A CRITICAL ANALYISIS OF THE INCOME TAX IMPLICATION OF INCOME FROM ILLEGAL ACTIVITIES IN SOUTH AFRICA

By

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DECLARATION

I, Delani Nxumalo, declare that the work presented in this dissertation is original. It has never been presented to any other University or Institution. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the degree of Master of Commerce (Taxation).

Signed…….

Date…….

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LIST OF ABBREVIATIONS

AAT	Administrative Appeals Tribunal
CIR	Commissioner for Inland Revenue
COT	Commissioner of Taxes
CSARS	Commissioner for South African Revenue Services
IRC	Internal Revenue Code
SARS	South African Revenue Services
SCA	Supreme Court of Appeal
SIR	Secretary for Inland Revenue

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SUMMARY

The question as to whether or not income received by the taxpayer in the course of carrying on illegal activities should be regarded as being received by such a taxpayer for the purposes of assessing such a person's gross income has been the subject of debate in South Africa. The meaning of "received by" as contained in section 1 of the Act has also seen its own debate.

In a recent judgment of the Supreme Court of Appeal, handed down on 2 May 2007, in the *MP Finance*[1] case concerning the taxability of amounts received by a pyramid scheme, it was held that illegal gains will be taxed in the hands of the taxpayer who had received the income for his own benefit. The court made use of the intention test to determine whether income should be taxed in the hands of the taxpayer who had received illegal income. This test suggests that illegal income will be taxed in the hands of a taxpayer who has the intention of keeping the illegal income for his or her own use.

The judgement in the *MP Finance*[2] case has also decided the question of whether the amounts stolen would fall within the meaning of "received" for the purpose of the definition of "gross income." The intention of the thief would determine that the amount would be received by him or her on his or her own behalf and for his or her own benefit, and the intention of the victim would be irrelevant.

[1] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 143.
[2] Ibid.

The first objective of this study was to determine the true position of the term "received by." The issue that needed to be investigated was whether the approach adopted by the Supreme Court of Appeal (SCA) in the *MP Finance*[3] case was due to an increasing pressure to subject stolen amounts to income tax. It is doubtful that the issue of tax liability for illegal receipts has been finally settled by the SCA, and therefore it is pertinent to analyse the court's ruling in detail.

The perpetrators of the illegal activities of prostitution, theft or fraud may incur expenses in deriving their ill-gotten income. The general deduction provisions make no mention that the deductions and allowances are prohibited in the case of illegal activities. There is some doubt as to whether the expenses incurred in generating illegal income would be deductible. The second objective of the study was to analyse the deductibility of expenses incurred in the production of income from illegal activities. An open question remains as to whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their illegal income.

In this treatise an analysis is made of relevant case law in relation to the provisions of the Income Tax Act in an attempt to provide clarity. A brief comparison is also made of Australia, United States of America, New Zealand and South African tax law. Similarities are found between the tax regimes in these countries and that in South Africa in relation to the taxation of income, but there appears to be more certainty in America and the Australia in relation to the deduction of expenses. The treatise concludes that recent case decisions have provided certainty in relation to the taxability of income from illegal activities, but the tax

[3] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.

status of the deduction of expenses incurred in the production of illegal income remains uncertain.

Key words:

Income tax, received by, illegal income

CHAPTER 1: INTRODUCTION AND GENERAL STATEMENT OF THE PROBLEM

1.1 Preamble

Moneymaking schemes such as prostitution, drug dealing, fraud, corruption, pyramid schemes and the sale of counterfeit goods have been around for years. The taxing of these transactions/schemes has become a contentious issue. It has recently been reported in the press that SARS has lodged a claim for R183 million in income taxes against the estate of the slain mining magnate, Brett Kebble, in respect of the R2 billion allegedly stolen by him from the mining companies of which he was a director.[4] It is further reported that the Master of the High Court has rejected the claim on the grounds that the amounts on which SARS sought to levy tax constituted money stolen by Kebble, and that stolen money is not subject to income tax. It has been reported that SARS is to take the Master's decision in this regard on review.[5]

The Kebble case raises an interesting and unresolved tax issue and, in view of the large sum at stake, it may be a case that will go all the way to the Supreme Court of Appeal and bring long-overdue certainty to the law.

The Income Tax Act No. 58 of 1962 (the Act) is of no assistance in determining the issue. Section 23(o) states that payments that are illegal in terms of Chapter 2 of the Prevention and Combating of Corrupt Activities Act No. 12 of 2004 or that constitute a fine or penalty for any "unlawful activity carried out in the Republic or in any other country if that activity

[4] https://www.saica.co.za/integritax/2009/1543.
[5] Ibid.

would be unlawful had it been carried out in the Republic" are not deductible for income tax purposes. There is, however, nothing in the Act to say that the recipient of corrupt or illegal payments is (or is not) subject to income tax on such amounts. This issue must, therefore, be resolved by the application of case law; that is to say, in terms of principles laid down by the courts.

The definition of gross income in s1 of the Act includes any amount "received by" a taxpayer. The term "received by" was interpreted by applying an objective interpretation. This was achieved by applying the concept of legal rights and obligations; in particular the principle of entitlement, as envisaged in *Geldenhuys v CIR.*[6] There is a general consensus by the courts when they apply this principle to amounts derived legally by a taxpayer. However, there has been a growing debate over the years as to whether stolen amounts could be taxable as a receipt under the Act. It became clear that the taxation of stolen amounts could not be achieved under the principle of entitlement, because a thief or an embezzler cannot acquire a "right" and has no legal entitlement over an amount.

The court applied an objective approach and focused on the legal rights and obligations of a taxpayer. It must be noted that the courts that applied this principle believed that ownership of a property right amounted to a receipt under the Act. The objective approach was rejected by the Supreme Court of Appeal (SCA) in the case of *MP Finance*[7] (See chapter 2).

[6] Geldenhuys v CIR 1947 (3) SA 256 (C), 14 SATC 419.
[7] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 143.

The court in the *MP Finance*[8] case followed a subjective approach that focused on the intention of the taxpayer. It held that if a taxpayer merely retains an amount as his, he would be liable under the definition of gross income, even when he does not have a legal right and entitlement over it.

A new approach to the interpretation of the term "received by" emerged. The term was interpreted with reference to the subjective intention of a taxpayer. This concept was introduced and applied only when the courts were faced with the question of whether stolen amounts were taxable under the Act. However, there was no general agreement among the courts over the application of the subjective approach and there were inconsistencies over the use of this principle.

1.2 Problem Statement

In *COT v G*[9] the Appellate Division of Zimbabwe held that a person who steals money does not receive it in the sense contemplated in the definition of gross income in the Act, because he does not acquire the money on his own behalf and for his own benefit. If this is correct, then the question of whether or not such an amount is income does not arise, since it is only once an amount has been received or accrued that the issue arises as to whether it is income or capital. However, the correctness of this decision is questioned. Certainly, from the thief's perspective, the reason why he stole the money was precisely to acquire it for his own benefit and the interpretation that the judge accorded this phrase is, with respect, legalistic, artificial and unsupported by authority.

[8] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[9] COT v G (1981) (4) SA 167 (ZA), 43 SATC 159.

In ITC 1789,[10] where the taxpayer in question had solicited millions of rand from a multitude of investors in a fraudulent and unlawful scheme, the court held that those moneys had been "received" as contemplated in the definition of gross income.

If the above decisions are good law, this would mean that (as was held in ITC 1789) a person who systematically cheats others out of money is subject to income tax on his booty, but that (as was held in *COT v G*) a person who actually steals money in a systematic way is not taxable. This, it is submitted, is a preposterous and untenable distinction.

It is submitted that both of these cases ought to have been decided on the basis of whether, in the particular circumstances, the amounts in question had the character of "income" in the hands of the felon, rather than on the issue of whether or not the moneys had been "received" by him. Beneficial receipt was surely self-evident in both cases. It can hardly be seriously contended that a thief or confidence trickster does not intend to acquire the victim's money for his own benefit and treat it as his own.

The issue of whether money that has been stolen or is otherwise tainted with illegality is income in the hands of the recipient and is therefore subject to income tax raises many thorny issues and has not to date been fully addressed, let alone resolved, by our courts.

[10] ITC 1789 (2005), 67 SATC 205.

Some of the aspects of the issue as to whether illegal receipts are taxable as income are:

- Illegal receipts range from those that are tainted with a mere technical illegality, such as those derived from trading without a licence, to morally reprehensible receipts such as the proceeds of drug-dealing or a fee paid to a hit-man for carrying out an assassination. In the tax context, do the same principles apply to every kind of illegal receipt?
- If SARS were to take a slice of an illegal receipt, would this not make the State complicit in the illegality?
- If income tax were to be imposed on the recipient of stolen money, this would reduce the funds available to repay the rightful owner. It needs to be remembered that, in common law, ownership of the money has passed to the thief, and all that the owner has is a claim *in personam* against the thief for repayment. If the thief has spent the money and is unable to repay it, the victim is merely a concurrent creditor in the thief's insolvent estate.
- It is submitted that as far as the illegal receipts and payments are concerned, it would be preferable for tax law to stand aloof, to attach no tax consequences to the receipt of the money, and to let the whole matter be decided in terms of criminal law.

1.3 Research objectives

The purpose of this study is to determine the true position of the term "received by." The main question that arises is whether or not the term "received by" must be interpreted with reference to the subjective intention of a taxpayer. The SCA in the *MP Finance* case[11] interpreted the term with reference to the subjective intention of a taxpayer.

[11] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 143.

A secondary question is whether or not this approach adopted by the SCA in *MP Finance*[12] case was due to an increasing pressure to subject stolen amounts to income tax. It is doubtful that the issue of tax liability for illegal receipts has been finally settled by the Supreme Court, and therefore it is pertinent to analyse the court ruling in detail.

To be precise, the following is aimed to be achieved by this study:

- To examine the term "received by" in the definition of gross income and determine whether or not it should be interpreted with reference to a subjective intention of the taxpayer (Chapter 2).
- To examine the ruling in the *MP Finance*[13] case in order to understand the principles applied by the court in determining the term "received by." This is achieved by studying the literal rule of statutory interpretation in an endeavour to understand its relationship with the subjective intention of the taxpayer in the interpretation of a fiscal statute (Chapter 2).
- To determine whether illegal schemes are entitled to a deduction under the section 11(a) general deduction formula and section 23(g), now that amounts produced by illegal activities are included under gross income (Chapter 4).

1.4 Importance and benefit of the study

There is a debate over the interpretation of the word "received by." Prior to the consideration of the issue of stolen amounts, the definition of "receipt" was regarded as settled in law through the application of rights and obligations, and so the reasoning behind the SCA ruling

[12] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[13] Ibid.

in the *MP Finance*[14] case needs to be clearly understood. There is a need to determine why the court interpreted the term subjectively, especially when there was the question of whether or not stolen amounts could be taxable.

There were many court cases in the lower courts, such as ITC 1789,[15] before the *MP Finance*[16] case took place, expressing conflicting views on whether one should be entitled to an amount or a mere claim to an amount for one's own benefit without regard to property rights and interests. The SCA in the *MP Finance*[17] case ruled contrary to the views of other jurisdictions, and it is therefore pertinent to analyse why the court rejected an objective test that focuses on rights and obligations and which was of long standing in our law in favour of a subjective test.

1.5 Research design

The research consists of two parts:

Firstly, it highlights how the courts have interpreted the term "received by" with regard to both legal and illegal transactions. See chapter 2.

Secondly, the implications of the ruling in the *MP Finance*[18] case are analysed in chapter 2. A further issue addressed is whether or not taxpayers involved in illegal schemes are eligible to deduct expenditure and losses incurred in the production of their illegal income. See chapter 4.

[14] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[15] ITC 1789 (2005), 67 SATC 205.
[16] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[17] Ibid.
[18] Ibid.

1.6 Structure of the research treatise

The treatise consists of this chapter plus five others, as follows:

Chapter one (this chapter)

Introduction to the problems which led to the study of the principles applied in the *MP Finance*[19] case, the objectives of the study, the importance of the study and the research design of the study are explained.

Chapter two

A study of cases is undertaken to highlight how the courts have interpreted the term "received by" for both legal and illegal proceeds. This clearly shows the circumstances under which a subjective approach was adopted, and the conflicts that arose between the courts as a result. A literature study is conducted to analyse the facts, arguments and reasoning of the *MP Finance*[20] case.

Chapter three

The interpretation by other jurisdictions of the term "received," namely those of the United States of America and New Zealand, is examined. These countries have adopted the subjective interpretation in their own processes, known as the doctrine of the claim of right, which is similar to the approach adopted by the SCA in the *MP Finance*[21] case. This doctrine was adopted in their Acts specifically to subject stolen amounts to income tax. The chapter focuses on whether the foreign concept should have been adopted in the light of our own Act.

Chapter four

[19] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[20] Ibid.
[21] Ibid.

The Income Tax Act provisions are analysed to understand the deductibility of expenses incurred in the production of income from illegal activities.

Chapter five

A brief examination is conducted of other jurisdictions on how they treat the deductibility of expenses incurred in the production of illegal income.

Chapter six

Chapter six provides the conclusion to the research, and also suggests areas for further research.

CHAPTER 2.

SUBJECTING INCOME FROM ILLEGAL ACTIVITIES TO INCOME TAX IN SOUTH AFRICA - RECEIPTS AND ACCRUALS

2.1 Preamble

A taxpayer's income tax is levied on his "taxable income" as defined in the Income Tax Act No 58 of 1962, for a particular year of assessment. The starting point in determining a taxpayer's taxable income is to ascertain his "gross income." The definition of gross income in section 1 of the Income Tax Act[22] begins as follows:

> "Gross income, in relation to any year or period of assessment means –
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such of such person from a source within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature…."

In determining the taxpayer's taxable income for a particular year of assessment, the first step is to determine the "total amount" that has been "received by" or has "accrued to" that taxpayer during that year of assessment. The juxtaposition of the word "or" in the phrase "received by or accrued to" connotes that the taxpayer must include not only income which

[22] Income Tax Act No. 58 of 1962.

has been received by him, but also income which has accrued to him during the year of assessment.[23]

The word "amount" in the definition of gross income refers not only to money but also to the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a monetary value.[24] In *CIR v Butcher Brothers (Pty) Ltd*[25] it was held that the word "amount ... must mean an amount having an ascertainable money value."

It is submitted that if a taxpayer steals property or defrauds a victim of property, the market value of such property will be the amount for tax purposes.

In *CIR v Delfos*[26] it was held that if an amount "is something which is not money's worth or cannot be turned into money, it is not to be regarded as income." This decision was not followed in the Appellate Division decision in *CSARS v Brummeria Renaissance (Pty) Ltd and Others,*[27] where it was held that "the question whether a receipt or accrual in a form other than money has a money value is the primary question and the question whether such receipt or accrual can be turned into money is but one of the ways in which it can be determined whether or not this is the case."

There must be either a receipt or an accrual, and in the absence of special provisions, when a person neither receives anything nor has anything accrued to him, there can be no amount to be included in his gross income.

[23] Williams, R.C. (2009), Income tax in South Africa cases and materials, third edition.
[24] Lategan v CIR (1926) CPD 203, 2 SATC 16.
[25] CIR v Butcher Brothers (Pty) Ltd 1945 AD 301, 13 SATC 21.
[26] CIR v Delfos 1933 AD 242, 6 SATC 92.
[27] CSARS v Brummeria Renaissance (Pty) Ltd and Others (2007 SCA), 69 SATC 205 at 207.

The core issue is to understand how the courts have determined what constitutes a receipt and whether the legality or illegality of an amount affects the nature of a receipt.

Thieves may steal either cash or goods; the perpetrators of fraud may defraud their victims of cash or goods; prostitutes may receive gifts as well as cash for their services. If the goods fall within the requirements of "gross income" they would be taxable and the "amount" would have to be determined.

2.2 The meaning of "received"

The interpretation of the word "received" in the definition of gross income has not given rise to difficulty[28] on legal receipts. In the case of *Geldenhuys v CIR*[29] it was decided in a judgment delivered by Justice Steyn that the expression "received by" means that money must be received by the taxpayer in such circumstances that he becomes "entitled" to it. In a separate judgment delivered by A.J. Herbstein, the word "received" was interpreted to mean received by a taxpayer on his own behalf and for his own benefit.

The case involved a woman who acquired a usufruct over the assets (livestock) of an estate with assets vesting in her children, the *dominium* holders. It was held that the usufructuary, being the taxpayer, was not entitled to the amount received on the realization of the assets subject to the usufruct. It remained the property of the children. In deciding this, the court paid due regard to the underlying common law obligatory and property rights of the usufructuary.[30]

[28] Williams, R.C. (2001), par 4.1.2 the meaning of received, 77.
[29] Geldenhuys v CIR 1947 (3) SA 256 (C), 14 SATC 419.
[30] Muller (2007) 17 Mercantile Law Journal, 171.

A person should not be subjected to tax on amounts received by him for the benefit of another. Simply put, the amount has to be the taxpayer's own amount to deal with as he pleases. In the Appellate division case of *CIR v Genn,*[31] the courts acknowledged that ownership and entitlement form part of a receipt. It was held that an amount was not received for the purposes of gross income if there was a legal obligation upon receipt to pay the amount to somebody else. The court used an example of a farmer who borrowed a tractor from someone else and said that from the very moment that this tractor is delivered to the farmer, he is under an obligation to return it to the owner. The tractor is not received by the farmer for his own benefit to use as he pleases. It is for this reason that he will not be liable to pay income tax in respect of this receipt.

The court said:[32]

> "It is certainly not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance money is obtained and banked by someone as agent or trustee for another, the farmer has not received his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual thing borrowed."

In *CIR v Witswatersrand Association Racing Clubs,*[33] an association consisting of the representatives of regional racing clubs had held a horse racing event in aid of charity. The money so raised, although duly paid to the charity organizations, was taxed in the hands of

[31] CIR v Genn 1955 (3) SA 293 (A), 20 SATC 113.
[32] CIR v Genn 1955 (3) SA 293 (A), 20 SATC 113.
[33] CIR v Witwatersrand Racing Clubs 1960 (3) SA 291 (A), 23 SATC 380.

the association, being income beneficially received by the association. According to the findings of the court, the race meeting was conducted by the association as principal, and not as agent, and therefore the income was taxable in its hands. Counsel for the association argued that an amount is beneficially "received by" the taxpayer only if his right thereto is absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment.

The attitude of the court was that unless the association had received the money *qua* agent, *stricto sensu* this money was received by the beneficiary and was therefore taxable in its hands. The fact that the association had organized the race meeting with the explicit intention of paying over the funds which it raised to charities, the fact that it received the money with this purpose, and the fact that it duly paid over the money; all of this, for the purposes of tax law, were regarded as irrelevant. A mere moral restriction as to the disposition, use or enjoyment of an amount received does not destroy the beneficial character of the receipt. The court's approach was the determination of the entitlement to the amount.

In *CSARS v Cape Consumers (Pvt) Ltd*,[34] Cape Consumers (Pvt) Ltd traded as a mutual buying organization. Acting on behalf of its members, the taxpayer would purchase goods from suppliers at a discounted price and the relevant member of the taxpayer company would then pay the taxpayer the full, undiscounted purchase price of the goods purchased on the member's behalf. After paying the suppliers for the goods and paying its own operational expenses, the taxpayer transferred the surplus to the buyers' aid fund. The taxpayer's articles of association provided that amounts transferred to the buyers' reserve fund were held for the benefit of the buyers. The issue was whether the amounts transferred by the taxpayer to the

[34] CSARS v Cape Consumers (Pty) Ltd 1999 4 SA 1213 (C).

buyers' reserve fund had been beneficially received by the taxpayer such that these amounts formed part of the gross amounts of the taxpayer.

The court held that the amounts transferred by the taxpayer, on behalf of its customers, to the buyers' reserve fund were held for the benefit of the buyers. The taxpayer was obliged to credit the income to the buyers' reserve fund. For this reason the taxpayer did not have a legal entitlement to such income, which was necessary for such amounts to have been received by or to have accrued to the taxpayer.

2.3 "Received" in relation to illegal transactions

Fraudulent schemes may take on many forms, and one such form that has frequently been the subject of court decisions is that where the perpetrator of the fraud enriches himself or herself out of moneys entrusted to him or her by others.

ITC 1792[35] concerned a stockbroker who was a member of a stock-broking firm on the Johannesburg Securities Exchange, buying and selling securities on behalf of clients for their benefit, thus acting as an agent pursuant to a mandate given to him by clients. He had become involved in a syndicate with dealers or portfolio managers acting on behalf of a client. The syndicate purchased shares which it generally knew the client intended to purchase, and sold the shares at a profit to the client. The stockbroker's share of these illegal profits was the subject of an appeal against the Commissioner for SARS, as the stockbroker had excluded those profits from his income on the grounds that they were not "beneficially received" by him, but were taxable in the hands of his principal. It was (as noted in the headnote at 238) held as follows:

[35] ITC 1792 (2005), 67 SATC 236.

"(i) That it is clear that income received is subject to tax notwithstanding the fact that it was tainted with illegality or was received from illegal activities, but this was not the issue in this case, as the issue to be determined was whether the receipt of secret profits by an agent fell within the "gross income" of the agent and it is accepted that illegally earned income can be taxable.

(ii) That on the facts of this case there was no "taking" as set out in *COT* v G[36] as appellant received the proceeds of the sales as well as the original shares and his act was not a unilateral act as in G's case; moreover, on the evidence, the syndicate and its members intended to "receive" the profits for themselves but this intention will be disregarded.

(iii) That the word "received" has various qualifications and not every obtaining of physical control over money or money's worth constituted a receipt for the purposes of the definition of "gross income" *(CIR* v *Genn* & *Co (Pty) Ltd* 20 SATC 113) and this was made clear by *Geldenhuys* v *CIR* 14 SATC 419 where "received by" was construed to mean received by the taxpayer on his own behalf and for his own benefit.

(iv) That in order for there to be a "receipt" the money must be "received" by the taxpayer for his own benefit and in this matter the subjective intention of the syndicate and the appellant was to receive the secret profits for themselves but this, however, did not mean that, legally, they had "received" the profits for their own

[36] COT v G (1981 (4) SA 167 (ZA)), 43 SATC 159.

benefit and to understand the distinction an examination of the law of agency is required.

(v) That the shares originally acquired by the syndicate belonged not to it but to its principal, M, and this was so because the law does not give effect to the subjective intention of the syndicate and the agent to appropriate the shares or the profits but deems the agent to have received them for and on behalf of the principal.

(vi) That it followed that by law neither the shares originally bought nor the profits realised belonged to the syndicate or the appellant and were never received by it or appellant in its own right or for its or his benefit but by the principal, M.

(vii) That, accordingly, the profits of R233 387 and R1 448 229 received by the appellant during the 1990 and 1991 years of assessment did not fall within his "gross income" for those years."

A frequently cited case in relation to theft is *COT v G.* [37] G had been in employment with the government of Rhodesia (now Zimbabwe) and entrusted with funds for secret operations. He stole money from the funds received in excess of what was required for operations, which he either deposited in his own bank account or used to purchase goods for himself. The Commissioner of Taxes (in Rhodesia) assessed the thief on the amounts he had stolen and imposed penalties. G appealed to the Special Court, which ruled that the amounts that had

[37] COT v G (1981 (4) SA 167 (ZA)), 43 SATC 159.

been stolen were not "received" by him within the meaning of the word in section 8(1) of the Income Tax Act (which was substantially the same as the definition of "gross income" in the South African Income Tax Act).

The Commissioner appealed against this decision to the Appellate Division of the High Court of Zimbabwe. Fieldsend, CJ, after quoting the definition of "gross income," proceeded to interpret the meaning of the word "received." He stated (at 163) that "it was common cause that the word 'received' was not to be given its ordinary wide meaning and that it had to be limited at least to meaning 'received as part of the recipient's patrimony.'" He referred to the analogy of borrowing a lawnmower or obtaining money on loan; in neither case would the asset or amount be part of the income of the recipient. He referred to *CIR* v *Genn*[38] and *Geldenhuys* v *CIR*[39] in support of his conclusion, which was formulated as follows (at 163):

> "Whether or not the respondent in this appeal received the money on his own behalf and for his own benefit must depend not only on his own intention but on the intention of the person who passed the money to him. To return for the moment to the lawn-mower, the person who obtains a lawn-mower from his neighbour genuinely intending to return it does not receive the mower in his own right; nor does a person who fraudulently induces his neighbour to lend him his mower intending to keep it for himself. The intention of the taker cannot of itself result in him receiving the thing in his own right. He can only receive the thing in his own right if the giver intends that result as well."

> "Applying this to the present appeal, the government never intended that any of the money it paid to the respondent should be his to do with as he liked. It was paid to him to

[38] CIR v Genn 1955 (3) SA 293 (A), 20 SATC 113.
[39] Geldenhuys v CIR 1947 (3) SA 256 (C), 14 SATC 419.

be applied to a specific government purpose. Accordingly, at no time did the respondent receive it on his own behalf and for his own benefit. Therefore, it did not fall within his gross income and he should not have been taxed on it."

The appeal was dismissed and the judge held that:

"(i) The word "received" in the definition must be given its ordinary dictionary meaning.

(ii) Section 8(l) of the Act, read together with its paragraphs (a) to (q), indicates that it is concerned with what comes to a taxpayer from another.

(iii) The respondent did not receive the money in issue; he stole it.

(iv) Furthermore, all the money paid to the respondent was paid to him to be applied to a specific Government purpose; accordingly, at no time did the respondent receive the money on his own behalf and for his own benefit. Consequently, the money in issue formed no part of the respondent's gross income and attracted no tax."

ITC 1545[40] was concerned with two matters:

• amounts received from the purchase and sale of stolen diamonds; and

• profits made from the sale of dried "milk cultures" by the taxpayer to a company owned and controlled by the taxpayer, which operated a scheme involving the buying and selling of dried "milk cultures."

[40] ITC 1545 (1992), 54 SATC 464 (C).

The first matter concerned the deduction in terms of section 11 (*a*) of the Act of amounts to be refunded to the owner of the stolen diamonds, to be discussed later in chapter 4.

The second matter concerned the profit made by the taxpayer from the sale of dried "milk cultures." It was common cause that the taxpayer was the instigator of the scheme and had in his personal capacity also participated as a "grower" in the scheme, making a profit of R1 million by buying and selling to a company to which he had sold his milk culture "business," and which was owned and controlled by him.

It was submitted on behalf of the taxpayer that the scheme was a lottery in terms of section 2(1) of the Gambling Act 51 of 1965 and the transactions giving rise to the money received were therefore void *ab initio.* The taxpayer was not entitled to the amounts and they were therefore not received by or accrued to or in favour of the taxpayer in terms of the definition of "gross income" in section 1 of Act 58 of 1962.

In this matter it was held as follows:

> "(vi) That assuming, without deciding, that the dried "milk culture" scheme did constitute a lottery in terms of s 2(1) of the Gambling Act 51 of 1965 and that the "sales" in pursuance of which the "growers" were paid for their crop were void *ab initio,* the amounts paid to the "growers" for their "milk cultures" were nevertheless amounts "received" by them in terms of the definition of "gross income" in s 1 of Act 58 of l962.

(vii) That, where an amount is received by a taxpayer on his own behalf and for his own benefit, but in pursuance of a void transaction, there appears to be no reason for holding that such amount is not "received" within the meaning of the definition of gross income in s 1, if that word is to be given its ordinary literal meaning.

(viii) That, indeed, it does not follow that because a contract is prohibited by statute and therefore void *inter partes,* it is to be totally disregarded and all the consequences flowing from it ignored.

(ix) That the mere fact that the taxpayer was in effect the organiser of the scheme did not justify the inference that he could not also have participated in it as an ordinary "grower" and, instead, must have simply helped himself to the funds available; there being no basis for the conclusion that there was merely a "taking" by the taxpayer as opposed to a receiving."

The Commissioner's assessments in respect of the amounts of R500 000 in each of the tax years 1984 and 1985 in respect of normal tax were confirmed.

It is submitted that, despite the apparent differentiation by the courts, the sole reason for thieves to steal is to acquire the stolen property for their own benefit. For the perpetrators of fraud, the same applies. Prostitutes, pimps and brothel owners engage in their activities to acquire income for their own use and benefit. It is submitted, therefore, that amounts derived

from theft, fraud and prostitution are *received* by the perpetrators of the crimes "for own benefit and on own behalf" irrespective of the intention of the victims, the contractual relationship (or lack thereof) between the perpetrator and the victim, or the fact that the transactions are void.

It is submitted that the root of the problem in the cases that dealt with illegal receipts is the inconsistent application of various approaches to the meaning of "beneficial receipt." The courts have followed an objective approach in some cases and a subjective approach in others.

South African Revenue Services (SARS) interpretation note 80 of 5 November 2014 deals with "the income tax treatment of stolen money" and provides as follows:

> "A person who derives funds illegally, whether by embezzlement, fraud or theft, is regarded as having "received" those funds for the purposes of the definition of "gross income" in section 1 and will be subject to income tax on those funds."

The dispute as to whether the term "received by" should be interpreted objectively or subjectively finally reached the superior court in the case *MP Finance.*[41]

[41] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 143.

2.4 MP FINANCE GROUP CC (in liquidation) v CSARS 2007 (5) SA 521 (SCA)

2.4.1 Preamble

A recent SCA case on this topic, the *MP Finance* case,[42] has once again highlighted the uncertain treatment of illegal income for the purposes of income tax. The case concerned the inclusion of the proceeds from a pyramid scheme as gross income in the hands of the scheme's perpetrators.

This discussion shows that, by consistently applying the subjective approach of paying regard to the intention of the taxpayer for the purposes of "beneficial receipt," the current confusion can be rectified. It should be noted that, although the treatment of illegal income involves both the inclusion of illegal income as part of gross income as well as the deductibility of expenses incurred in the carrying on of illegal activities, the case under discussion dealt only with the issue of the inclusion of illegal income.

2.4.2 The facts and arguments

This case involved an illegal investment enterprise, commonly called a pyramid scheme, and the scheme had been conducted by way of successively created entities, incorporated and unincorporated, all of which were eventually insolvent. The order made by the High Court stipulated that the original entities were to be consolidated into a single entity, being the Taxpayer for the purposes of the relevant tax assessments, and were to be represented by the joint liquidators of the various entities.

[42] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.

During the 2000, 2001 and 2002 years of assessments, one Maritjie Prinsloo operated an illegal and fraudulent investment enterprise, i.e. a pyramid scheme, through various entities with the aid of family and employees, as well as so-called agents, who solicited and transmitted investors' deposits in return for commission. She controlled the various entities in the names of the scheme and procured a range of convincing looking documents issued to investors when they made deposits. The documentation readily parted investors from their money by promising irresistible but unsustainable returns on various forms of ostensible investment, and it paid such returns for a while before finally collapsing owing many millions.

2.4.3 The taxpayer's arguments

The taxpayer relied on a passage in the judgment of the Supreme Court of Appeal pertaining to the same scheme in *Fourie NO v Edeling,*[43] in which the question was whether or not repayments to investors were recoverable by the liquidators, and held that because the scheme was liable in law immediately to refund the deposits, there was no basis on which it could be said that the deposits had been received within the meaning of the Act, and they were consequently not subject to tax.[44]

2.4.4 The reasoning of the court

The court's judgment in the matter of *Fourie v Edeling* did not assist the taxpayer, as that case had dealt with the relationship between investors and the scheme, and the present case dealt with the relationship between the scheme and the fiscus. Moreover, even if the scheme had been legally obliged to repay an investor immediately on receipt, that was because of the legal principles applicable to the parties to an illegal contract, as between themselves.

[43] Fourie v Edeling 2006 4 All SA 393 (SCA).
[44] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.

An illegal contract is not without all legal consequences, and it can have fiscal consequences; that is, the sole question between the scheme and the fiscus was whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Income Tax Act, and they unquestionably did. The amounts paid to the scheme had been accepted by the operators of the scheme with the intention of retaining them for their own benefit, and notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Income Tax Act.

2.4.5 A brief discussion

This decision is inconsistent with that in *COT v G*[45] and the latter can no longer be considered good law in South Africa.[46] The premise underpinning that decision, namely that a person who appropriates money for himself or herself intending to keep it does not "receive" it is untenable.[47]

Would the Supreme Court of Appeal, for example, regard the fee paid to a professional assassin as subject to income tax in his hands? Many people would regard such a possibility with revulsion. Or is there a difference between the taxability of a confidence trickster who merely deceives people into handing over their money and a thief who actually steals their money?

An argument can be made that the fiscus should not sully itself by staking a claim in the form of income tax to the proceeds of criminal activities, but should leave the criminal justice system to exact a forfeiture of the proceeds of crime. It is submitted that public opinion

[45] COT v G (1981 (4) SA 167 (ZA)), 43 SATC 159.
[46] RC Williams, Income Tax in South Africa, cases and materials 2009 at 90.
[47] Ibid.

would not countenance the State's taxing, for example, the fee paid to a professional assassin, and that no court that was mindful of the values underpinning the Constitution could hold otherwise.[48]

The decision in the *MP Finance*[49] case had a result that many would also find distasteful, namely that the fiscus, by virtue of its statutory preference in respect of income tax, took first bite at the residue of funds held by the insolvent pyramid scheme entity, thereby diminishing the proceeds that were available to pay the claims of the cheated investors.[50]

Another issue in the decision of the Supreme Court of Appeal is that it complicates two discrete issues, namely whether or not the amount was "income," and if so, was it "received." The perpetrators of the scheme knew that it was insolvent and fraudulent, and that it would be impossible to pay all investors what they had been promised. From that date the entities made their money by swindling the public.[51] This was their income, and it followed that the amounts they were paid in that period were "received," as contemplated in the definition of "gross income." The operators of the scheme accepted such amounts with the intention of retaining them for their own benefit.[52] Such amounts were therefore "received" even if the scheme was not legally entitled to retain those moneys.

2.5 Conclusion

In cases of theft and fraud the thieves or persons committing fraud do not acquire ownership of income or property received through their illegal trade. They can be sued and ordered to pay back all that was taken without the consent of the owner. This chance of being sued or

[48] RC Williams, Income Tax in South Africa, cases and materials 2009 at 90.
[49] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[50] Ibid.
[51] Ibid at 142.
[52] Ibid.at 143.

ordered to restore the status quo could be viewed as a condition for the accrual of income so received. In terms of South African law, income accrues to a taxpayer when all conditions have been fulfilled. If a condition still applies, such income cannot accrue.

The decision in the *MP Finance*[53] case established the principle that the fact that such income may not accrue to taxpayers because it is subject to a condition does not prevent the taxation of such income when it is received. The chance of being ordered to restore the status quo does not, therefore, prevent the taxation of the proceeds. If income was received for one's own benefit, such income is assessable to tax.

Thus, it has been made clear that, irrespective of the legal relationship between the perpetrator of the fraud and his or her victim (that of agency or a debtor/creditor relationship, for example), there exists a relationship between the perpetrator and the *fiscus*. There can be no doubt that the intention of the perpetrator of fraud was to obtain and retain the amounts for his or her own benefit and such amounts were therefore "received" for the purposes of "gross income."

The intention of the thief would determine that the amount would be received by him or her on his or her own behalf and for his or her own benefit, and the intention of the victim would be irrelevant. The contractual obligation of the thief to return the stolen goods or money would not alter this, as the contractual relationship between the perpetrator and the *fiscus* was the deciding factor.

[53] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.

It is submitted that the court came to a rather extreme decision, which will have consequences, including Constitutional consequences. The Special Court had previously held that a pyramid scheme is insolvent *ab initio* (from the moment it was entered into) and thus it was legally impossible for any person to receive such an amount for his own benefit and on his own behalf. The Supreme Court of Appeal decided differently, coming to the conclusion that in the case of a swindle, fiscal consequences arise, and because the taxpayer treated the deposits as his own, such amounts fell within the ambit of the literal meaning of "received by."

As far as Constitutional consequences are concerned, the decision could probably be challenged constitutionally by the investors on the basis that they are being unlawfully deprived of their property by the State, namely, that tax is being collected from the swindlers to the detriment of the depositors in that it reduces the available amount in the insolvent estate for repayment to the depositors.

CHAPTER 3: THE INTERPRETATION OF THE TERM "RECEIVED" BY OTHER JURISDICTIONS

3.1 United States of America

The Income Tax legislation in the United States at one stage made specific reference to the legality of the business for the purposes of determining income tax.[54] The Tax Act of 1913 (US) ch 16, 8II B 38 Stat 114, 167 stated the following:

> "The net income of a taxable person shall include gains, profits and income … from … the transaction of any lawful business carried on for gain or profit or gains or profits and income derived from any source whatever…."

This statute was amended in 1916 to omit the term "lawful" from the section. In interpreting the intention behind this amendment, the US Supreme Court stated the following:

> "This revealed we think the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest labourer taxed and the gains of the dishonest immune."[55]

The relevant amended section, as it stood in *James v United States*,[56] was section 22 of the Internal Revenue Code 1939 (US), which has been carried into the current Internal Reserve Code (US) as section 61, and now reads as follows:

[54] Black, C.K. (2005). 20 Australian Tax Forum 456.
[55] CIR v Akon (1990) STC 497, 506.

> "Gross Income defined.
>
> General definition; Except as otherwise provided in this subtitle, gross income means all income from whatever source derived; including (but not limited to) the following items…."

The courts in the United States considered the Income Tax treatment of funds obtained through illegal acts and developed the claim of right doctrine as a basis for assessing such amounts as income. The decision of the Supreme Court in *James v US*[57] provides authority for this approach. The taxpayer was a Union official who embezzled funds from his employer union and an insurance company. Having not disclosed such amounts in his tax returns for the relevant years, he was convicted of tax evasion and given a custodial sentence. In a majority decision the court decided that,

> "Income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition."[58]

The court simply meant that a person is taxable if he regards the proceeds in his control to be his, regardless of any existing obligations to repay the amount. The lead opinion in *James v US* proceeded to develop a rule for such cases, based on a holding that the language of the

[56] James v US 366 US 213, 218 (1961).
[57] Ibid.
[58] Ibid.

Internal Revenue Code, "all income from whatever source derived,[59] encompasses all accessions to wealth, clearly realized and over which the taxpayers have complete dominion.[60]

The legislature in the United States paved the way for the determination of taxable income by virtue of the subjective intention of the taxpayer, disregarding in clear and unambiguous fashion the need to determine the taxability of proceeds by legality or property rights. It provided a thin test that should be applied to determine income tax liability. All that is required is a claim to an amount by a taxpayer, regardless of any obligations to repay, and not a right to claim an amount. This is what is now known as the doctrine of "claim of right" in the North American jurisdictions.

3.2 New Zealand

The doctrine of claim of right was then adopted by the Australian High Court in *A Taxpayer v CIR*.[61] An accountant systematically embezzled over $2 million from his employer, which he used to speculate in the futures market. Unfortunately his future trading was not successful and he made losses. The Commissioner assessed him on the funds stolen and on income from his trading activities. The court considered that in equity constructive trust arises at the time the thief commits the act that obliges him or her to account to the rightful owner of the property.

[59] Section 61 Internal Revenue Code.
[60] James v US, 366 US 213,219 (1961).
[61] A Taxpayer v Commissioner for Inland Revenue 17 NZTC 12, 574.

This equitable remedy ensures that the thief does not acquire beneficial ownership of the property stolen. In a simple case of theft a thief has no fiduciary duty, as compared with the situation in a case of embezzlement, where there is a fiduciary duty on the part of the embezzler, which results in a constructive trust.

In reaching his decision Morris J[62] said,

> "The respondent (taxpayer) was under an obligation to return the stolen money. For the monies that he did no question of taxation arises. The remaining money he converted to his own use. While he is still liable in law to account for the monies he is taxable on them because he was in effect holding and using money for his own account. He is obliged to return the money because of the manner in which he held it. His duty to return the money is a separate issue to the question of taxation. While he is not the strict legal owner of the money he is holding it for his own use. The reality of the situation is that the taxpayer regarded the money as his own to use for his purposes as he chose. I therefore, conclude that the stolen monies constitute income and are assessable for income tax."

The court based its decision on Canadian and American decisions on the doctrine of claim of right. The doctrine of claim of right would allow the Commissioner to ignore any issues of restitution or constructive trust and to tax the funds stolen as a gain to the thief.

[62] CIR v A Taxpayer 17 NZTC 12, 574, 578.

However, the Court of Appeal[63] decided in favour of the taxpayer. The court rejected any reliance upon the North American cases. It rejected any reliance upon the economic reality of the situation, and based its decision upon the application of property and trust concepts. Referring to Arthur Murray (NSW) Pvt Ltd v COT[64] the majority of the court said:

> "The court obviously considered that sums received subject to a trust or charge did not have the quality of income derived by the recipient. In principle an embezzler is liable to return or repay the stolen property and the innocent party to embezzlement retains the right to trace the property or its proceeds into the hands of the embezzler. The embezzler does not have any claim of right to the stolen property. In the absence of a specific statutory provision allowing for the re-characterization or different characterization of the misappropriation receipt for tax purposes, the ordinary rules apply. Legal rights and obligations cannot be ignored. There is no gain to a taxpayer unless the receipt is derived beneficially by the taxpayer. Taxation by economic equivalence is impermissible."[65]

A closer analysis of the SCA ruling in the *MP Finance v C. SARS* leads one to arrive at the simple conclusion that the decision was influenced by the foreign concept of the claim of right in the Canadian and North American jurisdiction. The Australian Courts were interpreting the term "gain" in their gross income, as opposed to the term "received by" in the South African Income Tax Act.

[63] CIR v Taxpayer (1997) 18 NZTC 13, 350 (CA).
[64] Arthur Murray (NSW) v Commissioner of Taxes (1965) 114 CLR 314.
[65] CIR v Taxpayer (1997) 18 NZTC 13, 350 (CA).

However, legal rights and obligations are the basis of their tax law; the same should apply in our Act if the term is read in its proper context. The New Zealand Appeal Court in *A Taxpayer v CIR* held that no one would seriously contend that a sum borrowed is a taxable gain; economically the sum is a gain but it is subject to the counter-balancing obligation to repay the sum, which is a gain for income tax purposes.[66]

Australian authorities submit that it is the passing of ownership that determines, in part, whether a receipt is taxable or not, as the approach in *A Taxpayer* confirms, and the proceeds of drug trafficking or gambling can be seen to be beneficially derived by the taxpayer and thus taxable, whereas the proceeds of burglary or embezzlement are not beneficially derived, as a result of constructive trust and the right of restitution, and are therefore not taxable.[67]

Consequently, the application of ordinary concepts of property rights is a component in determining whether or not a taxpayer has received. It is submitted that this offers a more consistent test for determining which taxable activities give rise to taxable income. The Appeals Court decision in *A Taxpayer v CIR* was met by a swift legislative amendment. In 1998 the Income Tax Act (New Zealand) was amended to include a new section, CD6, which has the effect of including as income the proceeds of certain crimes such as embezzlement and theft.[68] The new provision achieves this result by including amounts in gross income where the taxpayer has possession or control over the property and disregards any constructive trust and right of restitution.

[66] A Taxpayer v Commissioner for Inland Revenue (1997) NZTC 13, 350 (CA).
[67] Gupta, R. (2008). Journal of the Australian Tax Teachers Association, Vol. 3 no. 2, 117.
[68] Black, C.M. (2005). Australian Tax Forum, 20, 456.

In section 106 of the Income Tax Act 1994 (NZ) CD6, gross income derives from certain property:

> "The gross income of a person is deemed to include an amount equal to the market value of property the possession or control of which that person detained without claim of right. Subsection (1) applies notwithstanding the existence of any constructive trust of which the person is the trustee…."

Amendments were also made to provide a corresponding deduction where amounts are later returned to the beneficiary.[69] Under the claim of right doctrine as developed, income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.[70]

It is submitted that it is unfortunate that the doctrine of claim of right stands as the interpretation of the term "received by" in the South African Income Tax Act. The gross income provision is not wide enough to be interpreted in line with such a foreign concept. It is clear that the legislative provisions on gross income require a re-characterization that would include proceeds from embezzlement and theft. Legal rights and obligations must prevail in the interpretation of the term "received by" in gross income.

[69] Income T0061 Act 1994 (NZ) DJ 18.
[70] Wolfe, S. (1996). Recovery from Hedper: The pain from additions to tax is not the sting of punishment. Hofstra Law Review, 15, 161, 167.

In the absence of an amendment that introduces the doctrine of claim of right the subjective approach should not be applied, and it is not the duty of the court to introduce the concept when the statute does not expressly state its existence. Amendments in New Zealand and the United States of America's Income Acts should be adopted by the legislature in South Africa, as there is a growing sentiment that a business carrying on unlawful activities should not be exempt from taxes.

3.3 Conclusion

Illegal activities can be grouped into two categories: a legal trade tainted by an illegal activity, and activities that are patently illegal.[71] In *CIR v Insolvent Estate Botha*[72] it was held that although illegal agreements are void *inter partes*, this does not rob them of all legal results. In other words, an illegal contract is not without all legal consequences. It continues to have fiscal consequences. This was also the decision in *MP Finance*[73]case.

Revenue laws in South Africa cast the net wide so as to catch and levy tax on a wide range of income.[74] For income from illegal activities (or legal activities) to be taxed it must fall within the ambit of the definition of gross income.[75] When determining the tax liability of a taxpayer the legality or illegality of a business carried on by the taxpayer is immaterial.[76]

[71]Monterio "Money doesn't smell" (2005) Without Prejudice 5 (7) at 12-13.
[72] CIR v Insolvent Estate Botha 52 SATC 47.
[73] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[74] ITC 1199 (1973), 36 SATC 16 at 19.
[75] Warneke and Warden "Fraudulent transactions: are the receipts taxable?" (2003) Tax Planning: Corporate and Personal 17 (2) at 26.
[76] CIR v Delagoa Bay Cigarette Company LTD (1918 TPD 391), 32 SATC 47.

Court decisions have established the principle that income is taxable, regardless of the legality or illegality of the source from which it was derived. Furthermore, the fact that the perpetrators of the crimes of theft or fraud may have to return the goods or compensate their victims does not suspend the inclusion of the amounts in their “gross income.”

CHAPTER 4: THE DEDUCTIBILITY OF EXPENSES INCURRED IN THE PRODUCTION OF INCOME FROM ILLEGAL ACTIVITIES

4.1 Preamble

Chapters 2 and 3 discussed the inclusion of amounts derived from illegal activities in the "gross income" of the perpetrators of the crimes and concluded that the illegality of the business from which the receipts or accruals arose did not prevent their inclusion in "gross income."

The perpetrators of the illegal activities of prostitution, theft or fraud may incur expenses in deriving their ill-gotten income. This matter is discussed in the present chapter. The second objective of the research is thus also addressed: to analyse the deductibility of expenses incurred in the production of income from illegal activities.

4.2 The general deduction formula

The deductibility of expenditure or losses is determined in accordance with the Income Tax Act. The dictates of accountancy principles or sound business practice are irrelevant. [77]

The preamble to section 11, section 11(a), section 23(f) and section 23(g) of the Income Tax Act constitutes the so-called general deduction formula which forms the cornerstone of the deduction provisions of the Income Tax Act. The preamble to and section 11(a) provide as follows:

[77] Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381.

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived -
>
> (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature ...."

Sections 23(*f*) and 23(*g*) provide as follows:

> "No deduction shall in any case be made in respect of the following matters, namely
>
> (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section 1*;*
>
> (g) any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade ...."

It is therefore submitted that for expenditure or a loss to be deductible it must meet all the requirements laid down in the preamble to section 11 and section 11(a) and not be prohibited by section 23 of the Income Tax Act. Failure to meet any one requirement results in disallowing part of or the whole deduction claimed. In *Sub-Nigel LTD* v *CIR*[78] it was held that the court is not concerned with deductions which may be considered proper from the point of view of a trader or an accountant, but is concerned with deductions which are permissible according to the language of the Act. "Regard must therefore be had to the Act in order to ascertain whether or not the deductions sought to be made are permissible".[79]

[78] Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381.
[79] Ibid.

4.2.1 Carrying on a trade

The first requirement in order to be granted the deductions provided for in the Income Tax Act (unless a specific section of the Income Tax Act provides otherwise) is that the person should be carrying on a trade. The definition of "trade"[80] includes: "every profession, trade, business, employment, calling, occupation or venture ..." The first question that arises is whether or not a prostitute, a thief or the perpetrator of fraud engaged in criminal activities is carrying on a trade.

A trade is anything that occupies the attention and time of any person for the purposes of making a profit.[81] A venture on the other hand means a transaction in which a person risks something with the object of making a profit.[82] Trade implies an active occupation as opposed to a passive earning of income. [83]

The word trade has a wide meaning and one can conclude that all activities undertaken by the taxpayer will constitute a trade as long as they are done with the object of earning income.[84] There are passive means of earning income which the Income Tax Act recognises as trades, and these activities are specifically provided for in the definition of "trade,"[85] such as the letting of property and the use or grant of use of patents, copyright, etc. In *ITC 770*[86] it was held that the word "trade" was intended to embrace every profitable activity and that the word should thus be given the widest meaning possible. In *De Beers Holdings (Pty) Ltd v CIR,*[87] on the other hand, it was held that the attainment of a profit is not the defining feature

[80] Income Tax Act No. 58 of 1962, sl.
[81] Jones v Welsh Insurance and Corporation LTD 54 TLR 52.
[82] ITC 368 (1936), 9 SATC 211.
[83] ITC 1275 (1978), 40 SATC 197 (C).
[84] De Koker and Urquhart Income Tax in South Africa 10-5.
[85] Income Tax Act 58 of 1962 s 1.
[86] ITC 770 (1953), 19 SATC 216.
[87] De Beers Holdings (Pty) Ltd v CIR (1986 (1) SA 8 (A)), 47 SATC 229.

in a trading transaction, as a trader may trade at a loss in order to gain a commercial advantage. Carrying on a trade does not necessarily give rise to income in any particular year of assessment.[88]

In defining a trade the Income Tax Act does not refer to legality, morality or public policy. The definition in the Act is wide, and thus one can argue that an illegal activity like prostitution amounts to a trade. South African law also provides that a person can carry on more than one trade. Thus, one could be legitimately employed and at the same time be the mastermind behind a fraudulent scheme, and thus be carrying on two trades. The definition of a trade in section 1 of the Income Tax Act and related case law indicates that for a trade to be carried on the taxpayer must actively do something and intend to make a profit, either now or in future.

Thieves and the perpetrators of fraud must actively do something, apply their time, wits and skill in the planning and execution of theft or fraud, and they must do this in order to make a profit. Lord Denning stated in *Griffiths (Inspector of Taxes) v JP Harrison (Watford)* Ltd[89] that a gang of burglars is not engaged in a trade although they have an organisation, spend money on equipment, acquire goods by their efforts, and sell them at a profit. The decision in this United Kingdom case does not appear to reflect the position in South African law and, it is submitted, does not address the definition of trade in the South African law.

When a taxpayer carries on more than one trade in the Republic, deductions under section 11 can be made from his aggregate income from all such trades.[90] This is subject to the

[88] De Koker and Urquhart Income Tax in South Africa 10-7.
[89] Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd 1963 AC 1 at 20.
[90] Williams Income Tax and Capital Gains Tax in South Africa Law and Practice 276.

provisions of section 20A,[91] which under certain circumstances limit the deduction of expenses to the income from certain trades carried on by a natural person who has taxable income (excluding the "suspect trade") which "equals or exceeds the amount at which the maximum marginal rate of tax is chargeable …"

Case law raises an inference that prostitutes, brothel owners and pimps are carrying on a trade because of the active application of their time and skill in an endeavour to produce income. It is less certain whether fraud or theft is a trade because of its inherent illegality and immorality, even though in theory it meets the requirements of trade.

Where fraudulent activities or theft are carried on continuously in a business-like manner, this would appear to constitute a trade. Single instances of these offences may not constitute a trade, although it was held in *Stephan v CIR*[92] that a first and only operation was a business venture. If the fraud or theft is planned and carried out in a business-like manner, even one instance may constitute a trade. It is less clear, however, in the case of a once-off opportunistic offence, rather than an ongoing activity, that this would constitute a trade.

Before a section 11(a) deduction can be claimed, an illegal enterprise or scheme must satisfy the requirement that it carries on a trade as defined in the Act. The definition of trade uses the word "every." This wording is critical. It could mean that anything with the attributes of a trade or business or profession, regardless of its legality or illegality, is a trade under the Income Tax Act. Therefore if illegality does not affect a venture's being regarded as a "profession, trade, business, employment, occupation or routine," then it is submitted that the illegal trade or illegal operation should also be regarded a trade.

[91] Income Tax Act No. 58 of 1962.
[92] Stephan v CIR (1919 WLD1), 32 SATC 54.

Once it has been established that the taxpayer is carrying on a trade, any loss or expense incurred would have to satisfy all the other requirements of the general deduction formula to qualify as a deduction.

4.2.2 Actually incurred

For an expense to be deductible it must actually have been incurred. Expenditure is actually incurred when it has been paid and when the taxpayer is under an unconditional obligation to pay the amount in question.[93] In *Caltex Oil (SA) Ltd* v *SIR*[94] it was held that the expression "actually incurred" means all expenditure for which liability has arisen, even if that liability has not yet been paid.

The victim of a loss due to theft or fraud has legal remedies in the form of the *mandament van spolie* and the remedy provided for in section 300 of the Criminal Procedure Act, 51 of 1977 (to be referred to here as the Criminal Procedure Act). The purpose of a spoliation order or a *mandament van spolie* is to restore the *status quo* and return the thing or property to a person who is able to prove that he or she was in undisturbed possession of the thing, and that he or she was unlawfully deprived of possession.[95] This remedy is not an appropriate remedy where property is destroyed. [96] Section 300 of the Criminal Procedure Act provides that where a person is convicted of an offence which caused damage to another, the court may, upon the request of the prosecutor acting on the instruction of the injured person, order compensation for such damage or loss.

[93] Williams Income Tax and Capital Gains Tax in South Africa Law and Practice 278.
[94] Caltex Oil (SA) Ltd v SIR (1975 AD), 37 SATC 1.
[95] Pienaar and Mostert Silberberg and Schoeman's The Law of Property 5th edition (2006) 295.
[96] Harms Amler's Precedents of Pleadings 6th edition (2003) 318.

A thief is under an obligation to repay stolen money or pay compensation for stolen property, but this obligation is subject to the victim's obtaining judgment against the perpetrator.[97] In other words, a thief is not under an unconditional obligation to pay the amount until a judgment is obtained against him or her. Thus incurring expenditure or suffering a loss, when there is a condition or an obligation to repay the stolen amount, is suspended until the rightful owner obtains a judgment ordering the perpetrator to repay the stolen amount. In *CIR v Golden Dumps (Pty) Ltd*[98] the expenditure in question was dependent on a court decision and the decision was delivered a few years after the case was brought to court. The court held that the expense was actually incurred only in the year of assessment in which the court handed down its decision.

Expenditure other than refunds, restitution or the payment of compensation incurred by thieves, perpetrators of fraud and those earning their income directly or indirectly through prostitution, or the payment of salaries and wages for the services of others involved in the illegal trade, is expenditure actually incurred when the obligation to pay has arisen, with no conditions attached.

When the existence of a liability is contingent and dependent upon the happening of an event, the liability is not incurred until the event happens.[99] In *Nationale Pers BPK v KB*[100] it was held that if payment is conditional, the expense is incurred only when the condition is fulfilled. An expense is therefore not incurred if there is a chance that it will not arise. As there is no guarantee that the victim will obtain a judgment and the exact amount to be

[97] ITC 1545 (1992), 54 SATC 464.
[98] CIR v Golden Dumps (Pty) Ltd (1993 (4) SA 110 (A)), 55 SATC 198.
[99] Edgars Stores Ltd v CIR 1988 (3) SA 876 (A), 50 SATC 81.
[100] Nationale Pers Bpk v KBI (1986 (3) SA 549 (A)), 48 SATC 55.

granted in the judgment is unknown, the expense of reimbursing the victim is not actually incurred until the judgment is obtained.

When expenditure has actually been incurred during that year of assessment but the amount cannot be quantified, it must be estimated using all available information.[101] When a liability is contingent, it is incurred in the year of assessment in which the condition is fulfilled.[102] In *CIR v Edgars Stores Ltd*[103] it was held that, where the existence of a liability is certain and established within a tax year but the amount in question cannot be accurately determined at the end of the tax year, the liability for that amount is nevertheless regarded as having been incurred in that tax year. When an expenditure is actually incurred in year one and paid in the next year of assessment, if it meets the requirements in section 11 (a) it is deductible in year one.[104]

In *ITC* 1499[105] the taxpayer sought to claim expenditure which was subject to a *bona fide* dispute and it was held that the expenditure lacked the degree of certainty and finality necessary to render it as having actually been incurred.

The fact that the victim of a crime may bring a claim for a certain amount does not necessarily mean that he or she will be granted a judgment equal to the claim, and therefore the thief cannot determine the actual amount for which he or she is liable until the judgment is handed down.

[101] Edgars Stores Ltd v CIR (1988 (3) SA 876 (A)), 50 SATC 81.
[102] Williams Income Tax and Capital Gains Tax in South Africa Law and Practice 280.
[103] Edgars Stores Ltd v CIR (1988 (3) SA 876 (A)), 50 SATC 81.
[104] Williams Income Tax and Capital Gains Tax in South Africa Law and Practice 278.
[105] ITC 1499 (1989), 53 SATC 266.

The first matter of concern in *ITC* 1545[106] was the amounts received from the purchase and sale of stolen diamonds. A number of submissions were made by counsel on behalf of the trustees of the taxpayer's insolvent estate. In the context it was common cause that the taxpayer was aware that the diamonds he bought and sold had been stolen, and that his conduct amounted to theft. It was also common cause that the proceeds of the sales amounted to a "receipt or accrual" within the meaning of "gross income." It was not a case in which there had been no receipt but merely a "taking" by a thief.

It was submitted that the taxpayer, because of his conduct, which amounted to theft, rendered himself liable to the owner of the diamonds for their return or their value. This liability was "an inseparable and necessary concomitant of the 'trade' of dealing in stolen diamonds and that, as it arose immediately with each transaction, it had constituted deductible expenditure in terms of s 11(a) of Act 58 of 1962 for each of the years in which a profit was made" (at page 467). It was also submitted that the assessments should be set aside and the taxpayer be re-assessed once the *quantum* of the owner's claim had been determined. (The owner had instituted proceedings against the taxpayer in later years of assessment.) The Commissioner's submission was that whatever the taxpayer's liability might turn out to be, it did not constitute expenditure incurred in the relevant years of assessment. Scott, J stated (at 467) that "[i]t is well established that in order for expenditure to be deductible it must have been incurred in the year of assessment concerned. In order to be deductible the liability must be one which is definite and absolute and not one which is merely contingent." It was held as follows in respect of this aspect of the case:

[106] ITC 1545 (1992), 54 SATC 464 (C).

"(iii) That the taxpayer's liability to the owner for the return of the diamonds or their value did constitute deductible expenditure in terms of s 11 (a) of Act 58 of 1962 as whether the taxpayer is ever made to compensate the owner or not depended in each case not only upon whether his crime was detected but also on the non-happening of an uncertain future event.

(iv) That, therefore, until at least the owner institutes proceedings against the taxpayer to recover his loss from him rather than from any other party, the taxpayer's liability did not amount to "expenditure ... actually incurred" within the meaning of s 11(a).

(v) That the proceedings against the taxpayer arising out of the transactions in question and brought by the owner of the stolen diamonds were instituted subsequent to the years of assessment in question and it followed that the appeal against the Commissioner's assessment of the taxpayer for normal tax in respect of the years ending 30 June 1980, 1981 and 1982 had to fail."

Therefore in terms of this judgment any contention that a thief or the perpetrator of fraud incurred a liability to return the property or to make good the loss of the victim of the crime *at the time the amounts were received* by him or her would fail.

The liability to repay the owner of the property or to return the property obtained by theft or fraud, or to compensate the victim, is thus dependent on judgment's being obtained against the perpetrator, and therefore the liability is not incurred until judgment is handed down. Only at the stage where the judgement is obtained will the liability actually be incurred and,

provided it meets the other requirements of section 11 (*a*), will it be deductible. Expenses actually paid by persons earning their income through the activity of prostitution, through theft or fraud, or expenses incurred in carrying on other illegal activities, for which there is a legal liability to pay will, however, have been "incurred" for the purposes of the general deduction formula.

4.2.3 During the year of assessment

The expenditure which the taxpayer claims as a deduction must be incurred during the year of assessment in which it is claimed. For example, in *Concentra (Pty) Ltd* v *CIR*[107] expenditure relating to directors' expenses which had arisen in earlier years was claimed as a deduction in those years and, as the claim had not been made at the right time, the right to claim a deduction in terms of section 11(a)[108] was forfeited. The Income Tax Act as a whole deals with a single tax year in that taxpayers are assessed on income they receive in one year of assessment, and thus the deductions should also be claimed for that one year of assessment.[109]

ITC 1624[110] dealt with a close corporation carrying on business as customs clearing and freight forwarding agents. The taxpayer fraudulently rendered accounts to a client reflecting wharfage fees disbursed in excess of the actual expenditure incurred. One of the submissions made by the appellant (the close corporation) was that it was entitled to claim as a deduction the same amount that it had overcharged the client (for which a provision had been created in the financial statements) as it had become subject to a simultaneous and corresponding liability to repay it.

[107] Concentra (Ply) Ltd v CIR (1942) CPD 509, 12 SATC 95.
[108] Income Tax Act No. 58 of 1962.
[109] Sub Nigel Ltd v CIR (1948 (4) SA 580 (A)), 15 SATC 381.
[110] ITC I624 (1996), 59 SATC 373.

The court held as follows:

> "(iv) That it does not follow from the fact that appellant had an obligation to restore what it had unlawfully taken from A that it "actually incurred" "expenditure" for that sum; it may well be that if it paid the amount it would incur a loss which would be treated as having been incurred in the production of its income as a necessary concomitant of the trade dishonestly carried on by it but that has not happened.
>
> (v) That it is not a correct reflection of what happened in the present case to say that appellant had voluntarily or even to say simply that it expended the amount it is liable to repay to A; it took the money with the obvious intention of keeping it in the hope that its fraud would not be found out and on the basis that the amount would be repaid if its misconduct was discovered, but only then.
>
> (vi) That the appellant had recognised that it had a liability to pay A the disputed amount so as to result in a loss to it and treated its position as such *ab initio (i.e.* in the year of assessment) is, in any event, difficult to accept as a probability; in any event, when the financial statements for the year of assessment in question were prepared, A had not yet discovered the fraud or in any way intimated that it intended to claim the money of which it had been defrauded - at most, it is probable that appellant had made a provision for the disputed sum and it did so, not by treating what it owed A as a liability for the repayment of stolen funds but by means of recording fictitious "purchases."

(vii) That, accordingly, the disputed sum could not be described as expenditure or a loss actually incurred in the production of appellant's income in terms of s 11(a) of the Income Tax Act 58 of 1962 in the year of assessment concerned and it was also not laid out or expended for the purpose of trade as required by s 23(g) of the Income Tax Act 58 of 1962."

The obligation to pay or refund the rightful owner of money or property arises after the money has been stolen from such an owner. The obligation in such cases is not certain as the obligation is further dependent on the victim's obtaining judgment against the perpetrator, unless the payment is made voluntarily. This means that the expenditure can be claimed only in the year it is actually paid, and if it meets all the other tests set out in section 11(a) of the Income Tax Act.

4.2.4 In the production of income

The leading case dealing with the phrase "in the production of income" is *Port Elizabeth Electric Tramway Co Ltd* v *CIR,*[111] which involved the payment of compensation to a driver of a tram injured during the course of his employment and who subsequently died from his injuries. The company resisted the claim in legal proceedings but eventually was ordered to pay damages and also incurred legal costs in resisting the claim. The question was whether or not these expenses were incurred "in the production of income."

Watermeyer AJP held that the test is twofold: the act to which the expenditure is attached must be performed in the production of income and the test to be applied is subjective: if it is performed *bona fide* for the purpose of carrying on the trade which earns the income, and the

[111] Port Elizabeth Electric Tramway Co Ltd 1936 CPD 241, 8 SATC 13.

expenditure in question must be so closely linked to such an act that it can be regarded as part of the cost of performing it.

It was held further that whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the efficient performance of such operations, they are deductible provided they are so closely connected with it that they may be regarded as part of the cost of performing it. The expenditure and losses referred to in the Income Tax Act refer to the outgoings and losses incurred in the course of or by reason of the ordinary operations undertaken for the purpose of conducting business.[112]

For expenditure to qualify as a deduction, the expenditure must relate to a trade carried on by the taxpayer.[113] The expenditure must have been incurred in order to produce income for the taxpayer.[114] The words "incurred in the production of income" mean actually incurred in the course of or by reason of ordinary business operations undertaken for the purposes of conducting the business.[115]

In *Weinburg* v *CIR*[116] it was held that an amount is not deductible if it was not incurred in rendering any service in the normal course of business. In *COT* v *Rendle,*[117] on the other hand, the court referred to three different types of expenses that can be incurred in the production of income: expenses necessary for the performance of the trade, expenses incurred for the *bona fide* efficient performance of trade activities, and expenses attached to the performance by chance.

[112] Lockie Bros Ltd v CIR (1922 TPD 42), 32 SATC 150 at 151-2.
[113] Williams Income Tax and Capital Gains Tax in South Africa Law and Practice 276.
[114] Ibid at 284.
[115] Lockie Bros Ltd v CIR (1922 TPD 42), 32 SATC 150.
[116] Weinburg v CIR (1946 CPD 429), 14 SATC 210.
[117] COT v Rendle (1965 (1) SA 59) (SRAD), 26 SATC 326.

Operational costs are costs that are naturally and reasonably regarded as expenses that are part of the cost of performing the operations.[118] The court has a duty to assess the closeness of the connection of an expense to the income-earning operations of the business, having regard to the purpose of the expenditure.[119]

It appears to be clear that, provided they meet the other requirements of the general deduction formula, the expenses (excluding the amounts specifically prohibited in section 23(o))[120] incurred by prostitutes, brothel owners and pimps would be expenses incurred in the production of their income. The situation with regard to the expenses incurred by thieves and the perpetrators of fraud and, in particular, the expenses incurred in compensating the victims of their crimes is not so clear.

In *COT v Rendle*[121] it was held that the deductibility of fortuitous expenditure depends on whether the chance or risk of its being incurred is sufficiently closely connected with the taxpayer's business operations. The taxpayer must show that the risk of the occurrence of the action which gives rise to the expenditure was inseparable from or is a necessary incident to the carrying on of the particular trade.[122] In *ITC* 233[123] the taxpayer was a stevedore and a passer-by was killed by an article that fell from a net while cargo was being off-loaded. The court held that the payment of damages is incidental to the trade of a stevedore and is deductible.

[118] CIR v Genn and Co (Pty) Ltd (1955 (3) SA 293 (A)), 20 SATC 113.
[119] Ibid.
[120] Income Tax Act, No. 58 of 1962.
[121] COT v Rendle (1965 (1) SA 59) (SRAD), 26 SATC 326.
[122] Ibid.
[123] ITC 233 (1932) 6 SATC 259.

Involvement in illegal activities is accompanied by the risk of imprisonment or a civil action, and in cases of fraud and theft it is accompanied by the risk of being ordered to refund the victim. Expenses associated with these risks cannot be said to have been incurred in the production of income, as they relate to a "penalty" in respect of income received in an earlier period and cannot be said to have been incurred *bona fide* for the purpose of producing income.[124] To qualify for deduction they would have to be inseparable from the type of trade being carried on, and their incurrence would have to be a concomitant of the business of involvement in illegal activities.

In *Joffe and Co (Pty) Ltd v CIR*[125] it was held that all expenditure attached to the performance of the operations which constitute the carrying on of a trade would be deductible, including expenditure which is not attached to trading operations but is *bona fide* incurred for the purposes of trade. The words "incurred in the production of income" must be given the meaning of "actually incurred in the course of and by reason of the ordinary business operations undertaken for the purpose of conducting the business."

4.2.5 Not of a capital nature

Expenditure of a capital nature does not qualify for deduction in terms of the general deduction formula. As is the case with receipts and accruals of a capital nature, there is no definition in the Income Tax Act of what constitutes an expense of a capital nature. It has been left to the courts to provide a number of tests which can be applied under different circumstances.

[124] Port Elizabeth Electric Tramways Co Ltd v CIR (1936 CPD 241), 8 SATC 13.
[125] Joffe and Co (Pty) Ltd v CIR (1946 AD 157), 13 SATC 354.

In *CIR* v *George Forest Timber Co Ltd*[126] it was held that money spent on creating or acquiring an income-producing concern or source of future income (as opposed to money spent on working it) was capital expenditure. In *New State Areas Ltd* v *CIR*[127] it was held that expenditure which is incurred for the purpose of establishing, improving or adding to the equipment of the income-producing structure is capital expenditure; whereas expenditure which is incurred as part of the cost of performing the income-producing operations is revenue expenditure.

Persons earning their income from illegal activities, including prostitution, theft and fraud, may incur expenditure in acquiring capital equipment needed for their trade. This expenditure, which is linked to their income-earning structure, would not be deductible in terms of section 11(a). Provided the expenditure meets the requirement of "trade," the capital expenditure may qualify for deduction in terms of section 11(e), the wear-and-tear allowance, or one of the other provisions of the Income Tax Act providing for the write-off in instalments of other types of capital expenditure.

4.3 The deductibility of expenditure and losses connected with illegal activities

As is the case with the definition of "gross income," the provisions comprising the general deduction formula (or any other provisions) do not state that the deductions and allowances are prohibited in the case of illegal activities. In the 1918 case, *CIR* v *Delagoa Bay Cigarette C0,*[128] Bristowe J held that "if the income (from an illegal business) itself is taxable, it follows I think that if the prizes had been a legitimate deduction (and not a disposal after they had been earned) had the business been legal, they would equally be a legitimate deduction if the business is illegal."

[126] CIR v George Forest Timber Co Ltd (1924 AD 516), 1 SATC 20 .
[127] New State Areas Ltd v CIR (1946 AD 610), 14 SATC 155.
[128] CIR v Delagoa Bay Cigarette Co Ltd (1918 TPD 391), 32 SATC 47.

A contrary view (albeit an *obiter dictum)* was expressed by Watermeyer AJP in the case of *Port Elizabeth Electric Tramway Co Ltd,*[129] when he stated that: "(w)here the act in question, though performed in the production of income, is unlawful or negligent, the expenditure attendant upon such act would probably not be deductible." Admittedly this related to the unlawfulness of the expenditure itself and not the illegality of the business.

In *ITC* 1199[130] it was held that if fines for criminal conduct would qualify as a deduction there would be no public policy barrier against allowing such deduction. These fines are not deductible even if the crime was committed in the course of income-earning operations.[131] This non-deductibility is based on public policy and supports the legislature's intention to decrease crime, and thus allowing the deduction would be inconsistent with the aim of the legislature.[132] Criminal sanctions are not imposed on the taxpayer *qua* trader but as a personal punishment.[133] A fine is a personal punishment, not a cost of performing business operations.[134]

In *ITC 1490*[135] the taxpayer was a cartage contractor deriving its income from transporting goods. The taxpayer wanted to deduct traffic fines incurred in that year of assessment. The court held that fines for criminal conduct in the carrying out of business operations cannot be regarded as expenditure in the production of income and therefore the expenditure does not qualify for deduction under section 11(a). In a Rhodesian case, *ITC 1210,*[136] it was held that a

[129] Port Elizabeth Electric Tramways Co Ltd v CIR (1936 CPD 241), 8 SATC 13.
[130] ITC 1199, 36 SATC 16 19.
[131] Williams, Income Tax and Capital Gains Tax in South Africa Law and Practice 337.
[132] Ibid.
[133] Ibid.
[134] Silke On South African Income Tax volume 1 (2003) 7-72.
[135] ITC 1490 (1990), 53 SATC 108.
[136] ITC 1212 (1974), 36 SATC 108.

deduction of fines incurred was disallowed on the grounds that the section that provides for deductions provides for the deduction of commercial losses only, and a loss that results from a breach of law is not a commercial loss.

Persons involved in illegal activities would frequently have to pay fines or penalties for so doing, and it is clear that these expenses would not be deductible. The arguments raised in the cases referred to above that to allow the deduction of fines and penalties would be contrary to public policy could also be raised against the granting of the deduction of other expenses incurred in the course of carrying on criminal activities. Jacobson,[137] however, argues that the use of public policy to disallow expenditure is against the philosophy of the Income Tax Act as a tax collection statute.

The only provision in the Income Tax Act that deals directly with illegal activities is section 23(o), which provides that no deduction will be allowed for any expenditure that constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004, and where a payment constitutes a fine imposed as a result of an unlawful activity. Section 3 of the Combating of Corrupt Activities Act describes the general offence of corruption, which relates to accepting or giving a gratification in order to influence another to act in a manner that amounts to the abuse of a position of authority, a breach of trust, or the violation of a duty or a set of rules, in order to achieve an unjustified result.

This includes the giving of a gratification to (or acceptance by) persons occupying public office, or parties in an employment relationship, and a list of other activities, including sporting events and gambling. The prohibition in section 23(o) would not, therefore, relate

[137] Jacobson RA, The tax treatment of illegal transactions (1986) at 25.

directly to the offences forming the basis of this research, except with regard to fines or penalties incurred in respect of the illegal activities, which would not be deductible. It is also likely that persons engaging in illegal activities would pay bribes or gratifications to persons in authority to promote the success of their activities. Such payments would be disallowed in terms of section 23(o).[138] On the issue of the deductibility of fines, Jacobson[139] proposes the consideration of businesses that cannot operate legally and which therefore incur fines as part of carrying on trade. Jacobson also argues that such traders know that if they conduct their business they will incur fines, but if they do not they will not earn income; therefore such fines incurred in the production of income and a deduction must be granted, as there can be no public policy bar to deductibility.

In such a situation it can be inferred that incurring fines is a necessary concomitant of the trade, and they are necessary for carrying on such a trade, thus they are deductible. Section 23(o) has settled the matter, however, and irrespective of the close connection of certain fines with the income-earning activities of the taxpayer they will not be deductible.

The policy which justifies the inclusion of illegal proceeds in gross income is one of revenue collection; the revenue laws place all taxpayers on an equal footing as far as the taxability of their receipts goes.[140] In other words, the Income Tax Act provides for the taxation of taxpayers on all their receipts and accruals, irrespective of their source.

It follows, then, that the policy underlying the deductibility of expenditure should also be one which seeks to place honest and dishonest taxpayers on an equal footing.[141] If the honest

[138] Income Tax Act No. 58 of 1962.
[139] Jacobson RA, The tax treatment of illegal transactions (1986) at 21.
[140] http://wwwserver.iaw.wlts.ac.zalworkshop/workshop03/WWLS.Bonthuysan dM onteiro .doc.
[141] Ibid.

taxpayer cannot be discriminated against through the delinquent taxpayer's being allowed to escape the inclusion of his receipts in gross income, then the delinquent taxpayer should not be discriminated against through the honest taxpayer's being allowed deductions to which he (the delinquent taxpayer) is not entitled.[142] In *ITC 1199*[143] Margo J stated *obiter* that since income from unlawful trading is assessable to tax, expenditure in the production thereof is deductible.

There should be no moral interpretation or consideration of public policy in interpreting the provisions of the Income Tax Act.[144] If an amount falls within the ambit of the Act it must be taxed and if on the other hand an amount meets the deductibility requirements it must be deductible.[145] Persons involved in prostitution or profiting from the activities of prostitution, who incur legal costs to prevent imprisonment and ensure their the ability to "continue earning income," would (all else being equal) be able to deduct the costs in terms of section 11(c)[146] as non-capital expenses closely connected with their normal business activities.

South African Revenue Services (SARS) interpretation note 80 of 5 November 2014 deals with "the income tax treatment of stolen money" and provides as follows:

> "Expenditure and losses incurred by a taxpayer in carrying on a trade as a result of embezzlement, fraud or theft of money and any legal and forensic expenditure incurred in investigating the crime will qualify as a deduction in determining taxable income provided it meets the requirements of section 11(*a*) or in the case of legal

[142] http://wwwserver.iaw.wlts.ac.zalworkshop/workshop03/WWLS.Bonthuysan dM onteiro .doc.
[143] ITC 1199, 36 SA TC 16 at 19.
[144] Jacobson RA, The tax treatment of illegal transactions (1986) at 25.
[145] Ibid.
[146] Income Tax, Act No. 58 of 1962.

expenses, section 11(*c*). An important factor in determining the deductibility of the expense or loss will be whether the risk of its incurral was a necessary incident of the taxpayer's trade. Any amounts allowed as a deduction which are recovered or recouped must be included in the taxpayer's income."

4.4 Conclusion

This chapter has discussed the general deduction formula and related case law in principle and in particular in relation to income from illegal activities. The principle that has been established is that no distinction is made between income obtained legally or illegally. The principle may, however, be different when it comes to the deductibility of expenditure incurred in the production of legal and illegal income.

In general, considerations of public policy may prevent the deduction of expenses relating to an illegal activity. Although the Income Tax Act does not specifically refer to illegal activities, it is fairly clear that prostitution and the direct and indirect earnings from prostitution and the income from fraud or theft carried on regularly and in a business-like manner would constitute a "trade." as defined. It also appears that the expenses relating to these illegal activities would qualify for deduction in terms of the general deduction formula, provided they are of a non-capital nature and provided they are *bona fide* incurred in producing the income or are closely connected with the production of the income.

Other deductions may be available in relation to the trade; for example, legal expenses, wear-and-tear allowances on capital equipment or its repair. In the case of theft or fraud, the deduction of compensation payable to the victims of the crimes may present a problem as these expenses would not be incurred in the production of income. The law is clear on one

aspect, however, and that is that the deduction of any fine charged, or any penalty imposed as a result of an unlawful activity carried out in South Africa, or carried out in another country if that activity would be unlawful in South Africa, and any other expenses relating to corrupt activities[147] is prohibited.

[147] An activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004.

CHAPTER 5: DEDUCTION FOR ILLEGAL ENTERPRISES IN OTHER JURISDICTIONS

5.1 Australia

The courts in Australia were faced with an unusual case in which a taxpayer sought deductions from illegal income. In *Commissioner of Taxes v La Rosa*[148] the taxpayer was involved in drug dealing. In 1996 he was sentenced to more than 12 years in prison after pleading guilty to charges relating to the importation and possession of heroin.[149] Following the taxpayer's criminal convictions, his financial affairs came to the Commissioner's attention. He had not lodged income tax returns for the seven years of income ended 30 June 1990 to 30 June 1996 inclusive.

Accordingly, the Commissioner issued default notices of assessment on the taxpayer. Included in the assessable income of the taxpayer was $220 000 that had accumulated from drug dealings, had been buried in the taxpayer's backyard, and was later dug out for an intended drug deal, in May 1995. The $220 000 was subsequently stolen from the taxpayer during that intended drug purchase. The Administrative Appeals Tribunal (the AAT) considered whether the taxpayer should be entitled to a deduction of the $220 000 stolen during the intended drug purchase. The AAT characterized the losses as one incurred in the process of gaining or producing assessable income. It had been lost during a robbery connected with a drug purchase operation directly connected with the taxpayer's illicit drug dealing business.

[148] COT v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).
[149] La Rosa v Queen (1999) 105 A Crim R 362,363.

The occasion of the loss was the theft of the money intended to be applied in connection with the purchase of trading stock for the taxpayer's business as a dealer in drugs. It did not matter that the drug dealing business was illegal, therefore the $220 000 was allowed as a deduction during the year ended 30 June 1995.

The Commissioner appealed the AAT's decision to allow the taxpayer to deduct the stolen funds. Nicholson J dismissed the Commissioner's grounds of appeal that deduction should be available for legitimate activities only. He said,[150]

> "To adopt the use of legitimacy would seem to introduce a measure of subjectivism which would give rise to uncertainty in the application in the law. More fundamentally, the contentions for it do not disclose any foundation either in case law or in the wording of ITAA upon which such a concept could be approached …."

The Commissioner also submitted that the stolen funds were not deductible on public policy grounds. The Commissioner submitted that the policy of the law is not served by allowing a deduction to the taxpayer for a payment or loss of funds in acquiring or attempting to acquire a substantial amount of prohibited drugs through drug dealing. In particular, the commissioner relied on *Mayne Nickless Ltd v Federal COT*,[151] which stood for the principle that the court will not allow a person to benefit from their wrong-doing. Nicholson J accepted that deductions may be limited by public policy considerations.

However, he held that none of the authorities relied on by the Commissioner supported the more general proposition that expenditure (other than fines and penalties) which has the

[150] COT v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).
[151] Mayne Nickless Ltd v Federal COT [1984] VR 863.

requisite nexus with the business operations is unlawful and involves breaches of the criminal law. He thus adopted a literal approach and held that the public policy argument of the Commissioner could not succeed. The Commissioner appealed the decision of Nicholson J to the Full Federal Court and contended that the deductions should not be allowed. Again the Commissioner's main submission was that the taxpayer's loss arose from conducting illegal business activities, and thus allowing a deduction for such a loss would be contrary to the public policy.

Hely J. accepted that the Administrative Appeals Tribunal had made a correct characterization of the $220 000 loss. He held that there were sufficient reasons between the loss and the business operations for the taxpayer.[152] He accepted that the risk that losses of that type would be sustained was inherent in the activities under consideration. Carr J concurred, and held that since illegal income had been interpreted literally, section 51(1) of the Income Tax Assessment Act for deductions also called for a literal interpretation, and as such the usual principles should be applied to allow the loss of $220 000 as a deduction.

Adopting the literal approach to statutory interpretation, Carr J acknowledged that the criminality of the occasion of the outgoing must be irrelevant.[153] The Commissioner argued that the policy of the law is not served by allowing a deduction to the taxpayer under the Income Tax Assessment Act. If allowed, the deduction would be given for an outgoing or loss that is clearly or sharply prohibited by the declared criminal law.[154] However, the court unanimously dismissed the submission on the grounds that allowing for such a deduction does not frustrate the operation of the criminal law, nor will any sanction imposed by that law

[152] COT v Jones (2002) 117 FCR 95, 98.
[153] SiskaLundi (2008). RLJ Article 7, Vol. 13, issue 1, 119-121.
[154] COT v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003), para 48.

be diluted by the allowance of the deduction for business expenses or losses.[155] The court held that the policy of the law does not disentitle the taxpayer to a deduction in relation to the $220 000. Hely J stated:

> "The purpose of the Income Tax Assessment Act is to tax taxable income, not to punish wrongdoing. The language ss17, 25, 48 and 51, is indifferent as to whether the income, loss or outgoing in question has its source in lawful and unlawful activity … There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities. Punishment for those who engage in unlawful activities is imposed by the criminal law and not by laws in relation to income tax."[156]

The Full Federal Court therefore rejected the taxpayer's public policy submission and allowed the deduction.

5.2 United States of America

In the United States the Internal Revenue Code s162 (which is similar to the South African Income Tax Act) allows all the ordinary and necessary expenses paid to be deducted. The court in the case of *New Colonial Ice Company v Helvering* (1934) ruled that the tax deductibility of expenses depends merely on legislative grace. This legislative grace approach means that all exclusions from gross income and every deduction can be viewed as a present from Congress. Thus a deduction is precluded on a tax return unless a specific provision in the tax law allows it; therefore the rule on deductions is summarized as "none, unless specified."

[155] Per Carr J, para 8, per Hely J, para 58; Commissioner of Taxes v La Rosa (2002) 50 ATR.
[156] Par 55, per Carr J, para 9; COT v La Rosa (2002) 50 ATR 450, [2003].

However, while section 162 does not allow taxpayers' deductions for bribes to public officials, illegal kickbacks and fines, based on the case of *The Commissioner v Sullivan*, all of the usual expenses incurred in the operation of an illegal business are deductible for tax purposes. Taxpayers owning an operating illegal gambling establishment incur various expenses to sustain such an activity. These expenses can include criminal fines, depreciation on equipment, illegal bribes, illegal kickbacks, interest, insurance, and pay-offs to law enforcement officials, rents, utilities and wages.

For such a business enterprise, every one of the usual expenses (depreciation on equipment, rent, insurance, interest, utilities, and wages) qualifies as a valid deduction. The other deductions are not permitted because section 162 does not allow taxpayers' deductions for bribes to public officials, illegal kickbacks, fines and etc.

Section 280E[157] provides an exception for expenses incurred in the illegal trafficking of drugs. No deduction is available for drug dealers regarding necessary and ordinary expenses incurred in such commerce.

An illegal scheme could actually qualify for deduction under section 11(a) of the South African Income Tax Act if the approach by other jurisdictions were to be followed. If the courts adopted a literal approach in determining the liability of an illegal enterprise to taxation on its proceeds, it should not be found an absurdity to apply the same approach when considering if these schemes should be entitled to a deduction.

[157] United States Internal Revenue Code.

5.3 Conclusion

The Australian Courts have held that businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, nor because they are illegal. The courts have determined that illegality is not a basis for disregarding an illegal activity as a business, and therefore illegal schemes or operations should qualify for a deduction.

The taxing statute in the United States of America empowers the Commissioner to levy tax on income received by a taxpayer and does not make any provision for the exclusion of income received from illegal activities. The law does allow deductions for expenditure incurred in the production of income but only if such expenditure is necessary. Expenditure on fines and penalties is not deductible, however.

While there are similarities between the taxation of income from illegal activities in South Africa, Australia and the United States of America, there appears to be more certainty in the Australia and United States in relation to the deductibility of expenses incurred in earning the illegal income.

An illegal trade or scheme in South Africa could qualify as a trade if the Australian and the United States approach were to be adopted. If the principles that have been laid out to determine a trade in South Africa are to be followed, then what is required among other things is proof that the illegal scheme is active and not passive, and that there is continuity.

Therefore, in terms of the South African law, an illegal activity that qualifies as a trade will result in the deduction of expenditure actually incurred for the purposes of earning that

income unless such a deduction is specifically prohibited. This, it is submitted, includes the repayment of stolen funds or goods.

CHAPTER 6: CONCLUSION AND GENERAL REMARKS

The taxation of income from illegal activities may appear to be unethical, and it may also appear that the Revenue authorities or government are condoning and benefiting from crime.[158] This disapproval of the government's taxing income from illegal activities stems from the fact that some people do not believe that it is possible to extract legal tax from illegal income. By contrast, one writer has given the title "money does not smell" to her article on tax, and it is submitted that this metaphorical statement is based on the view that South African tax law is rightfully claiming what is due to the *fiscus.* The feeling that government is benefiting from crime and should not be doing so is inevitable.

To be taxed, fraudulently earned receipts must fall within the ambit of the definition of gross income in section 1 of the Income Tax Act. Receipts from fraudulent transactions comply with most of the requirements of the definition, except possibly for the requirement that an amount must be received within the meaning of this word as used in the definition.[159] An overview of the interpretation of the term "received by" reveals that when proceeds from legal transactions were determined by the courts, they agreed that a consideration of legal rights and obligations was the yardstick to be used to prove tax liability. This approach was reversed only when the courts were faced with proceeds from an illegal activity and applied the literal rule with reference to the subjective intention of the taxpayer.

[158] T.H.B. Jr. "Income Tax Consequences of theft" (1949) 25(6) Virginia Law Review 759-773759.
[159] Warneke, D. (2003). Fraudulent Transactions: Are the Receipts Taxable? Tax Planning, 17, 26.

The courts have ruled that a unilateral taking such as theft confers no right upon the taker. In other words, they have said that he takes; he does not receive.[160] If a strict interpretation of the term "receipt" is to be adopted, "a taking" would amount to a receipt and a thief would be taxable. However, in view of the fact that the term "received by" must be read in its context, even if a strict application of the term is applied there must be a transfer of a right to the taker. If the taker infringes upon the property right of another, then there is no receipt, because no rights have passed to the taker.

There is a submission that illegal activities that do not traverse the property rights of others, such as illegal gambling, drug dealing and prostitution, are taxable under the Income Tax Act, whilst poaching, theft, fraud and embezzlement do not result in the transfer of a right but are forms of infringements of proprietary interests. The submission is questionable because a criminal derives no legal or moral entitlement to the proceeds of his crime. No legal rights can be passed in a drug deal, prostitution or illegal gambling.

The interpretation of the term "received by" with reference to the subjective intention of the taxpayer in the *MP Finance*[161] case is a clear adoption of the foreign concept, i.e. the doctrine of the claim of right, which was formulated in the United States.[162] The claim of right simply creates liability for a taxpayer who claims a right on a possession of an amount and does not focus on whether or not there is in fact a right to the amount. The doctrine was established as a result of an amendment that disregarded the issue of the legality of a receipt by a taxpayer in the United States of America.

[160] COT v G (1981 (4) SA 167 (ZA)), 43 SATC 159, at 162.
[161] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 143.
[162] James v US, 366 US 213.

The judgement in the *MP Finance*[163] case is a very important one as it puts to rest the debate as to whether illegally earned income is taxable or not in South Africa. The conclusion of the court is that illegally obtained income is a "receipt" and therefore such income must be subjected to the tax liability. The *MP Finance*[164] case remains the authority for South African law and will remain so until the contrary is proven or when the law is changed through legislation.

The courts have determined that a *bona fide* expense that is a necessary concomitant to the production of income is deductible under section 11(a).[165] An illegal scheme or operation should show only that the expenses it incurred, no matter how devious they may be, were necessary to the production of their fraudulently earned income. The courts in South Africa, together with s23(o) of the Act, have prohibited certain deductions, such as fines imposed on criminal activities, on the grounds of public policy.

The Appeals Tribunal in Australia has determined that if a court adopts a strict, literal interpretation in determining a receipt by a taxpayer, then it should adopt the same approach in determining whether an illegal enterprise is entitled to a deduction. The criminality of an enterprise is irrelevant in the determination of a deduction under the Act.

So if that approach is adopted, illegal schemes and other illegal trades could be described as trades. The income derived from an illegal operation or scheme is not passively received. Its

[163] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.
[164] Ibid.
[165] Port Elizabeth Electric Tramways Co Ltd v CIR (1936 CPD 241) 8 SATC at 246-247.

accumulation requires the taking of active steps such as creating convincing documentation and hiring individuals to solicit clients. There is a degree of continuity[166] until the illegal scheme or operation collapses or ceases to exist, and therefore these schemes must receive a deduction, regardless of their illegality.

A higher tax burden should not be imposed on a particular segment of taxpayers by refusing a deduction to those business activities that are unlawful as against lawful business activities, and punishment for those who engage in unlawful activities is imposed not by the Income Tax Act but by criminal law. However, before a section 11(a) deduction can be claimed, an illegal enterprise must satisfy the requirement that it carries on a trade under section 23(g) of the Income Tax Act.

The interpretation note 80 issued by SARS sets out SARS's view on theft. SARS take the view that a thief will be taxed on stolen money, because it is a receipt. The interpretation note further provides for the deductibility of expenditure and losses incurred by the taxpayer in carrying on an illegal trade, provided it meets the requirements of section 11(a). It is submitted that SARS's view is based on the principles of *MP Finance*[167] case.

In conclusion, it appears that a number of court decisions have provided certainty regarding the taxation of income derived from illegal activities. The question of the deductibility of expenses incurred in producing this income also appears to be resolved.

[166] ITC 1476 (1989), 52 SATC 141.
[167] MP Finance Group CC (in liquidation) v CSARS (2007 SCA), 69 SATC 141.

A grey area which requires further research, however, is the deductibility of compensation or restitution that the criminal may be called upon to make, if his or her crime is discovered.

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