CONCEPTS OF CAPITAL AND INCOME

By Andrew Alston, B.Juris, LL.B.(Hons) (*Monash*), LL.M. (*Cantuar.*)
Senior Lecturer in Law, University of Canterbury.

The Income Tax Act 1976 is described in its title as "An Act to consolidate the law relating to income tax". The key provision is section 38, sub-section (2) of which provides:

> "Subject to this Act, income tax shall be payable by every person on all income derived by him during the year for which the tax is payable."

Of the terms used in this sub-section, "Income Tax" is defined in section 2 to mean "income tax imposed under this Act" and "income" is not given a definition. However, the word is combined with other words to form expressions that are defined. Thus "Taxable income" is defined to mean "the residue of assessable income after deducting the amount of all special exemptions to which the taxpayer is entitled" and "Assessable income" is defined to mean "income of any kind which is not exempted from income tax otherwise than by way of a special exemption expressly authorised as such by this Act".

One may conclude from this that the definitions in the interpretation section of the Act are of little help in finding out what is taxable under the Act. The Act relates to "income tax" but what is income?

Some help may be derived from section 65(2) which lists a number of items that are "deemed" to be included as "assessable income". It concludes with "(1) Income derived from any other source whatsoever". Again, we are confronted with the undefined term "income". To ascertain its meaning, we must look beyond the Act.

This article discusses the meaning of income and, in particular, considers it in relation to the terms "capital" which is distinct from income and "capital gain" which may be defined as "that form of gain that arises to the owner when some property of his appreciates in value or when he realises it at a price greater than its cost of acquisition",[1] and which is possibly an aspect of income.

'The Ordinary Concepts and Usages of Mankind'

The courts have consistently avoided giving a comprehensive definition of "income". Literally, the word means "what comes in" but it does not follow that everything that comes in is income for income tax purposes.[2] Ultimately, the courts resort to vague generalisations. A frequently quoted aphorism is that of the "ordinary concepts and usages of mankind". Sir Frederick Jordan put it as follows:[3]

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[1] Royal Commission on Taxation of Profits and Income (U.K.) Final Report—Cmd 9474—1955 (Radcliffe Report) para. 82, p.26 cf. Taxation in New Zealand Report of the Taxation Review Committee, Wellington 1967 (Ross Report) para. 984, p.402: "A capital gain may be said to have accrued whenever a capital asset increases in value."

[2] *Mapp* v *Oram* (1969) 45 T.C. 651.

[3] Jordan C.J. in *Scott* v *C. of T.* (N.S.W.) (1935) S.R. (N.S.W.) 215, 219.

"The word income is not a term of art; and what forms of receipt are comprehended within it and what principles are to be applied to ascertain how much of those receipts ought to be treated as income must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts."

The ordinary concepts and usages of mankind are flexible. They vary from place to place and from time to time and at the same place and at the same time different elements of society—of mankind—may have different ordinary concepts and usages. Thus, we are told[4] that economists regard income as a stream of regular receipts, less the specific cost of making them—a view which purports to exclude capital gains—and accountants regard income as total receipts, including capital gains, less costs and to a limited extent capital losses.[5]

THE MEANING OF 'INCOME' VARIES FROM PLACE TO PLACE—ENGLISH AND AMERICAN PRACTICE COMPARED

The fact that ordinary concepts and usages may vary from place to place is well illustrated by a comparison of English and American practice prior to 1962.[6] The English system was consistent with the aforesaid economists concept of income. It taxed the stream of regular receipts. The American system was, and is,[7] consistent with the aforesaid accountants concept. It endeavours to tax the increase in economic power. The reason for this difference is uncertain. Professor Lawrence Seltzer[8] argues persuasively that it is to be found in the different economic environments of the two countries when income taxes were first imposed. England was essentially a landholding and agricultural community. Land rarely changed hands and consequently capital gains arising from the purchase and sale of land were also rare. Income was thought to arise from purposeful economic activity such as farming and it recurred regularly with the passage of time on a seasonal basis. Thus:[9]

"The courts adopted the view that a man's capital or estate, usually a farm or a group of farms, was a physical entity, and the income from it its separable fruit or harvest. Increases in the capital value of an entailed estate could not be regarded as income of the life tenant. What had been left to him was a life interest in specific pieces of physical property, not in a given capital value. He did not have a right to sell any part of the estate and therefore could not realise a gain in value if it occurred. Hence there was no useful sense in which appreciation in the value of the estate could be considered income. For similar reasons, declines in the value of the estate did not reduce the income allotted to the life tenant."

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[4] Kathleen M. Langley *Capital Gains Taxation*—Fabian Research Paper 1952 (Fabian Research Series No. 150) p.4.

[5] This is an over simplification. When economists turn their minds to taxation, they tend to think in terms of an increase in economic power. See for example H. C. Simons *Personal Income Taxation* University of Chicago Press (1938) pp.50-51.

[6] When England introduced a capital gains tax.

[7] This is perhaps a debatable point. Although capital gains are taxed in America, they are accorded special treatment.

[8] L. H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (Chicago 1951).

[9] Ibid., 26.

Of course, there was other property which was not entailed or bound by a trust. But such property was relatively rare and an increase or decrease in its value was, in a time of static ownership, of little importance. It did not fall within the "harvest concept of income".[10] It was regarded as an unexpected receipt and the result not of purposeful activity but of good luck.

Some support for this analysis of the English concept of income may be found in the judgment of Rowlatt J. in *Ryall* v *Hoare*.[11] In the course of considering the English Income Tax Act 1918 which by Schedule D, Case 6 imposed tax in respect of "any annual profits or gains not falling under any of the preceding cases" he made the following observation:[12]

> "anything in the nature of a capital accretion is excluded [from Case 6] as being outside the scope and meaning of these Acts confirmed by the usage of a century."

Conditions in America differed markedly from conditions in England. Land was not bound by fee tails or trusts. It was plentiful and it was cheap. Consequently it was frequently sold and resold. From this, Seltzer concludes that:[13]

> "In this environmental capital gains became scarcely distinguishable from ordinary business profits for many business men and a familiar source of private wealth. At the same time, unlike the situation in England, the value of a man's principal or capital, rather than the income he derived from it was generally adopted as the measure of his wealth. For these reasons the sharp distinction between ordinary income and capital gains that still prevails in England never obtained as strong a hold in the United States."

The Meaning of Income Varies from Time to Time

Our understanding of the concept "income" is largely influenced by changes in our environment. We have seen that England with its tradition of static land ownership developed the so-called "harvest concept of income", from which capital gains were excluded. In time, this tradition gave way to a new environment in which land ownership was more mobile and where land was more often bought and sold at a profit. Not only land but other types of property—notably stocks and shares—became a source of speculation. In this respect, the environment came to resemble the American environment from which mankind had been conditioned to accept capital gains as part of its concept of income. Thus, it might have been expected that in England the concept of income would develop to include capital gains and that they would be made liable to taxation. And so it was that in 1962 the first comprehensive capital gains tax was introduced.[14] It was not described as an income tax, but this is not important. What is important is that, from that time, capital gains were not just accepted as, but admitted to be, receipts of an income nature.

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[10] Idem.

[11] [1923] 2 K.B. 447.

[12] Ibid., 454.

[13] Seltzer *op.cit.* at p.30.

[14] 1962 Finance Act (10 & 11 Eliz. 2, c.44).

Here, we may raise a mild quibble. When Sir Frederick Jordan referred to the ordinary concepts and usages of mankind he made a proviso in respect of receipts that are not income in ordinary parlance but in respect of which statute states or indicates an intention that they are to be treated as income. Could it be said that in England capital gains are not really income but merely something that by statute is treated as income? The answer it seems depends on the attitudes of mankind. If mankind is conditioned to accepting capital gains as income then they are income. Assuming that mankind is so conditioned, it makes no difference to the character of the gains that there exists a specific statutory provision imposing a tax on them. If that provision was repealed they would still be income but—assuming that there is no general catch-all provision[15]—they may not be assessable income. The position is different in respect of other types of receipts. Gambling wins and various employment perks, for example, are not generally regarded as income. For these to be taxed as income depends entirely on the existence of specific provisions deeming them to be assessable income.

INCOME v. CAPITAL

Both the British (and consequently the New Zealand) and the American Courts acknowledge a distinction between receipts of an income and of a capital nature. These categories are said to be mutually exclusive. The distinction is sometimes explained by way of analogy with the fruit and the tree. This analogy was judicially adopted by Mr Justice Pitney of the Supreme Court of the United States in *Eisner* v *Macomber*.[16] The issue in question was whether a stock dividend (bonus share) was income. It was held that it was not. In delivering the judgment of the court Mr Justice Pitney said:[17]

> "The fundamental relation of capital to income has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as an outlet stream, to be measured by its flow during a period of time."

He concluded with the following statement on income derived from property:[18]

> "Here we have the essential matter; not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested or employed, and coming in being 'derived', that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is income derived from property. Nothing else answers the description."

These passages have been frequently quoted with approval in English cases[19] but the meaning that has been derived from them differs from the

[15] Such as, for example, section 65(2)(1) of the New Zealand Income Tax Act 1962

[16] (1919) 252 U.S. 189.

[17] Ibid., 206.

[18] Ibid., 207

[19] Notably by Viscount Finaly in *I.R.C.* v *Blott* [1921] 2 A.C. 171, 195.

meaning attributed them in America. In England, when income and capital are distinguished, capital is understood to include capital gains. Thus, in *Ryall* v *Hoare*[20] when Rowlett J. excluded capital gains from Case 6 he did so not only by reference to "the usage of a century" but also by reference to the fruit/tree analogy:[21] " 'Profits or gains' in Case 6 refer to the interest or fruit as opposed to the principal or root of the tree".

In America, on the other hand, capital is not understood to include capital gains which are included in the concept of income. Mr Justice Pitney himself when defining income said:[22]

> "Income may be defined as the gain derived from capital, from labour, or from both combined provided it be understood to include profit gained through the sale or conversion of capital assets."

Two years later this definition was adopted by the Supreme Court in *Merchants Loan and Trust Company* v *Smietanka*,[23] a case involving the taxability of an executor's profit on the sale of shares (admittedly a capital profit), where it was held that the word "income" included the gain from capital realised by a single isolated sale of property.[24]

Examples of the application of the distinction

The controversy over the taxation of capital gains is just one aspect of the income/capital distinction. The distinction applies in a number of cases of which the following are just a small but important selection:

(a) In consideration of landlord agreeing to lease premises, tenant agrees to

- (i) pay rent by regular instalments;
- (ii) pay a letting fee (premium) on the signing of the lease;
- (iii) build an extension to the premises thereby being allowed a reduction in rent.

Here, the first item—rent—is a payment of an income nature and the second item—the premium—is regarded as being of a capital nature.[25] If there was no specific provision deeming them to be income, the first item would be liable to taxation and the second item would not. It might then be desirable, particularly when the lease is for a short term, for the landlord to receive payment in the form of a high premium and low rent rather than a low premium—or no premium—and high rent. The total amount paid might be the same but in the first situation a smaller proportion would comprise income and the landlord would be liable to pay less tax. In this situation, the premium is paid as rent in advance which, of course, is not in the true nature of a premium. A premium is "best treated

[20] [1923] 2 K.B. 447.

[21] Ibid., 454.

[22] (1919) 252 U.S. 189, 207.

[23] (1920) 255 U.S. 509.

[24] Ibid., 520.

[25] *Smith* v *C.I.R.* [1969] N.Z.L.R. 565, 570 (Haslam J.)

as a sum of money paid upon a sale, the thing bought being the beneficial right or part of the beneficial right of occupation for the period of years in question".[26] Many premiums fall squarely into this category but in other cases it is difficult to distinguish them from receipts of an income nature.[27]

In New Zealand, this situation does not arise because section 65(2)(g) of the Income Tax Act (1976) deems as income, "premiums . . . derived by the owner of land from any lease . . .". This is a rare example under the Act of an acknowledged capital gain being taxed as income.

The third item in the example—the building of an extension to the premises in return for a reduction of the rent—is in itself neither capital nor income and the recipient of the benefit—the landlord, receives it tax free. It is a substitute for income which results in a capital gain, i.e., the increase in value of the premises.

(b) (i) vendor agrees to sell and purchaser agrees to buy property on terms as follows:

—purchase price: $60,000

—deposit on possession: 10%, i.e., $6,000

—balance to be paid by equal consecutive monthly instalments of $1500 each applied first, in payment of interest and secondly, in reduction of the purchase money;

—residue to be paid in full at the expiration of 5 years from the date of possession;

—interest to be paid on the amount of purchase money from time to time outstanding at the rate of 10% per annum calculated and adjusted quarterly as from the date of possession and included in the aforesaid monthly payments.

In this example, over the period of five years the purchaser will pay the vendor a total amount of $86,168.32 comprising the deposit of $6,000, instalments totalling $30,000 and a final payment of $50,168.32. Of this total amount $60,000 will represent a capital sum which is not liable to income taxation and $26,168.32 will represent interest which is so liable. Unlike the previous example where the premium payment could be seen as a payment of rent in advance, the distinction between the capital and the income component seem quite clear. But it need not be. Consider the following situation:

(b)(ii) Vendor agrees to sell and purchaser agrees to buy property on terms as follows:

—purchase price: $70,000;

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[26] Royal Commission on Taxation of Profits and Income (U.K.) Final Report—Cmd 9474-1955 (Radcliffe Report) para. 866.

[27] Report of the Law Commission and the Scottish Law Commission (U.K.) "Taxation of Income and Gains derived from Land" (1971) Cmnd 4654 para. 20: "A premium for a very short lease is not sensibly distinguishable from rent in advance and should be taxed as such at income tax rates." In New Zealand it is an offence under the Rent Appeal Act 1973 for a landlord of a dwellinghouse to stipulate for or demand or accept from the tenant any consideration in the nature of a premium. There is no similar provision in respect of other premises.

—deposit on possession: 10%, i.e., $7,000;

—balance to be paid by equal consecutive monthly instalments of $500 each applied first, in payment of interest and secondly, in reduction of the purchase money;

—residue to be paid in full at the expiration of 5 years from the date of possession;

—interest to be paid on the amount of purchase money from time to time outstanding at the rate of 5% per annum calculated and adjusted quarterly as from the date of possession and included in the aforesaid monthly payments.

The essential differences between this and the last example are that the purchase price has been increased by $10,000 and the interest rate has been reduced by 5% to 5%. The result of these differences is that the purchaser will pay less and the vendor will, after tax, receive more.

Over the period of five years, the purchaser will pay the vendor a total amount of $83,923.87 comprising the deposit of $7,000, instalments totalling $30,000 and a final payment of $46,923.87. This total amount is $2,244.45 less than the total amount in the last example. Of the total amount received by the vendor in the present example, $70,000 will represent a non-taxable capital sum and only $13,423.87 will represent taxable income in the form of interest.[28]

The second example illustrates a technique, sometimes described as "building interest into the purchase price". Like the premium paid as rent in advance it shows just how fine and how artificial the distinction is between capital and income.

(c) Taxpayer purchases property for $30,000. He then sells it for $40,000.

This situation involves not just a distinction between capital and income but also a distinction between capital gains and income (or other forms of income). The $30,000 used to purchase the property is capital, the property itself is capital and, taking no account of inflation, $30,000 of the $40,000 sale price is capital. The other part of the sale price—$10,000—the profit—is a capital gain. It is a gain "that arises to the owner when some property of his appreciates in value or when he realises it at a price greater than its cost of acquisition".[29] In England and New Zealand, unlike America, it is traditionally regarded as capital unless other factors exist which distinguish it as income—factors such as a connection with a number of similar transactions by the taxpayer[30] or a purpose of the taxpayer at the time of the purchase to make a profit by resale.[31] These factors distinguish the profit from an isolated capital gain and constitute it as a taxable profit.

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[28] Assuming it will not be caught as a tax avoidance scheme.

[29] See above note 1.

[30] Income Tax Act 1976 section 65(2)(a).

[31] Income Tax Act 1976 section 65(2)(e).

CONCLUSIONS

The noted American tax philosopher Henry Simons said that[32] "Tax laws do not really define income but merely set up rules as to what must be included and what must be deducted; and such rules by no means define income because they are neither exhaustive nor logically coherent". This is well illustrated by the New Zealand tax laws. Our major tax statute is called the "Income Tax Act". It contains a number of provisions imposing tax on a number of receipts. The most important of these provisions is section 65(2) which we have already noted and which starts with the words, "Without in any way limiting the meaning of the term, the assessable income of any person shall for the purposes of this Act be deemed to include, save so far as express provision is made in this Act to the contrary, . . .". It then lists twelve types of receipt which are thereby assessable. What do they have in common? Are they all receipts of an income nature within the narrow meaning of the word—that which excludes capital gains? Or do they comprise such a wide range of receipts so as to suggest that in New Zealand income or deemed income is generally understood to include capital gains?

In both cases, the answer seems to be no. Most of the specified items are not capital gains and it is clear that many capital gains escape taxation under the provision. But, some capital gains are caught. In particular item (f)—"All profits or gains derived from the sale or other disposition of any land within the meaning of section 67 of this Act, being profits or gains to which that section applies"—includes some capital gains.[33] So too apparently does the second limb of the item (e)—"All profits or gains derived from the sale or disposition of any personal property . . . if the property was acquired for the purpose of selling or otherwise disposing of it . . .". This provision seems to fall squarely within our definition of a capital gain as "that form of gain that arises to the owner when some property of his appreciates in value or when he realises it at a price greater than its cost of acquisition."[34] However, it has been suggested that it does not relate to capital gains. In *C.I.R.* v *Walker*,[35] in the Court of Appeal, North J. said:[36]

> "No doubt the third limb is wider in its application than the second, but in giving a meaning to the word 'purpose' in both clauses it is well to bear in mind that we are dealing with a taxing statute aimed at requiring people to pay tax on income as distinct from what may loosely be described as gains derived from a capital source."

This seems to represent the attitude of the courts to the Income Tax Act; that generally it imposes a tax on "income" as distinct from what may loosely be described as capital gains. And, as may be expected. the final item on the list in section 65(2)—"(1) Income derived from any other

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[32] H. C. Simons *Personal Income Taxation* (University of Chicago Press, Chicago 1938) p.105.

[33] *Lowe* v *C.I.R.* (1979) 4 N.Z.T.C. 61, 427 (H.C.) Roper J. at 61, 436; *Swan* v *C.I.R.* (1979) 4 N.Z.T.C. 61, 515 Thorp J. at 61, 521.

[34] See above note 1.

[35] [1963] N.Z.L.R. 339.

[36] Ibid., 361.

source whatsoever"—is interpreted so as not to apply to capital gains.

If it has been our purpose to define income then so far we have failed. We have been unable to find a definition in the Act. All it contains is lists. Nor have we found definition in the "ordinary concepts and usages of mankind." Like the Act, they merely indicate what items are and are not regarded as income. The fruit/tree concept of income is perhaps closer in form to a definition but it really amounts to little more than an attempt to distinguish between income and capital.

A different approach is to define income in all-embracing terms—as a comprehensive tax base—and then, if it is thought necessary, for the purpose of implementing tax laws, to state items that will not be liable to taxation. One definition which has been built upon by proponents of the comprehensive tax base is that of Henry Simons:[37]

> "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning."

This definition assumes as income a number of items that are not presently taxable as income in New Zealand. These include all capital gains, betting and gambling wins, bequests and gifts, social security payments and payments in kind. Any exemption of these items from tax would result in a corresponding erosion of the tax base. As a basis for taxation, Simon's and other similar definitions[38] have found favour with a number of tax philosophers but nowhere among Western countries have such definitions been adopted for the purpose of taxation.

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[37] H. C. Simons op.cit. pp.50-51.

[38] Robert M. Haig who formulated the "accretion" concept of income defined income as follows: "Income is the money value of the net accretion of one's economic power between two points of time":—R. M. Haig *The Concept of Income* in The Federal Income Tax, ed. Haig (New York: Columbia University Press, 1921), p.7.