THE CONCEPT OF INCOME

A MULTI-DISCIPLINARY ANALYSIS

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In short, income means different things to different people. But the different perceptions of income do not mean that scholars and policymakers should not attempt to refine its meaning. As Arnett puts it, "[i]n any field of endeavour, the participants must understand the meaning of the terms used in that field. This requires, ideally, that each word should identify something unequivocally, i.e., should have its own unique object of identification."[1]

Income is the means by which people survive. In an interdependent economy, money facilitates the derivation of income. On the other hand, in a barter economy the absence of a medium of exchange does not mean that participants do not derive income. Rather, their income is obtained in a non-monetary form.

All facets of economic activity are premised upon income of one sort or another. Without income there is no economy. In various works, the American doyen of early income and capital theory, Irving Fisher, reiterated the significance of income in economics. In 1912, he summarised the importance of income in the following way: "[i]ncome plays an important role in all economic problems. It is income for which capital exists; it is income for which labour is exerted; and it is the distribution of income which constitutes the disparity between rich and poor."[2] Later, he observed that "the concept of income is, without exception, the most vital central concept in economic science and that on fully grasping its nature and interrelations with other concepts largely depends the full fruition both of economic theory and of its application to taxation and statistics."[3]

More recent economic analysis places less emphasis on income and more emphasis on welfare.[4] However, Fisher's observations serve as a good point of introduction and, as this study concludes, remain valid in a practical economic policymaking context.

1 Arnett, Harold E., "The Concept of Fairness", (1967) *The Accounting Review*, April, 292.

2 Fisher, Irving, (1912) *The Nature of Capital and Income*, Macmillan, New York, first published 1906, viii.

3 Fisher, Irving, "Comment on President Plehn's Address", (1924) 14(1) *American Economic Review*, 64.

4 See under *Well-being* and *Optimal Tax Theory* below.

greater contribution to the welfare of society. Utilitarian reasoning suggests that the well-off can forego part of their well-being in favour of the less fortunate, so that well-being in the community as a whole may be improved.

Governments must identify an appropriate instrument (or instruments) to determine the well-being of the parties with whom the state is concerned. For policymaking purposes, the entity with which a government is concerned must also be identified. Is the government addressing the well-being of an individual, a family, a hetero- or homosexual *de facto* relationship, or an extended family group? The periods over which the well-being of the selected entity is measured must also be determined. These factors are beyond the scope of this thesis, which concentrates on an equity based notion of income as a determinant of well-being of individuals, who are presently accepted as assessable units, and whose income is typically measured on an annual basis.

The term *well-being* does not lend itself to precise or readily quantifiable interpretation. It is highly subjective, abstract, and inherently complex.[5] It is complex because well-being can be construed as a standard of living or quality of life that necessitates consumption of a combination of material goods and services (that is, those provided by the market and public goods and services) and non-material intangible benefits (for example, an environment with clean air, cultural harmony and no crime). The abstraction associated with well-being lies in these elusive factors. The notions of well-being differ because individuals have different perceptions about the optimum trade-off between the two competing components.

The notion of well-being can also be contradictory. Sen illustrates the point using the idea of "well-offness": "[y]ou could be *well-off* without being *well*. You could be *well*, without being able to lead the life you *wanted*. You could have got the life you *wanted*, without being *happy*. You could be *happy* without having much *free-*

5 Prebble, Mark, (1990) *An Integrated Approach to Redistribution: Issues of Policy, Economics and Information*, unpublished PhD thesis, Victoria University of Wellington, 9.

As society has become more liberal since Simons's work, there has been a tendency to give equity considerations greater prominence in balancing the conflicting tenets of taxation policy. For example, the Carter Commission in Canada gave highest priority to the equity criterion: "when faced with ... choices [between equity and other tax policy objectives] we have consistently given the greatest weight to the equity objectives ... . We are convinced that scrupulous fairness in taxation must override all other objectives where there is a conflict among objectives."[33]

Horizontal Equity

There are two dimensions to the notion of fairness: vertical and horizontal. The vertical aspect addresses equity in terms of people in different income classes. In particular, proponents of vertical equity in taxation argue that, to achieve an equitable distribution of the tax burden between people in different income bands, the income tax rate scale should be progressive. Such a scale reflects the ability of higher income earners not only to pay a greater absolute amount of tax than those on lower incomes, but it also reflects the ability of higher income groups to pay proportionately more of their income in taxation. This notion has an intuitive appeal to many people as an ideal way of distributing the tax burden among different income classes.

Horizontal equity is concerned with like treatment of people in like circumstances. In an income tax context, horizontal equity is achieved when two people who derive the same incomes (in whatever form) are each levied the same amount of tax. Chapter 2 argues that, for practical purposes, such equal treatment can only be achieved by adopting a Schanz-Haig-Simons-type accretion concept of income.

To exempt certain categories of gain from income defies the principle of horizontal equity. However, because economic objectives conflict, the purity of horizontal equity may need to be compromised in order to achieve other aims, such as stimulating economic

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33 Carter, Kenneth Le M., *et. al.*, (1966) 1 *Report of the Royal Commission on Taxation*, Queen's Printer, Ottawa, 4.

Macomber,[50] Justice Pitney said of a shareholder who received a bonus issue of shares:

> Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.[51]

Why this should be so has never been convincingly justified. The author submits that it is not tenable to contend that ability to pay is absent simply because assets are not held in cash. Payments can be made, if necessary, by transferring the assets themselves. The samples of tax legislation in Chapters 11 and 13 of this book clearly demonstrate that governments have not been constrained to an ability to pay notion based on cash in hand.

Still other commentators consider that income should be adjusted to allow for unusual expenses that reduce a taxpayer's ability to pay, such as medical expenses or losses arising from accidents.[52] These scholars also tend to favour unyielding vertical equity premised on ability to pay. For instance, Pechman states, in the context of the flattening of the progressive rate scale in the United States 1986 Tax Reform Act: "I have serious reservations about the elimination of graduation at the top rate of the income scale. Surely there is a difference in ability to pay out of a marginal dollar at $30,000 than at $300,000 of taxable income, yet the 1986 Act makes no distinction between the rates at these levels."[53]

Whether the proposition is accepted turns on subjective arguments, which are resolved at a political level. How the issue is determined also has macroeconomic repercussions. As already noted, a detailed discussion of vertical equity is beyond the scope of this dissertation. The principal concern here is with horizontal equity, which can be evaluated in a more objective manner.

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50 (1920) 252 US 189. This case is discussed in detail under *Eisner v. Macomber* in Chapter 5.

51 *Ibid.*, 213.

52 See, for example, Pechman, Joseph A., *op. cit.*, footnote 35, 86.

53 *Idem.*

Global and Schedular Income Tax Systems

Under a global system of income taxation, all income, regardless of its source, is aggregated and subjected to a single tax schedule. The purpose of the global approach is "to distribute interpersonal tax burdens, vertically and horizontally, according to the ability to pay principle".[54] Aggregating income under a global tax renders a progressive tax scale more effective (vertical equity) and does not discriminate between income from different sources (horizontal equity).

Taxation under a schedular system identifies income by source and imposes tax, sometimes at different rates, separately on the total income derived in each source classification. Often under the source method, some distinctions are made between earned and unearned income. Typically, capital gains receive a more favourable tax treatment than other passive or non-passive income. Schedular income tax systems that operate in this way undermine the principle of horizontal equity (and tax efficacy) and, therefore, augment the inequities in the income tax system.

Some countries use a schedular system. Examples include the United Kingdom,[55] Hong Kong,[56] Belarus,[57] and Sudan.[58] But these countries are in a minority.

54 Plasschaert, Sylvain R. F., (1977) *The Definition of Gross Taxable Income in Schedular or Global Frames of Income Taxation*, Centre for Development Studies, University Faculties St. Ignatius, University of Antwerp, Paper 77/22, Belgium, 26. Plasschaert's notion of the ability to pay principle here implies a person's economic power, rather than whether or not the person has cash on hand to satisfy a tax payment liability.

55 See under *History of the Legal Distinction Between Income and Other Receipts in England* in Chapter 5.

56 Following, as a British colony until 1 July 1997, the British tax system.

57 KPMG, "Corporate Profit Tax in Belarus" in Prokisch, Rainer G. *et. al.* (eds.), (1999) 5 *Guides to European Taxation – Taxation & Investment in Central and East European Countries*, International Bureau of Fiscal Documentation, Amsterdam, 27.

58 *Op. cit.*, footnote 54, 38. In 2001, the Netherlands also adopted a schedular system.

In OECD economies, in particular, there has been a trend away from the schedular system of taxation towards the global approach. Croatia moved from a schedular to global system in 1994.[59] Other examples include Colombia, which had a schedular system from 1821. It moved to the global basis of income measurement in 1920.[60] Belgium implemented a schedular system in 1919 and switched to an "impure" global system in 1963.[61] Italy moved to a global measure in 1974.[62] Mexico adopted the schedular basis in 1925 and moved to the global basis in 1964 for taxpayers with incomes above a prescribed amount.[63]

The global approach has tended to widen the tax base and achieve greater horizontal equity. However, no country has a complete global system: some gains are only partially taxable and others (for example, capital gains) may not be taxed at all as in New Zealand.[64] Conversely, countries that are generally treated as having a global system can be regarded as having weak schedular systems in that certain gains (capital gains, in New Zealand) are placed in a separate category and are not taxed or are taxed at concessional rates. There is no definite delineation between global and schedular income tax systems in practice. Each tax system is really a shade on a spectrum: "pure white" if income is formally categorised and different tax rates apply to each category, and "dark grey" if the system purports to be global, but in fact does omit some gains altogether (that is, a separate category upon which tax is imposed at zero per

59 Lactić, Goranka Šumonja and Bejaković, Predrag, "Croatia" in Prokisch, Rainer G. *et. al.* (eds.), (1999) 5 *Guides to European Taxation – Taxation & Investment in Central and East European Countries*, International Bureau of Fiscal Documentation, Amsterdam, 45.

60 Under Colombian law (like United States law), anything that adds to a taxpayer's wealth, and therefore his ability to pay tax, is, in principle, regarded as income, unless it is expressly excluded by operation of law. Accordingly, in Colombia, gross income comprises both ordinary and extraordinary receipts: Gómez, Álvaro Parra and de la Cueva González-Cotera, Álvaro, "Colombia", in Caballero, M. A. Gª. (ed.), (1999) 1 *Taxation in Latin America*, International Bureau of Fiscal Documentation, Amsterdam, 5.

61 *Op. cit.*, footnote 54, 35.

62 *Ibid.*, 36.

63 *Ibid.*, 38.

64 However, see Chapter 9 for exceptions where some "capital" gains are taxed as income.

CHAPTER 2

FOUNDATION CONCEPT OF INCOME

Introduction

Over time, there has been a shift from subjective interpretations of income to more objective interpretations. Early economists conceived the ideas of psychic income and utility.[1] Later economists made these abstract notions more practical by substituting monetary flows. Further theoretical development centred on increases in consumption rights acquired over a period, preservation of the source of income, and maintenance of a basic standard of living.

As demonstrated in Chapter 1, a foundation concept of income should be comprehensive, objective and equitable. However, before a receipt was treated as income and therefore subject to income tax, some economists imposed additional conditions, such as permanence of, and separability from, the source of a flow, and periodicity. Chapter 3 critiques these additional tests.

This chapter traces the development of the economic concept of income and examines the importance of the psychic income backdrop best expounded by Fisher, and the Schanz-Haig-Simons model[2] as a means of satisfying the fundamental equity and neutrality requirements of modern tax policy.

The Schanz-Haig-Simons model postulates that a practical concept of income is represented by a monetary increase in wealth plus imputed income and consumption expenditure over a period. That measure is a surrogate for immeasurable psychic income. To the

1 In this dissertation, generally the terms *psychic income*, *sensations*, *satisfactions* and *utility* are treated as generic and synonymous terms.

2 This study refers to the model as the *Schanz-Haig-Simons* model. Most of the literature refers to it merely as the *Haig-Simons* model. However, as explained under *Development of the Schanz-Haig-Simons Model*, the Germans, Sax and Schanz, had reached the same conclusions as Haig and Simons independently of, and earlier than, Haig and Simons.

extent that (at least some) imputed income can be measured, the Schanz-Haig-Simons model is justified as the most comprehensive model that can be practically implemented to determine a person's income and taxable capacity.

Later chapters use the Schanz-Haig-Simons model as a standard against which to compare income measures used in practice.

Psychic Income

Psychic income is a name for the pleasurable sensations that people derive from consumption. Because these sensations or satisfactions are abstract, they are of limited use in measuring income. Since they are incapable of quantification, they cannot be used as a basis for determining people's liability to contribute to the state.

Psychic income was referred to often in early economic literature on the income concept. In 1909, Ely noted that "[r]eal income ... has reference to the satisfaction which we derive from the use of material things or personal services during a period of time."[3]

Schanz had earlier alluded to the merging of income and satisfactions in formulating his conception of income. He observed that "[i]ncome is an entity which cannot be severed from a given individual and the satisfaction of his wants ... . Discounting infrequent cases of extravagance, all satisfactions are functions of income."[4] Although Schanz links his notion of income to satisfactions, he does not say the two equate. Indeed, if he did, his disregarding of "infrequent cases of extravagance" would be misplaced because high levels of psychic income are most likely to be experienced when one's behaviour is extravagant.

In a similar interpretation of income, Seligman referred to sensations: "[t]he income measurement of wealth is the more fundamental psychologically as well as historically. We derive things at

3 Ely, Richard T., (1909) *Outlines of Economics*, Macmillan, New York, 98.

4 Schanz, G. von, "Der Einkommensbegriff und die Einkommensteuergesetze", (1896) *Finanz-Archiv*, translated in Wueller, P. H., "Concepts of Taxable Income I – The German Contribution", (1938) 53(1) *Political Science Quarterly*, March, 83, 103.

the dangers or disamenities (including risk in the economic sense) of some occupations."[22]

There is clearly an enormous range of potential intangible benefits and costs associated with their derivation. However, Posner's reference to *pecuniary* receipts is inconsistent with the notion that income comprises the "intangible yields of activity". As noted by earlier writers, pecuniary receipts are merely the means to acquire the goods and services that produce satisfactions that constitute the psychic income ultimately derived by an individual. Contrary to Posner's opinion, the better view is that it is not so much the administrative costs *per se* that preclude use of Posner's broad definition of income; rather, the nature of the benefits makes it impossible to determine an amount of income upon which tax may be objectively assessed.

Subjective Measurements

In a practical sense, then, the compelling issue is how (if at all) psychic income can be measured. Take, for example, one of the conundrums described by Kleinwächter.[23] A prince's flügeladjutant receives compensation in the form of palace accommodation and food, and in accompanying the prince to hunting and operatic engagements. According to the economists referred to above, the flügeladjutant derives psychic income. But can that income be quantified?

One might take the measurement of that income to be the market value of the goods and services consumed. If the prince paid a pfennig for the food immediately before giving it to the flügeladjutant, the reader might conclude that the measurable amount of income obtained by the flügeladjutant is one pfennig. To the extent that the goods and services provided have ascertainable market values, an objective valuation method exists. However, the market value becomes much more subjective for goods and services pro-

22 *Ibid.*, 464.

23 Kleinwächter, F., (1896) *Das Einkommen und seine Verteilung*, Leipzig, cited in Simons, Henry C., (1938) *Personal Income Taxation – The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press, Chicago, 53.

vided for which there is not a ready market; for example, the value of palace accommodation or accompanying a member of the royal family on a hunting expedition. But, in terms of the pleasurable sensations experienced by the flügeladjutant upon his consumption of the food, the one pfennig market value will not be a truly representative valuation of the benefit derived by him.

Suppose the flügeladjutant detests living at the palace away from his close friends, detests continual rich food and detests the discomfort of riding and loud singing. Assume that he consumes the food only to oblige the prince. The pleasurable sensations or utility obtained might be valued by the flügeladjutant at an amount less than the one pfennig market value. If the market value measure of income was the basis on which (say) income tax is to be assessed, the flügeladjutant would be taxed on the value of a perquisite that exceeds the value that he personally attaches to the benefit. In this context, market value is not an accurate reflex of the flügeladjutant's psychic income, given his personal tastes and preferences.

Recognising the crudeness of approximation of the market value surrogate, the New Zealand Commissioner of Inland Revenue (at least in one instance) adopts a more subjective approach to valuing a personal benefit provided to an employee by an employer. In terms of the definition of *monetary remuneration* in section OB 1 of the Income Tax Act 1994, the value of accommodation provided by an employer to an employee is included in the latter's gross income. Where a house has been provided to a chief executive, for example, the Inland Revenue Department accepts that a lower rental can be substituted for market rental in the calculation of gross income. This approach is designed to take account of such factors as the house being more palatial than any that the employee would normally occupy, and the need for employment-related duties such as entertaining at home.[24]

24 See, Inland Revenue Department, *Inland Revenue Department Technical Rulings Manual* in (1992) *New Zealand IRD Tax Rulings*, CCH New Zealand Limited, Auckland, chapter 57.11.1. (The Inland Revenue Department announced in September 1998 that updating of its technical rulings has been discontinued. Now the rulings may be regarded as useful "historical guidelines" or "as background material, but the contents should **not** be relied upon as representing Inland Revenue's present views or practice" (emphasis in original): Inland Revenue Department, (1998) 10(9) *Tax Information Bulletin*, September, 10).

Although the ruling is designed to reflect the true value of the benefit to the employee as the basis for taxation, it is inconsistent with the rest of the Act. Elsewhere, the New Zealand income tax legislation bases valuation of benefits or gains on objective dollar measurements or on market values of benefits derived or of assets held.[25]

Precise valuation of a benefit obtained by an individual is a subjective matter. One difficulty associated with market pricing has already been referred to. However, to obtain a true impression of psychic benefit derived from the consumption of all goods and services, the circumstances under which an individual obtains the benefit must be taken into account. To illustrate, suppose that the flügeladjutant, having just endured an opera performance, yearns for food. He therefore attaches a high priority and personal value to satisfying this desire. Consequently, under these circumstances, he may be prepared to pay far more than one pfennig to obtain the food. The benefit he obtains is determined by the (total) utility of his consumption of food after the opera.[26]

Under different circumstances, the flügeladjutant may not attach such a high value to food. Suppose that he was provided with supper at the opera. On returning to the palace, the flügeladjutant is indifferent to the prince's offer of more food. It does nothing to augment the state of his body and soul. The value that the flügeladjutant places on food in these circumstances is small. A monetary value assigned to the benefit may be less than its one pfennig market value.

The Search for Objectivity

Simons rejects the psychic approach and asserts that "[i]ncome must be conceived as something quantitative and objective. It must

25 See, for example, sections CI 3(9) and CI 3(10) of the New Zealand Income Tax Act 1994, which prescribe the valuation methods of goods and services (excluding employee accommodation) provided by an employer to an employee.

26 His marginal utility declines as he consumes increasing amounts of food to the point where marginal utility from the last piece consumed equates to the price of that piece. If the prince continues to provide food free, the flügeladjutant (acting rationally) will continue consuming food until his marginal utility is zero.

be measurable; indeed, [the] definition must indicate or clearly imply an actual procedure of measuring."[27]

In 1916, the Italian economist, Lolini, attempted to devise a "practical concept of income" for tax purposes.[28] For Lolini, "income in order to be taxable must be expressible in terms of money; considerations of utility and other subjective factors are not admissible."[29]

Haig considered that psychic income is an "entirely impractical basis" for an income tax. He argued that goods and services are only of economic significance if they can be subjected to evaluation in monetary terms: "[t]he satisfactions themselves become economically significant ... only when they are susceptible of evaluation in terms of money. It is necessary as a practical proposition to disregard the intangible psychological factors ...".[30]

Chapter 1 recorded Thuronyi's contention that fairness is the central criterion in defining income. Thuronyi considers that well-being should not be used as a criterion for tax equity. This is because (as already explained) well-being is a nebulous concept, which defies practical measurement that is necessary for crystallising an amount of income for taxation purposes. Instead, Thuronyi opts for a monetary base because "[t]axes are paid in money and tax equity is, therefore, appropriately based on monetary factors or on observable factors that can be translated into money."[31]

As illustrated by the consumption of food under differing circumstances by Kleinwächter's flügeladjutant, the same thing consumed by the same person can yield different levels of satisfaction in different circumstances. This phenomenon is also apparent in the case of the same goods consumed by two different people in the same circumstances. Where income is determined by the benefit

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27 Simons, Henry C., (1938) *Personal Income Taxation – The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press, Chicago, 42.

28 Lolini, E., "Il concetto di reddito in finanza ed in economica pura", (1916) *Revista Italiana di Sociologia*, translated in Wueller, P. H., *loc. cit.*, footnote 10, 569.

29 *Idem.*

30 *Loc. cit.*, footnote 7, 6.

31 Thuronyi, Victor, "The Concept of Income", (1990) 46(1) *Tax Law Review*, 45, 56.

obtained, each person will have a different income. Yet when a monetary unit is adopted to measure that income (in the flügeladjutant's case, the one pfennig market value being adopted as the surrogate measure of the income amount), the same individual in different circumstances, or different individuals consuming the same goods in the same circumstances, are deemed to derive the same income. It is clear from the examples given above that such measurement is simply not a true reflection of the actual benefits (or disbenefits) procured, but society has accepted this inaccuracy of measurement in order to attain a administratively feasible measurement of income.

Money Income

The above discussion leads to the conclusion that, to obtain an administratively feasible and objective measure of income, money income needs to be adopted. In the interests of measurability, Taussig was prepared to abandon the superior theoretical principle of psychic income in favour of a monetary gauge: "it is best to content ourselves with a statement, and an attempt at measurement, in terms not of utility but of money income ... . The reason for the rejection of a principle which is in itself sound lies in the conclusion ... regarding total utility and consumer's surplus: They can not be measured."[32]

In 1914, Seligman attempted to integrate money income and psychic income, albeit with no practical effect: "income, at least for purposes of taxation, signifies in general money income, with an occasional inclusion of such psychic income as is notorious and easily calculable."[33]

Haig, who was concerned with the appropriate concept of income as a basis for taxation, points out that, after making this shift in principle: "everyone is, in effect, considered to be in receipt of his income when he gets the money with which to buy the goods and services which will yield the usances and satisfactions which go to make up his true income."[34]

32 *Op. cit.*, footnote 6, 120.

33 Seligman, E. R. A., (1914) *The Income Tax*, New York, 2 ed., 15.

34 *Loc. cit.*, footnote 7, 4.

In 1925, Seligman redefined his notion of income in terms of a monetary economy: "in a society based on transactions income denotes any inflow of satisfactions which can be parted with for money. It may not be money income, but it must be capable of being transmuted into money income."[35] These views are similar to that of Schanz, whose idea of income has been translated as "the net flow of means during a given period, including all usances and services having a money value."[36]

Ely also observed how even the market value substitute concept of income has in turn been relegated by the popular notion of income comprising money that comes in: "[m]oney income should, perhaps, refer to the value of the goods consumed and the services enjoyed, although in popular speech and by many economists the word is used in the literal sense of the net amount of money that comes in, whether it is spent for enjoyable things or is saved."[37]

Consumption Expenditure

The shift to adopting monetary income as a measure of true income highlights a conceptual difficulty: observing money received is an entirely different matter from observing the benefits arising from the consumption of goods and services. Utility is derived from consumption, which is represented by an *outflow* of expenditure. Money income is an *inflow*, which is taken as a measurable approximation of the utility to be ultimately derived. It is a measure taken earlier in the income-consumption-utility (or psychic income) process as a proxy for something that comes later: recall Fisher's analogy of "gauging the flow at the mouth of the stream by the flow at some point higher up which anticipates it …".[38]

Consumer expenditure, being a flow at a point lower down in the stream, is a better reflection of utility or psychic income derived from consumption.[39] In simplified terms, consumers' decisions to

35 Seligman, E. R. A., (1925) *Studies in Public Finance*, New York, 98.

36 Haig, R. M., *loc. cit.*, footnote 7, 20.

37 Ely, Richard T., (1909) *Outlines of Economics*, Macmillan, New York, 98.

38 See under *Fisher's Analysis of Total Flow of Services* above.

39 Although, as noted under *Source of Satisfactions* below, consumption expenditure does not reflect psychic income from sources other than consumption.

buy or not to buy goods and services are represented by actual expenditure that consumers incur. That expenditure is an indicator of a consumer's level of satisfaction derived from consumption of the goods or services, compared with the reflex offered by the consumer's income. The more of a good or service that a person purchases, the greater the amount of total satisfaction he expects to derive from consumption of it. In this sense, consumption expenditure avoids the approximation inaccuracies of money income in measuring satisfactions. Figure 2.1 illustrates the closer proximity of consumption expenditure to satisfactions derived from consumption than the proximity of income received to consumption satisfactions.

From this viewpoint, consumption taxes are conceptually superior to income taxes. This position is adopted by what can be called the "dispositionist school". However, taking account of all the tenets of a good taxation system, as discussed earlier, income tax prevails as the most significant and internationally widespread form of taxation.

Potentially, income tax casts a wider net than a consumption tax because not all income is spent on consumption. Some income is saved and invested in assets. The allocation of money income between consumption and saving is illustrated in Figure 2.2.

If the only tax in an economy is a consumption tax and not all income is spent on consumption, income saved and invested is not taxed. The principles of equity and economic neutrality, discussed in Chapter 1, establish that income saved should not be treated favourably, but should also be subject to tax. In other words, under those canons of taxation, a tax impost should not turn on how a person decides to apply her income or assets.

Kaldor is a leading advocate of consumption tax.[40] Kaldor was motivated by egalitarian concerns. He contended that an expenditure tax could address equity considerations at least as well as

40 See Kaldor, Nicholas, (1955) *An Expenditure Tax*, George Allen and Unwin, London.

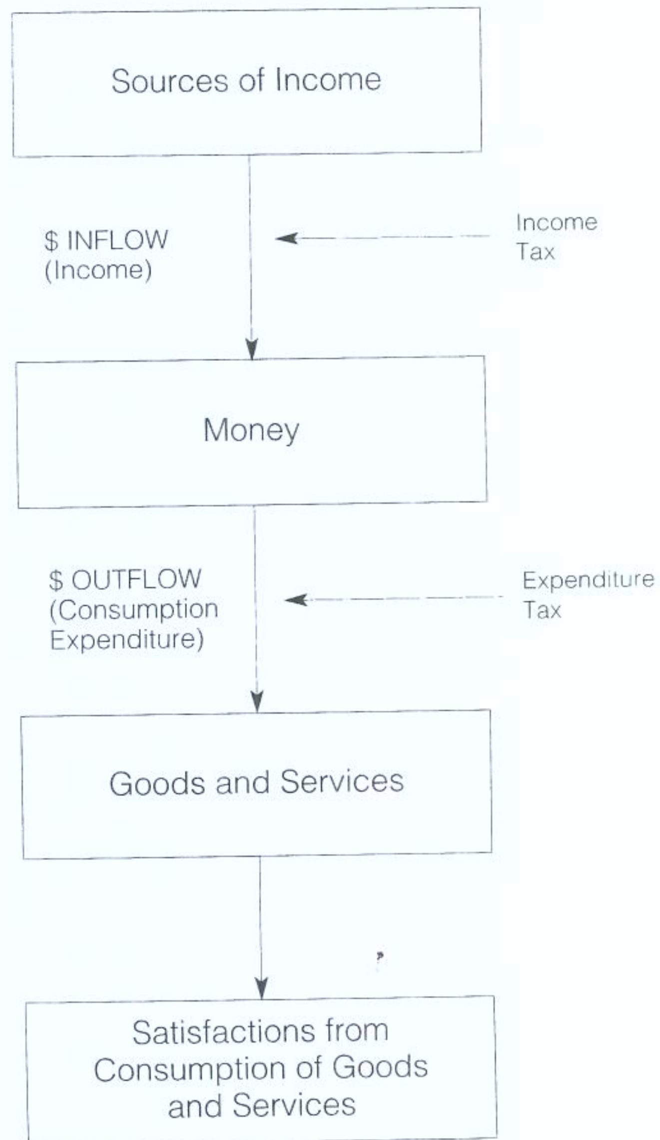

Figure 2.1
Proximity of Consumption and Income to Satisfactions Derived from Consumption of Goods and Services

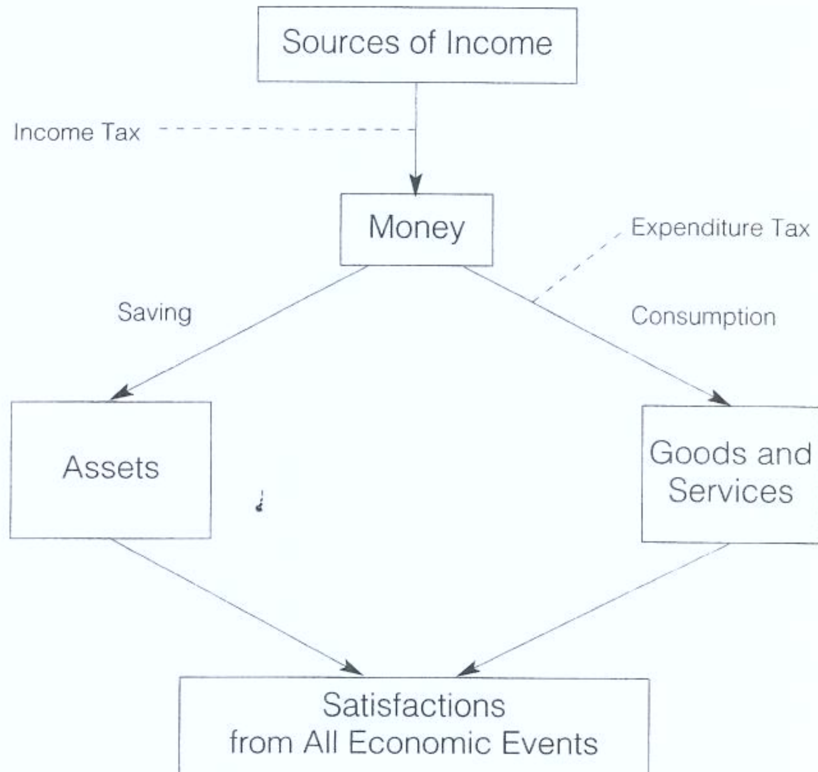

Figure 2.2
Allocation of Money Income Between Consumption and Saving

income tax. Kaldor recognised that, because savings fall outside the consumption tax net, indefinite concentration of untaxed wealth accumulation could occur. Welfare economists over a long period have been concerned about the distributional effects of such a policy; that is, disproportionate concentration of wealth, and therefore economic power, in the hands of a relatively few individuals or families. Therefore, Kaldor recommended that estate duty be imposed concurrently with an expenditure tax.[41]

41 *Ibid.*, 100-101.

This policy accords with the principle underlying Simons's interpretation of income discussed under *Simons's Concept* below. The difference is simply timing. Kaldor advocates a tax on consumption and wealth accrual, with tax on the latter being imposed at death. The Schanz-Haig-Simons model taxes unrealised wealth accrual when the accretions occur. Kaldor also opposed a flat-rate consumption tax because of its regressive impact on low income earners. He advocated graduation in consumption tax rates. This feature is evident in most value-added and sales tax systems by use of exemptions and concessional rates for goods and services, the expenditure on which comprises a relatively greater proportion of incomes of low, rather than middle or high, income earners. New Zealand is a notable exception. Its goods and services tax regime has no significant exemptions (other than financial services and domestic rental accommodation) and only one tax rate (other than zero rating). Administrative and economic neutrality, rather than equity, considerations dictate the absence of exemptions and the presence of a single rate. However, tax equity was not ignored when New Zealand introduced its uncomplicated goods and services tax regime. Compensation for the regressive impact of GST is offered through low income tax rebates and family income tax credits (that is, negative income taxes) in the income tax system.

Kaldor was attracted to an expenditure tax for two main reasons. The first was a moral reason: a tax on expenditure taxes "people according to the amount which they take out of the common pool and not according to what they put into it".[42] The second reason was based on Kaldor's egalitarian objectives. In 1955, wealth accumulation in Britain escaped tax while the prevailing income tax system went to great lengths to adjust taxable income to take account of personal circumstances. Unlike Fisher, Kaldor objected to income tax because it omitted taxing wealth accrual. According to Kaldor, wealth accrual could be brought into the tax net by operating both an expenditure tax *and* an estate duty or wealth tax. Fisher's notion of income, on the other hand, was confined to taxing streams of services (which primarily arise from consumption expenditure)

42 *Op. cit.*, footnote 40, 53.

obtained from capital. Streams of services explicitly excluded capital gains.

In terms of the satisfactions model discussed above, Andrews recognised that the shortcoming of reliance on consumption expenditure is the difficulty in defining *consumption*. While taking whatever people spend their money on as a starting point to identify consumption, Andrews held that the concept must be refined ultimately in terms of real goods and services. The market pricing system "makes what one pays an accurate measure of what one gets"[43] in the case of private goods and services, such as bread, wine, and housing. But that system fails to render a valuation of the benefit of public goods and services, which a person also obtains in life. Andrews therefore turns to income as a surrogate measure of a person's ability to participate in *all* consumption activities.

Andrews also recognised that it is not feasible to measure directly the quantity of real goods and services that a person consumes or accumulates. Consequently, money expenditures on *all* things (including savings) are relied on "to produce a practical measure of the real consumption and accumulation which such spending buys."[44] Even Andrews postulates that, with the advent of widely used value added taxes and goods and services taxes, it is still not practicable to record and audit all direct personal expenditure. Some expenditure falls outside the ambit of those taxes. Therefore, policymakers rely on "the long run equivalence between money income and money expenditures for consumption and accumulation and compute the tax on the basis of the former."[45]

Andrews concludes that:

> [t]he strategy of personal income taxation is to take money income as a readily ascertainable starting place, knowing that money income is either spent or accumulated and that money expenditures provide a measure of total consumption plus nonmoney accumulation. Then such adjustments are made as are practical and desirable to achieve a more refined reflection of aggregate real consumption and accumula-

43 Andrews, William D., "Personal Deductions in an Ideal Income Tax", (1972) 86(2) *Harvard Law Review*, December, 309, 314.

44 *Ibid.*, 327.

45 *Idem.*

tion. ... Income transactions provide the practical basis for computing and collecting the tax, but aggregate personal consumption and accumulation are its real objectives.[46]

Source of Satisfactions

The derivation of satisfactions is not confined to consumption of goods and services. Individuals can obtain satisfactions (or psychic income or utility) from wealth accumulation. Groves asks: "who is to say that current spending yields more satisfaction than postponement?"[47] Groves's use of "more" indicates that he takes for granted that wealth accrual yields at least some satisfaction. A good example of satisfactions arising from wealth accrual is the pursuit of wealth ostensibly for its own sake, but in reality to give its owner the satisfaction of knowing that the wealth is available for future consumption. If the owner is ostentatious, pleasurable sensations derived from wealth accumulation are determined by the way that the owner interprets how he is perceived by other people.

This broad notion of satisfactions is consistent with Fisher's analysis. If sensations are true income, an income tax (to use Fisher's analogy) must go beyond each mouthful of food or every laugh at the theatre to the ultimate psychic satisfactions that are derived from eating or laughing. Even Fisher's tax point is still upstream (albeit not too far) from the mouth of Fisher's stream. Since the mouth of the stream represents psychic satisfactions, everything that comprises those satisfactions must be a target for a tax impost. It is wrong in principle to take only satisfactions that arise from consumption of goods and services as a complete indicator of psychic satisfactions. Consumption sensations are merely a subset of an individual's total psychic income.

Therefore, to premise tax methodology on the satisfactions model of income by using a consumption expenditure tax is insufficient to capture all sources of satisfaction. The correct surrogate for

46 *Ibid.*, 327-28.
47 Groves, Harold M., (1974) *Tax Philosophers: Two Hundred Years of Thought in Great Britain and the United States*, Curran, Donald J. (ed.), University of Wisconsin Press, Madison, 109.

> in terms of the satisfactions themselves. *It has the effect of taxing the recipient of income when he receives the power to attain satisfactions rather than when he elects to exercise that power.*[72]
>
> (emphasis added)

Recall Kleinwächter's flügeladjutant. What Haig's definition tells the flügeladjutant is that when he is handed food (giving him the right to consumption), his income is the money value of that good; that is, one pfennig. Irrespective of the conditions under which the flügeladjutant consumes the food, Haig's definition adopts a single monetary surrogate for the unmeasurable satisfactions or dissatisfactions that are in fact determined by those circumstances.

On the receipt of income, an individual acquires the economic power to spend on consumer goods and services or to save. By addressing income in terms of that economic power, Haig's approach encompasses outcomes of the recipient's choice between consumption expenditure and saving. Haig does not confine himself to consumption expenditure nor to treating income in terms of satisfactions.

Reconciliation of Wealth Accrual and Psychic Based Concepts of Income

In terms of the argument under *Source of Satisfactions* above, the same result as Haig's would come about if satisfactions are interpreted to encompass utility derived from the enjoyment of savings represented by wealth accumulation, as well as enjoyment from the knowledge that the recipient of economic power has the ability to consume in the future. This broad interpretation of satisfactions yielding income to an individual reconciles the wealth accrual concept of income with the psychic based concept. This reconciliation entails the assumption that psychic income arises at the point when an individual *becomes aware* that he has the *means* to consume goods or services from which to derive later the favourable sensations from consumption. The individual's knowledge that he has the

72 *Loc. cit.*, footnote 65.

means or wealth now in itself generates satisfactions or utility. The satisfactions from that knowledge are distinguished from the satisfactions derived from ultimate consumption of goods and services. The former constitutes income. The latter is merely an application of that income. Consequently, the time at which income is recognised under Haig's model is earlier than that under the consumption sensations model.

Theoretically, there will be a difference in value between the two satisfactions (if indeed they could be valued) because the knowledge obtained is not perfect. In other words, there is a risk that satisfactions from consumption may not eventually transpire because adverse events may occur between the time the knowledge of power to consume is obtained and the time that the power is exercised in a consumption activity; that is, the value of the capacity to consume later is less than the value of immediate consumption.[73] The difference can be dealt with theoretically by incorporating within income the *increase* in satisfactions that arises from ultimate consumption; that is, additional income arises from the extra satisfaction that an individual obtains at the time of consumption from surviving the risks of losing the power ultimately to consume. The potential loss could occur between the time that the economic power was obtained and the time that the power is applied in consumption.

In this sense, income represented by total satisfaction is the sum of satisfactions derived in the period in which economic power that provides the right to consume arises *plus* the extra satisfaction derived in a later period when actual consumption takes place. The latter component is incremental satisfaction. It does not represent satisfaction arising from the consumption activity itself. Algebraically, this satisfactions based income model can be described as:

73 This is a well established economic proposition: see, for example, Blaug, M., (1968) *Economic Theory in Retrospect*, Heinemann Educational Books, London, 2 ed., 194.

on a person who transacts rather than self provides.[101] Haig elaborates, in the context of imputed income:

> The economics of this situation is very clear. … [G]oods and services which are of significance are those which are susceptible of valuation in money terms. It is not necessary that they should actually have passed through the process of a sale. From the point of view of equity it is theoretically important that all goods … and services received without payment should be accounted for in case it is possible to value them in terms of money.[102]

Simons speaks of rights "to which prices may be imputed".[103] These rights encompass the value of property rights that can arise from an individual's own effort or from the use of assets owned by her. While recognising the practical difficulties of incorporating imputed income into a tax base, Simons observed that "[n]eglect of these factors in true personal income is clearly unfortunate."[104]

Superiority of the Schanz-Haig-Simons Based Foundation Concept of Income

The discussion to this point can be summarised by elucidating six main areas where the foundation concept of income, which is based on the Schanz-Haig-Simons model, is more robust than Fisher's consumption based model.

Source of Pleasurable Sensations

Psychic income does not emanate solely from consumption. As the name indicates, psychic income is a psychological phenomenon, which may arise from physiological features, but it is not limited to those features. Changes in values of assets can produce pleasurable sensations or not so pleasurable sensations and, hence, positive or negative psychic income.

101 *Loc. cit.*, footnote 30.
102 *Idem.*
103 *Op. cit.*, footnote 27, 49.
104 *Op. cit.*, footnote 27, 121-122.

Imputed Income

Pleasurable sensations flow from imputed income; for example, people's enjoyment from the use of their houses, from growing their own vegetables and flowers, or from their leisure pursuits. These sensations fall within Fisher's psychic income concept through ultimate consumption of services provided by capital owned by an individual. However, the sensations are not taxed under his consumption expenditure model. In contrast, the Schanz-Haig-Simons model formally brings imputed income within its measurement net by virtue of the susceptibility of imputed income to valuation, rather than by its link to sensations.

Public Goods

Consumption expenditure readily identifies private goods and services that are acquired through the market system to fulfil a person's needs. But public goods also provide psychic income. Concentration on consumption expenditure fails to bring public goods within the income tax net. The foundation concept of income is wider. It captures increases in wealth as well as consumption expenditure. That concept's broader tax base means that people who enjoy increases in net wealth make an indirect contribution in respect of the benefit that they obtain from public goods.

Market Valuations

Fisher's capital valuation theory postulates that the value of any capital item is the present value of its future earnings stream discounted at a rate of interest. As interest rates change, expected future income changes. The change in expected future income is reflected in changes in market values of underlying capital items. Therefore, expected future income is measured by the change in market values of capital assets (and liabilities). If factors that affect market values (including the prevailing interest rate) change between the time of measurement of the values and the future derivation of the income stream (such that the income stream ultimately derived is different from the stream originally expected), the value of the asset is adjusted to reflect those changes. The difference between the old and new market values of assets reflects the new income stream.

Preservation of Source

The doctrine of preservation of source is essentially the same as the foundation concept. Hermann, the first German writer on the income concept, enunciated the doctrine in 1832. Coupling this doctrine with a periodicity requirement,[2] and making no reference to any psychic presumption, Hermann wrote:

> while income is commonly expressed in terms of money, it is apparent that it is not money that is truly income, but the economic goods which money will procure for the individual. When we speak of income, we take it for granted that these economic goods flow with a certain regularity. *Income is that portion of an individual's receipts which that individual may consume without injury to his capital stock.* Not every expenditure represents consumption and not every receipt represents income. Income is the sum total of goods which come within the disposing power of an individual within a given time interval. These goods may be tangible or intangible.[3]
>
> (emphasis added)

Source preservation conflicts with the periodicity element in this definition in that Hermann accepts the assumption of a regular flow[4] being a feature of income. He also emphatically states that income comprises the value added to one's capital stock during a period. Clearly, a single lump-sum receipt without the need for a regular inflow can achieve the latter.

Wueller regarded Hermann's definition as unsatisfactory because Hermann adopted the source preservation test without establishing limits to its application.[5] Wueller notes that the definition leaves the status of windfall gains indeterminate.[6] But Hermann seems to imply that the two tests are conjunctive; that is, there must be a regular flow of consumable receipts, which are not needed to

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2 Periodicity is discussed below.

3 Hermann, F. B. W., (1874) *Staatswirtschaftliche Untersuchungen*, Munich, first published in 1832, 297, translated in Wueller, P. H., "Concepts of Taxable Income I – The German Contribution", (1938) 53 (1) *Political Science Quarterly*, 83, 90.

4 Regularity of a periodic flow is discussed under *Periodicity* below.

5 *Loc. cit.*, footnote 3, 90-91.

6 *Ibid.*, 91.

trol over part of the social income, the item must be included as part of his personal income."[15]

Clear Surplus and Human Capital Maintenance

The "clear surplus" criterion specifies that income is only the portion of a person's increase in wealth that remains after she has met all personal outlays to maintain her original state. This interpretation attempts to incorporate some measure of maintenance of human capital. In this sense, the clear surplus notion is merely an extension of the foundation concept of income.

Held initially considered that income arises only when an individual's capital stock is maintained *after* he has acquired the necessities of life appropriate to his station; that is, income is what remains to be transmuted into capital after expenditure has been incurred on necessities to satisfy a person's most urgent needs. But Held acknowledges that the demarcation between the two "cannot be drawn with precision, because it is virtually impossible to determine, even if due consideration be given to the customs and standards of the period involved, the needs and requirements of individuals and families."[16]

In refining his earlier source preservation analysis of income, Held developed something closer to the consumption expenditure notion of income. He states that:

> [t]o further delimit the concept of personal income, we must confine the application of the term, when used in conjunction with the individual economy, to that portion of a person's receipts which that person may expend without impairing his capital stock. Reasonable expenditures, in this connection, include purchases of the necessities of life, outlays necessitated by the individual's social position and old age pension premiums. All these items of expenditure are made for the purpose of satisfying wants and it must be presumed that they do *not* impair the individual's capital.[17]
>
> (emphasis added)

15 *Ibid.*, 23.

16 Held, Adolf, (1872) *Die Einkommensteuer*, Bonn, 75, translated in Wueller, P. H., *loc. cit.*, footnote 3, 83, 94.

17 *Ibid.*, 95.

sistence. Rather, it denotes the provision of the services necessary to maintain the appropriate standard of living of the family or unattached individual relative to others.[23]

(emphasis added)

The commission believed that non-discretionary expenditure included at least some part of extraordinary medical expenses, gifts to close relatives to provide them with support and the special expenses of working mothers with young children.[24] Clearly, borderline issues such as what specific items of expenditure to include or exclude from the non-discretionary category and distinguishing between close and distant relatives are subjective judgments, which are required if the commission's approach is applied in practice.

It is logical to incorporate maintenance of human capital in the source preservation interpretation of income. Capital at the beginning of a period must be maintained before income can arise. Indeed, that is the *raison d'être* of the foundation concept. The theory can be applied equally to human and non-human capital. In other words, capital maintenance is not something unique to innate objects, but it applies to *all* factors of production. The practical difficulty, of course, is measurement of the depletion of human capital.

Net Product

The net product criterion is a very restricted recognition of wealth-accrual based income because it stipulates that income arises only if an individual's wealth accrual is a net addition to *society's total* income; that is, the accrual is the creation of new wealth. This approach eliminates transfer payments from income, whether in cash or in kind.

The net product criterion determines income by distinguishing sources of accrued wealth. Marshall illustrates the point: a landowner hires a private secretary, who in turn hires a servant. Payments made by the landowner to the secretary, and from the secretary to the servant, are in return for services rendered, and are

23 Carter, Kenneth Le M., *et. al.*, (1966) 3 *Report of the Royal Commission on Taxation*, Queen's Printer, Ottawa, 5.

24 *Ibid.*, 10.

The cash income method of measuring income is inadequate because most entities' lives span many years while users of financial information require that information on a more regular basis. The same periodic information requirement applies to individuals. For example, income tax collection agencies require information about a person's income (and require receipt of the consequential income tax payment) on a more frequent basis than one return and payment in respect of the whole of a person's life after he or she has died. Therefore, it is necessary to divide the life of an entity into pre-determined time periods, which are short enough to render useful information to decision makers, but long enough to outweigh administrative costs of compiling the information too often. Convention, based on the natural cycle of seasons, has struck a balance between those two competing objectives. Typically, income is reckoned for external reporting and assessment purposes on an annual basis, but shorter periods are often used for internal management purposes.

Segmentation of life-long income into yearly components means that annual income must be measured in an artificial manner. Objectively ascertainable income over the life of an entity must be apportioned on an *ex ante* basis to set time periods. Dissecting life-long income in this way involves estimation and assumptions about specific periods. Periodic income measurement thus becomes partly a subjective exercise.

Transactions Approach and Realisation of Income

Accounting theory postulates how income should be recognised in financial statements; in particular, is income recognised when an unrealised gain accrues or is recognition deferred until the gain is realised? The accounting profession has adopted a restricted approach to income recognition because of uncertainty surrounding measurement of unrealised gains and losses at the end of a measurement period. This approach has been influenced by the doctrine of conservatism and prudence. Subject to some limited exceptions, income is not recognised until a transaction with an external third party has taken place with the entity whose income is being measured; that is, a sale or exchange with an outside party must take

place before revenue is recognised. More precisely, the transactions approach recognises *revenue* when a transaction occurs. Expenditure that is incurred to derive that revenue is matched against the revenue to arrive at net income from the transaction. Therefore, if revenue from a transaction is recognised in a particular accounting period, the associated expenditure is also recognised in that period, notwithstanding the time when the expenditure is actually paid.

A transaction provides sufficient definition and objectivity to enable revenue to be measured. Typically, an exchange of goods or services between an entity and a third party triggers a realisation of revenue, which can be recognised in accounting statements. Paton and Littleton considered that revenue is realised "when it is evidenced by cash receipts or receivables, or other new liquid assets."[15] In other words, they required a firm to be a party to a transaction with another entity before revenue could be realised. Realisation may be in the form of cash that is received immediately (for example, a cash sale of an asset or a trading good or service) or in the form of a right to obtain cash in the future from the external party (for example, a credit sale). The United States Financial Accounting Standards Board adopts the convertibility into cash criterion.[16]

The transactions approach, therefore, rests on historic cost accounting. Since maintenance of capital is recorded using actual amounts that are transferred in past transactions, holding gains that arise from mere changes in *value* of a firm's net assets are not recognised. Those changes in value have not, by the end of the measurement period, been realised in an external transaction. The issue here is one of objective and verifiable evidence on which accountants can base their calculation of income. The prudent approach is to defer recognition of income until such evidence is obtained. In other words, it is not prudent to state that *x* dollars of income has been derived if the statement is based simply on an estimate of a change

15 Paton, William and Littleton, A. C., (1940) *An Introduction to Corporate Accounting Standards*, American Accounting Association, Florida, 49.

16 *Op. cit.*, footnote 12, 762, 781, ¶83(a) and Davidson, Sidney, "The Realization Concept", in Backer, Morton (ed.), (1960) *Modern Accounting Theory*, Prentice-Hall, Englewood Cliffs, 102.

measurement period. Comprehensive income also captures the first four components of Haig's income formulation.[60] Like the transactions and modified historic cost models, comprehensive income does not extend to embracing imputed income.

The discussion so far primarily analyses the accounting concept of income in theoretical terms. What requirements have accounting standard setters imposed to recognise comprehensive income in practice?

International Accounting Concepts

The International Accounting Standards Committee defines *income* as:

> *increases in economic benefits* during the accounting period in the form of inflows *or enhancements of assets or decreases of liabilities* that result in increases in equity, other than those relating to contributions from equity participants. ...
>
> The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise ... .
>
> *Gains represent increases in economic benefits* ... .
>
> The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long term assets. ...
>
> Income may also result from the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan. ...
>
> Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that *recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities* (for example, the net increase in assets arising on a sale of goods or services

60 Namely, money received as a return on factors of production, monetary gifts and windfall gains, benefits in kind, and the net monetary increase in asset values: see under *The Haig Contribution* in Chapter 2.

a generally accepted sense in its exposure drafts) is to shy away from taking a positive step forward to enhance the accounting measure of income as a conceptually sound basis on which decision makers can rely for a true and fair view of an entity's performance. In rejecting the Board's proposals, the Institute and its members lost the opportunity to attempt to integrate an accounting measure of income applicable in practice with a rational foundation concept of income. A more enlightened approach would be to redefine comprehensive income in a clearer and more consistent manner than that originally promulgated in *Exposure Draft No. 65* and subsequently pronounced in *Financial Reporting Standard No. 2*. Such an approach needs to set out the clear benefits, both from the conceptual viewpoint and for users of financial statements.

Remaining Differences Between Foundation and Accounting Concepts of Income

Theoretically, the accountants' notion of comprehensive income, as a measure of net change over a period, is well aligned to the foundation concept of income. The fundamental difference between the two concepts is that the foundation concept includes imputed income, whereas imputed income is excluded from comprehensive income. This omission is attributable to the difficulties of identifying and measuring imputed income.[101]

The difference between comprehensive income measurement that is applied in practice and the foundation concept of income is the extent to which modified historic cost accounting and financial reporting standards omit components of the foundation concept. Accounting standards are confined to revaluations of specifically nominated assets or to recording unrealised gains arising from nominated economic events.

However, the primary shortcoming of accounting standards that address comprehensive income is the absence of a mandatory requirement to revalue all assets and all liabilities at balance date. New Zealand accounting standards, for example, generally achieve only voluntary compliance to revalue specific assets; it is not com-

101 See Chapter 12.

teenth century,[3] a body of English law developed from which certain principles could be drawn to decide whether a particular receipt or benefit was taxable income. In this dissertation, those principles are referred to as "judicial propositions". They can be classified into three broad categories: (a) Income *v.* Non-Income/Non-Capital Receipts and Benefits; (b) Income *v.* Non-Income/Capital Receipts and Benefits; and (c) The General Requirement. The first two of these categories have their own sub-categories of features, as follows:

A. Income *v.* Non-Income/Non-Capital Receipts and Benefits

- Income must be an incoming.
- Income must be convertible into money or money's worth.
- Income must generally comprise a periodic or recurrent flow.
- Income must be the reward of effort or the produce of property.

B. Income *v.* Non-Income/Capital Receipts and Benefits

- Income must be realised.
- Income requires separation from its source.
- Income requires that a profit making purpose or motive, or a profit making scheme or undertaking, be present.

C. The General Requirement

- Ordinary concepts and usages of the word *income* apply.

This chapter will shortly review a selection of the early cases under categories A and B separately. However, to see how the propositions emerged, it is first necessary to understand the development of the income tax legislation that the courts endeavoured to apply to the circumstances of each case.

3 The main cases fell into three broad classes: (i) annuities, as distinct from principal repayments (see Chapter 8); (ii) profits or gains derived from the carrying on of a trade or business (see Chapter 6); and emoluments of officeholders (see Chapter 10).

The development of the income and capital aspect of the legal concept of income was founded in the agricultural harvest cycle.[92] In the predominantly agricultural economy in eighteenth and nineteenth century England and Continental Europe, income was viewed as a physical product: an annual harvest, or the cash into which the harvest could be converted. Income in this sense recurred regularly with the passage of seasons.[93]

Such income was related to the capital that produced it. The harvest arose out of farming, which took place on land. Land was a physical, fixed and continuing source of the annual harvest. The harvest was separable from the source and was available for unconstrained disposal or consumption without impairing the underlying capital. Therefore, a further feature of the early legal concept of income was separability from its source.

The need for a general legal concept of income first arose with the desire of English and European landowners to limit the inheritance of their estates to their heirs such that those heirs could not sell or bequeath the estates. Thus, the estates were to be retained within a genealogical lineage where an estate was held in trust for each succeeding heir, who was entitled only to the income from the estate during his (or, far less commonly, her) lifetime. An heir was not entitled to the capital of an estate, increases of which, during the heir's lifetime, were accumulated in the estate and passed on to successors. Consequently, a distinction between income, which could be consumed by a life tenant, and capital, which was to pass to remaindermen, was necessary.

Because a life tenant had no right to sell the estate or any part of it, he could not realise a gain in the value of the estate. In this context, there was no reason to treat appreciation in the value of an estate as income of a life tenant. Similarly, a decline in the value of an estate could not reduce a life tenant's income. It therefore became commonplace to view the economic position of the landed gentry in terms of the value of their annually recurring income as life tenants,

92 For a detailed historical perspective, see generally Seltzer, Lawrence H., "Evolution of the Special Legal Status of Capital Gains Under the Income Tax Act", (1950) 3 *National Tax Journal*, 18.

93 See under *Periodicity* and *Essential Nature of Periodicity* in Chapter 3.

tion concept of income) through the accountants' concept of income to the legal concept of income, the reader will have seen a progressive narrowing of the interpretation of the concept of income. In other words, there has been an increasing exclusion of items that comprise income as one progresses from one discipline to the next. This constriction on the meaning of income is illustrated in Figure 5.1 as an "income pyramid".

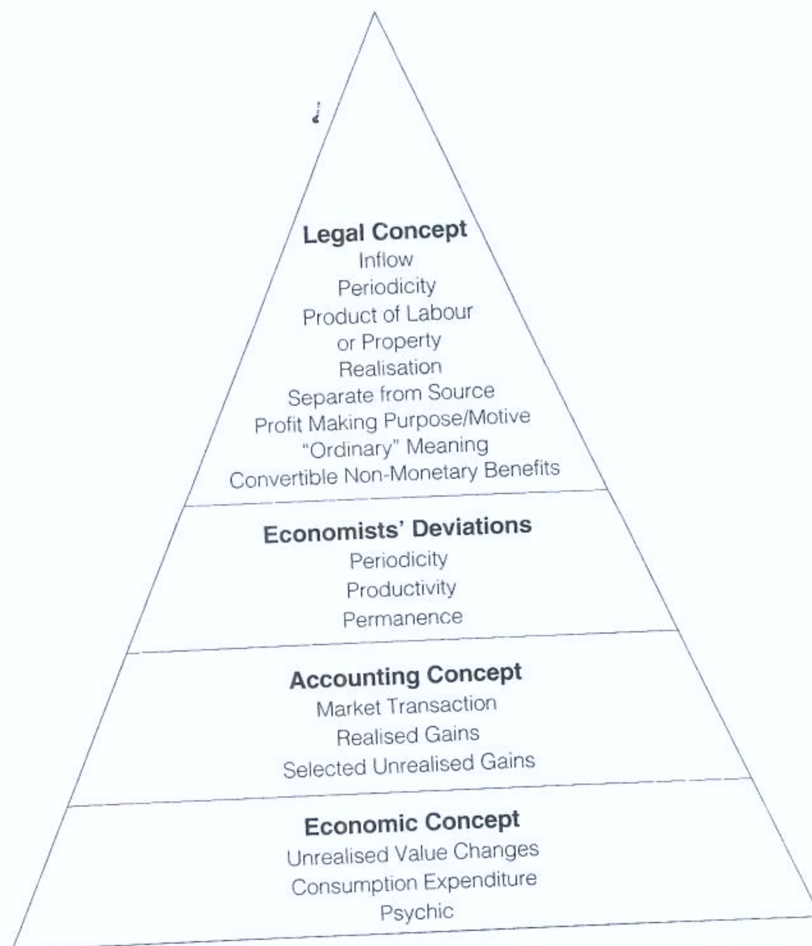

Figure 5.1
Income Pyramid