

An analysis of the taxability of illegal activities in South Africa

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ABSTRACT

An analysis of the taxability of illegal activities in South Africa

The South African Income Tax Act (58 of 1962) does not specifically deal with the tax treatment of receipts resulting from illegal activities. Expenditure resulting from illegal activities is also only partly dealt with in terms of Section 23(o) of the Income Tax Act. This has resulted in uncertainty pertaining to the normal income tax treatment of illegal activities within a South African context. In response to this, the South African Revenue Service has issued a draft interpretation note dealing with the tax consequences of embezzlement and theft of money for both the victim as well as the offender during 2013. This draft interpretation note also deals with the normal tax consequences of illegal receipt in the hands of the thief. In an attempt to evaluate this draft interpretation note to clarify the tax consequences of illegal activities in South Africa, the meaning of illegal receipts is firstly determined. Subsequently the concept of 'illegal receipts' is measured against the definition of 'gross income' contained in Section 1 of the Income Tax Act. Expenditure relating to illegal activities is also analysed and measured against the general deduction formula contained in Section 11(a) of the Income Tax Act. Relevant principles established from general case law applicable to the definition of gross income as well as the general deduction formula is analysed to determine its applicability within the context of illegal receipts and expenditure. Also, principles established through case law, both nationally and internationally, specifically applicable to the taxation of illegal activities were analysed to establish guidelines that could be applied to clarify the taxability of illegal activities within a South African context.

KEYWORDS:

Accrued to; capital gain; general deduction formula; gross income; illegal activities; illegal receipts; received by

OPSOMMING

'n Ontleding van die belasbaarheid van onwettige aktiwiteite in Suid-Afrika

Die Suid-Afrikaanse Inkomstebelastingwet (58 van 1962) behandel nie spesifiek die hantering van ontvangstes wat voortspruit uit onwettige aktiwiteite nie. Uitgawes wat voortspruit uit onwettige aktiwiteite word ook slegs gedeeltelik behandel in Artikel 23(o) van die Inkomstebelastingwet. Dit het gelei tot onsekerheid met betrekking tot die normale inkomstebelastinghantering van onwettige aktiwiteite in 'n Suid-Afrikaanse konteks. In reaksie hierop het die Suid-Afrikaanse Inkomstediens in 2013 'n konsep- interpretasienota uitgereik wat die belastinggevolge van verduistering en diefstal van geld vir sowel die slagoffer as die oortreder behandel. Hierdie konsep- interpretasienota behandel ook die belastinggevolge van die onwettige ontvangs in die hande van die dief. In 'n poging om hierdie konsep- interpretasienota te evalueer met die doel om die belastinggevolge van onwettige aktiwiteite in Suid-Afrika duideliker te maak, word die betekenis van onwettige ontvangste eerstens vasgestel. Hierna word die konsep 'onwettige ontvangste' gemeet teen die definisie van 'bruto inkomste' soos vervat in Artikel 1 van die Inkomstebelastingwet. Uitgawes wat verband hou met onwettige aktiwiteite word ook ontleed en gemeet teen die algemene aftrekkingsformule vervat in Artikel 11(a) van die Inkomstebelastingwet. Relevante beginsels vasgelê in die algemene regspraak wat van toepassing is op die definisie van bruto inkomste sowel as die algemene aftrekkingsformule word ontleed om vas te stel in hoeverre dit toepasbaar is binne die konteks van onwettige ontvangste en uitgawes. Beginsels wat vasgelê is deur die regspraak, sowel nasionaal as internasionaal, wat spesifiek van toepassing is op die belasting op onwettige aktiwiteite is ook ontleed om riglyne vas te stel wat gebruik kan word om die belasbaarheid van onwettige aktiwiteite in 'n Suid-Afrikaanse konteks duideliker te maak.

SLEUTELWOORDE:

Algemene aftrekkingsformule; bruto inkomste; kapitaalwinst; onwettige aktiwiteite; onwettige ontvangste; ontvang deur; toegeval aan.

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LIST OF ABBREVIATIONS

Abbreviation	Meaning
ATO	Australian Taxation Office
PRECCA	Prevention and Combating of Corrupt Activities Act
SAPS	South African Police Service
SARS	South African Revenue Service
SP	Starting price

CHAPTER 1

1. Introduction

1.1 Background to the research area

In the case of *Lindsay v IRC* (1933) it was stated that: *"It is, in my opinion, absurd to suppose that honest gains are charged to tax and dishonest gains escape.... The burglar and the swindler, who carry on trade or business for profit, are as liable to tax as an honest business man"*. Furthermore, in the case of *Sullivan v US* (1926) it was said that: *"It does not satisfy one's sense of justice to tax persons in legitimate enterprises, and to allow those who thrive by violation of the law to escape. It does not seem likely that [the Legislator] intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the burdens of others lawfully employed"*. In both these cases the courts agreed that it would be morally wrong if an honest person pays his income tax, but a taxpayer who receives its income through illegal activities does not.

In the case of the *Federal Commissioner of Taxation v La Rosa* (2003) it was further held that: *"The purpose of the ITAA is to tax taxable income, not to punish wrongdoing. The language of ss 17, 25, 48 and 51 is indifferent as to whether the income, loss or outgoing in question has its source in lawful or 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 of those who engage in unlawful activities is imposed by the criminal law, and not by laws in relation to income tax."* In this case the illegal activities of the taxpayer was found to be taxable but the court also added that the purpose of the law is to tax taxable income and not to punish taxpayers who engage in illegal activities.

Crime is continuing to be a challenge in South Africa. Although the crime statistics issued by the SAPS relating to robbery cases have decreased over the past ten years from 90 825 reported cases in 2004 to 53 858 reported cases in 2014, other crimes such as commercial crime has increased from 53 931 reported cases in 2004 to 79 109 reported cases in 2014 (SAPS, 2014). Based on this high crime rate it is questionable from a tax perspective whether the persons committing these crimes would be held liable for normal income tax if they were to be caught engaging in such criminal activities.

1.2 The meaning of “illegal receipts”

The Oxford online dictionary (2014) defines the term ‘illegal’ as “*contrary to or forbidden by law, especially criminal law*”. The Oxford online dictionary (2014) further defines ‘ill-gotten’ as “*acquired by illegal or unfair means*”.

The term receipt is not specifically defined in the Income Tax Act (58 of 1962) (hereafter referred to as ‘the Act’) but the derivative ‘received by’ is used in the definition of gross income in Section 1 of the Act. There have been various tax court cases in South Africa where an attempt was made to clarify the meaning of the term ‘received by’. In *Geldenhuis v CIR* (1947) it was determined that in order for an amount to be classified as ‘received by’ it must be received by the taxpayer “on his own behalf or for his own benefit”. A further interpretation was offered in *COT v G* (1981) where the term ‘received by’ was described as to “take into one’s hand, or into one’s possession (something held out or offered by another); to take delivery of (a thing) from another”.

By applying the above concepts as a basis for determining the meaning of ‘illegal receipts’, it could therefore be broadly described as receipts acquired by a person for its own benefit obtained through means forbidden by law. However, based on this description it is clear that the term ‘illegal receipt’ is a broad concept that could be widely interpreted.

1.3 Literature overview on the taxability of illegal receipts

1.3.1 A South African perspective

Receipts are normally included in gross income, and taxable for South African income tax purposes, if the receipt meets the definition of gross income. The meaning of gross income is defined in Section 1 of the Act 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 the 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 person from a source within or deemed to be within the Republic,*

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely...”.

For an amount to be included in the gross income of a taxpayer, the amount must either meet all the requirements of the definition of gross income in the Act or the amount must be specifically included into gross income in terms of paragraphs (a) to (n) of that definition. This list of receipts and accruals contained in paragraphs (a) to (n) of Section 1 of the Act specifically includes certain amounts in the definition of gross income even though the criteria of the general definition are not met.

There is no specific inclusion of illegal receipts by paragraph (a) to (n) of the Act. There is also no specific mention in the definition of gross income of receipts from illegal activities. If this was the case then there would be no uncertainty on the matter.

The phrases and expressions included in the definition of gross income are not defined in the Act. Case law has to some extent given direction to their meaning. If an item is therefore not specifically included in paragraphs (a) to (n) of the definition of gross income then case law could be applied to determine whether a specific item falls within the scope of the definition. The phrases forming part of the definition of gross income that will be specifically analysed and considered in this study are ‘received by’ and ‘accrued to’.

In *CIR v Genn & Co (Pty) Ltd* (1955) it was held that not every instance of obtaining control over monies will result in a receipt as per the definition of gross income in the Act. In *Brooks Lemos Ltd v CIR* (1947) deposits were mixed with other funds to be used for the day-to-day operations of a company where the Commissioner then proceeded to include the deposit amounts in the gross income of the company. In *Ochberg v CIR* (1931) the issue under consideration was whether a receipt or an accrual that does not give rise to a benefit to the taxpayer should be included in that taxpayer’s gross income.

Specific court cases dealing with illegal receipts will also be addressed. In *CIR v Delagoa Bay Cigarette Company* (1918) TPD 391 the court held that the payment of prize money was an expense incurred in the production of income and did not constitute the distribution of income after it was earned. In *COT v G* (1981) the court held that stolen money never becomes the property of the criminal, just like borrowed money never becomes the property of the person borrowing it. In *ITC 1545* (1991) the court held that amounts ‘received by’ or ‘accrued to’ should be included in gross income. The fact that the money did not accrue to the taxpayer did not mean that he did not receive it.

ITC 1789 (2005) specifically dealt with the classic pyramid scheme where the taxpayer received money from investors. In return for the investments made the taxpayer paid interest to the investors. Instead of keeping the invested funds separate from the interest, the taxpayer used some of the invested money to make interest payments. The taxpayer also misappropriated some of the invested money for its own personal use. The Commissioner then proceeded to include the amount received in the taxpayer's gross income. The court held that the taxpayer did indeed receive the money from the investor for its own benefit and that the intention was to gain from it personally. As a result it was regarded to be 'received by' the taxpayer and was therefore included in its gross income. ITC 1792 (2005) involved secret profits made by a taxpayer who was a member of a stockbroker firm. The court held that in terms of the law neither the shares bought nor the secret profits made by the appellant or the syndicate were received in his or its own right or for his or its own benefit. In *MP Finance Group CC (In Liquidation) v C* (2007) the Supreme Court of Appeal held that where there is a change in intention resulting in fraudulent activities after money was received by way of legal transactions from the public, the post-fraudulent actions by a taxpayer will not change the fact that the initial receipts were still received in terms of the definition of gross income as per the Act and should therefore be taxable.

From all the aforementioned case law it is clear that the decisions taken and the principles laid down in the latter cases have not been consistent. The South African Revenue Service (SARS) has attempted to clarify some of this uncertainty by issuing a draft interpretation note entitled '[the] deductibility of expenditure and losses arising from embezzlement or theft of money' (SARS, 2013) which also deals with the income tax consequences in the hands of the recipient of the ill-gotten gains. A natural outcome of the question whether income from illegal activities should be included in gross income is the question whether expenditure relating to these illegal receipts would be deductible for income tax purposes.

In the absence of specific income tax legislation applicable to expenditure relating to illegal activities, the general deduction formula should be considered to determine if this illegal expenditure could qualify for a deduction for normal income tax purposes. The general deduction formula is set out in Section 11(a) of the Act as follows:

“For the purposes 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 – expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature;”

This should be read together with Section 23(g) of the Act that states that no deduction will be allowed for “*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;*”.

The important phrases that will be analysed here and considered by way of principles laid down in relevant case law are ‘trade’ and ‘in the production of income’. The term ‘trade’ is defined in Section 1 of the Act and “includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property...”. The principle that the definition of ‘trade’ should be given a wide interpretation was described and well established in *Burgess v CIR* (1993). It was further held in the case *ITC 1476* (1989) that “...the carrying on of a trade involves an ‘active step’, something more than a watching over existing investments that are not income-producing and are not intended or expected to be so”. The phrase ‘in the production of income’ was addressed in the case of *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936) where it was established that where an act is performed for the purpose of earning income, the expenditure attendant upon it would be deductible. The SARS has also issued Interpretation Note: No. 54 entitled “Deductions – corrupt activities, fines and penalties” (SARS, 2010) that will be considered as part of this study.

1.3.2 *An international perspective*

In an attempt to determine the income tax treatment of illegal receipts in South Africa it is important not to focus only on principles laid down by South African case law, but also to compare these principles to the principles and interpretations laid down by the courts of another country with a similar income tax law as that of South Africa. This could highlight income tax principles or practices that could be useful within a South African context.

South African income tax legislation shows several similarities with that of Australia due to the fact that it originated from the New South Wales Act of 1895 (Australian Income Tax Act) (Brink & Viviers, 2012:439). South Africa and Australia are both former British colonies with a strong British influence in the development of its income tax legislation (Willemse, 2011:408). Australia is therefore regarded as a suitable country to be considered in the search for principles and practices that could be useful within a South African context. The focus for comparison will therefore be on the Australian Income Tax Assessment Act (38 of 1997) and relevant Australian case law.

The landmark Australian cases that will be considered and analysed are the *MacFarlane v Federal Commissioner of Taxation* (1986) case as well as the *Federal Commissioner of Taxation v La Rosa* (2003) case. The Australian Taxation Office has also issued a ruling (ATO, 1993) dealing with the possibility of assessing the proceeds from illegal activities, the treatment of amounts recovered and the deductibility of fines and penalties which will also be included in the ambit of this study.

1.4 Motivation for the study

The phrases and expressions forming part of the definition of gross income are not clearly defined in the Act to reach a conclusion on whether illegal receipts will fall within the ambit of this definition. Although case law has, to some extent, given meaning to the phrases in the definition of gross income, not all the cases were consistent in dealing with the phrases as can be seen from the literature review performed under part 1.3.

The deductibility of expenditure incurred relating to income that was the result of illegal activities is also left with some uncertainty. The SARS has issued a draft interpretation note (SARS, 2013) in an attempt to resolve some of these uncertainties. This draft interpretation note deals with the tax consequences of embezzlement and theft of money for both the victim as well as the offender. The publication of this document by the SARS, currently still in its draft form, highlights the fact that uncertainty still exists pertaining to the tax treatment of income and expenditure relating to illegal activities.

1.5 Limitation of scope

The shadow economy, also called the underground, informal, or parallel economy, does not only include illegal activities, but also unreported income from the production of legal goods and services, either from monetary or barter transactions (Schneider & Enste, 2002). The Oxford online dictionary (2014) defines the term 'shadow economy' as "illicit economic activity existing alongside a country's official economy, e.g. black market transactions and undeclared work".

The scope of this research study includes activities relating to the shadow economy. Because the shadow economy includes unreported income and undeclared work it will comprise illegal activities as well as legal non-disclosed activities. Legal non-disclosed activities will only be illegal when they are not disclosed. The scope is therefore limited to include only illegal activities.

According to Schneider and Enste (2002) illegal activities include monetary transactions such as the trade in stolen goods, drug dealing and manufacturing, prostitution, gambling (if illegal), smuggling and fraud. Illegal activities resulting from non-monetary transactions include barter of drugs, stolen or smuggled goods, producing or growing drugs for own use and theft for own use.

The Australian Taxation Office has issued a ruling dealing with the possibility of assessing the proceeds from illegal activities. According to this ruling illegal activities means: “any activities not permitted by law such as those related to drug dealing, insider trading, misappropriation, prostitution, SP bookmaking etc.” (ATO, 1993:1)

Unreported income as a result of legal activities could however also result in illegal activities by the taxpayer. According to Stiglingh *et al.* (2014:811) tax evasion refers to “illegal activities deliberately undertaken by a taxpayer to free himself from a tax burden”. The taxpayer could therefore have received income through legal means, but the fact that the taxpayer is failing to disclose the income, causes it to result in an illegal activity.

Illegal activities are normally not disclosed to tax authorities as this could result in penalties imposed by tax authorities as well as possible prosecution for the illegal activity. Tax authorities will normally only become aware of the income derived from illegal activities when the taxpayer is prosecuted for the illegal activity.

As the taxation of illegal receipts does not normally depend on whether or not it was voluntarily disclosed by the taxpayer or whether the taxpayer was caught or not, it will not be necessary to limit the scope of this study in this respect.

In summary, the scope of this study will only include and focus on the taxability of receipts from illegal activities. As the tax treatment of disclosed or non-disclosed illegal receipts is the same, the study will focus on both disclosed and non-disclosed illegal receipts.

1.6 Research question

The research question which is investigated in the study can be formulated as follows: Has the draft interpretation note issued by the SARS on ‘the deductibility of expenditure and losses arising from embezzlement or theft of money’ (SARS, 2013) clarified the uncertainties in respect of the tax treatment of illegal receipts and the deductibility of expenditure resulting from illegal activities?

1.7 Research objectives

In order to answer the research question the following research objectives are addressed:

- To define the meaning of the term “illegal receipts” in the context of this research study.
- To determine whether illegal receipts adheres to and falls within the ambit of the general definition of gross income.
- To analyse the items specifically included in the definition of gross income to determine whether they also relate to illegal receipts.
- To determine whether expenditure resulting from illegal activities will be deductible for normal income tax purposes.
- To compare the legislation and case law in Australia to that of South Africa to determine whether the tax legislation and principles regarding the tax treatment of illegal receipts in Australia could be useful in a South African context.
- To identify a set of clear principles to establish whether or not an illegal receipt is taxable and whether or not expenditure relating to it would be deductible for normal income tax purposes.
- To develop a decision tree that could be utilised by taxpayers made up of factors to consider in determining whether or not illegal receipts are taxable and also whether expenditure relating to it would be deductible for normal income tax purposes.

1.8 Research methodology

According to Coetzee *et al.* (2014:27) a relativist world view is when “reality depends on many circumstances and factors”. In addition to this, it also states that “...if you have a relativist view of the world, you view knowledge as multi-layered and complex. A single phenomenon will have multiple interpretations.”

Based on this, the philosophical paradigm in which the research will be conducted will be the interpretiveist paradigm. The research will explore legislation, legal cases and other research to investigate the different dimensions of the research question.

Inductive reasoning will be used to conduct the research as legal cases will be analysed and conclusions will be drawn in order to establish certain principles. A post-structural or doctrinal research methodology will be applied to conduct the research as the relevant provisions of the Act, together with court decisions, published articles, reports and textbooks relating directly to the objectives will be analysed and conclusions drawn (McKerchar, 2008).

The definition of gross income as well as the general deduction formula will be evaluated to determine whether income from illegal activities is received or accrued in terms of the definition and whether the expenditure relating to it could be deducted for normal income tax purposes. There are specific sections in the Act that exclude or include certain income in terms of the definition of gross income in the Act. These sections will need to be evaluated and considered to determine whether they are applicable within the context of 'illegal receipts'. The study will also consider whether or not the capital or income nature of receipts will make any difference to or will have an influence on the normal income tax treatment of illegal receipts.

Relevant case law will also be identified and considered as not all phrases contained within the definition of gross income and the section on the general deduction formula are defined. Case law will also be analysed, compared and evaluated in an attempt to clarify some of the principles laid down in these relevant cases.

Another country is also selected to be compared to South Africa to obtain an international perspective. The country selected that will be compared to South Africa in this study is Australia. Please refer to the discussion under 1.3.2 for a motivation on why Australia is deemed to be an appropriate country for this comparison.

The comparative analysis between South Africa and Australia will include the following:

- An investigation on the possible differences between the two countries in respect of the interpretation and tax treatment of 'illegal receipts' and its related expenditure;
- The identification of any possible similarities or differences between the interpretation and application of principles established through court cases between these two countries.

1.9 Chapter outline and structure of the study

Chapter 2: Illegal activities and gross income

The purpose of this chapter is to determine whether illegal receipts adhere to and falls within the ambit of the general definition of gross income. Firstly the meaning of 'illegal receipts' is determined as understanding this concept is crucial before it could be determined whether these receipts should form part of gross income. The items specifically included in the definition of gross income are then analysed to determine whether they can also relate to illegal receipts. Court cases specifically dealing with illegal transactions will be analysed to identify similarities.

Chapter 3: Deduction of expenditure resulting from illegal activities

This chapter will focus on expenditure resulting from illegal activities. The deductibility of this expenditure will be analysed by measuring it against the requirements of the general deduction formula in the Act. Specific sections dealing with illegal transactions will also be identified. The interpretation notes and draft interpretation notes issued by the SARS will also be considered.

Chapter 4: Taxability of illegal activities: An international perspective

In this chapter a critical analysis and comparison of legislation and practices in Australia are performed to determine its applicability in a South African context. In addition, this chapter attempts to provide commentary on whether it is an internationally accepted practice to include illegal receipts in the taxable income of the taxpayer and for expenditure as a result of the illegal activities to be deductible for normal income tax purposes.

Chapter 5: Summary, conclusions and recommendations

This chapter will summarise the findings of chapters 2 to 4 in order to draw final conclusions in respect of the research question and to make possible recommendations. A suggested model/decision tree will be developed that could be applied in an objective/subjective context by taxpayers to determine the taxability of illegal receipts.

Chapter 2: Illegal activities and gross income

2.1 Introduction

The SARS has issued a draft interpretation note on ‘the deductibility of expenditure and losses arising from embezzlement or theft of money’ (SARS, 2013). In this draft interpretation note the SARS attempts to clarify the uncertainties in respect of the deductibility of expenditure resulting from illegal activities as well as the tax treatment of illegal receipts. In this draft interpretation note the SARS is of the opinion that: “*A thief will be taxed on embezzled or stolen money if it falls within the thief’s gross income.*” (SARS, 2013:11)

For an amount to be included in the gross income of a taxpayer it needs to meet the definition of gross income as defined in the Act. There are no sections in the Act that deal specifically with receipts from illegal activities. It therefore follows that receipts from illegal activities also have to meet the definition of gross income in terms of the Act before it could be included in the taxable income of a taxpayer. This principle is also in accordance with the method used by the SARS in the draft interpretation note (SARS, 2013) where the definition of gross income was also analysed to determine whether receipts from illegal activities needs to be included in gross income.

The definition also provides a list of receipts and accruals in terms of paragraphs (a) to (n) of Section 1 of the Act that should specifically be included as part of gross income. These paragraphs will be analysed to determine how they relate to the receipts from illegal activities.

After the various components of the definition of gross income are analysed an analysis will be performed of case law dealing specifically with receipts from illegal activities. This will be done to determine whether there are specific principles established through case law that determine the taxability of receipts from illegal activities.

2.2 The meaning of illegal receipt

The Oxford online dictionary (2014) defines the term ‘illegal’ as “*contrary to or forbidden by law, especially criminal law*”. There is no definition of the term ‘receipt’ in the Act but the term ‘received by’ forms part of the definition of gross income in Section 1 of the Act. In *Geldenhuys v CIR* (1947) it was determined that in order for an amount to be classified as ‘received by’ it must be received by the taxpayer “on his own behalf or for his own benefit”. A

further interpretation was offered in COT v G (1981) where the term 'received by' was described as to "take into one's hand, or into one's possession (something held out or offered by another); to take delivery of (a thing) from another".

Based on the interpretation by the two court cases above as well as the definitions contained in The Oxford online dictionary (2014) it is therefore submitted that 'illegal receipts' could be defined as receipts acquired by a person for his/her own benefit obtained through means forbidden by law.

2.3 The definition of gross income

Income from illegal activities should meet the definition of gross income in the Act before it could be included in the gross income of a taxpayer. This is in agreement with the method followed by the SARS in its draft interpretation note (SARS, 2013) to determine whether income as a result of theft or embezzlement should be included in the gross income of criminals or not.

Gross income is defined in Section 1 of the Act 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 the 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 person from a source within or deemed to be within the Republic,*

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely..."

The definition can be broken down into the following components:

- i) total amount;
- ii) in cash or otherwise;
- iii) received by;
- iv) accrued to;
- v) in favour of;
- vi) during such year or period of assessment;
- vii) residence and source; and

viii) excluding receipts of a capital nature.

The various components included in the definition of gross income are not formally defined in the Act. No specific mention of receipts from illegal activities is made within the definition of gross income either. Most of these components in the definition have been the subject of court cases in the past. Some of the court cases also specifically deal with receipts that the taxpayer has received by conducting illegal activities.

2.4 Case law and gross income

Case law has, to some extent, given direction to the meaning of the various components of the definition of gross income. If an item is therefore not specifically included in terms of paragraphs (a) to (n) of the definition of gross income, then case law could be applied to determine if a specific item falls within the ambit of the definition.

As there is currently no distinction between receipts from legal and illegal activities in the Act, the principles established from these court cases should be applicable to receipts from both legal and illegal activities. The definition of gross income will therefore be analysed by using case law to determine whether it is possible to conclude that income from illegal activities could be included in gross income.

2.5 Analysis of gross income using general case law

General case law dealing with the various components of the definition of gross income definition needs to be examined before analysing case law specifically dealing with receipts from illegal activities. The reason for this is because the principles established by general case law are also used in the court cases specifically dealing with receipts from illegal activities and will therefore form a basis for the discussion to follow.

The key components of the definition of gross income that will determine whether illegal receipts could be included in gross income are:

2.5.1 Total amount

A landmark case dealing with the component 'total amount' is the case of *Lategan v CIR* (1926). In this case the court had to decide what is meant by the term "amount" to be

included in the gross income of a taxpayer. The court held in this case that “...*the word ‘amount’ must be given a wider meaning [than an amount of money] and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value*”. Therefore not only actual money received or accrued by the taxpayer should be included in gross income, but also every form of property that can be converted into money or has a monetary value.

In the case of *CIR v Butcher Bros (Pty) Ltd (1945)* the Commissioner was unable to determine the amount that accrued to a taxpayer. The court determined in this case that as a result of this there can be no amount included in the gross income of the taxpayer. It needs to be possible to determine the amount that was accrued to or received by the taxpayer before there can be any inclusion in the gross income of the taxpayer.

Based on the above principles it is clear that for receipts derived from illegal activities to be taxable, there has to be an amount or something that has a monetary value. In addition to this, it should also be possible to determine the amount or the value to be included in the taxpayer’s gross income.

2.5.2 In cash or otherwise

In *Ochberg v CIR (1931)* the court held that the value of the shares should be determined objectively. This was again confirmed in *Lace Proprietary Mines Ltd v CIR (1938)* where it was established that the value of non-monetary items (such as shares) in the hands of a taxpayer is irrelevant and that the value should be determined objectively by referring to the open market value of such items. In *ITC 475 (1940)* the value of shares was included in the gross income of a taxpayer by the court even though the taxpayer argued that the shares did not have any value in its hands.

From the aforementioned cases it could therefore be determined that any receipt that has a cash value or that could be converted into cash should be included in gross income. Based on this, cash receipts from illegal activities as well as any item received that could be converted into cash, could qualify for inclusion in gross income.

2.5.3 Received by

The *Geldenhuis v CIR (1974)* case played a prominent role in an attempt to determine the meaning of the term 'received by'. Steyn J remarked in this case: *"Both 'income' and 'taxable income' are in their respective definitions linked up with the definition of 'gross income' and it seems to be clear that in the definition of 'gross income' the words 'received by or accrued to or in favour of any person' relate to the taxpayer, and the words 'received by' must mean 'received by the taxpayer on his own behalf for his own benefit'..."*

The principle laid down here by the court is that 'received by' must mean received by the taxpayer on his own behalf for his own benefit. Based on this principle it therefore follows that one of the factors to consider is that receipts from illegal activities have to be received by a taxpayer on its own behalf and to its own advantage before it can be included in his or her gross income.

In *CIR v Genn & Co (Pty) Ltd (1955)* it was held that not every instance of obtaining control over monies will result in a receipt as per the definition of gross income in the Act. If an agent received or banked an amount on behalf of someone else the agent has not received it in terms of the definition of gross income. The same was held with regard to receipt of monies borrowed from someone else. If a taxpayer receives an amount with the obligation to repay it, it cannot be included in the gross income of such a taxpayer as the receipt will rather constitute a loan. If, however, a taxpayer has an obligation to repay a loan but there is no intention by the taxpayer to actually settle the amount due, the loan could arguably be under the control of the taxpayer rather than under the control of the lender.

In various court cases involving illegal receipts (*ITC 1789 (2005)*; *ITC 1545 (1991)*) the defendant usually attempts to argue that no control was obtained over the money and it should therefore not be taxable. The Genn case, as discussed above, was applied as the authority for this defence. In most cases the defence was unsuccessful.

The case of *Brooks Lemos Ltd v CIR (1947)* dealt with deposits received from customers by a company. In this case the company did not hold the deposits in trust for the customers. The deposits received were not deposited into a separate trust bank account either, but the funds were mixed with other funds to be used for the day-to-day operations of the company. The Commissioner then proceeded to include the deposit amounts in the gross income of the company on the basis that the amounts were received by the company. Deposits are normally just money held on behalf of customers that will normally eventually be paid back to such customers. The principle established in this case was that deposits received by

customers that are not held in a separate trust account are properly received by the taxpayer and should therefore be included in the gross income of such a taxpayer.

Illegal receipts in the form of deposits are to be treated in the same way as 'legal' deposits received. If illegal deposits, for example as part of an illegal operation or scheme, are not held in a trust or is mixed with the other receipts of a taxpayer and are utilised to fund ordinary business or personal expenditure of the taxpayer, it would be difficult for the taxpayer to prove to the Commissioner that the income should not be included in his/her gross income. The Commissioner will argue that the illegal receipt was received for the benefit of such a taxpayer.

2.5.4 *Accrued to*

In terms of the definition of gross income an amount received by or accrued to a taxpayer should be included in gross income. The 'or' used between 'received by' and 'accrued to' effectively means that an amount received by a taxpayer could be taxable even if the amount has not yet accrued to the taxpayer. It also means that a taxpayer can be taxed on receipts which he has not actually received yet but which he is entitled to receive.

The general rule according to De Koker and Williams (2010) is that if there is not a receipt or an accrual, there could be no tax liability. Although there are certain exceptions to this rule, these exceptions will not be dealt with in this discussion as they normally do not arise from illegal receipts, but are normally specifically included in the Act.

De Koker and Williams (2010) identified a further question for consideration. If a receipt or an accrual does not give rise to a benefit to the taxpayer should it then still be included in his gross income? An attempt was made to answer this question by the decision in the case of *Ochberg v CIR* (1931) (Williams, 2008:102). In this case the taxpayer did not dispute the valuation of the share done by the Commissioner but argued that he did not receive any additional benefit from the issue of the shares as he already had the controlling share in the company. The majority of the court held that the fact that there was no additional benefit for the taxpayer as a result of the issue was not the deciding factor.

Schreiner JA in *CIR v Genn & Co (Pty) Ltd* (1955) also stated the following in this regard:

"...the presence or absence of a benefit to the taxpayer from something that passes into his possession does not provide a proper test in applying the definition of 'gross income'..."

Therefore, there is no requirement that there must be a benefit for the taxpayer from illegal receipts for the amount to be included in his gross income.

In *SIR v Silverglen Investments (Pty) Ltd* (1969) the court concluded that the Commissioner cannot elect between the date of accrual and the date of receipt where the decision of including an amount in the gross income of the taxpayer is under consideration (De Koker & Williams, 2010). If the date of accrual and the date of receipt are in different years of assessment the Commissioner has to include the amount in the earlier of the two. If an amount is therefore received as a pre-payment it should be included in the year it is received even if it is only due in a subsequent year of assessment. It follows therefore that if an amount is due in one year of assessment but only received in a subsequent year of assessment it should be included in the year of assessment that it is due.

Illegal receipts would normally not be invoiced in the legal sense as it would not normally be owed by one party to another. The year in which the illegal receipts are actually received should then normally be used as the overriding factor to determine in which year it should be included in the gross income of the taxpayer.

2.5.5 In favour of

The landmark case dealing with the component 'in favour of' is the case of *CIR v The Witwatersrand Association of Racing Clubs* (1960). In this case the taxpayer organised a race-meeting with the proceeds to be divided between two charities. The Commissioner included the proceeds in the gross income of the taxpayer. The court held that the taxpayer acted as the principal and received the proceeds for its own benefit. The principle established in this case was that if a taxpayer received an amount as a principal and the taxpayer is then obliged to dispose of the receipt, the taxpayer has still received the receipt and the amount should be included in such taxpayer's gross income. The implication of this principle on illegal receipts is that even if a taxpayer disposes of an illegal receipt immediately after the receipt was obtained the taxpayer will still be liable for normal income tax on such receipt.

2.5.6 Residence and source

2.5.6.1 *Tax base of residents versus non-residents*

Residents therefore pay normal income tax in South-Africa on their worldwide income. Non-residents pay tax in South-Africa on their income from a South African source. The source of illegal receipts for a resident will therefore not be important as the resident will be taxed on worldwide illegal receipts, but the source of illegal receipts of a non-resident is crucial as the non-resident will only be taxed in South Africa on illegal receipts from a South African source.

2.5.6.2 *Section 9 of the Act*

Section 9 of the Act contains source rules with regard to several classes of receipts. The source rules in Section 9 of the Act will be mostly applicable to non-residents as non-residents are taxed on income from a South African source.

Section 9(2)(f) of the Act states that an amount is received from a source in South Africa if the amount: *“...is received or accrues in respect of the imparting of or undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in the Republic, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information.”*

Illegal receipts of a non-resident relating to industrial espionage, or bribery payments for the exchange of scientific, technical, industrial or commercial knowledge would therefore be from a South African source if the information will be used in the Republic.

2.5.6.3 *Case law applicable to source*

The term ‘source’ is not specifically defined in the Act. Watermeyer CJ stated the following in CIR v Lever Bros & Unilever Ltd (1946) in respect of the meaning of source: *“...one possible meaning is the originating cause of the receipt of the money, another possible meaning is the quarter from which it is received...”*

The courts have determined the source of certain transactions not included in Section 9 of the Act. For instance, the source of employment and service rendered is the place where the services are rendered. It does not matter where the contract was concluded or where the remuneration is paid. In ITC 77 (1927) it was decided that the source of the fees paid to a chairman for meetings in the Union was the place where the meetings was held. Therefore the source of remuneration received in return for services rendered would be the place where the services were rendered. Receipts from illegal services rendered (for example income as a result of bribery) by a non-resident in South Africa will therefore be taxable in South Africa.

In CIR v Epstein (1954) the activities test was used to determine the source of receipts from business activities. Centivres CJ stated in his judgement that: *“All the activities of the respondent were carried on in the Union and it was as a result of these activities that he earned the profits which the Commissioner now seeks to tax. It therefore follows that those profits were received from a source within the Union...”* (De Koker & Williams, 2010).

Illegal business activities will likely also be subjected to the activities test. If the activities test concludes that the illegal activities of the taxpayer are carried out in South Africa, the non-resident will be subjected to tax in South Africa.

2.5.6.4 Foreign entertainers and sportspersons

The taxation of foreign entertainers and sportspersons are specifically dealt with in section 47A to 47K of the Act. The term ‘entertainer or sportsperson’ is defined in Section 47A of the Act as: *“Includes any person who for reward:*

- (i) performs any activity as a theatre, motion picture, radio or television artist or a musician;*
- (ii) takes part in any type of sport; or*
- (iii) takes part in any other activity which is usually regarded as of an entertainment character;”*

Specified activities are defined in Section 47A(b) of the Act as:

”means any personal activity exercised in the Republic or to be exercised by a person as an entertainer or sportsperson, whether alone or with any other person or persons”.

The term entertainer is not clearly identified and the term 'specified activities' also leaves room for interpretation. It is therefore submitted that the terms 'entertainer' and 'specified activities' have a wide interpretation. The term could include activities such as prostitution services or other illegal entertainment services provided by a non-resident. If these illegal activities are included in the definition of 'entertainer' and 'specified activities' they will be subjected to Section 47B of the Act.

In terms of Section 47B of the Act foreign entertainers or sportspersons are subject to withholding tax of 15% on all specified activities exercised in the Republic. A resident who fails to deduct or pay over to the SARS the correct withholding tax from a payment made to a foreign entertainer or sportsperson will be personally held liable for the withholding tax on such a payment in terms of Section 47G of the Act. Income from illegal activities as a result of prostitution services or other illegal entertainment services could therefore be subject to withholding tax in South Africa and the person who pays for these services could be held liable for the payment of the withholding tax on such payments.

2.5.7 Excluding receipts of a capital nature

2.5.7.1 The nature of receipts

Capital proceeds from illegal activities are not specifically dealt with in the Act. The same principles which would normally apply to capital gains and losses on the disposal of assets will also apply to illegal capital proceeds.

The Eighth Schedule to the Act deals with capital gains and losses on the disposal of assets. Before the Eighth Schedule can be applied one first needs to determine whether a receipt is revenue or capital in nature. The principles and tests used to determine this has been set by case law. CIR v Visser (1937) is one of the landmark cases dealing with the question of capital versus revenue receipts. In this case Maritz J referred to the 'fruit and tree principle' and stated the following: *"... 'Income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree."*

In this case the principle was established that revenue (the fruit) is produced by capital (the tree). If a producer of illegal drugs for instance acquired a machine (the tree) to be used in the manufacturing process of the drugs (the fruit) and then later wants to sell the machine at a profit, the profit will be subject to capital gains tax consequences. This will obviously only occur if the Commissioner becomes aware of the transaction.

2.5.7.2 *The intention of the taxpayer*

Additional tests are applied by the South African courts to determine if a receipt is revenue or capital in nature. This includes objective tests (such as the nature and reason of the receipt with no bearing on intention) and subjective tests (such as the intention of the taxpayer and whether or not the taxpayer is conducting a scheme of profit making). According to the SARS (2011:10) the most important subjective test to determine whether a receipt or accrual is of a capital nature is the intention test.

De Koker and Williams (2010) support this viewpoint and indicate that the intention of the taxpayer is the golden rule employed by the courts in deciding whether the proceeds arising from the disposal of an asset are income or capital in nature. The judge in *CIR v Stott* (1928) stated the following: *“The primary intention with which property is acquired is conclusive as to the nature of the receipt arising from the realization of that property unless other factors intervene which show that it was sold in pursuance of a scheme of profit-making.”*

With illegal activities the intention of the taxpayer will be considered the same way as the intention of the taxpayer would be considered with legal activities. If the intention of the taxpayer is to hold the asset for capital appreciation rather than a short term gain then the proceeds on the disposal of the asset will be capital in nature. This treatment should be the same for legal and illegal activities. The taxpayer’s own submission with regard to his or her intention will be considered by the courts together with external factors. It is, however, submitted that a taxpayer’s own submissions under scrutiny of illegal activities will not carry as much weight as with legal activities.

(i) Change of intention

- The intention of a taxpayer is subjective in nature and could therefore change as a result of a change in circumstances or simply because the taxpayer changed his mind. This change of intention is not a change of intention between holding an asset for legal and illegal activities, but rather a change in the nature of the asset for normal income tax purposes. This is illustrated in *CIR v Richmond Estates (Pty) Ltd* (1956) where assets have changed from trading stock to fixed capital by way of a change of intention of the taxpayer.

A change in intention of a taxpayer can therefore result in the reclassification of an asset previously held as capital to trading stock and the profit on the disposal of the asset will therefore not be subject to capital gains tax but will

meet the definition of gross income in Section 1 of the Act and the receipt will be included in the gross income of the taxpayer. This principle will be the same for assets held as part of either illegal or legal activities.

(ii) *Mixed intentions*

It is possible for a taxpayer to acquire an asset with mixed intentions. In *COT v Levy* (1952) the court held that the dominant purpose of a taxpayer in acquiring an asset should be considered. The fact that there was possible alternative ways in dealing with the transaction should not be considered when deciding what the intention of the taxpayer was when the asset was acquired. Only when the asset is sold should the dominant purpose during acquisition be considered. This principle will again be applied in the same manner irrespective of whether the assets are held as part of legal or illegal activities.

2.5.7.3 Carrying on a trade or a scheme of profit-making

One of the subjective tests applied by the courts to determine if an amount received is capital or revenue in nature is whether or not the taxpayer was carrying on a trade or a scheme of profit-making. If a scheme of profit-making was carried on then the proceeds should be revenue in nature and if not, the proceeds should be capital in nature.

i) Isolated illegal transactions

A 'trade' is defined in Section 1 of the Act as: "...every profession, trade, business, employment, calling, occupation or venture...". This is a broad definition that could be widely interpreted. As can be seen from the previous discussions an amount does not have to be derived from a trade to be included in the gross income of a taxpayer. The receipts of a person who is carrying on a scheme of profit-making will normally, however, be included in the definition of gross income. In this regard, refer to the case of *CIR v Stott* (1928) as discussed under section 2.4.7.2.

If this principle established in the case of *CIR v Stott* is applied to illegal activities, then receipts from illegal activities which have many of the characteristics of a legal scheme of profit-making (for example, prostitution, hijacking or drug-dealing), will normally have to be included in the gross income of the taxpayer.

ii) *Isolated illegal transactions*

An isolated transaction may be more difficult to classify as a scheme of profit-making. In *CIR v Stott* (1928) the court treated the case as an isolated transaction as only the facts of the case in question were considered. Based on this case isolated transactions by individual taxpayers are normally classified as capital in nature.

However, in *CIR v Leydenberg Platinum Ltd* (1929) the court found that the profits made by the company on the properties sold were made by carrying on a scheme of profit-making and therefore had to be included in the taxable income of the company. In this case Stratford JA observed that: *“The test to be applied in the case of an individual is not quite the same as the test in the case of a trading company”*. The reason for this statement is that a trading company is normally authorised by its constitution to carry out more than one business at a time. Based on this case, isolated transactions carried out by company taxpayers are normally classified as being part of its scheme of profit-making.

The courts have concluded, as a result of the above case as well as other cases, that a company could carry out an isolated transaction as part of a profit-making scheme, but an individual taxpayer could normally not. Isolated illegal activities carried out by individuals (such as isolated housebreakings) could therefore be excluded from gross income as a result of the principles laid down in the aforementioned cases.

2.5.7.4 *Capital gains tax*

Paragraph 2 of the Eighth Schedule to the Act states that: *“...this Schedule applies to the disposal on or after valuation date of –*

(a) Any asset of a resident; and

(b) The following assets of a person who is not a resident, namely –

(i) Immovable property situated in the Republic, held by that person or any interest or right of whatever nature of that person to or in immovable property situated in the Republic; or

- (ii) *Any asset which is attributable to a permanent establishment of that person in the Republic*”

Whether a receipt is capital in nature is normally determined by the application of case law and the tests described above. If it is determined that a receipt is capital in nature the Eighth Schedule to the Act will apply. Paragraph 2 of the Eighth Schedule will be applicable when the capital asset is disposed of.

Capital proceeds from both legal and illegal activities will be included in the taxable income of a taxpayer. The Eighth Schedule to the Act, however, contains certain exclusions where the capital gain or capital loss on the disposal of an asset should be disregarded. These exclusions are available for capital proceeds from both legal and illegal activities. Some of these exclusions could therefore be applied to exclude the capital gains on illegal activities from capital gains tax.

i) Primary residence exclusion

Paragraph 45 of the Eighth Schedule to the Act specifically deals with the primary residence exclusion. Paragraph 45 states that:

“(1) Subject to subparagraphs (2), (3) and (4), a natural person or a special trust must, when determining an aggregate capital gain or aggregate capital loss, disregard –

(b) so much of a capital gain or capital loss determined in respect of the disposal of the primary residence of that person or that special trust as does not exceed R2 million; or

(b) a capital gain or capital loss determined in respect of the disposal of the primary residence of that person or that special trust if the proceeds from the disposal of that primary residence do not exceed R2 million.”

If, for example, the producer of illegal drugs acquires a primary residence with the profits realised from his illegal activities and then later disposes of the residence, the primary residence exclusion will also apply. If the primary residence is also used as the place where the drugs are manufactured the drug producer will have to apportion the amount of the primary residence exclusion between the floor space used for this illegal business activities and the floor space applied for personal use. Only the section of the house used for personal purposes will qualify for the exemption.

ii) Other exclusions

Paragraph 52 to 64B of the Eighth Schedule to the Act deal with other circumstances under which capital gains and capital losses should be disregarded. Paragraph 60 deals with gambling, games and competitions as follows:

” (1) A person must disregard a capital gain or capital loss determined in respect of a disposal relating to any form of gambling, game or competition.

(2) Notwithstanding subparagraph (1), a capital gain may not be disregarded-

a) By any person other than a natural person; or

b) By any natural person, unless that form of gambling, game or competition is authorised by, and conducted in terms of, the laws of the Republic.”.

It is therefore submitted that the capital gains realised from any illegal gambling activities will be included in the taxable income of the taxpayer, but any capital losses will have to be disregarded.

2.5.8 Conclusion on illegal activities and gross income

The SARS, in its draft interpretation note (SARS, 2013), attempted to determine if income as a result of theft or embezzlement should be included in the gross income of the thief using the definition of gross income in Section 1 of the Act. Using this same method as applied by the SARS it was determined that illegal receipts adhere to and fall within the ambit of the general definition of gross income through the application of general case law principles, unless the illegal receipts are capital in nature.

Specific case law applicable to illegal activities could however have established specific rules pertaining to receipts from illegal activities that differ from the general application of case law falling under the definition of gross income. This specific case law will now also be analysed to determine whether or not the same principles will be applicable.

2.6 Case law specifically applicable to illegal receipts

South African case law specifically dealing with the taxation of illegal receipts is limited. The case law available has, however, established a number of principles to be applied in future

cases. In the draft interpretation note issued by the SARS (SARS, 2013) case law specifically applicable to illegal receipts were also identified and analysed to determine the principles that could be applied as part of the process to determine the taxability of illegal receipts.

2.6.1 *Illegal receipts*

One of the first reported cases of illegal receipts was CIR v Delagoa Bay Cigarette Company (1918). In this case the court held that the payment of prize money was an expense incurred in the production of a company's income and did not constitute the distribution of income after it was earned. It was further held that the legality or illegality of the business which generated the income was not a matter of concern when determining the taxability of the income. In this regard Bristowe J stated the following: *"I do not think it is material for the purpose of this case whether the business carried on by the company is legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum... The source of the income is immaterial."*

In this case the general principles applicable to the definition of gross income were used to determine if the receipts were taxable as the court was of the opinion that it did not matter whether the receipts were obtained from a legal or illegal source as the income tax treatment thereof would be the same.

2.6.2 *Stolen money and goods*

In COT v G (1981) the court held that stolen money never becomes the property of the criminal just as borrowed money does not become the property of the person borrowing it. Fieldsend CJ also highlighted that: *"...In short a thief takes, he does not receive, and that is what the respondent in this case did."* He further stated that:

"I appreciate that the relevant English tax legislation is based upon taxation of the profits of trade, but the remarks, albeit obiter, of Lord Denning in Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd 1963 AC 1 at 20 are of interest in showing the need for a common sense approach. He said:

'...take a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their

efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any details that it lacks. But still it is not a trade, nor an adventure in the nature of trade. And how does it help to ask the question: If it is not a trade, what is it? It is burglary and that is all there is to say about it.”. (Williams, 2008:196)

The court in this case concluded that the money that was stolen by the taxpayer was not taxable as it was not received by him. According to Williams (2008) the real question in this case was overlooked as the question should not have been whether the receipts had been received for tax purposes but whether the receipts possessed the quality of income in the hands of the taxpayer. This case was later overruled by the Supreme Court of Appeal decision in *MP Finance Group CC (In Liquidation) v C* (2007).

In the case of *ITC 291* (1933) court held that as no money was due from the supposed debtor, the payment could not be interest or other income in the hands of the taxpayer. In this case the taxpayer also received the receipts but as the income did not possess the quality of income (no amount was actually due from the debtor) it was not deemed to be taxable by the court.

In *ITC 1545* (1991) the taxpayer traded for profit in stolen diamonds with the full knowledge that the diamonds were in fact stolen goods. The conduct of the taxpayer amounted to theft. In this case both the taxpayer and the Commissioner agreed that the proceeds from the sale of the stolen diamonds amounted to receipts and accruals as per the definition of gross income and should therefore be included in the gross income of the taxpayer.

In *ITC 1545* (1992) the taxpayer sold milk cultures to the public. The public then used ‘activators’ to grow the milk cultures which they then dried and then sold back to the taxpayer’s company. This was in essence a pyramid scheme. The taxpayer submitted as part of his defence that as he was not entitled to the proceeds from the transactions as it was illegal he should not be taxed on it. The court held that amounts ‘received by’ or ‘accrued to’ should be included in gross income. The fact that the money did not accrue to the taxpayer did not mean that he did not receive it. Because the taxpayer did receive the illegal money for his own benefit it had to be included in his gross income and therefore be taxed.

ITC 1789 (2005) was another case involving a classic pyramid scheme. As in *ITC 1545* above his legal representative argued that as he was not entitled to the funds because it was an illegal scheme he should not be taxed on it. The basis for the argument was a comment made in the *Genn* case that the borrower that is under an obligation to repay the funds does

not receive it for his own benefit. The court held that as the taxpayer did indeed receive the deposits for his own benefit, as his intention was to gain from it personally, it was in fact received by him and should therefore be included in his gross income.

In ITC 1624 (1996) the appellant overcharged one of its customers. The issue under review was whether or not the amount overcharged constituted an amount received. The judge in this case distinguished between the circumstances in which a person stole money from the circumstance where a person overcharged his customers fraudulently in the course of his trading activities. In the latter case the amount would be taxable as it fell within the definition of gross income.

ITC1792 (2005) and ITC 1810 (2006) are however in direct conflict with ITC 1624 (1996). ITC 1792 (2005) involved secret profits realised by a taxpayer, who was a member of a stockbroker firm. The issue in this case was whether the receipt of secret profits by an agent falls within the definition of gross income and would therefore be taxable in the hands of the agent. The court held that by law neither the shares bought or the secret profits realised by the appellant or the syndicate were received in his or its own right or for or its own benefit. As the benefits were rather received by the principal the secret profits realised by the appellant did not qualify as gross income and as a result were not be taxable.

The judge in ITC 1792 (2005) fell back on the law of agency to make a decision in this case. The law of agency determines that secret profits realised by an agent could never become the property of such an agent as it belongs to the principal. The principal should therefore be taxed on such profits. As the principal is taxed on the profits the agent cannot be taxed on the same profits.

Similarly in ITC 1810 (2006), the judge fell back on the Law of Insolvency to decide whether investors will be taxed on interest paid in a pyramid scheme. He decided that as there was a legal condition attached to the receipt or accrual it could never be taxable in the hands of the investors. This legal condition referred to is that if the scheme is to be declared insolvent, any interest paid would have to be returned where the payer of the interest is to be placed in liquidation.

MP Finance Group CC (In Liquidation) v C (2007) was one of the landmark cases dealing with illegal receipts. In this case, Marietjie Prinsloo, with the help of her family and employees, operated an illegal and fraudulent pyramid scheme in Gauteng and neighbouring provinces. In this scheme she convinced investors to part with their money by promising unsustainably high returns on their investments. She then ran a cash float where most of the investors' money was pooled. She paid interest and some of the capital back to

investors from this float. Substantial amounts of money were also withdrawn by Prinsloo and her accomplices for personal use. What was also very important in this case was that Prinsloo as well as her accomplices knew that the scheme was insolvent, fraudulent and that it would not be possible to repay all the money deposited by the investors. The defence of the appellant rested on the fact that the scheme was liable by law for refunding the deposits to the investors. It could therefore not be said that the deposits were received by the appellant. As the deposits were not received by the appellant, it did not fall within the definition of gross income as defined in Section 1 of the Act.

The Supreme Court of Appeal held that whatever contractual intention Prinsloo and her accomplices had before 1 March 1999, it changed after this date as the entities which Prinsloo ran realised profits by way of defrauding the public. Whatever money was received from the public was therefore received in terms of the definition of gross income as per the Act and should therefore be taxable. The taxpayer needs to discharge the onus of proof that the monies received should not be included in gross income as per the now repealed Section 82 of the Act (replaced by Section 102 of the Tax Administration Act (28 of 2011)). In terms of the old Section 82 of the Act the burden of proof that an amount is not taxable rested upon the taxpayer. In the MP Finance Group case, Howie P stated the following:

“The sole question as between the scheme and fiscus is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Unquestionably they did. They were accepted by the operators of the scheme with the intention of retaining them for their own benefit. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act. In other words it does not matter for present purposes that the scheme was not entitled, as against the investors, to retain their money. What matters is that what they took in was income received and duly taxable...”

2.6.3 Concluding on specific case law applicable to illegal receipts

In the draft interpretation note issued by the SARS (SARS, 2013) case law specifically applicable to illegal receipts were identified and analysed to determine the principles that could be applied as part of the process to determine the taxability of illegal receipts. The principles established by the case law specifically applicable to illegal receipts are however mostly derived from an analysis of the phrases in the definition of gross income and applying this to the facts of each case. Applying the definition of gross income in Section 1 of the Act

to the illegal receipt will therefore be a significant step to determine the tax treatment of the receipt.

In Section 1 of the Act there are items specifically included in the definition of gross income. These specific inclusions should be accessed before the phrases in the definition of gross income are used to determine if receipts are to be included in gross income.

2.7 Income specifically included in gross income

2.7.1 Introduction

Paragraph (a) to (n) of the definition of gross income specifically include certain items in gross income. The items specifically included would not necessarily have been included in gross income by applying the definition of gross income to the receipt. Although illegal receipts are not specifically listed in paragraph (a) to (n) the items listed should be analysed to determine if illegal receipts will have an impact on the tax treatment of these items.

2.7.2 Know-how

Paragraph (gA) of the definition of gross income in Section 1 of the Act specifically includes in gross income: *“any amount received or accrued from another person as consideration (or payment of like nature) for the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or for the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information;”*.

It can be argued that payments relating to industrial espionage, or bribery payments for the exchange of scientific, technical, industrial or commercial knowledge could fall within the ambit of this paragraph due to the fact that this paragraph allows for a wide interpretation. These payments are therefore to be included in the gross income of the person receiving it and case law need not be applied as an argument for the amount to be taxable.

2.7.3 Services rendered

Paragraph (c) of the definition of gross income in Section 1 of the Act specifically includes in gross income: *“any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount (other than an amount referred to in section 8 (1)) received or accrued in respect of or by virtue of any employment or the holding of any office...;”*

Bribery payments for other knowledge not included in paragraph (gA) of Section 1 of the Act or payments made to a person to act in a certain way or not to act could be classified as payments made for services rendered. These illegal receipts received by the taxpayer will therefore also have to be included in the gross income of the person and will therefore be taxable.

2.7.4 Fringe benefits

Paragraph (i) of the definition of gross income in Section 1 of the Act includes the cash equivalent of any fringe benefit calculated in terms of the Seventh Schedule to the Act. In terms of Paragraph 2 of the Seventh Schedule a fringe benefit will only arise if there is an employee-employer relationship and the benefit is granted by virtue of such employment or as a reward for services rendered or to be rendered by the employee.

Unauthorised use of company assets or unauthorised personal expenditure by an employee can therefore not result in a fringe benefit as the employer is normally not aware of such incidents. If the employer does, however, become aware and then reduces the employee's salary as a result to make up for the additional expenditure incurred there will be a fringe benefit. The amount should then be calculated in terms of the Seventh Schedule and included in the gross income of the employee.

If there is no employee-employer relationship there can be no fringe benefits in terms of the Seventh Schedule. Misappropriation of employer-owned assets and unauthorised expenditure by third party contractors are therefore not covered by the Seventh Schedule.

2.7.5 Conclusion

Illegal receipts are not specifically mentioned in paragraph (a) to (n) of the definition of gross income which includes specific items in the definition of gross income. Some of the items included could, however, have an application within the context of illegal receipts. It is submitted that if there is a sufficient connection between the illegal receipt and the specific inclusion the illegal receipts could be specifically included in the definition of gross income in Section 1 of the Act. This inclusion can be done without even having regard to the rest of the definition of the gross income to determine whether the receipts should be included.

2.8 Conclusion on receipts resulting from illegal activities

The taxation of illegal receipts is by no means a subject with clear guidance in legislation and case law. The SARS has issued a draft interpretation note (SARS, 2013) dealing with the deductibility of expenditure and losses arising from embezzlement or theft of money. Included in this draft interpretation note is a section dealing with the receipt of embezzled or stolen money. This is also a further indication that case law and legislation have still not provided full guidance on the taxation of illegal receipts.

The SARS is of the opinion in the draft interpretation note that: "A thief will be taxed on embezzled or stolen money if it falls within the thief's gross income." (SARS, 2013:11). Based on the examination of the components of the definition of gross income in the sections above as well as the principles established by case law dealing specifically with taxation of illegal receipts it is concluded that illegal receipts could be included in gross income if it meets the definition of gross income.

After the tax treatment of illegal receipts is determined the tax treatment of deductions as a result of illegal receipts should also be considered as this also forms an important component of the taxation of illegal activities.

Chapter 3: Deduction of expenditure relating to illegal activities

3.1 Introduction

An important component of the taxation of illegal activities is the tax treatment of the deduction of expenditure relating to illegal activities. The SARS has issued a draft interpretation note (SARS, 2013) dealing with the deductibility of expenditure and losses arising from embezzlement or theft of money. The focus of the draft interpretation note is more from the perspective of a business with legal activities incurring losses due to embezzlement or theft of money. The fact that there was a need to issue a draft interpretation note is a clear indication that uncertainty still exists as to whether or not expenditure relating to illegal activities should be deductible for normal income tax purposes.

In the draft interpretation note (SARS, 2013) the general deduction formula in Section 11(a) as well as Section 23(g) and 23(c) were considered to determine whether expenditure and losses arising from embezzlement or theft of money should be deductible for normal income tax purposes. In this study the general deduction formula in Section 11(a) read together with section 23(g) will also be analysed using general case law to establish whether the requirements of the general deduction formula would allow for the deduction of expenditure as a result of illegal activities. There is also case law where a specific ruling was made on the deductibility of expenditure as a result of illegal activities. This case law will be analysed to determine whether the principles established are in agreement with the principles of the general deduction formula.

Section 23(o) deals with expenditure relating to corrupt activities as well as the deduction of fines due to unlawful activities. Section 23(o) is currently not included in the draft interpretation note (SARS, 2013) issued by the SARS as the draft interpretation note only deals with the specific topic of embezzlement or theft of money. As the scope of this study is more comprehensive, Section 23(o) will also have to be considered to determine its impact on the deduction of expenditure relating to illegal activities.

3.2 The general deduction formula

In the absence of specific Income Tax Legislation applicable to expenditure relating to illegal activities, the general deduction formula should be applied to determine whether expenditure relating to illegal activities could qualify for a deduction for normal income tax purposes. In

the draft interpretation note issued by the SARS (SARS, 2013) the general deduction formula in Section 11(a), read together with Section 23(g) was also analysed to determine whether expenditure and losses arising from embezzlement or theft of money should be deductible for normal income tax purposes. The same method will be applied in this study to determine the deductibility of expenditure relating to illegal activities.

The general deduction formula is set out in in Section 11(a) of the Act as follows:

“For the purposes 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;”.*

read together with Section 23(g) of the Act as follows:

“...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;”.

The components included within Section 11(a) and Section 23(g) of the Act, as stated above, are not defined in the Act. Case law has to be applied to determine their meaning.

The general deduction formula could be divided into the following elements, all of which need to be present before any expenditure could qualify for a deduction for normal income tax purposes:

- i) carrying on any trade;
- ii) the income;
- iii) expenditure and losses;
- iv) actually incurred;
- v) during the year of assessment;
- vi) in the production of income;
- vii) not of a capital nature; and
- viii) to the extent not laid out for the purposes of trade.

These components will now be analysed individually to determine their meaning and applicability to the deduction of expenditure resulting from illegal activities.

3.2.1 *The carrying on of any trade*

The preamble to Section 11(a) of the Act requires that the carrying on of a trade needs to be present before there could be a deduction in terms of the general deduction formula. This is different from the requirements of receipts and accruals to be included in the definition of gross income.

For an item to be included in the definition of gross income a trade need not necessarily be present. A good example of this is interest income and dividend income which are not normally receipts associated with a trade but receipts from a scheme of profit making. In ITC 1476 (1989) it was held that: “...*the carrying on of a trade involves an ‘active step’, something more than a watching over existing investments that are not income-producing and are not intended or expected to be so.*” If no income is therefore produced or if income is produced that does not require an ‘active step’ then a taxpayer will not be carrying on a trade and there will be no deduction available in terms of the general deduction formula.

This is also in agreement with the practice note (SARS, 1994) issued by the SARS dealing with the income tax consequences with regard to interest paid on moneys borrowed. In this practice note (SARS, 1994) it is stated that the intention of the taxpayer should also be considered when it is determined whether or not a taxpayer is carrying on a trade. According to the practice note (SARS, 1994) if the intention of the taxpayer is to make a profit it will be a good indication that the taxpayer is carrying on a trade.

‘Trade’ is defined in Section 1 of the Act as follows: “*includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property...*”. In *Burgess v CIR* (1993) the court held that the definition of trade “...should be given a wide interpretation.” (Williams, 2008:252). It does not matter if a venture that a taxpayer is involved in carries little risk. As long as a taxpayer risks something with the objective of making a profit it will be considered to constitute a trade. The objective of a taxpayer when engaged in illegal activities is normally also to realise a profit. In addition to this, there is normally a measure of risk associated with illegal activities. It can also be argued that for instance a burglar or fraudster does exercise a certain level of skill and ingenuity when applying their trade. It is therefore concluded that illegal activities could constitute and fall within the ambit of the definition of ‘trade’.

In ITC 1653 (1998) the court was of the opinion that the main objective of a taxpayer who acquired a property was to obtain it as an asset for capital appreciation and that the expenditure was therefore not incurred wholly or exclusively for the purposes of a trade. In

Reef Estates Ltd v CIR (1954) the court also held that the expenditure relating to an empty stand used as a parking site was not incurred to earn rental income but for the purpose to hold the stand as an asset. The expenditure had therefore further not been incurred wholly and exclusively for the purposes of the taxpayer's trade. If the main motive of a taxpayer is therefore not to carry on a trade then there is no basis to deduct the expenses associated with the activities under the general deduction formula. In ITC 1627 (1997) the taxpayer tried to off-set interest on loans that he incurred on his township development activities against salary income after his township trading activities ceased. The taxpayer was therefore trying to offset income from one activity with expenses relating to another activity. The taxpayer was also able to prove that he was engaged in a trade. The principle established in this case was that a taxpayer will be allowed to offset income from one activity with expenses relating to another activity if the taxpayer is carrying on a trade. Section 20A of the Act does however contain ring fencing of the assessed losses of certain trades and this section should therefore also be considered when the principle is applied.

In Borstlap v SBR (1981) some of the expenses incurred by the taxpayer were disallowed by the court as the expenses were not incurred to earn rental income but to prepare the property for the construction process. In this case the court allowed for an apportionment of a global amount that was paid that was partially allocated to capital and partially expenditure incurred as part of carrying on a trade. Apportionment of expenditure is therefore acceptable if a global amount is paid and part of the expenditure was a part of carrying on a trade.

The carrying on of a trade is one of the requirements that must be met before expenditure can be deducted using the general deduction formula. Because the definition of trade has a wide interpretation it will be possible to argue that illegal activities should also be incorporated in the definition. If the expenditure relating to the illegal activities is, however, not incurred wholly and exclusively for the purposes of the taxpayer's illegal trading activities then the taxpayer will not be allowed to deduct the expenditure.

3.2.2 *The income*

Income is defined in Section 1 of the Act as “...*the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax...*”. Section 23(f) of the Act further prohibits a deduction for normal income tax purposes “...*any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined...*”. The effect of section 23(f) is therefore

to disallow the deduction of expenditure for normal income tax purposes if there will never be income as defined in Section 1 of the Act associated with the income.

This principle is also confirmed in *CIR v The Standard Bank of SA Ltd (1985)* where the court disallowed a proportion of the interest paid by the bank as some of the deposits received from its customers were used to produce exempt dividend income. As receipts in the form of local dividends are exempt in terms of section 10(1)(k) of the Act it does not constitute income as defined in Section 1 of the Act. As a result of this, the expenditure associated with the receipts was disallowed as a deduction.

In *SIR v Rand Selections Corp Ltd (1956)* the expenses incurred by the taxpayer were apportioned by the court and the portion allocated to the exempt dividend receipts was disallowed as a deduction for tax purposes. This method was also followed in *Commissioner for South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd (2014)*. Based on this it is therefore allowed to apportion expenses between those associated with exempt receipts and those associated with taxable receipts and to claim only the expenses associated with taxable receipts as a deduction in terms of the general deduction formula.

In terms of the general deduction formula it is a requirement that there must be income associated with the expenses claimed as a deduction in terms of the general deduction formula. A taxpayer can therefore not claim expenses resulting from illegal activities as a deduction without also declaring the actual receipts associated with such expenditure. This effectively means that a taxpayer will have to declare its receipts from illegal activities and bear the risk of being prosecuted as a result of it, before the taxpayer would be allowed to claim deductions against such illegal receipts. The likelihood that taxpayers will actually declare their illegal receipts is therefore debatable and open for interpretation.

3.2.3 *Expenditure and losses*

In *Joffe & Co (Pty) Ltd v CIR (1946)* the meaning of “loss” was described by Watermeyer CJ as “...in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.” In this case a taxpayer paid compensation to the family of a worker who was killed while on duty and sought to deduct such expense. The Commissioner disallowed the expense and the court held that “*There was no evidence that the negligence which caused the damages was an inevitable concomitant of the taxpayer’s business.*”

Based on this a taxpayer will have to prove that the loss or expenditure was as a result of a normal business risk or in the normal course of the operations of the taxpayer.

In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR (1936)* the court was of the opinion that the term 'loss' means "...losses of floating capital employed in the trade which produces the income". As a result of this, capital losses were therefore excluded and thus could not be deducted in terms of the general deduction formula.

Thus, there needs to be an expenditure or loss as a result of illegal activities before the general deduction formula can be applied to deduct expenditure resulting from illegal activities from the income of a taxpayer. The illegal expenditure or loss also needs to be closely related to the normal business operations or a loss as a result of an expected business risk of the taxpayer.

3.2.4 *Actually incurred*

The difference between actually incurred and necessarily incurred widens the scope of tax deductible expenditure. What might be an unnecessary high expense as a result of ineffective business conduct according to the Commissioner cannot be disallowed on this base as the expense was still actually incurred.

In the case of *Caltex Oil (SA) Pty Ltd v SIR (1975)* the taxpayer incurred liabilities to two of its overseas co-subsidiaries in sterling. In this case the principle was established that an expense arises when the liability is incurred and not when the expense is actually paid. De Koker and Williams (2010) are further of the opinion that expenditure does not have to be both due and payable at the end of the year for it to be "actually incurred".

In *CIR v Golden Dumps (Pty) Ltd (1993)* the taxpayer became indebted to ex-employees after a disputed claim from a couple of years back was resolved in court. In this case the court held that the taxpayer was not indebted until the time that the ruling was made as before the ruling the expenditure still lacked the degree of certainty and finality to be classified as 'actually incurred'. The taxpayer therefore only "actually incurred" the expenditure when the ruling by the Appellate Division was made. Furthermore, in *KBI v Nasionale Pers Bpk (1986)* the taxpayer attempted to claim a deduction for the provision of annual bonuses. The court held that as there was a certain degree of uncertainty at year-end about whether or not the bonuses would actually be paid out, the liability was not unconditional and as a result was not allowed as a deduction.

In yet another case, *Edgars Stores Ltd v CIR (1988)*, the taxpayer attempted to deduct a turnover rental amount. This rental amount could only be finalised after the tax year as the turnover amount on which the rental was to be calculated would only have been known at the financial year-end of the company. The court held that this constituted a contingent liability and was not “actually incurred” at the end of the year of assessment.

One of the requirements of the general deduction formula is that the expenditure and losses need to be actually incurred before there can be deduction in terms of the general deduction formula. The deduction can only be claimed when there is an unconditional liability to incur the expenditure at the end of the taxpayer’s year of assessment. A taxpayer can therefore not claim expenditure as a result of illegal activities either until there is an unconditional liability to pay the expenditure. A taxpayer who, for example, pays bribes will only be able to deduct the bribery amounts when the liability to pay becomes unconditional. However, as this is not a payment made by law the liability might never become an unconditional liability. In cases like this the expenditure will rather be deductible when the bribery amount is actually paid.

3.2.5 During the year of assessment

The courts have held that only expenditure incurred in a particular tax year can be deducted in that tax year. Expenditure can therefore not be carried forward or carried back. In *Baxter v COT (1937)* the taxpayer attempted to deduct interest payments made by him in prior years to match the interest received in arrears for a couple of years on his loan account. The court held that only the interest paid by him in the current year could be deducted by him in the current year.

Section 23H of the Act which deals with the distribution of pre-payments covering more than one period should also be considered. Section 23H of the Act states in short that only pre-payments made within six months after the year of assessment can be deducted for tax purposes limited to a total deduction of R100 000.

Expenditure resulting from illegal activities could therefore also only be deducted during the year of assessment that the expenditure was incurred. The effect of this is that a taxpayer cannot decide to declare its receipts resulting from bribery for instance and try to claim all the bribery amounts from previous years in that same year. The only way the taxpayer would be able to deduct these amounts for tax purposes would be to try and re-open the assessments of previous years. This is not likely to happen as it will also have the

implication that the taxpayer will be penalised for not declaring the receipts resulting from its bribery activities.

3.2.6 *In the production of income*

In the case of *Port Elizabeth Electric Tramway Co Ltd v CIR (1936)* the taxpayer was a tramway company. A driver of one of the trams was killed in an accident. The taxpayer company was ordered to pay compensation to the driver's widow. The court held that the compensation does comply with the requirements to be deductible.

The taxpayer had to show in this case that:

- There was an inherent risk that as part of his business activities one of the drivers might get hurt in an accident;
- The expense was incurred in the production of income; and
- The act that led to the payment was undertaken by the taxpayer to produce income and that the payment was closely linked to that act.

In the judgement of the court Watermeyer AJP stated the following:

"If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible...". However, he also continued by saying the following: *"If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible."* The tests resulting from this case was that if the expenditure is incurred to produce income the expenditure incurred will probably be deductible for tax purposes. The expenditure should, however, not be as a result of an unlawful act otherwise it will probably not be deductible for tax purposes.

Broomberg et al. (2003:223) are of the opinion that the above tests are too mechanical and that the test developed in *Lockie Bros Ltd v CIR (1922)* is a far better test. The test resulting from this case is that expenditure incurred by the taxpayer would be allowed as a deduction if it was incurred in the course of the ordinary operations undertaken by the taxpayer in the carrying on of his trade. Neither does this test exclude expenditure as a result of an unlawful act like the test in the *Port Elizabeth Electric Tramway Co Ltd v CIR (1936)* case above.

This exclusion would have resulted in automatically prohibiting the deduction of a wide range of expenditure resulting from illegal activities in terms of the general deduction formula. The court cases dealing with the term 'in the production of income' were therefore not entirely consistent, thus contributing even more to the level of uncertainty with regard to the deductibility of expenditure relating to illegal activities.

3.2.7 *Not of a capital nature*

In the case of *New State Areas Ltd v CIR (1946)*, the taxpayer was legally obliged to incur expenditure to construct internal sewers (which would have become the property of the taxpayer) and external sewers (which would never have become the property of the taxpayer). The test laid down in this case was whether the expenditure incurred was closely connected to the income-producing structure and thus capital in nature or closely connected to the income earning-operations and therefore deductible expenditure.

Another important test identified by De Koker and Williams (2010) is the 'enduring benefit' test. In the case of *Anglo-Persian Oil Co Ltd v Dale*, Rowlatt J stated that by 'enduring' is meant: "...*enduring in the way that fixed capital endures.*" (De Koker & Williams, 2010:7-24-1). This statement by the judge introduced the distinction between fixed and floating capital. Fixed capital will have a more lasting nature whereas floating capital will be more temporary in nature. A further application of the 'enduring benefit' test can be found in the case of *COT v Nchanga Consolidated Copper Mines Ltd (1964)*. In this case the company paid an associated company to reimburse the company for operating cost while the company ceased production. The court held that the expenditure was an operating cost in nature and should therefore be deductible. Expenditure resulting from illegal activities could also have either an enduring benefit or a more temporary benefit. If a person operated an illegal pyramid scheme and purchased computers and other electronic equipment with which to operate the scheme with the receipts, the enduring nature of the equipment would ensure that the expenditure is rather classified as capital in nature.

Yet another test, according to De Koker and Williams (2010) the 'once-and-for-all' test, was applied in the case of *Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes) (1910)*. According to this test capital expenditure will be spent as a once-off, whereas income expenditure is more recurring in nature and will be incurred every year. This test is, however, only effective up to a point as some capital expenditure is recurring where a once-off payment could be income expenditure as well.

The classification of expenditure as either capital expenditure or recurring operating expenditure is also relevant when the expenditure results from illegal activities. This expenditure is not all capital or all revenue and as with expenses from legal activities the distinction needs to be made in order to be deductible in terms of the general deduction formula.

3.2.8 To the extent not laid out for the purposes of trade

Section 23(g) forms part of the general deduction formula in the Act. This section prohibits the deduction of expenditure not incurred wholly or exclusively for the purposes of trade.

In *Tiktin Timbers CC v CIR (1999)* Hefer JA stated that “...*the purpose for which the expenditure was incurred is the decisive consideration in the application of s 23(g).*” This section will therefore exclude an expense as a deductible expense if the expenditure was not wholly or exclusively for the purposes of trade.

In the context of this study the trade of a taxpayer might include illegal activities. If this is the case and the expenditure relating to the illegal activities is not incurred wholly or exclusively for the purposes of this illegal trade, the taxpayer will not be able to claim expenditure relating to this trade under the general deduction formula.

3.2.9 Conclusion on illegal activities and the general deduction formula

The SARS, in the draft interpretation note (SARS, 2013), attempted to determine whether expenditure as a result of theft or embezzlement can be deducted by a taxpayer that falls victim to this embezzlement or theft using the general deduction formula. The focus in this study is more on taxpayers attempting to deduct expenditure while engaged in illegal activities, but in both cases the method applied to analyse the general deduction formula by way of general case law principles was applicable. From this analysis it is concluded that nothing in the general deduction formula specifically prohibits the deduction of expenditure resulting from illegal activities.

Specific case law applicable to illegal activities could, however, have established specific rules pertaining to expenditure resulting from illegal activities. These principles could possibly differ from the general application of case law in the general deduction formula as

already discussed. This specific case law will now be analysed to determine whether specific principles need to be applied for expenditure relating to specific illegal activities.

3.3 Case law specifically applicable to illegal activities

There is limited case law in South Africa specifically dealing with the deduction of expenditure relating to illegal receipts. The case law available has, however, set a number of principles to be used in future cases. These principals were also identified and discussed in the draft interpretation note (SARS, 2013) issued by the SARS.

In *COT v Rendle* (SARS, 2013) the Commissioner allowed the deduction of costs and legal fees to investigate embezzlement by an employee of some of the funds of one of the clients of the audit firm. This was allowed as the expense was seen as closely related to the business operations of the taxpayer.

In *ITC 952* (SARS, 2013) the taxpayer was part of a partnership of attorneys. The partner of the taxpayer stole funds from the partnership and the taxpayer attempted to deduct the stolen funds for tax purposes. In this case the taxpayer was not successful in its claim as the court ruled that it is not an inherent risk of the business that a partner of the firm will attempt to steal funds from the trust account.

In *ITC 1383* (SARS, 2013) the taxpayer, a commercial bank, attempted to deduct an amount that was stolen by one of its senior employees. In this case the claim of the taxpayer was successful as the court was also of the opinion that there is a close link between the theft and the normal business activities of the company.

From the above court cases it is clear that the principle established here is that if the incurrance of the illegal activity is an inherent or normal risk of the business of the taxpayer, the expense will be deductible for normal income tax purposes.

3.4 Section 23(o) of the Act

3.4.1 Introduction

South Africa is a member of The Organisation for Economic Co-operation and Development (OECD). The 1996 Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials issued by OECD tried to put an end to the practice claiming bribes paid to foreign public officials as tax-deductible expenditure.

Section 23(o) was introduced into the Act with effect from 1 January 2006 and it applies to any year of assessment commencing on or after that date. The section was included in the Act in an effort to combat corruption and bribery.

Section 23(o) of the Act prohibits the deduction of:

“any expenditure incurred-

- i) where the payment of the expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No. 12 of 2004); or*
- ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic.”*

To clarify the meaning and scope of Section 23(o), Interpretation Note: No. 54 was issued by the SARS (SARS, 2010). Before the section came into effect the issue of deducting expenditure relating to bribery and corruption had to be considered under the general deduction formula (as discussed under 3.2). If a taxpayer could therefore successfully argue that the bribe or payment made:

- was incurred in the production of income;

- for the purpose of trade; and

- was not of a capital nature;

the expense could possibly have qualified as a deduction under the general deduction formula before the implementation of Section 23(o).

3.4.2 The Prevention and Combating of Corrupt Activities Act No. 12 of 2004

According to Chapter 2 of the Prevention and Combating of Corrupt Activities Act No. 12 of 2004 (hereafter referred to as 'PRECCA') the general offence of corruption is defined as:

“Any person who, directly or indirectly –

- a) accepts or agrees or offers to accept any gratification from any other person, whether for the benefit of himself or herself or for the benefit of another person; or*

b) gives or agrees or offers to give to any person any gratification, whether for the benefit of that other person or for the benefit of another person,

in order to act, personally or by influencing another person so to act, in a manner –

i) that amounts to the –

(aa) illegal, dishonest, unauthorised, incomplete, or biased; or

(bb) misuse or selling of information or material acquired in the course of the,

exercise, carrying out or performance of any powers, duties or functions arising out of a constitutional, statutory, contractual or any other legal obligation;

ii) that amounts to –

(aa) the abuse of a position of authority;

(bb) a breach of trust; or

(cc) the violation of a legal duty or a set of rules;

iii) designed to achieve an unjustified result; or

iv) that amounts to any other unauthorised or improper inducement to do or not to do anything,

is guilty of the offence of corruption.”

The PRECCA then also continues to describe corruption specifically relating to public officers, foreign officials and agents, members of legislative authority, judicial officers and members of the prosecuting authority. The term ‘gratification’ is defined in Section 1 of the PRECCA. Not all gifts and other free items can be classified as corruption. This will depend on a number of factors including the value of the gift, how regularly this is done as well as the position of the recipient.

The crime of corruption is highly reliant on moral principles as most of the wordings and phrases relating to corruption in Section 3 of the PRECCA depend on value judgements. The result of Section 23(o) of the Act is that any expenditure in respect of the unlawful activities (for example the payment of bribes) described in terms of Chapter 2 of the PRECCA will not be deductible for normal income tax purposes.

3.4.3 Deduction of fines

The Commissioner does not allow the deduction of fines as a result of unlawful activities of a taxpayer. Before Section 23(o) came into effect the Commissioner had to rely on case law to support this view. An example of a court case that supports this view is the decision in ITC 1199 (1973) where: *"...it was held that in view of 'the juristic nature and character of fines, and on weight of authority in English and Australian cases fines for criminal conduct in the carrying out of business operations cannot be regarded as constituting expenditure incurred in the production of income and therefore may not be deducted under s 11(a)."*

Penalties imposed under the Act, the Value-Added Tax (VAT) Act, Regional Services Council Act, Skills Development Levies Act and Unemployment Insurance Contributions Act are not allowed as a deduction as per Section 23(d) of the Act. After Section 23(o) came into effect the deduction of any fines imposed as a result of an unlawful act is prohibited. Black's Law Dictionary 8th Edition 2004 (SARS, 2010:8) defines an 'unlawful act' as: *"[c]onduct that is not authorised by law; a violent or criminal law"*.

Penalties and fines imposed by another country will also be prohibited as a deduction as per Section 23(o)(ii) of the act as it would have been unlawful if it was committed in South Africa. Commercial penalties do not normally fall within the scope of Section 23(o). These commercial penalties will, however, still have to meet the deduction requirements as per the general deduction formula of Section 11(a) and Section 23(g) in order to be deductible.

Section 23(o) is not applicable to amounts payable as compensation or damages. To qualify as a deduction the expenses also have to meet the deduction requirements as per the general deduction formula of Section 11(a) and Section 23(g) in order to be deductible. There needs to be a very close connection between the event leading to the damages or compensation and the income earning activities of the business.

In the case of *Joffe & Co (Pty) Ltd v CIR (1946)* Watermeyer CJ stated the following in this regard: *"There is nothing...to show that the appellant's method of conducting his business necessarily leads to accidents, and it would be somewhat surprising if there were."* With regard to the unlawfulness or carelessness of an action leading to a compensation or damages claim, Watermeyer AJP stated the following in the case of *Port Elizabeth Electric Tramway Co Ltd v CIR (1936)*: *"If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible."*

3.4.4 Conclusion on fines

If all expenditure relating to all illegal activities were included in section 23(o) there would not have been any uncertainty with regard to the deductibility of expenses resulting from illegal activities. Section 23(o), however, only deals decisively with all fines resulting from unlawful acts as well as expenses resulting from activities contemplated in Chapter 2 of the PRECCA as this section specifically prohibits the deduction of these two types of expenditure. As a result, the draft interpretation note (SARS, 2013) issued by the SARS does not specifically deal with the application of section 23(o) of the Act because there is no uncertainty relating to the application of the law in this regard.

3.5 Section 11(c) of the Act

Section 11(c) of the Act deals with the deduction of legal fees. This section states that legal fees will be deductible for normal income tax purposes if it is incurred in the carrying on of a trade, is not capital in nature and is not incurred with regard to any claims against the taxpayer for payment of damages if the amount of damages paid was prohibited as a deduction under Section 11(a) of the Act.

The draft interpretation note (SARS, 2013) issued by the SARS also deals with the deduction of legal fees resulting from illegal activities. The draft interpretation note also confirms the link between the deduction of legal fees and the deduction of expenses resulting from illegal activities. According to the draft interpretation note (SARS, 2013) legal fees will be deductible in terms of Section 11(c) if the expenses resulting from illegal activities are allowed as a deduction in terms of Section 11(a) of the Act.

3.6 Section 23(c) of the Act

Section 23(c) of the Act deals with the deduction of amounts that are recoverable. Section 23(c) of the Act prohibits the deduction of: *“any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity.”* The effect of this section is therefore that any loss resulting from illegal activities that is covered under an insurance contract will not be deductible for normal income tax purposes.

3.7 Theft of assets

3.7.1 Theft of cash

Theft of cash is deductible for income tax purposes if the crime was not committed by the managing director or a manager or the owner of the business. The principle on which this is based was established in *COT v Rendle* (1965). Senior employees or managers are supposed to be the custodians of the company and expenditure or losses as a result of theft of cash by senior employees will not be allowed as a deduction in terms of the general deduction formula in the Act. Cash is also specifically excluded from the definition of an asset in Paragraph 1 of the Eighth Schedule to the Act. There will therefore be no capital gains tax implications resulting from the theft of cash.

3.7.2 Theft of capital assets

The deduction of capital expenditure is prohibited in terms of the general deduction formula. As assets are capital in nature it will not be allowed as a deduction for income tax purposes.

3.7.3 Theft of stock

Theft of stock is normally excluded from the closing stock at the end of the year. It will therefore automatically be deducted from taxable income for income tax purposes. This is supported by case law as after the case *ITC 1060* (1963) the Commissioner allowed the deduction of theft of stock for tax purposes. The SARS will only allow the deduction of the amount exceeding the recoverable amount as per any insurance policy to be in line with Section 23(c) of the Act.

3.8 Conclusion

The SARS has issued a draft interpretation note (SARS, 2013) dealing with the deductibility of expenditure and losses arising from embezzlement or theft of money. In this draft interpretation note the SARS is of the opinion that: *“Expenditure and losses incurred by a*

taxpayer in carrying on a trade as a result of embezzlement 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 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.” (SARS, 2013:13)

Based on the above analysis of the general deduction formula as well as the examination of case law specifically applicable to the deduction of expenditure and losses as a result of illegal activities it is concluded that the treatment of expenditure as a result from illegal activities is probably correct as proposed in this draft interpretation note.

The draft interpretation note also deals with the application of Section 11(c) and Section 23(c) of the Act. According to Section 11(c) legal fees resulting from illegal activities will only be deductible if the expenses relating to the illegal activities are also deductible in terms of Section 11(a) of the Act. There is therefore a direct link between Section 11(a) and Section 11(c).

Section 23(c) of the Act then further confirms that only expenses not covered by insurance contracts can be deducted for normal income tax purposes. If this section was not included in the Act a taxpayer could potentially have claimed a deduction for expenses that could be reimbursed by third parties.

South African income tax legislation shows several similarities with that of Australia due to the fact that it originated from the New South Wales Act of 1895 (Australian Income Tax Act) (Brink & Viviers, 2012:439). In the next chapter the draft interpretation note (SARS, 2013) will therefore be compared to the tax legislation developed in Australia to determine whether the SARS is moving in the same direction as international trends in respect of the tax treatment of illegal activities.

Chapter 4: An international perspective on the taxability of illegal activities

4.1 Introduction

Due to the fact that South African income tax legislation shows several similarities with that of Australia (Brink & Viviers, 2012:439), Australia is regarded as a suitable country to be considered in the search for principles and practices that could be useful within a South African context. By comparing the principles and interpretation laid down by South African legislation and case law to the principles and interpretations laid down by the courts of Australia, income tax principles or practices could be highlighted that could be useful within a South African context.

The Australian equivalent of the Act is the Australian Income Tax Assessment Act (38 of 1997) (hereafter referred to as 'the ITA Act'). The ITA Act will be compared to the Act to determine if there are any similarities between the treatment of income and expenses resulting from illegal activities between the two countries.

The Australian Tax Office (the equivalent of the South African Revenue Service in Australia) has issued a ruling (ATO, 1993) dealing with the possibility of assessing the proceeds from illegal activities, the treatment of amounts recovered and the deductibility of fines and penalties. This ruling will also be compared to the draft interpretation note (SARS, 2013) issued by the SARS to determine if there are any similarities between these two documents.

Case law has been applied extensively in a South African context where uncertainty exists in respect of the phrases or definitions contained within the Act. According to Gupta (2008:109) the Australian common law is based on the doctrine of precedent. Based on this, Australian case law is also used if there is uncertainty about the phrases or definitions in the ITA Act in an Australian context. South African case law can therefore also be compared to landmark Australian case law to determine if there are any similarities between the development of the principles in the context of the taxation of receipts and expenditure relating to illegal activities.

4.2 Illegal activities and gross income – An international perspective

Before the definition of gross income is compared to the Australian equivalent it is important first to determine if the definition of taxable income will actually be relevant in an Australian

context as the method to calculate taxable income could be different in the two countries. Section 4-15 of the ITA Act states that “*Taxable income = Assessable – Deductions*”. This is very similar to the definition of taxable income in Section 1 of the Act which states that taxable income “...*means the aggregate of –*

(a) the amount remaining after the deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income...”

The method of calculating the taxable income of a taxpayer according to Section 1 of the Act is therefore in short income less allowable deductions. It is therefore submitted that the method of calculating taxable income is similar in South Africa and Australia.

The term ‘assessable income’ is also defined in the ITA Act just as the definition of gross income is defined in Section 1 of the Act. Section 6-5(2) of the ITA Act states that:

“If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year.”

The term ‘ordinary income’ is further described in ATO (1993:1). According to Paragraph 5 of this ruling: “*What is normally accepted as income is determined according to the ordinary usages and concepts of mankind. Receipts from a systematic activity where the elements of a business are present are income irrespective of whether the activities are legal or illegal.*” (ATO, 1993:1). Therefore, according to the Australian Tax Office ruling (ATO, 1993) if the taxpayer is systematically and regularly engaged in activities where an element of business is present the income derived from the activities will be income in the hands of the taxpayer whether the receipts are from legal or illegal activities.

From a South African perspective there are no rulings issued by the SARS specifically dealing with the tax consequences of receipts resulting from illegal activities. The SARS has, however, issued a draft interpretation note (SARS, 2013) which deals with the deductibility of expenditure and losses arising from embezzlement or theft of money. Included in the draft interpretation note is a section dealing with the tax consequences of receipts resulting from embezzlement or theft of money. In the draft interpretation note the SARS applies the definition of gross income in Section 1 of the Act together with relevant case law applicable to the phrases in the definition to determine the tax treatment of these illegal receipts. The SARS is of the opinion in the draft interpretation note that a taxpayer should be taxed on illegal receipts from embezzlement or theft. The reason for this, according to the SARS, is

the fact that the taxpayer who received illegal receipts from embezzlement or theft is regarded as having “received” the receipts in accordance with the definition of gross income as defined in Section 1 of the Act. The illegal receipts will therefore be taxed as it complies with the definition of gross income in Section 1 of the Act.

The Australian case of *MacFarlane v Federal Commissioner of Taxation* (1986) deals with the tax consequences of deemed dividends assessed by the Federal Commissioner as a result of an increase in profits of the taxpayer by adding undeclared income as well as adding back fraudulent deduction of expenses. One of the judges in the case, Burchett J referred to the judgement in the English case *Partridge v. Mallandaine* (1886) where the question of dealing in stolen goods was considered and Denman J stated:

“But I go the whole length of saying that, in my opinion, if a man were to make a systematic business of receiving stolen goods, and to do nothing else, and he thereby systematically carried on a business and made a profit of 2000 pounds a year, the Income Tax Commissioners would be quite right in assessing him if it were in fact his vocation. There is no limit as to its being a lawful vocation, nor do I think that the fact that it is unlawful can be set up in favour of these persons as against the rights of the revenue to have payment in respect of the profits that are made.” (*MacFarlane v Federal Commissioner of Taxation* (1986)).

The case of *Partridge v. Mallandaine* (1886) is used as authority for part of the decision made in the case of *MacFarlane v Federal Commissioner of Taxation* (1986). The conclusion here is therefore if it is part of the business activities of a taxpayer to make a profit through illegal activities the profit should be included in the taxable income of the taxpayer.

Burchett J takes this one step further and stated as part of his judgement that:

“In the light of the statements in these cases, I think it can be safely concluded that “profits” in sec. 44(1)(a) should be construed as including de facto profits, though arising out of illegality. Furthermore, the existence of a right of recovery in some person, upon discovery and proof of the illegality, does not mean that the profit in fact received was any the less a profit. Though the law-breaker may receive his desserts elsewhere, which may include an order for restitution, he has also had his reward, and it was a profit.” (*MacFarlane v Federal Commissioner of Taxation* (1986)).

Based on this, all real profits should be included in the taxable income of a taxpayer and the legality of the profits should not have any bearing on the tax consequences of the profits. Furthermore, the fact that the illegal receipts should be paid back if it was discovered should not have any impact on the taxability of the illegal receipts either.

Although the argument might not be exactly the same, the case is also in agreement with the judgement laid down in the landmark South African case of *MP Finance Group CC (In Liquidation) v C* (2007) where the court determined that the intention of the taxpayer was not to receive the loans to pay them back later but the true intention of the taxpayer was to defraud its clients and not to pay the loans back. As a result the taxpayer has therefore received the receipts in terms of the definition of gross income in Section 1 of the Act and the amount received should be included in the taxable income of the taxpayer.

Another Australian landmark case dealing with the question of the taxability of illegal receipts is the case of the *Federal Commissioner of Taxation v La Rosa* (2003). In this case the taxpayer, Francesco Domenico La Rosa, was a convicted drug dealer who in the years before his conviction ran a mechanical workshop and a drug dealing business. After his conviction of possession and dealing in drugs, the Federal Commissioner raised income tax assessments for the years that the taxpayer had not submitted tax returns. Included in the assessments was an amount of 220 000 Australian dollars which was buried in the taxpayer's backyard and dug up for use in a drug deal. The court also ruled in this case that as the taxpayer was systematically carrying on the business of drug dealing with the intention of making a profit, there were elements of business present in its activities. The taxpayer should be taxed on its profits irrespective whether that the activities are legal or illegal in nature.

It is therefore clear that from an Australian perspective it does not matter whether the receipt is legal or illegal, it would still be taxable if the activities of the taxpayer include an element of business. From a South African perspective illegal receipts need to comply with the definition of gross income before it can be included in the taxable income of a taxpayer. Although illegal receipts are normally to be paid back when they are discovered, the intention of the criminal is to keep the receipts for its own benefit. The receipts are therefore also included in the taxable income of the taxpayer. The Australian requirement does seem a bit less complex with a greater chance that all illegal receipts will be included in its scope. The shortcoming anticipated with the Australian perspective is, however, that a taxpayer might try to argue that a single instance of receiving illegal receipts might not constitute the carrying on of business activities.

4.3 Illegal activities and deduction of expenditure – An international perspective

4.3.1 General deduction provisions

Before a comparison on the tax treatment of deductions resulting from illegal activities between South African and Australia could be made an evaluation needs to be performed in respect of any similarities between the legislation applicable to general deductions between the two countries. Section 11(a) read together with Section 23(g) of the Act contains the South African general deduction formula. Section 11(a) of the Act determines what is allowed as a deduction while Section 23(g) determines what is not allowed as a deduction. The Australian equivalent of this is contained in Section 8-1 of the ITA Act. Section 8-1(1) determines what is allowed as a deduction and states the following:

8-1(1) - You can deduct from your assessable income any loss or outgoing to the extent that:

- (a) it is incurred in gaining or producing your assessable income; or*
- (b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.*

Section 8-1(2) contains the provision of what is not allowed as a deduction. This section determines the following:

8-1(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

- (a) it is a loss or outgoing of capital, or of a capital nature; or*
- (b) it is a loss or outgoing of a private or domestic nature; or*
- (c) it is incurred in relation to gaining or producing your exempt income or your non-assessable non-exempt income; or*
- (d) a provision of this Act prevents you from deducting it.*

Section 8-1(1) of the ITA Act is very similar to Section 11(a) of the Act as both sections require expenditure to be incurred in the production of income before it could qualify for a deduction. Section 8-1(2) is also very similar to Section 23(g) of the Act as both sections prohibit the deduction of private or domestic expenditure. Refer to Chapter 3 for a detailed discussion on the elements of Section 11(a) as well as Section 23(g). It is therefore submitted that it will be practical to compare the tax treatment of deductions resulting from

illegal activities between the two countries as there are similarities in the legislation applicable to general deductions of both these countries.

In the case of the Federal Commissioner of Taxation v La Rosa (2003) the taxpayer, a convicted drug dealer, attempted to deduct 220 000 Australian dollars for tax purposes that was stolen from him during an attempted drug purchase. Hely J, one of the judges in the case, stated the following:

“The purpose of the ITAA is to tax taxable income, not to punish wrongdoing. The language of ss 17, 25, 48 and 51 is indifferent as to whether the income, loss or outgoing in question has its source in lawful or 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 of those who engage in unlawful activities is imposed by the criminal law, and not by laws in relation to income tax.”

The judge in this case was therefore of the opinion that a person engaged in illegal activities should not have a higher tax burden than a person engaged in legal activities and that it was not the purpose of tax legislation to punish taxpayers engaged in illegal activities. According to this the tax treatment of deductions from legal and illegal activities should therefore be the same and both should be deductible if the expense was incurred as part of the business activities of a taxpayer.

There is limited case law in South Africa specifically dealing with the deduction of expenditure relating to illegal receipts. The case law available has, however, set a number of principles to be used in future cases. These principles were also identified and discussed in the draft interpretation note (SARS, 2013) issued by the SARS.

From a South African perspective the principle relating to the deduction of expenditure resulting from illegal activities was established in the cases of COT v Rendle (SARS, 2013), ITC 952 (SARS, 2013) and ITC 1383 (SARS, 2013). The principle established in these cases was that if the incurrance of the illegal activity is an inherent or normal business risk of the business of the taxpayer the expense will be deductible for tax purposes. This principle was arrived at by applying the principals established by general case law applicable to the general deduction formula to these cases involving deduction of expenses resulting from illegal activities.

By considering only the general deduction provisions in both countries it is therefore submitted that the tax treatment of the deduction of expenditure resulting from illegal

activities are similar in nature for both countries. However, there might be specific provisions dealing with expenses resulting from illegal activities that should also be considered.

4.3.2 *Specific deduction provisions*

Section 26-54 in the ITA Act specifically deals with the deduction of expenditure relating to illegal activities. Section 26-54 states that:

“(1) You cannot deduct under this Act a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment.

(2) Despite section 170 of the Income Tax Assessment Act 1936, the Commissioner may amend your assessment at any time within 4 years after you are convicted of the relevant offence for the purpose of giving effect to subsection (1) of this section.”

The result of this section is therefore that it prohibits the deduction of expenditure resulting from activities that are against an Australian law, therefore illegal activities. This section was included in the ITA Act after the case of the Federal Commissioner of Taxation v La Rosa (2003). This section therefore overrides the principle established in the case of the Federal Commissioner of Taxation v La Rosa (2003) making it impossible for a taxpayer in Australia to deduct expenditure resulting from illegal activities.

In a South African context there is currently no specific provision in the Act prohibiting the deduction of all expenditure resulting from illegal activities. This has resulted in some uncertainty as the general deduction formula is used to determine if expenditure resulting from illegal activities should be deductible for normal income tax purposes.

4.3.3 *Amounts recovered or repaid*

Section 23(c) of the Act deals with the deduction of amounts that are recoverable and this section prohibits the deduction of amounts recoverable under an insurance contract.

The method followed by the Australian ITA Act is slightly different from the South African legislation. Section 25-45 of the ITA Act deals with the deduction of losses resulting from theft as follows:

“You can deduct a loss in respect of money if:

- (a) you discover the loss in the income year; and*
- (b) the loss was caused by theft, stealing, embezzlement, larceny, defalcation or misappropriation by your employee or agent (other than an individual you employ solely for private purposes); and*
- (c) the money was included in your assessable income for the income year, or for an earlier income year.”*

The effect of this section is therefore to allow the deduction of losses resulting from theft, stealing, embezzlement, larceny, defalcation or misappropriation by an employee. Section 20A of the ITA Act deals with the insurance, indemnity or other recoupment of deductible expenditure. The effect of section 20A is to include the receipts resulting from the recoupment of deductible expenditure.

In a South African context the losses resulting from theft or embezzlement are only deductible if the expenditure complies with the requirements of the general deduction formula. This is also the method used by the SARS in the interpretation note (SARS, 2013) dealing with the deduction of losses resulting from theft or embezzlement. In an Australian context there are specific provisions in the ITA Act dealing with these expenditure and losses.

4.3.4 Treatment of fines and penalties

Gupta (2008:120) has identified three potential reasons for the exclusion of fines and penalties as deductions in Australia. The reasons are that the illegal activity resulting in the fine is not part of business activities, it is not in the best interest of the public, and that the fine is actually private expenditure. The legislature in Australia seems to agree with this as there is a specific section 26-5 in the ITA Act prohibiting the deduction of penalties as follows:

“(1) You cannot deduct under this Act:

(a) an amount (however described) payable, by way of penalty, under an Australian law or a foreign law; or

(b) an amount ordered by a court to be paid on the conviction of an entity for an offence against an Australian law or a foreign law.

(2) This section does not apply to an amount payable, by way of penalty, under Subdivision 162-D of the GST Act.”

The result of this section is therefore that it prohibits the deduction of penalties received under Australian and foreign law.

This viewpoint held by Australian law is in agreement with the South African Legislature. The equivalent South African legislation dealing with penalties and fines is regulated in terms of Section 23(o) of the Act which prohibits the deduction of any fine or penalty resulting from an unlawful act. Fines and penalties are therefore generally not deductible expenses in terms of both South African and Australian legislation.

4.3.5 Deduction of bribes

Section 26-52 in the ITA act deals with bribes to foreign public officials and section 26-53 deals with bribes to Australian public officials. The term ‘public official’ is defined in section 995-1 of the ITA Act as: *“means an employee or official of an Australian Government Agency or of a local governing body.”*

The term ‘foreign public official’ is defined in the Criminal Code Act No. 12 of 1995 as follows:

“foreign public official means:

(a) an employee or official of a foreign government body; or

(b) an individual who performs work for a foreign government body under a contract; or

(c) an individual who holds or performs the duties of an appointment, office or position under a law of a foreign country or of part of a foreign country; or

(d) an individual who holds or performs the duties of an appointment, office or position created by custom or convention of a foreign country or of part of a foreign country; or

- (e) an individual who is otherwise in the service of a foreign government body (including service as a member of a military force or police force); or*
- (f) a member of the executive, judiciary or magistracy of a foreign country or of part of a foreign country; or*
- (g) an employee of a public international organisation; or*
- (h) an individual who performs work for a public international organisation under a contract; or*
- (i) an individual who holds or performs the duties of an office or position in a public international organisation; or*
- (j) an individual who is otherwise in the service of a public international organisation; or*
- (k) a member or officer of the legislature of a foreign country or of part of a foreign country; or*
- (l) an individual who:*
 - (i) is an authorised intermediary of a foreign public official covered by any of the above paragraphs; or*
 - (ii) holds himself or herself out to be the authorised intermediary of a foreign public official covered by any of the above paragraphs.”*

In terms of section 26-52(2) of the ITA Act an amount is a bribe to a foreign public official if:

- “ (a) you incur the amount in, or in connection with:*
 - (i) providing a benefit to another person; or*
 - (ii) causing a benefit to be provided to another person; or*
 - (iii) offering to provide, or promising to provide, a benefit to another person; or*
 - (iv) causing an offer of the provision of a benefit, or a promise of the provision of a benefit, to be made to another person; and*
- (b) the benefit is not legitimately due to the other person (see subsection (6)); and*
- (c) you incur the amount with the intention of influencing a foreign public official (who may or may not be the other person) in the exercise of the official’s duties as a foreign public official in order to:*
 - (i) obtain or retain business; or*

(ii) obtain or retain an advantage in the conduct of business that is not legitimately due to you, or another person, as the recipient, or intended recipient, of the advantage in the conduct of business (see subsection (7)).”

The definition of a bribe to a public official is also contained in section 26-53(2) of the ITA Act and is very similar to the definition of a bribe to a foreign public official. Both the definition of a bribe and of a foreign public official has a wide meaning as to make the section applicable to as many circumstances as possible. Both section 26-53 and section 26-54 specifically prohibit the deduction of bribes to foreign public officials and public officials respectively.

In a South African context the deduction of bribes to public officials is also specifically prohibited in terms of Section 23(o)(i) of the Act. The South African and Australian legislation is therefore similar with regard to the deduction of bribes to persons in public office.

4.3.6 Conclusion

In South Africa there are sections dealing with some of the expenditure resulting from illegal activities but no specific section in the Act prohibiting the deduction of all expenditure resulting from illegal activities. As the general deduction formula in the Act is used in most cases to determine whether expenditure resulting from illegal activities is deductible or not there is some uncertainty in a South African context. This uncertainty is also highlighted by the SARS who issued a draft interpretation note (SARS, 2013) dealing with the deduction of expenditure resulting from embezzlement and theft of money.

In Australia there were principles established with regard to the treatment of deductions resulting from illegal activities in the case of the Federal Commissioner of Taxation v La Rosa (2003). This case law was however overridden with the introduction of specific legislation dealing with expenses resulting from illegal activities contained in section 26-54 of the ITA Act. This section specifically prohibits the deduction of expenses resulting from illegal activities. It is therefore submitted that specific legislation applicable to the deduction of illegal activities is also needed in a South African context.

4.4 Conclusion on illegal activities – An international perspective

South African income tax legislation shows several similarities with that of Australia due to the fact that it originated from the New South Wales Act of 1895 (Australian Income Tax Act) (Brink & Viviers, 2012:439). The treatment of income resulting from illegal activities is similar in both South Africa and Australia. In Australia receipts resulting from illegal receipts will be taxable if there is an element of business included in the activities of the taxpayer resulting in the illegal receipt. The authority for this is the case of the Federal Commissioner of Taxation v La Rosa (2003) as well as a ruling issued by The Australian Taxation Office (ATO, 1993) dealing with the taxation of proceeds from illegal activities. In South Africa illegal receipts need to comply with the definition of gross income before it can be included in the taxable income of a taxpayer. Although illegal receipts are normally to be paid back when they are discovered, the intention of the criminal is to keep the receipts for its own benefit. The receipts are therefore also included in the taxable income of the taxpayer. The authority for this is the principle established in the MP Finance Group CC (In Liquidation) v C (2007) case. The SARS has also issued a draft interpretation note (SARS, 2013) where the authority for this case was underlined.

With regard to tax deductible expenditure, there are more significant differences between the tax treatment of expenditure resulting from illegal activities between the two countries. In South Africa expenditure resulting from illegal activities is deductible if the expenditure complies with the general deduction formula whereas in Australia the deduction of this expenditure is specifically prohibited by section 26-54 of the ITA Act. The SARS has also issued a draft interpretation note (SARS, 2013) where the general deduction formula was also used to determine whether or not expenditure resulting from illegal activities should be deductible for normal income tax purposes. It is therefore submitted that South Africa probably also needs specific legislation dealing with the deduction of expenditure resulting from illegal activities to clarify the uncertainty relating to the tax deductibility of this expenditure.

Chapter 5: Summary, conclusions and recommendations

5.1 Introduction

Considering the high crime rate in South Africa it is clear that crime continues to have a significant impact on the South African economy. The tax consequences of illegal activities have been dealt with in various court cases in the past, but many uncertainties still exist in respect of the normal income tax treatment of illegal receipts and its related expenditure. These uncertainties are supported by the need of the SARS to issue an interpretation note during 2013 attempting to clarify the tax deductibility of expenditure and losses arising from embezzlement or theft of money (SARS, 2013).

The research question investigated in the study was to determine whether or not this interpretation note issued by the SARS, currently still in its draft format, is sufficient in its attempt to clarify the uncertainties in respect of the tax treatment of illegal receipts and the deductibility of expenditure resulting from illegal activities.

5.2 Gross income resulting from illegal activities

The scope of this study was limited to exclude undisclosed legal receipts. As the tax treatment of disclosed or non-disclosed illegal receipts is the same, the focus of the study included both disclosed and non-disclosed illegal receipts.

The first step in the research process was to determine the meaning of the term “illegal receipts” within the context of this study. It was established that “illegal receipts” is not formally defined in the Act but that it could be described as the receipts acquired by a person for its own benefit obtained through means forbidden by law.

Hereafter it was determined whether illegal receipts adhere to and fall within the ambit of the general definition of gross income. Also, it needed to be established whether illegal receipts possibly fell within the ambit of any of the special inclusion paragraphs which include items as part of the gross income definition irrespective of the fact that they do not meet the requirements of its general definition.

The phrases and expressions contained within the definition of gross income are not defined in the Act itself. As a result, various case law have been inspected in order to clarify the

meaning of these phrases and expressions. Case law specifically dealing with illegal receipts and activities were also analysed.

5.2.1 Findings

An important principle established by general case law was that the value of non-monetary items to the taxpayer is irrelevant but the value should be determined objectively. The cash value of non-monetary receipts should therefore also be included in gross income. One of the steps to determine if an illegal amount should be included in gross income is therefore that if there is an amount in cash or otherwise the value of the amount should be included in gross income.

The next step to determine if illegal receipts should be included in gross income was supported by the principle laid down by the courts that 'received by' must mean received by the taxpayer on his own behalf for his own benefit. Following from this it was held in another case that not every instance of obtaining control over monies will result in a receipt as per the definition of gross income in the Act. A general rule was also established that if there is not a receipt or an accrual, there could be no tax liability. The rule was also laid down by the courts that that if a taxpayer received an amount as a principal and the taxpayer is then obliged to dispose of the receipt, the taxpayer has still received the receipt and the amount should be included in his gross income. Based on the above if there is an amount received by or accrued to in favour of a person, the value of the amount should be included in gross income if the other requirement of the definition of gross income is met.

The principles established from general case law were also used as the basis of the decisions in case law specifically applicable to illegal receipts. In one of the earlier cases in South Africa the court ruled that the legality or illegality of the receipts should not have an impact on the tax treatment of the receipts.

The intention to repay illegal amounts received by or accrued to a person were underlined in various court cases specifically dealing with illegal receipts. In one of the earlier cases the court held that money that was stolen by the taxpayer was not taxable as it was not received by him. This case was later overruled by the Supreme Court of Appeal decision in *MP Finance Group CC (In Liquidation) v C* (2007) where it was held that because the taxpayer received the receipts with no intention to repay the receipts it was received according to the definition of gross income in the Act and was therefore taxable. It does not matter that the receipts are in fact repayable by law. As this case was heard by the supreme court of appeal

in South Africa it will be the ultimate authority for case law with regard to illegal receipts. The result of this is that if a taxpayer received an illegal receipt with the intention of not repaying it the amount will normally be taxable if the other requirements of the definition of gross income are also met.

The definition of gross income in Section 1 of the Act does not include capital receipts. In one of the cases dealing with capital receipts the principle was established that revenue (the fruit) is produced by capital (the tree). The intention of the taxpayer when purchasing the asset was also identified as an important indicator of the nature of the receipt.

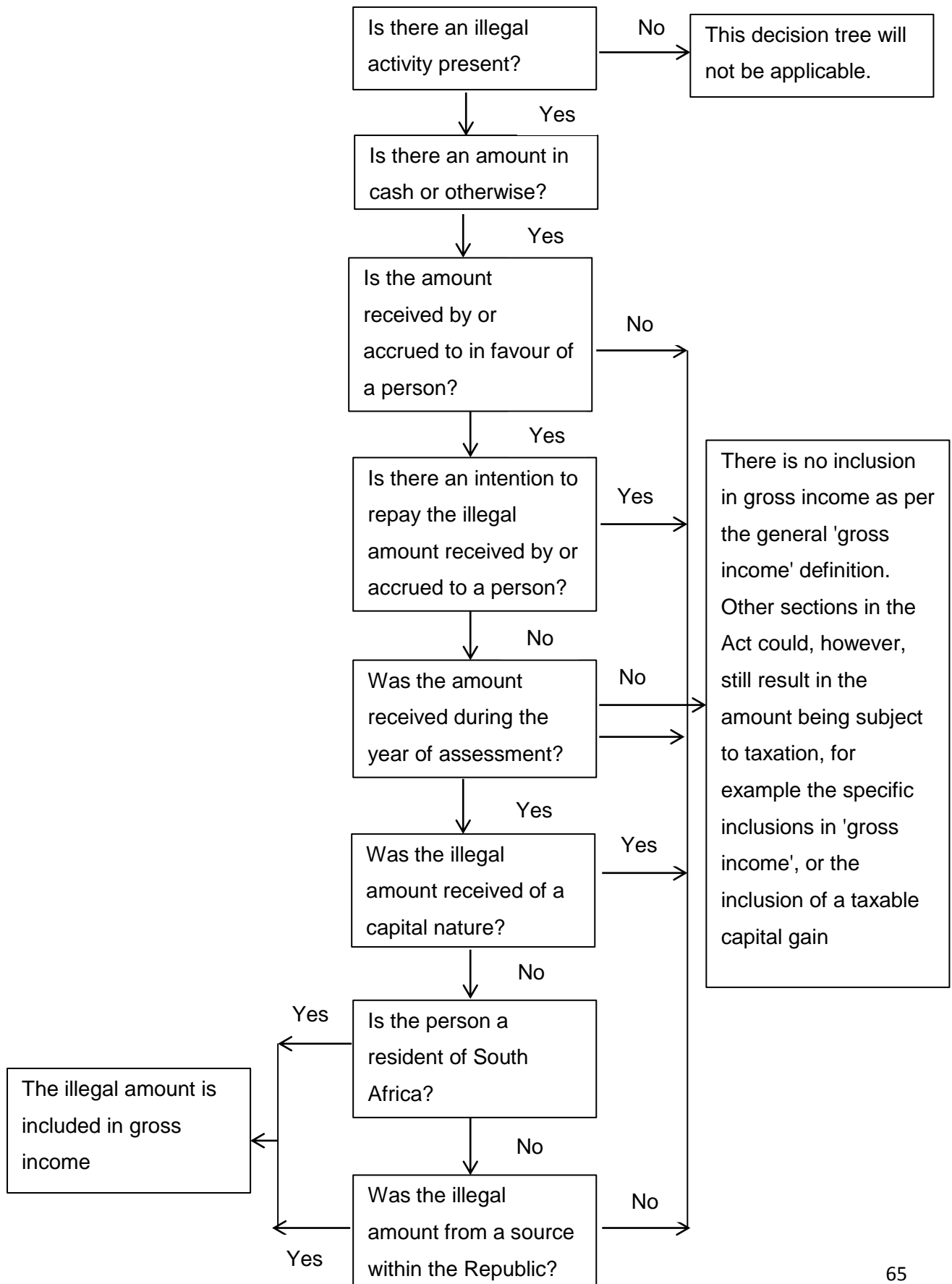
The definition of gross income further includes all residents of South Africa as well as the South African source income from non-residents. The term resident is defined in Section 1 of the Act and source is decided in Section 9 of the Act. There is therefore less uncertainty with regard to the meaning of resident and source.

Based on the above it is submitted that there are a set of established rules developed in the court cases above that will govern the tax treatment of receipts from illegal activities. The rules could be grouped together and developed into a decision tree.

5.2.2 Development of decision tree

A decision tree was developed in Stiglingh *et al.* (2014:17) to help determine if receipts will comply with the definition of gross income in the Act. As the case law relating to illegal receipts also used general case law to determine whether the receipts are taxable or not, it is submitted that this decision tree could also be adopted and applied to determine if illegal receipts will comply with the definition of gross income.

The decision tree in Stiglingh *et al.* (2014:17) was adopted for the taxation of illegal receipts as follows:



The above decision tree uses the principles established by general case law to provide guidance on whether an illegal receipt complies with the components of the definition of gross income in the Act. The principles derived from case law specifically dealing with illegal receipts is also incorporated into the decision tree, namely that if the intention of the taxpayer is not to pay the stolen money back the receipt will normally be taxable.

5.3 Expenditure resulting from illegal activities

After the tax consequences of illegal receipts were analysed expenditure resulting from illegal activities was also evaluated to determine whether or not it would be deductible for normal income tax purposes. The legislation and case law of Australia were also compared to that of South Africa to determine whether this tax legislation and these principles regarding the tax treatment of illegal receipts in Australia could be useful within a South African context.

5.3.1 Findings

The general deduction formula is contained in Section 11(a) of the Act read together with Section 23(g). The phrases and expressions contained in the general deduction formula have not been formally defined but case law has determined their meaning to some extent. The courts have therefore developed some principles based on these meanings.

Trade is defined in Section 1 of the Act. Case law has also established that trade should be given a wide interpretation. Section 11(a) of the Act further requires that the carrying on of a trade needs to be present before there could be a deduction in terms of the general deduction formula. If there is therefore no trade present the taxpayer will not be able to use the general deduction formula to deduct expenses.

The next step in the general deduction formula is to include expenditure and losses actually incurred by the taxpayer. The meaning of loss was determined by the courts as to mean losses of floating capital employed in the trade which produces the income. Capital losses are therefore excluded as a result and can therefore not be deducted in terms of the general deduction formula. The court also determined that if the expenditure incurred was closely connected to the income-producing structure it will be capital in nature and not be deductible. If the expense was rather closely connected to the income-earning operations of

the taxpayer the expense will probably be deductible. A further principle that was established by the court was that an expense arises when the liability is incurred and not when the expense is actually paid. It was also further established that the expenditure does not have to be both due and payable at the end of the year for it to be actually incurred.

Another requirement laid down by the general deduction formula is to include only expenditure and losses incurred in the production of income. This was also confirmed by case law where a test was established by the court that if the expenditure is incurred to produce income the expenditure incurred will probably be deductible for tax purposes. The expenditure should, however, not be a result of an unlawful act otherwise it will probably not be deductible for tax purposes.

The last step in the general deduction formula is to exclude expenses of a capital nature. An important principle established through case law was whether the expenditure incurred was closely connected to the income-producing structure and thus capital in nature or closely connected to the income-earning operations and therefore deductible expenditure.

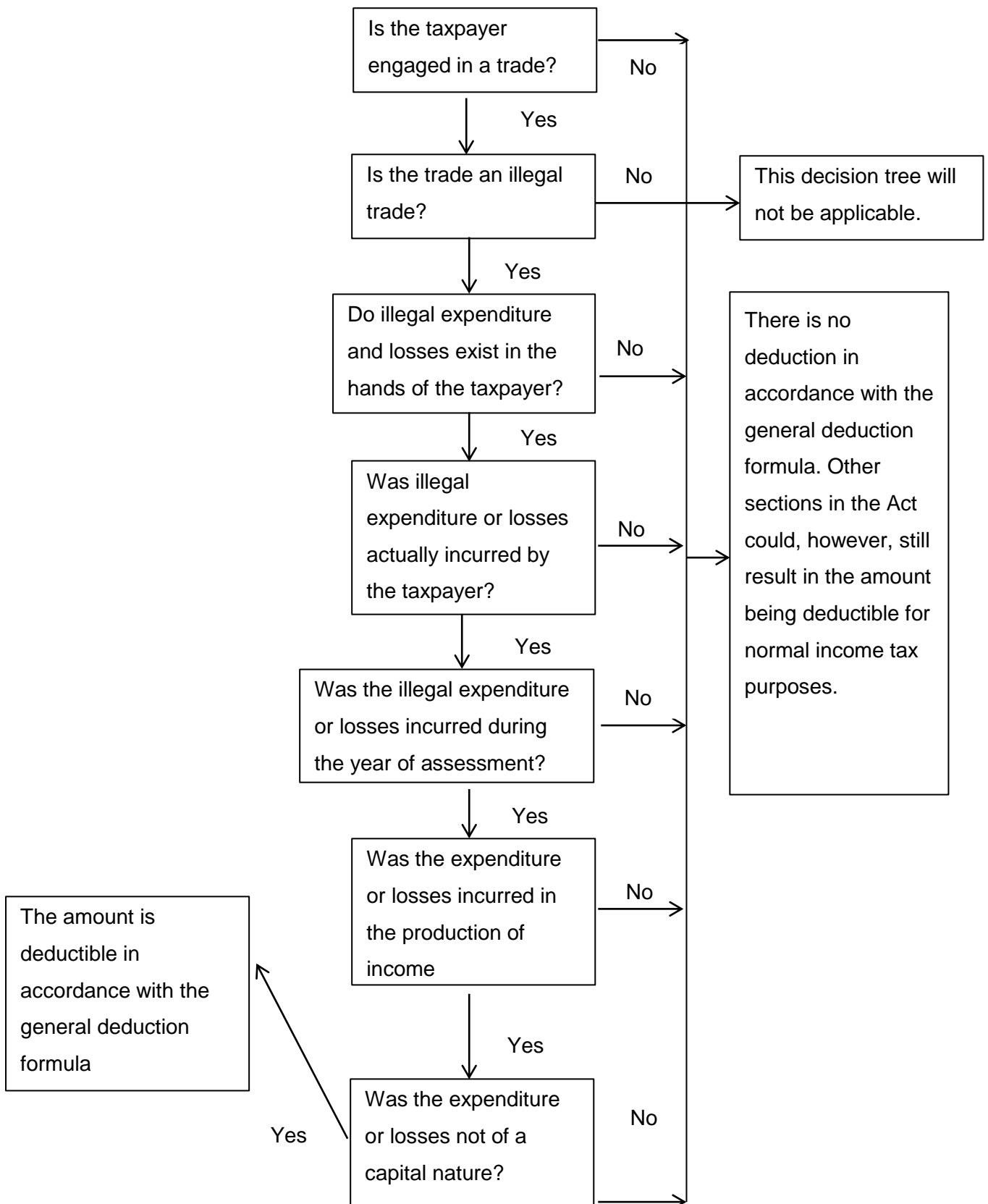
In one of the cases it was also noted that the purpose for which the expenditure was incurred is the decisive consideration in the application of Section 23(g). This section will therefore exclude an expense as a deductible expense if the expenditure was not wholly or exclusively for the purposes of trade.

Based on the above it is submitted that there are a set of established rules developed in the court cases above that will govern the tax treatment of expenses relating to illegal activities. The rules could be grouped together and developed into a decision tree.

Based on the process followed above an attempt will now be made to identify a set of clear principles to establish whether or not expenditure relating to an illegal receipt would be deductible for normal income tax purposes. These principles will then be incorporated into a decision tree that can be used to determine whether or not illegal receipts are taxable and also whether its related expenditure would be deductible for normal income tax purposes.

5.3.2 *Development of decision tree*

A diagram is included in Stiglingh *et al.* (2014:136) to help determine the tax treatment of expenses with regard to the general deduction formula contained in the Act. The diagram was amended to be applied within the context of expenditure relating to illegal activities as follows:



The above decision tree can be used to assist in determining the tax treatment of expenditure with regard to the general deduction formula. The principles resulting from general case law are also incorporated into the decision tree to determine the tax treatment

of expenditure resulting from illegal activities. It is therefore submitted that the above decision tree can, in conjunction with general case law relating to the phrases in the general deduction formula, assist the taxpayer in determining the tax treatment of expenditure resulting from illegal activities.

5.4 Conclusion and recommendations

In South Africa it is the ultimate responsibility of National Treasury to ensure that taxpayers fairly contribute to the national coffers and that the tax base of the country is protected from unfair tax advantages made available to certain taxpayers. Not paying tax on receipts resulting from illegal activities would be regarded as unfair in comparison to taxpayers that are taxed on receipts from legal activities.

It is therefore recommended that National Treasury needs to provide clear guidelines that will assist the SARS and the taxpayers in determining the tax treatment of receipts resulting from illegal activities as well as its related expenditure. These guidelines could be issued by way of a final regulatory document in the form of a final interpretation or practice note or even by way of an amendment to the Act to include legislation that will specifically regulate and govern the tax consequences of illegal activities. It is submitted that the current interpretation note, still in its draft form, does not provide sufficient authority to clarify and govern the uncertainties relating to the tax consequences of illegal activities.

However, the current draft interpretation note issued by the SARS is regarded to provide a suitable platform for such a final regulatory document to be established. It is recommended that the proposed regulatory document should specifically incorporate the fact that a taxpayer would only be taxed on illegal receipts if it could be established that it was received on his own behalf for his own benefit. Thus, illegal receipts obtained without the intention to repay it back to its legal owner, will therefore be included in the gross income of the person who conducted the illegal activity.

The current draft interpretation note mostly deals with the deduction of expenditure resulting from illegal activities from the perspective of the victim of embezzlement or theft of money. It is recommended that the proposed regulatory document should also incorporate clear guidelines on the deductibility of expenditure resulting from illegal activities from the perspective of the person engaged in the illegal activities.

Comparing South Africa to Australia it was found that the ATO has issued a ruling specifically dealing with the tax consequences of illegal receipts. From this ruling it is clear

that illegal receipts will be taxable if the activities of the taxpayer include an element of business. Although this method does seem a bit less complicated than the method used in South Africa, where the definition of gross income together with case law is used, the risk is that a taxpayer might try to argue that a single instance of receiving illegal receipts might not constitute the carrying on of business activities. It is therefore recommended that the proposed guidelines to be issued should rather keep to the method currently used in South Africa.

The ITA Act in Australia specifically prohibits the deduction of expenditure resulting from illegal activities. In the Act some expenditure resulting from illegal activities are prohibited as a deduction (for example the penalties listed in Section 23(o)). It is therefore possible that expenditure resulting from illegal activities that is not specifically prohibited by Section 23 could qualify for a deduction if it meets the criteria of the general deduction formula. The method used in Australia is far less complex than in South Africa and it is therefore recommended that legislation specifically dealing with expenditure resulting from illegal activities to be incorporated in the proposed regulatory document.

South Africa is regarded as a country with some of the highest crime rates in the world. Clear guidance on the tax treatment of illegal receipts and expenditure resulting from illegal activities should therefore have a significant impact on the national fiscus. This study highlighted important principles that could be considered and applied in establishing such final guidelines that will govern the taxability of illegal activities within a South African context.

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