CASE NOTE

HEPPLES v. FEDERAL COMMISSIONER OF TAXATION[1]

INTRODUCTION

It took six years for two extraordinary provisions of the capital gains tax[2] to come under the spotlight of the Full Bench of the High Court. Sub-sections 160M(6) and (7) cast an almost indeterminate tax net, appearing to catch just about any transaction creating new rights (in the case of sub-s. 160M(6))[3] and just about any receipt relating to an asset (in the case of sub-s. 160M(7)). In addition to their remarkable breadth, their meaning is confused by a most unfortunate choice of words by the legislative drafters. When, in particular, sub-s. 160M(6) begins by referring to 'a disposal of an asset that did not exist', one can empathize with the judge who described this provision as having been 'drafted with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms'.[4]

The importance of sub-ss 160M(6) and (7) cannot be overstated, for three reasons. First, they appear on their face to catch such a broad array of transactions that the techniques available to a court to ascertain Parliament's true intent are tested to the limit. Secondly, they deny any cost base (except for disposal costs) for the asset which they deem to be disposed of, so that virtually the whole of the consideration in respect of the disposal[5] is assessable. Thirdly, they appear to apply to transactions which could be assessable under some other provision of the Act but which do not involve the disposal of an asset in the ordinary sense, for instance a payment for services performed in relation to an asset.[6] This raises the question why such provisions were included in capital gains tax at all, and also the spectre of double taxation.

Hepples' case was therefore a marvellous opportunity for the High Court to demonstrate how courts, the Commissioner and taxpayers should balance the needs for *certainty* in the law (whereby the actual wording of a statute is paramount) and *fairness* (whereby the underlying policy of a statute is paramount). *Hepples'* case also presented a chance for the High Court to clarify the

[1] (1991) 102 A.L.R. 497. This case note is an edited version of an article being published in *Taxation in Australia*, Taxation Institute of Australia.

[2] Part IIIA of the Income Tax Assessment Act 1936 (Cth).

[3] *E.g.* a loan transaction which creates an enforceable right to repayment and/or interest for the lender: *Hepples*, *supra* n. 1, 537 *per* McHugh J.

[4] *Federal Commissioner of Taxation v. Cooling* (1990) 22 F.C.R. 42, 61 *per* Hill J.

[5] Which would frequently be the market value of the asset disposed of: sub-s. 160ZD(2).

[6] Sub-s. 160M(7).

law by defining the extent of what seems like a limitless tax, as well as to give some definition to that curious asset, 'goodwill'.

Sadly, the Full Court did none of these things: it created more confusion than it resolved, with seven different judgments from which the safest *ratio decidendi* is the proposition that a case with substantially identical facts before the same court would probably be decided the same way. In relation to sub-s. 160M(6), it is possible to patch together some agreement as to how its scope is to be limited, although the reasoning raises serious questions about the lengths to which a court may go in curing defects in legislation. By contrast, sub-s. 160M(7) has been left like a time bomb waiting to explode on the thousands of other situations distinguishable from the facts of *Hepples'* case.

THE FACTS OF HEPPLES' *CASE*

Briefly stated, Hepples received $40,000 as consideration for agreeing to abide by certain terms of his employment agreement for a period of two years beyond termination of employment. In essence, Hepples agreed:

- not to divulge trade secrets or 'special processes';
- not to compete with his employer within Australia;
- to assign patent protection for any invention made from using a 'special process'; and
- not to solicit the employer's customers with whom Hepples had dealt.

Payments as consideration for entering into such restrictive convenants have generally been regarded as capital and therefore not taxable under sub-s. 25(1) of the Income Tax Assessment Act 1936 (Cth).[7] Accordingly, *Hepples'* case concerned only the capital gains provisions of the Act (Part IIIA); and since there was no pre-existing asset which could be said to have been disposed of by Hepples,[8] the case concerned the question whether Hepples could be *deemed* to have disposed of an asset in one of the contrived ways provided for by sub-ss 160M(6) and (7). Each of these provisions will now be analysed and considered by reference to an appraisal of the various judgments.

SUB-SECTION 160M(6): THE CREATION OF NEW ASSETS

> 160M . . . (6) A disposal of an asset that did not exist (either by itself or as part of another asset) before the disposal, but is created by the disposal, constitutes a disposal of the asset for the purposes of the Part, but the person who so disposes of the asset shall be deemed not to have paid or given any consideration, or incurred any costs or expenditure . . . in respect of the asset [other than any incidental costs of disposal].

Although the opening words taken in isolation might seem a bid odd (how can one dispose of something which does not exist?), the intention gleaned from the remainder of the provision seems clear enough: when an asset is first brought into existence, it is deemed to constitute a disposal.

[7] See the cases cited by Deane J. in *Hepples*, *supra* n. 1, 511.

[8] In a loose sense, Hepples may be thought of as having disposed of part of the 'right to work' (in so far as Hepples was restricted from competing with the employer and from soliciting the employer's customers with whom Hepples had dealt) but the 'right to work' does not constitute an asset: see the cases referred to by Brennan J., *Hepples*, *supra* n. 1, 504.

Because of the breadth of the provision, and the absurdity of its application to transactions such as loans,[9] it is not surprising that some of the judges fastened on drafting errors in order to deny its full effect. The first error is that, instead of referring at the outset to an 'act, event or transaction' and then deeming it to constitute a disposal,[10] a 'disposal' 'is deemed to constitute a disposal'. The second drafting error is that the reference in sub-s. 160M(6) to 'an asset that did not exist . . . before the disposal' is inconsistent with other important provisions which appear to require *prior ownership* of the asset which is disposed of.[11]

A further problem with sub-s. 160M(6) is its relationship with the provisions dealing with part-disposals. It appears that sub-s. 160M(6) was not intended to apply to part-disposals (it expressly excludes a newly-created asset which previously existed 'as part of another asset'),[12] yet the scope of this exclusion is not clear. In fact, the exclusion seems to contradict the majority's effective conclusion that sub-s. 160M(6) can apply only where the asset to which it refers is carved out of another asset.

The fourth problem with sub-s. 160M(6) is its breadth. If its apparent intent to embrace the creation of any asset were given effect, it would, for example, subject to tax a simple loan whereby the lender acquires the right to repayment and/or interest. This is regardless of the fact that such rights may be offset by liabilities or outgoings (such as advance of the loan moneys) which cannot be taken into account because the rights are treated as a separate asset (sub-s. 160A(a)) without any cost base except for disposal costs (sub-s. 160M(6)).

Hepples' case thus raised fascinating issues. To what extent can the words of sub-s. 160M(6) be read down by reference to the purpose of Part IIIA as a whole, or by reference to the absurd consequences of not reading it down? In other words, what tools are available to judges to rectify drafting errors endorsed by Parliament?

The High Court had a choice between giving effect to the plain meaning of the words used in sub-s. 160M(6) (which suggest that capital gains tax applies whenever an asset, and in particular the contractual right conferred by Hepples upon his employer, comes into existence); or reading into sub-s. 160M(6) some limitation whereby the newly-created asset must be carved out of some other asset in order for capital gains tax to be leviable (which is hereafter referred to as 'the purposive approach'[13]).

Brennan J. (with whom Dawson and Gaudron JJ. agreed) expressed the 'plain meaning' approach with lucidity when he said:

> Once the legislature chooses to provide for a case where there is a 'disposal' of an asset 'that did not exist (either by itself or as part of another asset)', it is impermissible, in my opinion, to read that provision down so that it applies only if the asset created is born of, carved out of or created out of or over existing assets.[14]

[9] *Ibid.* 537 *per* McHugh J.

[10] As in sub-s. 160M(7), discussed below; *cf.* sub-s. 160ZZC(3)(a).

[11] Sub-ss 160L & C(1). Sub-s. 160M(7) also suffers from this drafting error, since the asset which it deems to have been disposed of is a fictitious asset which did not previously exist and hence was not *owned by* a person prior to disposal.

[12] See Gummow J. in the Federal Court: (1990) 22 F.C.R. 1, 33.

[13] So called because such a limitation is consistent with the *purpose* of a capital gains tax being to assess a realisation of wealth in respect of assets.

[14] *Hepples*, *supra* n. 1, 507.

However, a majority of four judges adopted a purposive approach in order to construct a limit on the operation of sub-s. 160M(6). One of the problems with the purposive approach is that it involves a patchwork of different provisions (and an ounce of guesswork) to gauge what Parliament really intended — which makes it difficult for judges to agree on the precise formulation of such an intention. Consequently each of the majority judges expressed a slightly different formulation as to the limit to be attributed to sub-s. 160M(6) — although the essence of all such formulations is that sub-s. 160M(6) applies only if the newly-created asset is *derived* from ownership of another asset.

Deane J. stated that 'the newly-created "asset" to which [the sub-section] refers arises from, or involves the use or exploitation of, an existing "asset" owned by the person alleged to be liable to tax "immediately before the disposal"'.[15] Toohey J. stated that:

> at the very least, it is necessary to identify something that the taxpayer owned or something that the taxpayer did in the capacity of owner, which is the subject of disposal. To say this may seem to come close to acknowledging that there must be a pre-existing asset but I do not think that this is so.[16]

McHugh J. (with whom Mason C.J. agreed) stated:

> Parliament perceived the sub-section to be concerned with gains made from disposing of rights which were created out of or over existing assets by transactions which created and simultaneously disposed of those rights.[17]

It is interesting to see how the judges managed to construct these limitations. Deane J. referred to the first two of the drafting problems mentioned above. His Honour suggested that the drafting technique cast doubt on the scope of sub-s. 160M(6), and that such doubt should be resolved in favour of the taxpayer in the context of taxing statutes which 'derogate from the ordinary rights of the citizen in that they represent a compulsory exaction of money'.[18] Reference was made to a statement of the Privy Council that:

> the intention to impose a tax or duty, or to increase a tax or duty already imposed, must be shown by clear and unambiguous language and cannot be inferred from ambiguous words.[19]

His Honour considered that sub-s. 160C(1) contained a 'plain and unqualified direction' that a reference to 'taxpayer' in the key provisions of sub-ss 160ZC(1) and 160ZO(1) referred to the person who owned the asset 'immediately before the disposal took place'.[20] Sub-s. 160M(6) could only be reconciled with this if its scope were limited to assets which were carved out of a pre-existing asset. We will see shortly that such a limitation does *not* in fact reconcile sub-s. 160M(6) with sub-s. 160C(1).

McHugh J. felt bound to give credence to use of the word 'disposal' at the beginning of sub-s. 160M(6), since the possibility of sub-s. 160M(6) having an unrestricted operation was to be avoided as it would mean, for example, that a

15 *Ibid.* 513.
16 *Ibid.* 522.
17 *Ibid.* 539.
18 *Ibid.* 510.
19 *Brunton v. Commissioner of Stamp Duties* [1913] A.C. 747, 760.
20 *Hepples, supra* n. 1, 513.

borrower of money would be subject to tax under Part IIIA 'on the whole amount of the borrowing'.[21] His Honour stated:

> without straining the meaning of the word 'disposal', there are forms of property which can be said to be disposed of even though they did not exist until an act of the disponor simultaneously created and vested that property in another person.

He then referred to the creation of an easement or a *profit a prendre* in respect of land and the grant of a lease as examples of such disposals.[22]

Toohey J. also appeared to give emphasis to use of the word 'disposal' at the beginning of sub-s. 160M(6), but he indicated a pre-existing asset was not essential, provided the taxpayer did something 'in the capacity of owner' so that there is an asset which is 'disposed of at the moment of its creation'.[23] With respect, this formulation involves such a subtle distinction and is so abstract (especially without the benefit of any examples) that it is difficult to imagine Parliament intended it. His Honour claimed 'there is no warrant for reading words into the provision or giving it a meaning which its words do not ordinarily bear',[24] yet it appears that this is what His Honour then proceeded to do.

The idea that doubt or ambiguity in the interpretation of taxing statutes should be resolved in favour of the taxpayer is appealing in principle. But *how much* doubt or ambiguity must there be before a court should read into a provision something which Parliament could easily have expressed but did not? Also, where the alternative, more favourable interpretation is more at odds with the legislation, but appears to promote better the purpose of the legislation, how far at odds must it be before it is rejected?

It is respectfully submitted that the majority judges overstated the doubt about Parliament's intent, and understated the problems associated with their own interpretation of sub-s. 160M(6). It is true that sub-ss 160C(1) and 160L(1) require that the person disposing of an asset must have *owned* the asset before the disposal; but paragraph 160M(5)(c) provides that 'the creation of an asset *by* or *for* a person constitutes the acquisition of the asset by the person' (emphasis added). So it is quite consistent with the express terms of the provisions that Hepples, when he created the rights to enforce the restrictive covenant, acquired those rights immediately before disposing of them if only just to satisfy the prior ownership requirement in sub-ss 160C(1) and 160L(1).[25] Also, to the extent that a prior acquisition is required by sub-ss 160C(1) and 160L(1), a deemed acquisition should be implicit from a deemed creation and disposal of an asset.

In any case, the majority's interpretation of sub-s. 160M(6) does not conform to such a prior ownership requirement anyway. Using the easement example

[21] *Ibid.* 537. By contrast, McHugh J. was prepared to countenance a broad construction of sub-s. 160M(7): *ibid.* 532.

[22] *Ibid.* 537.

[23] *Ibid.* 522.

[24] *Ibid.* 521.

[25] *Ibid.* 506 *per* Brennan J.; *cf.* 513 *per* Deane J. who omitted to refer to sub-s. 160M(5)(c) in this context. It is likely that the main, if not the only, purpose of the reference to the creation of an asset *by* a person is to cover a situation where the person created the asset for himself or herself (such as the founder of a business). But the wording justifies a broader construction, especially one which resolves conflict elsewhere (*i.e.* between sub-ss 160M(6) and (7) and sub-ss 160C(1) and 160L).

cited by McHugh J., it is true that the person granting the easement was the owner of *an* asset [the land] 'immediately before the disposal took place',[26] but the grantor was not owner of *the asset* to which sub-ss 160C(1) or 160L(1) relate — namely the asset which was disposed of (the easement).[27] This appears to be an important point overlooked by all the majority judges. If there is a drafting error, it lies within sub-ss 160C(1) or 160L(1) for not explicity taking account of situations comprehended by sub-ss 160M(6) and (7), rather than vice versa; and such an error may, as mentioned above, be resolved by paragraph 160M(5)(c) with only a fraction of the inference relied upon by the majority judges.

SUB-SECTION 160M(7): ASSET-RELATED RECEIPTS

The relative simplicity of this provision is obscured by its verbiage. The two preconditions to the application of this section are contained in paragraphs (a) and (b):

(a) there must be an act or transaction in relation to, or an event affecting, an asset; and
(b) there must be a receipt of money or other consideration by reason of the act, transaction or event.

Naturally, one must always refer back to the words of sub-s. 160M(7), but its extraordinary breadth is revealed by abridging the preconditions further, so as to read: 'a receipt of money or other consideration in relation to an asset'.

Under sub-s. 160M(7), like sub-s. 160M(6), the taxpayer can claim only disposal transaction costs as the cost base — meaning that the rest of any amount received as consideration for the disposal will constitute a capital gain. The issue in *Hepples'* case was whether the entering into of the restrictive covenant by Hepples was 'in relation to' or 'affected' his employer's goodwill or some other asset. This key issue lies in paragraph (a) and may be referred to as the 'nexus requirement'.[28] Provided there is some nexus between a receipt of money or other consideration[29] and a pre-existing asset, then sub-s. 160M(7) would appear to apply.

The extraordinary breadth of this provision is immediately apparent; and its place in the capital gains tax provisions is remarkable since there is no reference to the recipient of money or other consideration having realized an asset in any sense, or even needing to be the owner of the asset in relation to which the payment was made. This seems to be acknowledged by the fact that Parliament needed to invent a fictitious asset 'created by the disposal' quite distinct from the pre-existing asset referred to in paragraph (a) in relation to which the act, transaction or event underlying the payment took place.[30]

26 Sub-ss 160C(1) & 160L(1).
27 As Brennan J. pointed out, if sub-s. 160L(1) or sub-s. 160C(1) were construed strictly so that Part IIIA could only ever apply to existing assets, then sub-s. 160M(6) would be denied any effect: *Hepples*, *supra* n. 1, 506.
28 See Gummow J. in the Federal Court: (1990) 22 F.C.R. 1, 28.
29 Or more specifically, the act, transaction or event prompting the receipt of money or other consideration.
30 *Cf.* future property: *Hepples*, *supra* n. 1, 583 *per* McHugh J.

Applying the nexus requirement to the facts of a case will involve identifying a pre-existing asset to which the relevant act, transaction or event can be said to relate. In *Hepples'* case, most of the judges regarded the relevant pre-existing asset as being the *goodwill*[31] of the employer, but there was significant disagreement in applying the nexus requirement: three judges found that there was,[32] and three judges that there was not,[33] a sufficient nexus between entry into the restrictive covenant and an asset of the employer. In the author's view, much of this disagreement and the absence of clear analysis can be explained by confusion over the nature of *goodwill* for capital gains tax purposes.

Although not made explicit by the judges, applying sub-s. 160M(7) to the facts of a case involves two steps: identifying the relevant pre-existing asset, and applying the nexus requirement.

Step 1: Identifying the relevant pre-existing asset

(a) Goodwill. Dawson J. stated that goodwill 'is notoriously difficult to define',[34] and then he (and McHugh J.[35]) quoted Lord Lindley who said of 'goodwill':

> I understand the word to include whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and *agreed absence from competition*, or any of these things, and there may be others which do not occur to me. In this wide sense, goodwill is inseparable from the business to which [it] adds value, and, in my opinion, exists where the business is carried on.[36]

This passage was cited with approval in an earlier case by four members of the High Court,[37] who fastened on part of the quote by stating that goodwill 'includes whatever adds value to a business'.[38] This latter formulation is clearly too broad, since tangible assets (such as land or machinery) clearly add value to a business but would not be a component of goodwill.[39] It would be consistent with Lord Lindley's formulation to postulate that goodwill is whatever adds value to a business *other than* assets which have identifiable value.[40] Goodwill should be regarded as a *residual* amount, calculated by deducting the value of all identifiable assets from the purchase consideration of a business disposed of.[41]

It seems, however, that the true nature of goodwill was overlooked by the judges in *Hepples'* case. By and large, the judges appeared to accept the existence of goodwill just because the employer's business was a going concern.

31 Except Gaudron J. who regarded the relevant asset as being the earlier promises under the employment agreement: *ibid.* 523, considered below.
32 Dawson, Toohey and Gaudron JJ.
33 Mason C.J., Brennan and McHugh JJ.
34 *Hepples*, *supra* n. 1, 516.
35 *Ibid.* 534.
36 *I.R.C. v. Muller & Co.'s Margarine Limited* [1901] A.C. 217, 235. The emphasis was added by Dawson J. in *Hepples*, *supra* n. 1, 516.
37 *Box v. Federal Commissioner of Taxation* (1952) 86 C.L.R. 387, 396-7 *per* Dixon C.J., Williams, Fullagar and Kitto JJ.
38 *Ibid.*
39 In fact, McHugh J. seemed to equate goodwill with total capitalisation or total value, by suggesting that 'goodwill is commonly valued by capitalising the expected future net profits': *Hepples*, *supra* n. 1, 534.
40 This is an *exhaustive* definition, whereas Lord Lindley's formula is *inclusive*.
41 Australian Accounting Standards 18, para. 38.

The only judge who came close to recognizing that the mere carrying on of a business does not mean that goodwill necessarily exists was McHugh J., who said:

> the special case referred does not contain any fact establishing that, at the time of entry into the deed, [the employer] had any trade secrets, trade connection or goodwill of value.[42]

But his Honour considered it 'proper to infer that [the employer] . . . had some form of goodwill which had some value' merely because the division which Hepples managed 'accounted for a very significant proportion (approximately two thirds)' of the total business activities of the employer.[43] With respect, this logic appears misconceived in two respects. First, the significance of Hepples' particular division as part of the total operation is irrelevant to the question of whether the total operation has goodwill. Second, His Honour appears to have overlooked that goodwill, particularly in the context of the capital gains tax provisions, is a residual item which can be said to exist only if the total value of the business exceeds the sum of individual asset values.

(b) Trade secrets, trade connections and special processes. Statements by Dawson and Toohey JJ. suggest that trade secrets, 'special processes' or 'trade connection'[44] constitute separate 'assets' for capital gains tax purposes.[45] But such a proposition is suspect: the balance of authority appears to suggest that confidential information does not of itself constitute a form of property,[46] and would not therefore constitute an 'asset' pursuant to paragraph 160A(a).

In the capital gains tax context, there is a special reason (overlooked by Dawson and Toohey JJ.) why trade secrets, trade connections and special processes should not constitute assets: the fact that *double taxation* could result on a sale of business if these 'assets' were assessed separately and again as part of 'goodwill'. To avoid this result would require these items to be excluded from goodwill, which would strip goodwill of significance for businesses whose main intangible asset is confidential information. In reality, trade secrets, trade connections and special processes are ordinarily regarded as things which tend to (although do not necessarily) give rise to or increase the value of *goodwill* in a business, rather than as constituting separate assets.

(c) 'Earlier promises' in the employment agreement. Gaudron J. regarded the relevant asset as being the earlier promises in the employment agreement (not to compete, *etc.*), which entry into the restrictive covenant effectively varied by extending their term.[47] In legal terms, entry into the restrictive covenant did not appear to affect the earlier promises, which had ceased to apply by virtue of an oral agreement between Hepples and the employer.[48] Also, there is some doubt

42 *Hepples*, *supra* n. 1, 534.
43 *Ibid.* 534.
44 This presumably refers collectively to business relationships with suppliers and customers.
45 *Hepples*, *supra* n. 1, 516 *per* Dawson J. and 519 *per* Toohey J.
46 See the conclusion reached by Dean, R. in *The Law of Trade Secrets* (1990) 83-4, and the cases mentioned in the preceding discussion therein, especially the High Court's decision in *Federal Commissioner of Taxation v. United Aircraft Corporation* (1943) 68 C.L.R. 525. *Cf.* the statement by Gummow J. in the Federal Court ((1990) 22 F.C.R. 1, 31-2), endorsed by Toohey J. in *Hepples*, *supra* n. 1, 519.
47 *Hepples*, *supra* n. 1, 523.
48 *Ibid.* 524, *per* McHugh J.

whether these earlier promises should be regarded as an 'asset' since, although a *chose in action* is specifically referred to in the definition,[49] a *chose in action* must have the character of property to be included, and there is some suggestion that the right to enforce an employment agreement is not proprietary but personal because it is non-assignable.[50]

(d) Ownership of the pre-existing asset. Deane J. considered that a limitation should be inferred whereby the pre-existing asset referred to in paragraph (a) of sub-s. 160M(7) must be owned by the recipient of money or other consideration referred to in paragraph (b).[51] The justification for reading in this limitation was the same as for the limitation requiring the asset under sub-s. 160M(6) to be carved out of an existing asset: principally, the fact that ss 160C and 160L[52] require the taxpayer effectively to *own* the disposed-of asset prior to disposal.[53] The above criticisms of the majority's decision in relation to sub-s. 160M(6) apply also to Deane J.'s decision on sub-s. 160M(7), but with even greater force since the asset deemed to be disposed of by sub-s. 160M(7) could not have been owned by anyone since it is entirely fictitious.

In any case, four judges[54] considered that such a limitation was not justified, preferring to give effect to the plain words of the subsection,[55] whilst the two other judges refrained from expressing a view on the point.[56]

Step 2: Is there a sufficient nexus?

The other major requirement of sub-s. 160M(7) is that the act, transaction or event giving rise to a receipt of money or other consideration must have been 'in relation to' or 'affecting' the identified pre-existing asset. The High Court was evenly divided as to whether this nexus requirement was satisfied: three judges finding that it was, and three judges finding that it was not, with one judge (Deane J.) deciding the issue on a different point (by requiring that the pre-existing asset must be owned by the taxpayer/recipient).

Dawson, Toohey and Gaudron JJ. found the nexus requirement *was* satisfied. Dawson and Toohey JJ. held effectively that the goodwill was benefited by entry into the restrictive convenant.[57] Gaudron J. found that entry into the restrictive convenant in effect varied the terms of promises under the employment agreement.[58]

Brennan J. (with whom Mason C.J. agreed) and McHugh J. found that the nexus requirement was *not* satisfied. Brennan J. acknowledged that the benefit of

49 Sub-s. 160A(a).

50 See Gummow J. in the Federal Court ((1990) 22 F.C.R. 1, 27) who found that English authority to the contrary should not be applied in Australia; *cf. O'Brien v. Benson's Hosiery (Holdings) Ltd* [1980] A.C. 562; *Zim Properties Ltd v. Proctor* (1984) 58 T.C. 371, 389-90.

51 Following Hill J. in the Federal Court: (1990) 22 F.C.R. 1, 38.

52 On which sub-ss 160Z(1), 160ZC(1) and 160ZO(1) depend.

53 *Hepples, supra* n. 1, 514-5.

54 *Ibid.* 517 *per* Dawson J. (with whom Gaudron J. appeared to agree at 523), 519 *per* Toohey J. and 532-3 *per* McHugh J.

55 Which is consistent with the majority in the Federal Court: (1990) 22 F.C.R. 1, 14 *per* Lockhart J. and 32 *per* Gummow J.

56 Brennan J., with whom Mason C.J. agreed.

57 *Hepples, supra* n. 1, 517 *per* Dawson J. and 520 *per* Toohey J.

58 *Ibid.* 523.

the restrictive covenant became part of the employer's goodwill,[59] but later concluded (paradoxically it seems) that none of the employer's assets were affected by entry into the restrictive covenant.[60] It appears that Brennan J. considered goodwill as an asset early in his judgment, but failed to consider goodwill as the relevant asset when considering the nexus requirement,[61] and instead may have limited his consideration to the employer's existing assets other than goodwill. Whatever the case, His Honour's finding appears illogical and, with respect, ill-considered.

McHugh J.'s judgment was shaped by his rather odd notion of what constitutes goodwill. His Honour considered that the employer's goodwill at the time of entry into the restrictive covenant was constituted by the *sources of earnings* as at that date.[62] Since the restrictive covenant was to take effect at some future time (upon termination of employment and for a period of two years thereafter), it could not be known precisely what the employer's sources of earnings would be at that time. Therefore, it could not be said with certainty that entry into the restrictive covenant will in fact affect the employer's sources of earnings. With respect, this line of reasoning appears artificial and illogical, especially when McHugh J. had earlier given a broad description of goodwill,[63] and even went as far as to suggest that goodwill 'may exist even though the business has not made any profits and is unlikely to do so for some time'.[64] How can McHugh J. state that goodwill can exist when there are no existing sources of earnings, and then suggest that goodwill is composed only of the sources of earnings existing at any particular time?

Given that goodwill was included in paragraph 160A(a) as an asset for capital gains tax purposes, it appears quite logical to conclude that the benefit of a restrictive covenant either increases the value of, or at least is included as part of, the employer's goodwill (assuming it can be said to exist at all); and that entry into the restrictive covenant is therefore an act or transaction in relation to, or an event affecting, the goodwill.

CONCLUSION

The question before the High Court was expressed in terms, broadly speaking, of whether $40,000 was included in Hepples' assessable income. If this question were taken at face value, a majority would have replied affirmatively,[65] since although those in such a majority would not have agreed on which of sub-ss 160M(6) or (7) applied, each of those judges considered that *either* provision applied. But the High Court confirmed, in supplementary proceedings,[66] that the above question should be construed as containing two separate questions, namely

[59] *Ibid.* 506.
[60] *Ibid.* 508.
[61] *Ibid.*
[62] *Ibid.* 535.
[63] *Ibid.* 534.
[64] *Ibid.*
[65] Brennan J. in relation to sub-s. 160M(6), Dawson and Gaudron JJ. in relation to both sub-ss 160M(6) and (7), and Toohey J. in relation to sub-s. 160M(7).
[66] *Hepples v. Federal Commissioner of Taxation (No. 2)* (1992) 104 A.L.R. 616.

the question whether there was a disposal within sub-s. 160M(6), and the question whether there was a disposal within sub-s. 160M(7). Each of these implied questions of law would be answered in the negative by a majority of four to three,[67] and so the end result was that Hepples' payment was not included in assessable income.

So far as sub-s. 160M(6) is concerned, the decision is not convincing. The majority reached its decision not by means of a simple choice between giving effect to one of two provisions and then resolving the ambiguity in favour of the taxpayer, but instead compromised the plain words of all the relevant provisions to achieve the so-called purpose of the legislation. The decision may be welcomed as a victory for self-assessing taxpayers[68] who may in future seek to have complex and vague provisions construed strictly, but the decision raises questions about how far judges can go in effectively rewriting legislation to achieve Parliament's unspoken purpose.

So far as sub-s. 160M(7) is concerned, the judges had one less drafting error to rely upon compared with sub-s. 160M(6) (namely, its first anomalous reference to 'disposal'), and therefore appeared less willing to read in a limitation on its scope. The contrast between the judges' willingness to read in a limitation in the context of sub-s. 160M(6), and their unwillingness (except for one judge)[69] to do so in the context of sub-s. 160M(7), highlights the delicate and imprecise balancing act required by the purposive approach. One is tempted to say that if a provision is drafted *very poorly* judges may go to some lengths to rewrite the provision, whereas if a provision is only drafted *poorly* their liberty to do so is restricted.

The judges' unwillingness to read a limitation into sub-s. 160M(7) may also have been because there was another 'safety valve' whereby its scope could be limited: the nexus requirement. However, it is questionable whether the majority's interpretation of the nexus requirement stands up to close analysis. In any case, their interpretation fails to solve the much bigger problem of defining a limit to the scope of sub-s. 160M(7) for the purposes of other fact situations not involving that strangest of assets, goodwill. It is still not clear, for example, why sub-s. 160M(7) should not apply to a simple gift of money by cheque which, it may be said, affects the donor's *chose in action* against the bank in respect of the donor's bank account.

In conclusion, it appears that payments in respect of restrictive covenants are safe so long as the legislation is not amended and the composition of the High Court remains unchanged. Yet, for other transactions involving a receipt of money or other consideration, the scope of sub-s. 160M(7) is still highly uncertain. By contrast, the limits of sub-s. 160M(6) have now been relatively clearly defined (at least in relation to assets created pursuant to contracts),[70]

[67] In relation to sub-s. 160M(6), Mason C.J., Deane, Toohey and McHugh JJ. in the majority, with Brennan, Dawson and Gaudron JJ. dissenting; and in relation to sub-s. 160M(7), Mason C.J., Brennan, Deane and McHugh JJ. in the majority, with Dawson, Toohey and Gaudron JJ. dissenting.

[68] See the reference by Deane J. to the self-assessment system and the extra reason it provides to construe taxation provisions strictly: *Hepples*, *supra* n. 1, 515.

[69] *Ibid. per* Deane J.

[70] *Cf.* sub-s. 160U(6)(a).

although in the process a precedent has been set whereby courts can effectively rewrite bad legislation, undermining certainty in the law. Ignorance of the law is no excuse,[71] yet surely one *should* be excused for not knowing the law when the High Court cannot agree upon it.

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[71] *Ignorantia juris quod quisque scire tenetur non excusat.*

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