrary taxation for taxation under the rule of law and, indeed, to subvert the rule of law itself..." (at p60)

This passage was cited with approval by a plurality of the High Court on appeal\(^6\) and described as “basic to the maintenance of a free society”. Barwick CJ went on to say:

“The function of the court is to interpret and apply the language in which the Parliament has specified [the circumstances which will attract an obligation on the part of the citizen to pay tax]. The court is to do so by determining the meaning of the words employed by the Parliament according to the intention of the Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.”

The consequences to each taxpayer in our free society are the same where the dangerous and fallacious approach is *bona fide* taken as where a court deliberately attempts to mould the statutory language.

Individual judges with actual knowledge of the passage of the relevant legislation have been very careful to guard against encroaching upon the Legislative function. In England it has been the case that members of the House of Lords have been involved in the passage of legislation and then been required, years later, to construe its meaning. Those judges have considered themselves not the best, but the worst, equipped to construe its meaning. For example, Lord Halsbury LC\(^7\) abstained from writing a judgment, saying:

‘I have more than once had occasion to say that in construing a statute I believe the worst person to construe it is the person who is responsible for its drafting. He is very much disposed to confuse what he intended to do with the effect of the language which in fact has been employed. At the time he drafted the statute, at all events, he may have been under the

\(^5\) (1979) 24 ALR 139
\(^6\) (1980) 144 CLR 55
\(^7\) *Hilder v Dexter* [1902] A.C. 474 at 477.
impression that he had given full effect to what was intended, but he may be mistaken in construing it afterwards just because what was in his mind was what was intended, though, perhaps, it was not done.’

The Commissioner’s statutory responsibility

It is of course to administer the tax laws correctly as they relate to each taxpayer. It is a neutral role, as the following passage from the Full Federal Court’s decision in *Lighthouse Philatelics Pty Ltd v FCT* exemplifies:

[The Commissioner] has an obligation to administer the Act and may determine to allow the objection for grounds totally unrelated to those raised by the taxpayer, if that be the correct course, just as he could form the view, based on a reconsideration of the matter, that the assessment should be confirmed for reasons which he had not previously considered. His task is to ensure that the correct amount of tax is paid, “not a penny more, not a penny less”.

He also sees himself as having to wear a different hat, being “an advisor to the government through Treasury on what we are seeing in the marketplace.” He states on the ATO website:

“... if we find that the underlying policy intent of the law is not being achieved or there are unintended consequences, whether they benefit or are to the detriment of an individual taxpayer, we would bring such matters to the attention of Treasury and government. In this even-handed way we champion both the interests of individual taxpayers and of the community.”

All this can be accepted, though it has been submitted to the Joint Committee of Public Accounts and Audit that the Commissioner must report to all of Parliament, not just secretly to Treasury.

Take as an example the above-mentioned problems with Division 7A. No one could cavil with the Commissioner reporting to Treasury that many taxpayers were inadvertently falling foul of its provisions and that he should be allowed to provide some relief where honest and inadvertent mistakes were made and corrected in a timely fashion.

The ATO’s political approach to statutory construction

But the Commissioner goes too far in forming and then acting on an a priori view of what a provision really means by reference to his view of “underlying policy intent” of that provision, rather than text itself, which is controlling. And to think that he

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8 (1991) 32 FCR 148
9 *Carr v State of Western Australia* [2007] HCA 47
knows what a provision means because he assisted in its drafting merely compounds the error by leading to intransigence. Another quote (Kitto J in Moreton Central Sugar Mill Co Ltd v FC of T\textsuperscript{10}):

“Every case ... must be read by reference to the words of the section itself, and no general notion of policy can be used as a substitute.”

I prefer to call the Commissioner’s view, in keeping with the theme of this Conference, “the ATO’s political approach” to statutory construction.

This approach is not to be confused with the correct (and now required by statute - see s 15AA Acts Interpretation Act 1901) “purposive” approach, which requires the text actually to bear a number of meanings. For example, in Newcastle City Council v GIO General Ltd\textsuperscript{11} McHugh J said:

“Nevertheless, as I pointed out in Kingston v Keprose Pty Ltd, in applying a purposive construction, ‘the function of the court remains one of construction and not legislation.’ When the express words of a legislative provision are reasonably capable of only one construction and neither the purpose of the provision nor any other provision in the legislation throws doubt on that construction, a court cannot ignore it and substitute a different construction because it furthers the objects of the legislation.”

I do not wish to be too alarmist, because nine times out of ten no harm is done in taking this approach; it may well be a convenient shortcut and as a matter of human nature cannot be helped by those with an in-depth knowledge of taxation policy. But there must be self awareness, and restraint must be exercised, lest there come the “periodical tenth case”.

There are at least two adverse consequences of the ATO’s political approach.

First, individual taxpayers are unnecessarily embroiled in misconceived litigation, leaving them to suffer immediate adverse consequences as well as impeding their business plans.

Second, if the 1988 observation of Deane J in Hepples v FCT\textsuperscript{12} that the content and drafting of technical provisions reflects the advice and views of ATO officers remains true today, the ATO Public Rulings regime also contains the inherent flaw adverted to by Lord Halsbury.

Lest it be suggested by the ATO that the views of Griffith CJ are anachronistic and do not reflect the modern judicial approach, recent examples of the Court’s rejection of

\textsuperscript{10} (1967) 116 CLR 151.
\textsuperscript{11} (1997) 191 CLR 85.
\textsuperscript{12} (1992) 173 CLR 492.
the ATO’s political approach are in *Intoll Management Pty Ltd v C of T*¹³ and in *International All Sports Pty Ltd v FCT*¹⁴.

Intoll Management concerned the application of s 23AJ ITAA to an Australian entity that was paid non-portfolio dividends. That entity was a trust that was the head entity of a consolidated group and deemed for core Consolidation purposes to be a company.

The ATO’s amended assessment took the taxpayer by surprise, because the ATO had issued a public ruling in the following terms:

“section 23AJ will apply to a dividend that is paid to a trust which is part of a consolidated group or a multiple entity consolidated (MEC) group”.

The ATO’s objection decision read like a submission to Treasury as to the reasons why, as a matter of OECD policy, the s 23AJ dividend exemption should not apply to trusts, even those deemed to be companies. It also went on to assert that it was not bound to assess in accordance with its public binding ruling.

The taxpayer did not engage in a tax policy debate as to why there was no failure of “underlying policy intent” because, like any “real” company, any subsequent distributions would be treated as unfranked dividends. It simply relied on the plain words of s 23AJ and, as a back-up, the public binding ruling.

The Court unusually commenced the proceedings by asking the Commissioner to make submissions first, indicating that the taxpayer’s position was well understood and that he had a real case to answer.

The Court rejected the ATO’s political approach emphatically:

“Even if it were to be found in the extrinsic materials cited by the Commissioner in its support, the supposed policy that s 23AJ should not apply to an entity taxed as a head company is one which would not displace the clear words of the statutes. The meaning is to be found in the statutory language, not in unstated policies inferred from a preferred outcome.”

This echoes another observation of Griffith CJ in *Tindal v Calman*¹⁵:

“"In this case the court is asked ... to construe a statute ... according to some notion of what the legislature might have been expected to have said, or what this court might think it was the duty of the legislature to have said or done. But the duty of a court is to examine the language used, and to give effect to it ..."”

¹⁵ (1905) 3 CLR 150.
The *International All Sports case* concerned the construction of the gambling provisions in the GST Act. Under the provisions a gambling enterprise was obliged to pay GST, in relation to a gambling event, on the total amount wagered less the total monetary prizes payable in relation to that gambling event. If there were a negative amount loss it was offset against positive amounts on other gambling events.

The problem – or *casus omissus* - was that the total amount wagered concerned only taxable supplies (not GST-free) supplies (not non-resident bets), yet the total monetary prizes concerned all prizes, irrespective of to whom they were payable. So if five residents and five non-residents bet $100 each in a lottery for a $800 prize, the enterprise’s net profit would be $200, but the taxable margin would be $500 less $800, i.e. - $300.

The Commissioner appealed to the policy intent of the GST Act to tax net profit, but then only suggested an equally anomalous alternative construction, being that prizes should only be counted if won by residents. That submission was rejected:

This is not, in my view, a case in which a court can look at a provision of an Act of Parliament and be confident not only that the words of the provision could not have been what the legislature intended but also that the meaning actually intended was an obviously alternative, identifiable, one. At most, it might be a case in which the statutory draftsman had not thought through the implications of the words which he or she employed. It is quite possible that he or she did not have in the forefront of his or her mind the arithmetical outcome ordained by those words in situations in which successful gamblers were based overseas. It would not be the first time that some practical, possibly only occasional, impact of new legislation of broad application had escaped the conscious anticipation of the draftsman. However these things may be, they provide no warrant for the court, either under s 15AB or generally, not only to hold that the legislature probably did not mean what it said, but also to supply what it considers would most probably have been the draftsman’s chosen wording, had the matter been given the attention which it required. I accept the submission of the applicants that I should follow the advice of Lords Simonds and Reid in *IRC v Wolfson* [1949] 1 All ER 865, 868 and 870:

‘It is not the function of a court of law to give to words a strained and unnatural meaning because only thus will a taxing section apply to a transaction which, had the legislature thought of it, would have been covered by appropriate words.’

These cases might be said to exemplify merely the waste of time and resources engendered by the ATO’s political approach. That itself is an intrusion on individual rights under the Rule of Law.

In any event, more palpable danger to the Rule of Law arises whenever the Commissioner’s starting point to statutory construction is also his ending point, where he becomes blind to the words of the relevant section, so much so that he
ignores his obligation under the Constitution to follow those charged with construing it, the Judiciary.

The starkest example, of course, is *Commissioner of Taxation v Indooroopilly Children Services (Qld) Pty Ltd*[^16].

It will be recalled that the specific FBT issue in that case was whether a fringe benefit had to be provided in respect of the employment of a particular employee, or whether it was sufficient that the benefit be provided in respect of employment generally.

In his 1 September 2008 speech delivered, ironically to the Law Council of Australia Rule of Law Conference, the Commissioner said that he chose to issue an adverse private FBT ruling to the taxpayer, in the face of Federal Court decisions telling him what Parliament intended by the relevant section, because he was

> “armed with our understanding of the policy intent of the relevant provisions and a view that we had reasonable prospects of success”.

(That view on prospects appears not to be an independent view, but a view of an especially qualified ATO officer.)

To emphasise, “our understanding of the policy intent of the relevant provisions” was the Commissioner’s stated justification for telling the taxpayer and then the Federal Court that he was “not bound by single judge decisions”.

Perhaps if the ATO had not made this inflammatory claim at each stage of the Part IVC proceedings things would have been different in respect of the Notice of Contention in the *Indooroopilly case*. But the ATO did make this assertion in his objection decision, and did not water it down in his written submissions, although the Commissioner has attempted to do so subsequently.

Whether things would have been different is not the subject of today’s paper, though if I have time I will digress and share my views. I am also happy to share my views about whether the ATO could have sought a declaration before issuing their ruling, which has been the subject of much debate and, it has been asserted, that Edmonds J has recanted extra-judicially.[^17]

My point today is that if the ATO had actually approached the relevant provisions correctly, *a fortiori* with the then best evidence of the meaning of the provisions[^18], being the decisions of

- Kiefel J in *Essenbourne Pty Ltd v Commissioner of Taxation* 2002 ATC 5201;

- Merkel J in *Spotlight Stores Pty Ltd v Commissioner of Taxation* 2004 ATC 4674;
- Kenny J in *Caelli Constructions (Vic) Pty Ltd v Commissioner of Taxation* (2005) 147 FCR 449 (Kenny J); and
- Ryan J in *Cameron Brae Pty Ltd v Commissioner of Taxation* 2006 ATC 4433.

then it would have been decided that the “underlying policy intent” of the FBT provisions was more likely than not to be as those judges had decided.

The ATO did not do so, and its resultant “astonishing” conduct was considered by the Full Federal Court to have subverted the Rule of Law.

Allsop J, with whom Stone J and Edmonds J agreed, said:

“What should not occur is a course of conduct whereby it appears that the courts and their central function under Chapter III of the Constitution are being ignored by the executive in the carrying out of its function under Chapter II of the Constitution, in particular its function under s 61 of the Constitution of the execution and maintenance of the laws of the Commonwealth.”

His Honour concluded:

“There was some inferential suggestion in argument that the appellant was somehow bound by legislation (not specifically identified) to conduct his administration of the relevant statute by reference to his own view of the law and the meaning of statutory provisions, rather than by following what the courts have declared. It only need be said that any such provision would require close scrutiny, in particular by reference to issues raised by s 15A of the *Acts Interpretation Act* 1901 (Cth).”

Moreover, the Court did not accept the Commissioner’s excuse for why he did not appeal the *Essenbourne case*. And he did not proffer any excuse for why he did not appeal any of the other cases.

Of course the Court was not concerned with its own dignity, but with that of the relevant citizens living under the Rule of Law. They are the ones affected by the Commissioner’s conduct in not applying the enacted law. For them following decisions where the Commissioner had joined as a party in the engagement of judicial power under the Constitution he has been provided fair opportunity to present his position fully, and had had that position rejected emphatically. Of that I will say a little more below.
Eight years ago, at this annual conference, Professor Woellner delivered a paper about the *Indooroopilly case* entitled “Is the ATO a law unto themselves?”.  

Professor Woellner lamented that many practitioners in the tax community perceived that the ATO had not behaved properly. He concluded that time will tell whether the ATO believes it is a law unto itself.

Certainly I have not seen another ATO objection decision stating that the Commissioner is not bound by single judge decisions.

Since Professor Woellner wrote his paper the ATO have implemented a “Decision Impact Statement” regime, where they provide commentary on particular tax decisions and how they impact tax laws and presumably tax administration.

A search of those DISs disclosed no overt rejection of any decision as wrong and not to be followed, but discloses that the Commissioner is of the view that decisions he loses are not “final” until all appeal rights are exhausted.

He also can be reluctant to accept that he has lost a point. For example, in the DIS about *Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd*20, where the Full Federal Court rejected his submission that a tax deduction under the alternative postulate must be under the same provision as the tax deduction claimed under the scheme for a taxpayer to succeed in a submission that the scheme did not give rise to any s 177C tax benefit, he states:

“The possible inconsistency in the Full Federal Court between Lenzo on the one hand and Trail Bros and Ashwick on the other as to whether the allowable deduction (if any) identified in the alternative postulate has to be of the same kind or character as that allowable (but for Part IVA) under the scheme creates some uncertainty for both taxpayers and the Commissioner.”

“The Commissioner will take all decisions of the High Court and Federal Court into account in applying Part IVA to the particular facts of cases. The Commissioner notes however the weight of authority now provided by the judgments in Trail Bros, Ashwick and AXA on the interpretation of s 177C (1).”

As I have attempted to explain in this Paper, that is not the basal problem. The problem remains extant. In this regard I have not finished with the *Indooroopilly case* because the Commissioner has in speeches and before the Joint Committee for Public Accounts and Audit since tried to justify his conduct.

What he must do but has not done is self-assess how the ATO could have been “armed with our view about the underlying policy intent of the relevant provisions”.

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In 2012 the Commissioner addressed the Joint Committee for Public Accounts and Audit, following an anonymous public submission that he still considered himself as not being bound by single Federal Court decisions. The Chairman summarised it as follows:

'I submit that Mr D'Ascenzo insists that the ATO is not required to follow single-judge decisions.'

The Commissioner responded oddly by wanting to know the identity of this “invisible” person.

He then addressed the substance of the submission:

“We have had a lot of discussions since 2007 and I would have thought by now this would be dead and buried, but let me go back to this issue. This issue arises from a case we won. It was based on two grounds and we won one ground. We won the case and we had other cases in the courts on the other issue. We said we would progress the other issue to get clarification from the courts. We were saying we wanted to listen to the courts and get this reviewed by the full Federal Court because we thought this could be incorrect. We had counsel's advice to the effect that we were doing everything in a proper way—that was from the Solicitor-General. We would not have done it if we had not had a clear mandate that this was in accordance with the proper application of the law.”

He concluded that he was at a loss as to the reason why there was such a fuss:

“I do not know why some people took it in any other way than the way that it was meant, to have clarification in the full Federal Court, but they did. It ran its own little course for some reason. It is interesting that since that time there have been comments by jurists, including the Supreme Court of New South Wales, saying that was the proper course of action in any event.”

What is really troubling about the Commissioner’s view of the underlying policy intent is that by the time of the Indooroopilly ruling, leaving aside the Federal Court decisions he chose to ignore, Parliament had inserted core FBT provisions that made it abundantly clear that a fringe benefit had to be provided in respect of the employment of a particular employee and the taxable value of that benefit had to be attributed to that employee on his or her group certificate for social security and other benefit purposes.

So even if the ATO political approach to statutory construction were correct and it was also correct to ignore the Judiciary, the “underlying policy intent” of the FBT provisions alone was pellucidly clear.
So it would appear that the underlying policy intent to which the Commissioner referred was the broader idea that the “holy grail”, as he called it in his Rule of Law speech, should not exist. That is, in his belief Parliament could not have intended that an employer could get a tax deduction under the ITAA for a contribution made for the benefit of its employees without also being liable to FBT.

Suspending disbelief for a moment about being able to find properly the meaning of the relevant provisions of the FBT Act by reference to s 8-1 ITAA97, in his speech, and in his subsequent evidence before the JCPAA, the Commissioner was at pains to emphasise that he had won the s 8-1 tax deductibility battle. That is, he had proved that the holy grail did not exist at the time, so on his argument there was in fact no underlying policy intent to impose FBT. Rather, the policy intent would have led to double taxation (indeed triple taxation because he also ruled in Indooroopilly that the employees were liable to tax if and when they received their shares).

More disturbingly, because the Commissioner has evaded commenting on this aspect of the ATO conduct as far as I can tell, it is impossible to believe that the Solicitor—General would have given “a clear mandate” that it was “a proper course of action” to penalize taxpayers (e.g. see Benstead Services Pty Ltd v FCT21) at the rate of 40% because, by following the Federal Court decisions, they had acted recklessly, a fortiori when TR 95/4 stated:

“Failure to self assess in accordance with the decision of the AAT or court at the time of lodgment of a tax return would ordinarily amount to carelessness by the employer.”

Perhaps the ATO’s approach to penalizing individual taxpayers might solve the mystery for the Commissioner as to why some people took the Indooroopilly matter in another way from him.

Again, what we see is an intransigence that misled the ATO not only into defying the Federal court authorities but into believing its position on FBT was so unarguably correct that taxpayers or their advisors must have acted recklessly to apply the FBT law as they did.

Of course, other equally irrelevant consideration must have been at play for the ATO to have imposed FBT penalties for recklessness on taxpayers, such as shutting down the businesses of “tax promoters”.22

But the insidious problem at the heart of this matter is the ATO’s well-meant but dangerous and fallacious adherence to their “political” (as opposed to purposive) approach to statutory construction.

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21 (2006) 64 ATR 1232
Here, it seems, the ATO are now ignoring Parliament in favour of its own view of what *should* be the law. What should be the law is a worthy question, but is for members of this Association and others with like public interest, not the ATO.