The illegal diamond trade in South Africa and its tax consequences

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Abstract

The object of the research was to discuss the taxability of the illegal diamond trade in South Africa and to identify the consequences of not declaring income obtained from the illegal diamond trade to the South African Revenue Services.

The research was conducted by means of a critical analysis of documentary data with specific reference to the Income Tax Act, the Value-Added Tax (VAT) Act, the Tax Administration Act and relevant case law. The Income Tax Act and the Value-Added Tax Act were referred to in relation to the tax consequences of the illegal diamond trade and the Tax Administration Act was used to determine the consequences of not declaring income to the South African Revenue Services.

It was established that amounts received from the sale of illegal diamonds are to be included in the taxpayer's gross income, whilst in relation to income received from diamond theft it was not as clear. The *MP Finance Group* case held that the nature of the receipt and the way in which the transaction occurred in each individual situation will be the deciding factor as to whether or not the stolen diamonds will be taxable in the hands of the thief. The buying and selling of "blood" or stolen diamonds can amount to a trade. As there have been no definitive case decisions in South Africa, it remains unclear whether expenses relating to an illegal trade are deductible. Assuming that expenses relating to an illegal trade are deductible, the provisions of section 11(a) will apply to expenses incurred as a result of dealing in illegal diamonds and it was concluded that qualifying expenses will be deductible. A taxpayer buying and selling "blood" or stolen diamonds is required to register for VAT if sales exceed the threshold and would be required to account for VAT on these transactions. If the taxpayer does not declare the income for income tax purposes or register for and pay VAT to the South African Revenue Services from either the sale of illegal diamonds or the theft of diamonds, this will amount to tax evasion and the dealer will be subject to penalties and even imprisonment.

Key words:

Blood diamonds; diamonds; general deduction formula; gross income definition; illegal income; Income Tax; Kimberley Process Certification Scheme; South African diamond industry; tax evasion; theft in South Africa; Value-Added Tax

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Introduction

1.1 Context of the research

The first diamond, known as Eureka, was discovered in South Africa in 1867 when a fifteen year old boy, Erasmus Jacobs, found a transparent rock on his father's farm on the south banks of the Orange River. This was the start of the diamond era and over the next few years South Africa produced more diamonds than India had in over 2000 years (Cape Town Diamond Museum, online: undated). Today South Africa's diamond production industry is ranked third in the world and produces about fourteen per cent of the world's diamonds (Statistic Brain Research Institute, online: 2015).

The diamond industry is approximately 99.8 per cent conflict free and this is due to the diamond industry regulators (South African Diamond and Precious Metals Regulator, online: 2013). The South African Diamond and Precious Metal Regulator (referred to as the Regulator) is responsible for the regulation of diamonds, which includes the use of the Kimberley Process Certification Scheme. Experts claim that due to the introduction of Kimberley Process Certification Scheme, the diamond industry is now almost conflict-free.

The diamond industry is, however, far from perfect as illegal diamonds do make their way into the market. The "Four C's" diamond grading system is used to assess the quality of the stone based on its colour, clarity, cut and carat (Cape Town Magazine.Com, online: 2015). However, there is another C, the fifth C, which is referred to as "conflict". This relates to the illegal trade of diamonds in African countries, known as blood diamonds or conflict diamonds (How stuff works, online: 2015).

It is not just blood diamonds that form part of the small percentage of diamonds that are traded illegally, many South Africans have been arrested for being in possession of unpolished and uncut diamonds, as well as smuggling these uncut diamonds in and out of South Africa and in turn selling them illegally. The issue that arises is that the sale of the diamonds leaves no paper trail and therefore there is no record that the sale existed. This in turn becomes an issue with the South African Revenue Services (referred to as SARS) in relation to the inclusion of the proceeds of the sale of the illegal diamonds in the taxpayer's tax return. The definition of "gross income" in section 1 of the Income Tax Act, 58 of 1962 (referred to as the Act), requires South African residents to be taxed on their world-wide

income and non-residents to be taxed on income from a source within South Africa (Stiglingh, Koekemoer, van Schalkwyk, Wilcocks and de Swart: 2014). The issue that arises is whether income relating to illegal transactions, such as the sale of illegal diamonds, is subject to tax.

The gross income definition in section 1 of the Act determines whether an individual will include the proceeds from the sale of illegal diamonds. One of the requirements of the definition is that an amount must have been "received by" the person. In the case of theft, the thief does not become the owner of the stolen thing and if caught would have to return it or its monetary equivalent to the rightful owner. The question therefore is whether the illegally obtained diamonds are "received by" the thief. The term "received by" is not defined in the Act, and therefore case law becomes relevant. *CIR v Delagoa Bay Cigarettes Co Ltd*, 1918 TPD 391, 32 SATC 47 (referred to as the *Delagoa Bay* case) deals with the taxability of income from illegal transactions. It is made clear in this case that illegal receipts are taxable and SARS will collect taxes on them if they are made aware of these receipts (Stiglingh *et al*: 2014). Another important case is *MP Finance Group CC (In Liquidation) v C: SARS* (2007 SCA), 69 SATC 141 (referred to as the *MP Finance Group* case). The Supreme Court of Appeal ruled in the *MP Finance Group* case that illegal gains will be taxed in the hands of the individual who received the amount for his or her own benefit (Stiglingh *et al*: 2014).

Regardless of the unanimous opinions of various case law, the issues then arises, is it morally correct to tax income from an illegal source? Justice Murphy once stated in relation to the taxation of illegal income: "Moral turpitude is not the touchstone of taxability" (Business Daily Africa, online: 2016). It has been argued that these cases should not encounter any tax consequences, but rather be dealt with by criminal law. However, the Act is mainly concerned with the collection of taxes on gross income and does not consider the morality or legality of the activity that is creating the source of income (Business Daily Africa, online: 2016). Therefore, in the view of uncertainly in the law, the South African Revenue Services can hardly be faulted in this respect, and income from an illegal source is just as taxable as income from a legal source.

Where taxpayers include income received from the sale of an item in gross income and incur expenses in generating that income, they would be entitled to deduct qualifying expenses in arriving at their taxable income in terms of the preamble section 11 of the Act, section 11(a) and section 23(g) (known as the "general deduction formula") or another

provision in the Act. The same principle should, in turn, apply to illegal activities and therefore also the illegal sale of diamonds.

Section 23(o) prohibits the deduction of certain expenditure relating to unlawful activities, but only refers to penalties and fines and actions dealt with in the Prevention and Combating of Corrupt Activities Act, 12 of 2004 (referred to as the Corrupt Activities Act) (Stiglingh *et al*: 2014), which include actions such as bribes and match-fixing, but not illegal activities *per se*.

It is not only income tax that is affected when the income from illegal diamonds is not declared to SARS. Value-Added Tax (referred to as VAT) in terms of the Value-Added Tax Act, 89 of 1991 (referred to as the VAT Act), is a further tax that may be affected. The Supreme Court of Appeal ruled in the *MP Finance Group* case that amounts received in respect of illegal transactions, such as illegal diamond sales, will be included in the taxpayer's income irrespective of their illegal nature (Stiglingh *et al*: 2014). The question is whether this principle can be applied in respect of VAT. Should the taxpayer be required to register as a VAT vendor and declare output tax on the sale of illegal diamonds?

In most cases that involve illegal transactions, SARS is not made aware of the income received in relation to these transactions and the taxpayer does not pay the necessary taxes. This is deliberate evasion of tax and a serious offence which is subject to penalties and interest in terms of the provisions set out in the Tax Administration Act, 28 of 2011 (referred to as the Tax Administration Act), and in some serious cases even imprisonment (Stiglingh *et al*: 2014).

The question may therefore be posed whether the income of the illegal diamond trade in South Africa is taxable. Research on the gross income definition in relation to the proceeds from the sale of illegal diamonds and the deductibility of expenditure relating to the illegal diamond trade will provide clarity on this issue.

1.2 Goals of the research

The goal of the research is to determine the taxability of the illegal diamond trade in South Africa, and identify the consequences of not declaring income from illegal diamond trade to SARS. The goal of the research will be achieved by addressing the following sub-goals:

1. Discuss the context relating to the diamond industry and the illegal trade in diamonds, including the history and current situation of the South African diamond

industry, and how it has changed over the past years, the diamond industry regulators and how they have developed over the past years, diamond theft in South Africa and how this affects the diamond industry, as well as the problem of "blood diamonds".

2. Consider to taxability of illegal diamond trade by discussing the gross income definition in relation to the proceeds from the sale of illegal diamonds.
3. Consider the deductibility of expenditure relating to the illegal diamond trade.
4. Discuss the possible VAT consequences in relation to illegal diamond trade.
5. Discuss the consequences on tax evasion in relation to illegal diamond trade.

1.3 Methods, procedures and techniques

The research falls within the interpretative paradigm. This approach is appropriate for the research as it seeks to describe and explain (Bobbie & Mouton: 2009). A *doctrinal* methodology is applied. This methodology has been described as a synthetic exposition of rules governing particular legal category (in the present case the legal rules relating to the interpretation of tax statutes and the legal rules for the inclusion of amounts either received by or accrued to a taxpayer, as well as the legal rules relating to the deductibility of expenditure in the production of income), the analysis of the relationship between the rules, an explication of areas of difficulty and is based purely on documentary data (McKerchar: 2008).

The methodology is qualitative, involving the analysis and interpretation of documentary evidence, including the Income Tax Act, VAT Act, journal articles, internet articles, case law relating to relevant issues and other documents.

Due to the volume of literature available regarding the diamond industry, only internet and journal articles published in the previous ten years will be researched and analysed.

As all the documentary data used for the purposes of the research are in the public domain, no ethical considerations arise in relation to their use. Opinions will be included in their written form and no interviews will be conducted.

1.4 Overview of the thesis

To determine whether income received from illegal diamond trade is taxable, the Income Tax Act and VAT Act were analysed. The Tax Administration Act was analysed to determine the consequences of not declaring illegal income to the South African Revenue Services. In Chapter 2 a brief history of the South African diamond industry was provided. This analysis included a discussion of the current situation of the South African diamond industry, including a discussion relating to the diamond industry regulators, and the effect of the availability of "blood" diamonds and theft of diamonds on the diamond industry.

Chapter 3 involved an interpretation of the Income Tax Act in relation to gross income (in terms of the definition in section 1 of the Income Tax Act) to determine whether an amount "received" by a taxpayer in relation to illegal diamond transactions and the theft of diamonds is taxable.

An interpretation of the Income Tax Act in relation to the "general deduction formula" (the preamble to section 11, section 11(a) and section 23(g)) was dealt with in Chapter 4. This was carried out in order to determine whether expenses relating to the sale of diamonds, whether stolen or "blood" diamonds would be deductible.

Chapter 5 involved an interpretation of the VAT Act, and the provisions relating to the need to register for VAT purposes and the payment of VAT relating to illegal enterprises.

In Chapter 6 the Tax Administration Act was discussed in order to identify the consequences of not declaring the income from illegal diamond dealing for income tax purposes and the non-disclosure of illegal supplies that are subject to VAT.

Chapter 7 concluded the research, summarising and discussing the research findings.

Chapter 2

The diamond industry

2.1 Introduction

The diamond industry in South Africa has developed from the discovery of the first diamond in 1867. However, the production of diamonds has drastically decreased as a percentage of the world's production. The history and current situation of the South African diamond industry will be discussed in this chapter, as well as how it has changed over the past years.

The theft of diamonds in South Africa has been an ongoing issue for many years. However, this is not the only form of illegal diamond trade in South Africa. Blood diamonds are smuggled across the South African border from conflict-inflicted countries and these diamonds are passed off as legitimate diamonds in the market. Blood diamonds and the theft of diamonds in South Africa will also be discussed in this chapter as background to the discussion of the taxation of income from illegal activities involving diamonds.

The diamond industry is aware of the issues that affect the industry and has systems and programs in place to regulate the industry. The diamond industry regulators will be discussed, and how they have developed over the past years in an attempt to eliminate illicit diamonds from the market.

2.2 The South African diamond industry

The first diamond, known as Eureka (22 carats) was discovered in South Africa in 1867 when a 15 year-old boy, Erasmus Jacobs, found the transparent rock on his father's farm on the south bank of the Orange River near Kimberley in the Northern Cape Province. It was a neighbour, Schalk van Niekerk, who identified the rock as a diamond (Cape Town Magazine.Com, online: 2015). Erasmus Jacobs was unaware of the huge influence this would have on the South African economy over the next few years. South Africa produced more diamonds than India had in over 2000 years, and became one of the major diamond producers in the industry (Cape Town Diamond Museum, online: 2015).

Diamond prospectors began searching for diamonds on dry land. This was encouraged by the discovery of diamonds found in farmhouse bricks which were made from local earth.

Two of the most sought-after "dry digging" areas were found on a farm owned by two brothers, Johannes Nicolas and Diederick Arnoldus de Beer. In 1871 the two brothers sold the farm to prospectors for a total of £ 6 300 (Rough Guides, online: 2015).

In 1871 Fleetwood Rawstone and his group of British fortune hunters, known as the Red Cap Party, discovered the diamond deposits in Kimberley (Cape Town Magazine.Com, online: 2015). In the 1870s and 1880s, mines in Kimberley produced 95 per cent of the world's diamonds. Cecil John Rhodes and Barney Barnato owned large claims in the Kimberley mines (Rough Guides, online: 2015). In 1888 and 1889 Cecil John Rhodes bought out Barney Barnato and merged all of his holdings to launch the company known worldwide today as De Beers Consolidated Mines (Cape Town Magazine.Com, online: 2015). In 1927, Sir Ernest Oppenheimer, the founder of the Anglo American Corporation of South Africa, took over De Beers Consolidated Mines. This company is still owned by the Oppenheimer family, and has grown to become one of the largest in the diamond industry (Cape Town Magazine.Com, online: 2015).

Sir Thomas Cullinan, the founder of Premier Mines, established Premier Mines with the discovery of the Cullinan Diamond Pipe near Pretoria in 1902 (Cape Town Magazine.Com, online: 2015). The Cullinan Mine is still in operation, and is producing some of the biggest diamonds in the world. In 2010 a 507 carat diamond was found at the Cullinan Mine, and was sold for US$ 35.3 million. This is the highest price ever paid for a diamond (Cape Town Magazine.Com, online: 2015).

In 1919 the benchmark diamond shape, known as the modern round brilliant cut, was designed. Gemologist and engineer, Marcel Tolkowsky, transformed diamond cutting with a design based on mathematical principals to ensure that the white light reflects through the top of the diamond to ensure the spark is never lost (Cape Town Magazine.Com, online: 2015). The "Four C's" of the diamond grading system was introduced in 1939 by the Gemologist Institute of America. This system assesses the diamond on four levels, namely cut, clarity, colour and carat (Cape Town Magazine.Com, online: 2015).

In 1992 De Beers Consolidated Mines opened the Venetia diamond mine, located 80 kilometres from Musina in the Limpopo province. This mine was South Africa's largest diamond producer in 2009, producing 2.2 million carats in that year. This mine is currently an open-pit mine. However, prospectors are hoping to convert the mine into an

underground mine as it becomes deeper. This conversion is expected to take place between 2018 and 2021 (Mbendi, online: 2015).

In 1994 Shimansky opened their first store in South Africa. In 2003 they developed the "Eight Heart Diamond" which has been trade-marked worldwide. Yair Shimansky, the founder of the company, spent three years researching and designing the first internationally patented square-cut diamond with a diamond-shaped table facet (Cape Town Magazine.Com, online: 2015).

The recession in 2008 caused the diamond industry to experience a downturn. This, however, did not last long as South Africa produced 6, 139, 682 carats of diamonds in 2009, and both prices and production stabilised. The large production of diamonds in South Africa in 2009 encouraged junior diamond miners to resume production, and continue with their proposed expansion projects (Mbendi, online: 2015).

De Beers Consolidated Mines ceased operations in almost 60 per cent of their mines. However, they still produced 4.8 million carats of diamonds (Mbendi, online: 2015).

In 2009 Yair Shimansky developed another brilliant diamond, this time the "Brilliant 10" which outshines all other diamond cuts (Cape Town Magazine.Com, online: 2015).

In June 2010 De Beers Consolidated Mines announced the planned reconstruction of the Finsch Mine located 165 kilometres west of Kimberley. The planned reconstruction will sustain future business operations of the mine for years to come (Mbendi, online: 2015).

Today South Africa is ranked 3rd in the world in the diamond production industry and produces about 14 per cent of the world's diamonds (Statistic Brain Research Institute, online: 2015). South Africa has mines operational in five of its nine provinces: Gauteng, Free State, North West, Limpopo and the Northern Cape provinces (Cape Town Magazine.Com, online: 2015). South Africa has one the widest ranges of diamond deposits in the world, including open pit, underground kimberlite mining, alluvial mining and offshore marine mining, near the mouth of the Orange River in the Northern Cape (Rough Guides, online: 2015). De Beers Consolidated Mines contributes approximately 45 per cent to the world's diamond market. Other major diamond producers include Petra Diamonds, Trans Hex and Diamondcorp (Mbendi, online: 2015).

Since the discovery of the first diamond in 1867, the diamond mining industry in South Africa has changed. In 1871, mines in Kimberley produced 95 per cent of the world's

diamonds. The production rate started to slowly decline over the next few years. However, South Africa was still producing some of the highest value diamonds. Today the production of diamonds in South Africa has decreased to 14 per cent of the world's diamonds. However, South Africa has produced some of the world's most magnificent diamonds and is known for the development of two world famous diamond cuts.

2.3 The Diamond Industry Regulators

The South African Diamond Board was established in 1987 in terms of the Diamond Act, 56 of 1986 (referred to as the Diamond Act) (South African Diamond and Precious Metals Regulator, online: 2013). The South African Diamond Board was established to regulate control over the possession, purchase, sale, processing and export of diamonds.

In 2007 three acts were promulgated, including the Diamond Amendment Act, 30 of 2005 (referred to as the Diamond Amendment Act), the Diamond Second Amendment Act, 30 of 2005 (referred to as the Diamond Second Amendment Act), and the Precious Metals Act, 37 of 2005 (referred to as the Precious Metals Act). This broadened the legal mandate of Boards to allow the regulation of precious metals (South African Diamond and Precious Metals Regulator, online: 2013).

In March 2007 the South African Diamond Board was delisted as a schedule 3A public entity, and replaced by the South African Diamond and Precious Metal Regulator (referred to as the Regulator) (South African Diamond and Precious Metals Regulator, online: 2013). The Regulator was established in terms of section 3 of the Diamond Act (as amended in 2005), and was established to administer the Diamond Act, Precious Metals Act and Diamond Export Levy Act, 2007 in collaboration with SARS (referred to as the Diamond Export Levy Act) (South African Diamond and Precious Metals Regulator, online: 2013).

The Regulator is responsible for the regulation of gold, diamonds and platinum group metals, and is classified as a schedule 3A entity in terms of the Public Finance Management Act, 1 of 1999 (referred to as the Public Finance Management Act) (South African Diamond and Precious Metals Regulator, online: 2013). The Regulator receives all funding through the Department of Mineral Resources in the form of state grants. The main function of the Regulator is to facilitate the buying, selling, exporting and importing process of all diamond transactions through the Diamond Exchange and Export Centre (South African Diamond and Precious Metals Regulator, online: 2013). The Diamond Exchange and Export Centre started operations on 14 January 2008. The Diamond Exchange and Export Centre was established

by the Regulator in terms of section 59(b) of the Diamond Amendment Act (South African Diamond and Precious Metals Regulator, online: 2013).

The Diamond Exchange and Export Centre plays a vital role in ensuring that unpolished diamond tenders are facilitated fairly to the local market. This is done through a secure and controlled environment. On 15 February 2013 the Diamond Exchange and Export Centre launched an additional service, which involves the facilitation of polished diamonds through the same secure and controlled environment (South African Diamond and Precious Metals Regulator, online: 2013).

The diamond industry is approximately 99.8 per cent conflict free, and experts claim that this is due to the introduction of the Kimberley Process Certification Scheme. The diamond industry is, however, far from perfect. Diamonds have been used for many years to finance conflicts and wars in African countries. These diamonds are known as blood diamonds or conflict diamonds. The warlords and army rebels used the proceeds from the sale of these diamonds to fund civil wars against legitimate governments. The illicit diamond trade takes place outside of the Kimberley Process Certification Scheme and creates channels for illegal diamonds to pass through with relative ease. Illicit diamonds are smuggled diamonds used for illegal purposes. Both situations take advantage of the weak government trade regulators in their countries, and this resulted in the introduction of the Kimberley Process Certification Scheme (South African Diamond and Precious Metals Regulator, online: 2013). The Kimberley Process Certification Scheme is a system used to prevent conflict and illicit diamonds from entering the legitimate diamond industry supply chain, and in turn weakening the diamond market.

The Southern African diamond producing states met in Kimberley, South Africa in May 2000 to try to find a solution and stop the trade of blood diamonds from African countries and to prevent the trade of illicit diamonds. The launch of the Kimberley Process Certification Scheme took almost two years. The first meeting took place in May 2000. This was followed by a further eight meetings that took place in various places across the world. On 5 November 2002, the Kimberley Process Certification Scheme was launched in Interlaken, Switzerland. The Kimberley Process Certification Scheme was implemented from 1 January 2003 (South African Diamond and Precious Metals Regulator, online: 2013).

To date the Kimberley Process Certification scheme has the support of more than 74 governments, as well as civil society, the diamond industry and the European community.

All major diamond producing and trading countries participate in the scheme, which processes approximately 99 per cent of the global production of rough diamonds (South African Diamond and Precious Metals Regulator, online: 2013).

The Kimberley Process Certification Scheme requires participants to import and export rough diamonds only to and from other participating countries. Each participating country has to certify that the rough diamonds imported or exported are conflict-free or have not been smuggled through illegal channels. To ensure this, each participant in the scheme has to implement effective diamond control systems (South African Diamond and Precious Metals Regulator, online: 2013).

Further to the Kimberley Process Certification Scheme, the World Diamond Council introduced the System of Warranties. This was introduced to reassure consumers that the polished diamonds they are purchasing are from a source free of conflict and are not illicit diamonds, from origin to the diamond jewellery retailer. The main element of the program assures consumers that the polished diamond they receive is in compliance with the regulations of the United Nations. Assurance is provided by a declaration on the consumer's invoice (South African Diamond and Precious Metals Regulator, online: 2013).

The Kimberley Process Certification Scheme is not the only system that has been implemented by the Regulator. Various other programs have been implemented, including the Administration Program. This program provides the Regulator with administrative and strategic support services (South African Diamond and Precious Metals Regulator, online: 2013). Another program implemented by the Regulator is the Diamond Trade Program. The Diamond Trade Program comprises of the Government Diamond Valuator, the Diamond Exchange and Export Centre and the various Kimberley Process Certification Scheme sub-programs (South African Diamond and Precious Metals Regulator, online: 2013). The purpose of the Diamond Trade program is to regulate the processes of importing and exporting diamonds, and the buying and selling of diamonds in order to ensure that they are traded at their fair market value and also to ensure that these diamonds are conflict-free (South African Diamond and Precious Metals Regulator, online: 2013).

The last program implemented by the Regulator is the Regulatory Compliance program. The purpose of this program is to regulate the diamond industry. The program consists of sub-programs, including the Licensing and Diamond Inspectorate (South African Diamond and Precious Metals Regulator, online: 2013). The Licensing program is responsible for the

license applications for trading in unpolished diamonds, as well as the beneficiation and research of unpolished diamonds. The Diamond Inspectorate is a program that ensures that all Diamond Act legislation is complied with (South African Diamond and Precious Metals Regulator, online: 2013).

The programs to regulate diamonds have developed from the establishment of the South African Diamond Board in 1987, to the replacement of the South African Diamond Board in March 2007 by the Regulator, and the introduction of the Kimberley Process Certification Scheme in November 2002. The introduction of the Regulator facilitated ensuring the integrity of all diamond transactions, including buying, selling, importing and exporting. The Regulator also strives to ensure economic empowerment, business excellence and the transformation of the diamond and precious metals industry. The introduction of the Kimberley Process Certification Scheme was a major milestone for the diamond industry. Today, the diamond industry is approximately 99.8 per cent conflict-free, as a result of the scheme. Critics, however, claim that the program does not prevent diamonds from being easily smuggled from African countries to countries that participate in the Kimberley Process Certification Scheme, in turn being passed off as legitimate. Due to this the human rights groups continue to push for stricter regulations in the diamond industry to ensure that it becomes 100 per cent conflict-free.

2.4 Blood diamonds

The diamond industry is far from perfect as illegal diamonds do make their way into the market. The "Four C's" diamond grading system is used to assess the quality of the stone based on its colour, clarity, cut and carat (Cape Town Magazine.Com, online: 2015). However, there is another C, the fifth C, which is referred to as "conflict". This relates to the illegal trade of diamonds in African countries, known as blood diamonds or conflict diamonds (How stuff works, online: 2015).

During the last twenty years, seven African countries, including the Central African Republic, Zimbabwe, Angola, Cote D'Ivoire, Sierra Leone, Liberia, and the Democratic Republic of the Congo, have all been involved in brutal civil wars over the struggle for diamonds and the ownership of diamond mines (Brilliant Earth, online: 2015). The diamond mines in these African countries have not only been the source of diamonds, but also civil wars, work exploitation, violence, human suffering and the degradation of the environment.

Experts claim that the proceeds from the sale of blood diamonds in various African countries have produced billions of dollars to fund civil wars and other conflicts. Warlords and army rebels in these African countries take advantage of the weak legislation and trade regulators in place in their countries and use the proceeds to fund civil wars against the legitimate governments (How stuff works, online: 2015). Not only the warlords and army rebels are involved in blood diamonds, but also governments and mining companies in African countries that are not currently at war (Brilliant Earth, online: 2015).

According to a documentary produced by National Geographic News, a total of more than four million lives have been lost in African countries. This figure is not only the result of the bloodshed and death of innocent Africans, but includes deaths from abuse, ranging from the use of child soldiers, to rape (How stuff works, online: 2015). Millions of people, the family and friends of the Africans who lost their lives during these civil wars, are still dealing with the heartache caused by the bloodshed and abuse.

The mining of blood diamonds still takes place in some African countries, with armed groups using force to take control of the diamonds. The African countries and rival groups often fight against each other to take control of land that is rich in diamonds (Brilliant Earth, online: 2015). Even though the mining of blood diamonds has ended in most African countries, it still remains a serious problem.

The Central African Republic is still the victim of violent crimes today, with militants fighting over diamonds, as well as other resources of the country. This has resulted in an increase in the death toll and more than one million people have left their homes. Approximately 100 000 people are living in a refugee camp situated near the Bangui airport (Brilliant Earth, online: 2015). The Kimberley Process Certificate Scheme has banned the export of diamonds from the Central African Republic in the hope of stopping the violence and civil wars caused by the blood diamonds. However, blood diamonds are still easily being smuggled across the Central African Republic border and sold to international diamond consumers (Brilliant Earth, online: 2015).

Zimbabwe is another African country involved in the mining of blood diamonds. The Zimbabwean army took control over the valuable Marange diamond deposit in Eastern Zimbabwe in 2008. Over 200 diamond miners were killed in the process. Today the violence and abuse continues at the Marange diamond deposit, with many people still being beaten and killed. The army has private companies in charge on the diamond deposit (Brilliant

Earth, online: 2015). Despite the violence and abuse that occurs in Zimbabwe, in 2011 the Kimberley Process Certification Scheme allowed Zimbabwe to re-enter the diamond producing industry (Brilliant Earth, online: 2015). This could result in the entry of blood diamonds into the diamond industry.

Zimbabwe is not the only African country that is involved in the mining of blood diamonds, and still a member of the Kimberley Process Certification Scheme. Angola is also a culprit. Angola is the fourth largest diamond producer in the world and is finally a member of the Kimberley Process Certification Scheme after ten years. Angola has been free of war for ten years since the horrific civil war over diamonds in 2005. However, this was short lived as the diamond fields are once again prone to violence (Brilliant Earth, online: 2015).

Recently migrants from the Democratic Republic of the Congo have been illegally crossing the Angolan border in search for diamonds in Northeast Angola. The Angolan army, the guards at the various mines and local Angolan miners, have been putting a stop to these migrants. The army has been demanding bribes on a recurring basis from local Angolan miners, and if they do not cooperate, they are been beaten and killed. The army has been expelling thousands of the migrants each year across the border, however, in the process, they are first raping many of the women (Brilliant Earth, online: 2015). The Angolan leaders refused to take action against the problems in their country, but rather filed a criminal defamation charge against the journalist who identified these issues. More than 100 people were murdered and over 500 people were tortured in only two mining towns situated in Angola. The Kimberley Process Certificate Scheme has once again ignored the serious issues that exist in Angola, and has elected them as scheme leader 2015 (Brilliant Earth, online: 2015).

Even though migrants from the Democratic Republic of the Congo have been trying to cross the border and illegally mine diamonds in Angola, the Democratic of the Congo is still a participant in the Kimberley Process Certification Scheme. The Democratic Republic of the Congo currently accounts for eight per cent of the world's diamond production, and is a proud member of the Kimberley Process Certification Scheme. Even though citizens of the country do try to mine diamonds illegally from their neighbouring country, Angola, it can be assumed that no blood diamonds are being mined in the Democratic Republic of the Congo today (Diamond Facts, online: 2015).

Cote D'Ivoire, the Ivory Coast, is free of civil wars caused by blood diamonds. There is still, however, a small percentage of informal diamond mining taking place North East of the Ivory Coast. This has not resulted in violence or abuse of any people of the Ivory Coast (Diamond Facts, online: 2015). The government of the Ivory Coast is working closely with the Kimberley Process Certification Scheme and the United Nations to ensure that this ban is not put in place again and, together, they are successfully overcoming various challenges and establishing positive solutions in this regard (Diamond Facts, online: 2015).

Liberia was once at war. However, in April 2007, Liberia was admitted to the Kimberley Certification Process Scheme, and it is now free from war (Diamond Facts, online: 2015).

Sierra Leone is another country that was the victim of brutal civil wars. For a period of ten years, between 1991 and 2002, Sierra Leone suffered a terrible civil war. As a result, in October 1999 the United Nations established their largest peacekeeping operation in the world, known as the Mission in Sierra Leone. The Abuja Agreement was finally entered into in 2001, and by the end of January 2002 the civil war came to an end. Sierra Leone is now a democratic country. Following the signing of the Abuja Agreement, the Government Diamond Office was set up to provide technical assistance and training to the Ministry of Mines in Sierra Leone. In 2003, Sierra Leone was invited to join the Kimberley Process Certification Scheme, with 99 per cent of their diamond production being free from blood diamonds (Diamond Facts, online: 2015).

Blood diamonds have been an issue in African countries for many years, and are still an issue in some African countries today. It is not just the diamond industry market that is affected, but many African people have suffered brutal torture and death in the civil wars, resulting in the suffering of many family members and friends. With the introduction of the Kimberley Process Certification Scheme in 2002, the chance of blood diamonds entering the diamond market has decreased, and in turn the violence and torture of Africans has decreased. Critics of the scheme, however, claim that the Kimberley Process Certification Scheme does not prevent blood diamonds from being smuggled from African countries to legitimate countries and being passed off as legal diamonds. As a result, human rights groups continue to push for stricter laws to ensure that the diamond industry is 100 per cent conflict-free in years to come.

2.5 Diamond theft and the illegal diamond trade in South Africa

Blood and conflict diamonds have been traded illegally in Africa for many years, and have been the reason for many civil wars. In some instances, these diamonds do make their way into South Africa. Smugglers from South Africa illegally import blood diamonds into the country, and they end up being passed off as conflict-free diamonds in the market. However, blood diamonds are not the only form of illegal trade in South Africa. There are various other ways individuals become involved in the illegal diamond trade.

One of the biggest diamond "busts" in the history of South Africa occurred in August 2014. The operation included raids and seizures which targeted at least thirty five people ranging between the ages of twenty three and seventy years (IOL, Online: 2014a). The investigation, referred to as Project Darling, started in October 2011. It was an investigation into a multi-million rand syndicate. The investigating team consisted of members of the Directorate of Priority Crimes Investigation (Hawks), National Prosecuting Diamond Authority (NPA), Financial Intelligence Centre (FIC) and the South African Police Services (SAPS) (Ann7, online: 2014). The Kimberly High Court granted the NPA ten preservation orders in terms of the Preservation of Organised Crime Act (POCA) (Ann7, online: 2014). This allowed the NPA to freeze orders to the value of R 43 million in cash. This was made up of proceeds from criminal activities including the use of five fixed properties and four vehicles that were used to commit the illegal diamond activities (Ann7, online: 2014).

More than R 1 million in cash and diamonds was found in one of the raids that took place in a house in the Northern Cape (Ann7, online: 2014). During the seizures that occurred, sixty-six diamonds were recovered (ENCA, online: 2015). During the raids, a prominent diamond trader in Kimberley was arrested. He later received bail of R 500 000.00, set by the Magistrate in the Kimberley Magistrates' Court (Ann7, online: 2014). Two other accused also received bail of R 500 000.00 (IOL, Online: 2014a). In Gauteng, eight suspects handed themselves over to the police, accompanied by their legal representatives. Included in the arrested in Gauteng was a seventy year-old businessman who was arrested for alleged illicit diamond dealing (Ann7, online: 2014). Bail ranged from R 50 000.00 to R 750 000.00 and amounted to R 4.4 million for a total of twenty two people (IOL, Online: 2014a).

The accused faced charges for money laundering, use of unregistered premises as a diamond trade house, illegal diamond trade, possession and sale of unpolished diamonds; charges for tax evasion were later added (ENCA, online: 2015). Hawks spokesperson,

Captain Paul Ramaloko, said that the suspects were buying illegal diamonds from illegal miners and these were being sold with allegedly falsified authentication certificates to legal markets (Ann7, online: 2014). The illegal diamond miners were from across the country, with the highest number of illegal dealers coming from the Northern Cape (Ann7, online: 2014). Ramaloko explained that they had made controlled purchases worth R 43 million over a period of a year during the investigation (Ann7, online: 2014). Ramaloko also mentioned that in thirty one transactions, 490 diamonds were sold to the accused and this amounted to R 43.18 million, and in twenty three transactions, seventy six diamonds were purchased from the accused amounting to R 380 000.00 (ENCA, online: 2015). Ramaloko explained that these diamonds were being sold both in South Africa and internationally to specific buyers, and he believed that this syndicate formed part of a bigger international illicit diamond trade. He believes that the success of Project Darling will lead to the bust of international syndicates and will eventually even out the diamond market (ENCA, online: 2015).

Since the diamond raid in August 2014 various other illicit diamond crimes have occurred. On the morning of 2 November 2014 a woman tried to cross the border from Lesotho to South Africa when she was arrested for being in the possession of an unpolished diamond and dealing in unpolished diamonds (SAPS Journal, online: 2015c). It was during a routine inspection at the Maseru Port of Entry that a member of the police found an unpolished diamond in her bag (SAPS Journal, online: 2015c).

Another arrest was made by members of the Hawks on 4 February 2015 in the Northern Cape. A forty year-old man was arrested for dealing in uncut diamonds (SAPS Journal, online: 2015a). It was alleged that he had purchased diamonds illegally from an agent in Project Darling in three transactions amounting to R 9.75 million. He was released on bail in the Upington Magistrates Court for an amount of R 50 000.00 (SAPS Journal, online: 2015a). The investigation into Project Darling continues.

On 28 April 2015 the Hawks arrested five suspects aged between thirty-two and sixty years of age in connection with selling unpolished diamonds in Montana, Pretoria. The police received information that the suspects were selling 33.3 carats of unpolished diamonds (SAPS Journal, online: 2015b). A sting operation was conducted and the five suspects were found to be in the possession of unpolished diamonds to the value of R 5.9 million. They faced charges for dealing in unpolished diamonds (SAPS Journal, online: 2015b).

It is not only illegal diamond trade that is rife in South Africa. Diamond theft is another issue that South Africa is dealing with. In January 2015 six people were arrested for the theft of three diamonds from a mine near Prieska in the Northern Cape. Approximately sixteen men forced their way into the mine at about 3.40 am. The men approached a mine truck driver at gun point and assaulted him before tying him up. At this stage, the manager of mine was approached by the same group of men on the way to the mine. The men were now in control of two of the mine vehicles, the truck and the mine manager's vehicle. On their way to the mine, they approached a front loader. The men drove the truck straight into the front loader, but the driver tried to drive away. In the process one of the men tried to shoot the front loader's battery, but the driver carried on. Once again the same man tried to shoot the driver in the head, but they missed (News 24, online: 2015). The men continued onto the mine and tied up and assaulted two employees and the mine guards. When they entered the mine, they managed to blast open the safe and escaped with three diamonds. The value of the diamonds stolen was not disclosed (ENCA, online: 2015).

A previous incident occurred in Belville, Cape Town in 2014. Four armed men broke into a house and managed to override tight security. They forced the owners to hand over the jewellery that was hidden in the walk-in safe. The men escaped with diamonds worth R100 million. The owner was involved in the diamond trade, and it is believed that the robbery was in connection with a business deal that had fallen through a week before the robbery occurred. The businessman believed to be involved in the robbery had seen the diamonds in the owner's walk-in-safe. Seven sources explained to the Weekend Argus that criminals involved in such activities exchange the diamonds so that there is no paper trail (IOL beta, online: 2014b).

The illegal diamond trade and diamond theft in South Africa are on-going issues. The crimes discussed above are only a fraction of what actually occurs in South Africa, and only relate to recent crimes. The trade in illegal diamonds has become a business in South Africa, as more and more individuals are becoming involved in these illegal dealings. The problem is that the sale of the diamonds leaves no paper trail and therefore there is no record that the sale existed.

2.6 Conclusion

Since the discovery of the first diamond by Erasmus Jacobs in 1867, the diamond industry in South Africa has changed. In 1871, mines in Kimberley produced 95 percent of the world's diamonds. Today this rate has decreased to only 14 percent. However, South Africa has produced some of the world's most magnificent diamonds and is known for the development of two world famous diamond cuts. In 2010, the Culinan mine produced a 507 carat diamond and it was sold for US $ 35.3 million. Yair Shimansky also developed the "Eight Heart Diamond" in 2003, which has been trademarked worldwide, as well as the famous "brilliant 10" in 2009 which outshines all other cuts.

South Africa has programs in place to regulate the diamond industry. These programs have developed over the past years, from the establishment of the South African Diamond Board in 1987, to the replacement of the South African Diamond Board by the Regulator in March 2007, and the introduction of the Kimberley Process Certification Scheme in November 2002. The Regulator was introduced to facilitate all diamond transactions, including buying, selling, importing and exporting of diamonds. The Kimberley Process Certification Scheme was introduced to prevent conflict and illicit diamonds from entering the diamond industry. This was a major milestone for the diamond industry as today the diamond industry is approximately 99.8 percent conflict-free.

"Blood" diamonds have been an issue in African countries for many years, and continue to be an issue today. Both the African people in these countries and the diamond industry suffer. The mining of "blood" diamonds has resulted in the outbreak of civil wars causing brutal torture and death. Critics claim the Kimberley Process Certification Scheme does not prevent "blood" diamonds from being smuggled from African countries to legitimate countries and being passed off as legal diamonds. As a result, human rights groups continue to push for stricter laws to ensure that the diamond industry is 100 per cent conflict-free in years to come.

"Blood" diamonds are not the only illegal diamonds that affect the diamond industry. Theft in South Africa is an on-going issue. The crimes discussed only relate to crimes that have occurred in South Africa in the recent past, and are only a fraction of what has actually occurred. More individuals are becoming involved in the buying and selling of "blood" or stolen diamonds, and theft is becoming a business. The issue that arises is whether income relating to these transactions is subject to tax. This is discussed in the chapter that follows.

Chapter 3

Taxability of the illegal diamond trade in South Africa in relation to the gross income definition

3.1 Introduction

Blood diamonds have been an ongoing issue in African countries for many years and continue to be an issue today. With the loopholes in the Kimberley Process Certification Scheme, blood diamonds are being easily smuggled from the affected African countries to other countries and passed off as conflict-free. South Africa is one of the countries that have been involved in smuggling blood diamonds from affected African countries and in turn, these diamonds get passed off as being conflict-free in the diamond market. Blood diamonds are not the only form of illegal diamond trade in South Africa. There are various other ways in which individuals have become involved in the trade of illegal diamonds.

Another prevalent problem in South Africa is theft.

Seven sources explained to the Weekend Argus that criminals involved in such activities exchange the diamonds so that there is no paper trail, and in turn there is no record that the sale existed (IOL beta, online: 2014b). The issue that arises is whether the income received from these crimes is subject to tax.

For an amount to be included in a taxpayer's gross income, all the elements of the "gross income" definition in terms of section 1 of the Act need to be met. In relation to illegal diamond transactions, the underlying issue is to determine whether the amount has been "received by" or "accrued to" the taxpayer. There are two instances that arise in relation to illegal diamond transactions. The first is whether the proceeds received from the sale of "blood" or stolen diamonds are included in gross income and the second is whether the value of a stolen diamond is included in gross income in the hands of the thief. The "gross income" definition in terms of section 1 of the Act will be discussed, making reference to case law to determine whether these amounts will be included in the taxpayer's gross income.

3.2 Gross income in relation to the trade of illegal diamonds

In order to assess a person's taxable income, it first has to be determined what constitutes gross income. Reference to a person includes a natural person, a juristic person, an insolvent estate, a deceased estate, a trust or a portfolio of a collective investment scheme (Stiglingh *et al*: 2014). The "gross income" definition requires South African residents to be taxed on their world-wide income and non-residents to be taxed on income from a source within South Africa. The issue that arises is whether the income relating to illegal transactions, such as the proceeds received from illegal diamonds, is subject to tax.

Section 1 of the Act, defines "gross income" 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 . . .

Not all of the terms used in this definition are defined. It is necessary, therefore, to refer to case law in order to provide clarity on their meaning, in order to understand the meaning of gross income.

In the case of a South African resident who receives proceeds from illegal diamond transactions, a total amount must be received, either in cash or any other form that has a monetary value. This amount must be received by or accrued to the person in the relevant year of assessment and not be of a capital nature. The underlying issue is to determine whether the proceeds received from illegal diamond transactions have been "received by or are accruing to" the taxpayer. Illegal diamond transactions can be separated into two categories. The first is the proceeds received from the sale of illegal diamonds, and whether the proceeds from the disposal will be included in the taxpayer's gross income. The second relates to stolen diamonds, and whether the thief will include the diamond stolen in his or her gross income.

3.2.1 The meaning of "Total amount in cash or otherwise"

A "total amount" must be received by the taxpayer. However the total amount is not required to be in a monetary form.

In *Lategan v CIR*, 1926 CPD 203, 2 SATC 16 (referred to as the *Lategan* case), the term total amount is given a wider meaning. It is made clear the meaning does not only include money, but rather the value of any form of property earned by the taxpayer, whether tangible or intangible, as long as it has a monetary value (Huxham & Haupt: 2011).

When proceeds are received from illegal diamond transactions, an amount has been received. Whether the proceeds are in a monetary form or not, is immaterial. As long as the proceeds have a monetary value, the proceeds received from the sale of illegal diamonds will be included in the taxpayer's gross income, subject to the other elements of the gross income definition being met.

When a thief steals a diamond, the issue is whether the diamond is gross income in the hands of the thief or not. A stolen diamond is not in a monetary form, it is a tangible asset. However, in terms of the principle established in the *Lategan* case, the monetary value of the stolen diamond is an "amount" that has been received by the thief.

Even though an "amount" has been received by the diamond thief, the issue is then at what value the stolen diamond will be included in the thief's gross income. Should a taxpayer receive an amount in a form other than cash, the asset will be included in gross income at its market value, and at the earlier of receipt or accrual. This is the general principle (Stiglingh et al: 2014). The Act does not define the concept "in cash or otherwise", therefore case law will be analysed to clarify this concept.

In C:SARS v *Brummeria Renaissance (Pty) Ltd and others*, 69 SATC 205 (referred to as the *Brummeria Renaissance* case) the taxpayers (a group of companies) granted life-rights over units in a sectional title scheme that was operating as a retirement village. In exchange for the life-rights, the occupiers of the units granted interest-free loans to the taxpayers. The life-rights were in a non-monetary form, and there was an issue regarding how the life-rights should be valued and included in gross income. The Supreme Court of Appeal held that the method used to value such a right was an objective method, being at open market value, rather than a subjective method (Huxham & Haupt: 2011).

In the *Lace Proprietary Mines Ltd* v CIR, 1938 AD 267, 9 SATC 349 (referred to as the *Lace Proprietary Mines* case) the taxpayer acquired certain mineral rights over the farm Spaarwater for the purpose of disposing of those mineral rights to a company to be formed to mine the property. The contract of sale stated that the price would be paid by the allotment of shares to the taxpayer. The issue to be decided upon was whether the cash price or value was to be included in the gross income of the taxpayer. The court held that an amount or asset received other than in cash should be included in gross income at the same value as if it were to be sold on the open market under any reasonable method of sale (Stiglingh *at el*: 2014). If the principle established in the *Brummeria Renaissance* case and the *Lace Proprietary Mines* case are applied to stolen diamonds, then it can be argued that the stolen diamond will be included in the thief's gross income at its open market value, subject to the other elements of the "gross income" definition being met.

3.2.2 The meaning of "not of a capital nature"

The "gross income" definition specifically excludes receipts of a capital nature, unless they are specifically included in terms of one of the special inclusions (none of which apply in the present case). Case law provides a number of tests that have become accepted in determining whether an amount is capital or revenue in nature. Certain tests are subjective and test the taxpayer's intention. However, there are a number of objective factors identified by the courts to determine the true intention of the taxpayer (Stiglingh *et al*: 2014).

To determine whether proceeds received from the sale of illegal diamonds are capital or revenue in nature, the intention of the taxpayer's motive to make a profit will need to be considered. Guidance can be taken from CIR v *Pick 'n Pay Employee Share Purchase Trust*, 54 SATC 271 (A) (referred to as the *Pick 'n Pay Employee Share Purchase Trust* case). The taxpayer formed a trust to provide shares to its employees. The trust acquired the shares at market value from the company, and the shares were disposed of to the employees of the company. The trust had no intention of making a profit on the sale of the shares. However, the trust was required to dispose the shares at a certain price, which resulted on a profit being made on the sale of the shares. The majority of the court considered the taxpayer's motive to make a profit. It was held that there was no scheme of profit making, and therefore the proceeds were capital in nature (Goldswain: 2010b).

The proceeds received from the sale of illegal diamonds are of a result of the taxpayer having a motive to make a profit from the sale of the diamonds. With guidance taken from the *Pick 'n Pay Employee Share Purchase Trust* case, it can be concluded that the proceeds received from the sale of the illegal diamonds are revenue in nature and therefore will be included in the taxpayer's gross income, subject to the other elements of the gross income definition being met.

Stolen diamonds, however, can be revenue or capital in nature. Subjective factors relate to the taxpayer's intention. Therefore the intention of the thief will need to be considered, the original intention of the thief, as well as whether there has been a change in the thief's intention (Stiglingh *et al*: 2014).

The taxpayer's intention is an important test used by the courts. However, this test is subjective and therefore the burden of proof in terms of section 102 of the Tax Administration Act rests with the taxpayer to prove that the amount is capital in nature. The court will consider the taxpayer's intention and this will be measured against the objective factors of the case to determine whether it is capital or revenue in nature (Stiglingh *et al*: 2014).

The first step is to consider the taxpayer's intention when the asset was acquired to determine whether the taxpayer acquired the asset as a capital asset or with the intention of making a profit (Stiglingh *et al*: 2014). If the thief stole the diamond with the intention to resell it, the stolen diamond will be revenue in nature. However, if the thief stole diamond with the intention to keep the diamond or make a gift of it, it will be capital in nature.

In some instances, the taxpayer may change his or her intention and the intention of the taxpayer will be considered during the period the asset was held. When determining whether the individual has changed his or her intention, the original intention of the individual will be considered, as well as his or her activities during the period the asset was held. To determine whether there was a change in intention, the objective factors of the case need to be considered during the time the stolen diamond was held. The court will consider the following factors (Stiglingh *et al*: 2014):

1. the length of time the diamond is held by the thief;
2. the nature of the thief's business;
3. continuity of activities thief's activities;
4. the conduct of the thief in relation to the transaction; and

5. the frequency of similar transactions

The court will consider these factors during the period the stolen diamond was held, and compare these in relation to the original intention of the thief in order to determine whether the stolen diamond is capital or revenue in nature. There is no clear answer to whether a stolen diamond is capital or revenue in nature.

3.2.3 The meaning of "received by" or "accrued to"

There are two ways in which income may be earned by the taxpayer. He or she may have received the income or it may accrue to him or her (that is, the amount is due to the taxpayer). In some instances this may happen at the same time (Huxham & Haupt: 2011).

The words "received by or accrued to" are not defined in the Act and therefore case law will be considered. In *CIR v Delfos*, 1933 AD 242, 6 SATC 92 (referred to as the *Delfos* case), it was held that an amount cannot be included in the taxpayer's gross income both when it accrues to him and when he receives it. The amount must be included in the taxpayer's gross income on the earlier of receipt or accrual (Stiglingh *et al*: 2014). In relation to the proceeds received from the transactions relating to illegal diamonds, the amounts will be included in the taxpayer's gross income at the earlier of receipt or accrual.

In SIR v *Silverglen Investments (Pty) Ltd*, 1969 (1) SA 365(A), 30 SATC 199 (referred to as the *Silverglen Investments* case), it was held by the Supreme Court of Appeal that the amount should be included at the earlier of receipt or accrual. Where the amount has been shown as an accrual by the taxpayer, it had to be included at that date in the taxpayer's gross income (Goldswain: 2010a). The principle held in the *Delfos* case was the same principle held in the *Silverglen Investments* case. This principle will be applied in respect of transactions relating to illegal diamonds. The proceeds will be included in the taxpayer's gross income at the earlier date of receipt or accrual.

As stated previously, the Act does not describe the term "received by" and therefore case law will be used to provide a meaning to the concept. In *Geldenhuys* v CIR, 1947 (30 SA 256(C), 14 SATC 419 (referred to as the *Geldenhuys* case), the taxpayer inherited a usufructuary interest in the flock of sheep after the death of her husband. Her children inherited the bare dominium, being the ownership of the sheep. The taxpayer only enjoyed the use of the flock of sheep. After a drought, a number of sheep and lambs died, and the number of the flock was never allowed to reach its former level, as the farm was considered

to be over-stocked. As a result, the taxpayer gave up farming and her children agreed to sell the flock of sheep as the number of sheep had decreased since the death of their father. The proceeds from the sale of the stock were deposited into the appellant's bank account, and she used it to invest in a bond in her favour. As a result the Commissioner included the difference between the proceeds of the sale of the stock and the value of stock at the date when the taxpayer took over the farm in her income. She appealed against the Commissioner's decision on the grounds that she only enjoyed the usufruct of the joint estate, and the amount realised was an estate asset and of a capital nature. The appellant's appeal was disallowed by the Special Court and she requested the case be stated to the Cape Provincial Division of the Supreme Court. The appellant's appeal was allowed by the court. They held that the appellant was only the usufructuary beneficiary of the flock of sheep, and the number of sheep had decreased from the date when her usufruct commenced and thus there was no surplus to which she was entitled. Therefore, the proceeds realised on the sale of the flock of sheep belonged to the heirs of the estate and were not included in her gross income (Goldswain: 2010a).

The principle that was applied in the *Geldenhuys* case is that an amount can only be received by taxpayers if they receive the amount for their own benefit and on their own behalf. This principle can be applied to transactions relating to illegal diamonds. There are, however, issues that arise in this instance. The first one is the issue of legality. The "gross income" definition does not differentiate between legal and illegal receipts and accruals, and thus the question arises as to whether the proceeds from the sale of illegal diamonds should be included in the taxpayer's gross income. This relates to instances when a taxpayer purchases blood diamonds or stolen diamonds from a thief and then disposes of them. The second issue relates to stolen diamonds, and to whether the thief has received the stolen diamond on his or her own behalf and for his or her own benefit. Each issue will be discussed individually.

3.2.3.1 Gross income in relation to the proceeds received from the sale of illegal diamonds

Assuming that the diamonds were not held on capital account, the first issue that arises is whether the proceeds received from the sale of blood diamonds or stolen diamonds should be included in the taxpayer's gross income. In some instances, the taxpayer is unaware that he or she has purchased a stolen diamond or blood diamond, and when these diamonds are sold the issue of legality arises. Should the proceeds from the sale of the stolen or blood diamond be included in the taxpayer's gross income as the "gross income" definition does

not differentiate between legal and illegal receipts? It is necessary, therefore, to refer to case law in order to provide clarity on the issue of legality.

As stated previously, the principle established in the *Geldenhuys* case is that an amount can only be received by taxpayers if they receive the amount for their own benefit and on their own behalf. If a taxpayer purchases blood diamonds or a stolen diamond and sells the diamond, the proceeds received from the sale of the diamond will be received by the taxpayer for his or her own benefit and on his or her own behalf, and therefore "received by" the taxpayer in terms of the "gross income" definition.

Even though the principle established in the *Geldenhuys* case will be applied to the proceeds received in respect of the disposal of blood diamonds and stolen diamonds, the problem relating to legality still arises. Even if taxpayers receive the amount for their own benefit and on their own behalf, the question arises as to whether the amount should be included in the taxpayer's gross income if it is from an illegal source. The Act does not provide guidance in respect of income from an illegal source and therefore case law will be used to provide clarity in respect of this.

In CIR v *Delagoa Bay Cigarette Company*, 32 SATC 47, 1918 TPD 391 (referred to as the *Delagoa Bay Cigarette* case), the taxpayer was a cigarette company that advertised a scheme where it sold packets of cigarettes which contained numbered coupons. The company set aside two thirds of the amount received in respect of the scheme and used this money as the prize money. Two monthly distributions had been made and a third one had being advertised. During this time, criminal proceedings had been instituted against the company on the grounds that they were running a lottery. It was held by the Commissioner that the distribution of prizes constituted a distribution of profits in the hands of the company. Further, the Commissioner required the company to submit an interim return of its income for the period from the commencement of its operations to the date when the books were closed prior to the company's advertising the distribution of prizes (Goldswain: 2010a).

The company stated that it was not possible to fulfil the request of the Commissioner. In addition the Commissioner issued an interim assessment based on an estimate for the period in question. As a result the company appealed against the claim on the following grounds (Goldswain: 2010a):

1 the demand for an immediate payment is not in terms of the Act;

2 the payments relating to the prizes were outgoings incurred in the production of income of the company and therefore did not form part of their taxable income, and

3 the business of the company was illegal and the state is not entitled to collect taxes of profits that form part of illegal transactions.

In turn the court disallowed the appeal and held the following (Goldswain: 2010a):

1 The payment of prizes in respect of the contract of purchase and sale entered into with the buyers represented an outgoing incurred in earning income rather than a distribution of income earned.

2 It was further held that there is nothing in the Act that does not allow the Commissioner to demand an immediate payment of taxes on an interim assessment issued, if he finds this necessary in the collection of taxes.

3 Lastly, the legality of the income earned is irrelevant to the fact that tax in still due on the income earned.

The *Delagoa Bay Cigarette* case makes it clear that the illegal receipts are taxable by the Revenue Authorities. The fact that they are illegal does not change their nature and is irrelevant in relation to the fact that income tax is due on a receipt of an illegal nature. In the instance when the taxpayer is aware he or she has purchased a blood or stolen diamond, this will amount to theft. The issue of theft will be discussed separately below. If a taxpayer purchases a blood diamond or stolen diamond, and is unaware of the fact that is has been stolen or is a blood diamond, and disposes of it, he or she has nevertheless received the proceeds on his or her own behalf and for his or her own benefit as previously discussed in terms of the *Geldenhuys* case. The principle established in the *Delagoa Bay Cigarette* case can be applied in this instance, and the fact that the diamond sold was from an illegal source does not change the nature of the receipt. Income tax is still payable on the proceeds received from the sale of the diamond, irrespective of the receipt being illegal income.

Even though illegal receipts are taxable in accordance with the principle adopted in the *Delagoa Bay Cigarette* case, the issue is still unclear as to whether stolen monies or goods are taxable.

3.2.3.2 Gross income in relation to the theft of diamonds

The next issue that arises is whether stolen diamonds are gross income in the hands of the thief. The issue in question is whether a thief has "received" the stolen diamonds. As previously stated, the principle established in the *Geldenhuys* case is that an amount can only be received by taxpayers if they receive the amount for their own benefit and on their own behalf. The question then arises whether stolen diamonds will be received by thieves on their own behalf and for their own benefit. A stolen diamond never becomes the property of a thief, and therefore cannot be received by a thief on their own behalf and for their benefit.

In CIR v *Genn & Co. (Pty) Ltd*, 1955 (3) SA 293(A), 20 SATC 113 (referred to as the *Genn & Co.* case), it was held that physical control over an asset with a monetary value or money does not necessarily constitute a receipt for the purposes of the "gross income" definition (Goldswain: 2010a). The court used the concept that borrowed money will not become the property of the borrower even though he or she is given possession of the money. He or she is obliged the repay the money and therefore the money is not "received by" the borrower for his or her own benefit and on his or her own behalf (Stiglingh *et al*: 2014). A thief is not given a diamond, but rather takes it. Even though a thief may be in the possession of the stolen diamond, he or she is obliged to return the stolen diamond or pay the equivalent value to the rightful owner is the stolen diamond is later sold, and therefore the stolen diamond cannot be the property of a thief. Thus in terms of the principle established in the *Genn & Co.* case, a thief cannot receive a stolen diamond on his or her own behalf and for his or her own benefit.

In the *Geldenhuys* and *Genn & Co.* cases, the principle established is that an amount must be received by the taxpayer on their own behalf and for their own benefit to be "received by" the taxpayer in terms of the "gross income" definition. As previously discussed, a thief may be in the possession of the stolen diamond, but the stolen diamond does not become the property of a thief as he or she is obliged to return the stolen property or compensate the owner. Therefore, he or she cannot receive a stolen diamond on his or her own behalf and for his or her own benefit.

With regard to stolen monies, the case of *COT v G*, 1981 (4) SA 167 (ZA), 43 SATC 159 (referred to as the *COT v G* case) may be relevant. The Appellate Division of the Zimbabwe High Court held that stolen monies, being unilateral takings, do not constitute a receipt as

the stolen money would never become the property of the thief. The matter of legality is not the issue, the issue of possession arises as the thief is in possession of someone else's money and therefore it does not accrue to him and neither is it received by him (Stiglingh *et al*: 2014). The principle established in the *COT v G* case mirrors the principle held in the *Genn & Co.* case. The issue of possession arises again. Stolen property cannot become property of a thief and thus it is not "received by" him or her. As previously discussed, a thief is not given a diamond, but rather takes it. This results in theft and thus the stolen diamond is not the property of the thief, and therefore is not "received by" the thief in terms of the "gross income" definition.

A foreign case that deals with stolen monies is *Griffiths* v JP Harrison Ltd 1963 AC 1 AT 20 (referred to as the *Griffiths* case). The court pointed out that the Act provides for the taxation of income earned or gained from another. A thief does not gain the money or assets stolen, he takes rather than receives and therefore the stolen monies do not constitute gross income (Goldswain: 2010a). It was noted in the *Griffiths* case that the Act provides for the taxation of income that is earned or gained by the taxpayer. In relation to a thief, he or she takes the diamond, rather than earns it. Therefore, the stolen diamond is not "received by" the thief in terms of the "gross income" definition.

ITC 1624, 59 SATC 373 (referred to as the *ITC 1624* case) is another case that relates to the issue of stolen monies. In *ITC 1624* the issue arose as to whether overcharging customers constituted an amount received, in terms of the "gross income" definition. Counsel for the appellant argued that, in light of the decision passed in *COT v G*, the overcharging of customers does not constitute a receipt. The judge managed to differentiate between the two situations where a person steals money and where a person overcharges a customer in the course of his business operations. It was held that the first situation, where a person steals money, this does not constitute a receipt and does not fall within the gross income definition because there is no contract or transaction that has occurred. In the second situation, where a person overcharges a customer, this amount is received by the person and falls within the gross income definition as it has been received by virtue of a contract or agreement between the taxpayer and the customer (Goldswain: 2010a). Once again the judge in the *ITC 1624* case followed the principle applied in the case of *COT v G.* Stolen monies or assets will not constitute gross income as no transaction has occurred between the individuals. When a thief steals a diamond from another individual, there is no contact or transaction that has taken place between the two individuals. Thus in terms of the

principle established in *ITC 1624,* the stolen diamond cannot possess the quality of a receipt in terms of the "gross income" definition.

ITC 1792, 67 SATC 236 (referred to as the *ITC 1792* case) also dealt with the question of theft. The taxpayer involved was a member of a stockbroking firm and acted as an agent for the firm. On the instructions from clients, he purchased and sold securities on behalf of the clients, and for the benefit of the clients. In later years he became involved in a syndicate with the portfolio manager and dealer of one of his clients. The purpose of the syndicate was to manipulate certain share transactions and in turn to realise a profit at the expense of his client. The syndicate realised profits amounting to R10 million, of which R1, 7 million was the share of the agent in the stockbroking firm. The agent was convicted of fraud and sentenced to imprisonment, but repaid his client the profits realised, including interest. The issue that arose was whether the secret profits realised by the agent fell within the "gross income" definition and were taxable in the hands of the agent (Goldswain: 2010a).

The court held that the secret profits earned by the agent constituted "gross income" in terms of the definition, and the fact that the secret profits were from an illegal source did not affect their taxability. The court also held the following (Goldswain: 2010a):

1. Taking into account the facts of this case, the court held that the appellant received proceeds from the sale of the shares. There was no unilateral undertaking, as previously stated in the case of *COT v G,* as the appellant did not "take" from the client, but rather received proceeds from the sale of the shares.
2. The concept of "received by" was considered by the court in relation to the *Genn & Co*. case and the *Geldenhuys* case. The principle established by the courts that an amount must be received by the taxpayer on their own behalf and for their own benefit was considered in relation to the secret profits received by the agent. The intention of the agent and the syndicate was to receive the secret profits for their own benefit. This however, did not mean that they had legally "received" the secret profits, and this led to the examination of the law of agency.
3. The court considered the law of agency and the fact that the shares were originally acquired by the agent on behalf of the client, and thus belonged to the client. Further, by law, the profits realised were not received by the syndicate or the agent, but rather by the client as they will never be received by the agent on his behalf and for his own benefit. As a result, the secret profits realised by the agent did not constitute "gross income" in his name in terms of the definition.

Initially, the court considered the principles held in the *Genn & Co.* Case and the *Gendenhuys* case, and held that the secret profits realised by the agent were "received by" the agent on his own behalf and for his own benefit. However, the court then considered the law of agency as the agent had not legally received the secret profits. Upon consideration of the law of agency, the court held that the agent had not received the secret profits on his own behalf and for his own benefit as the secret profits would never become property of the agent. In terms of the law of agency, the secret profits belong to the client.

MP Finance Group CC (In liquidation) v C:SARS, 69 STAC 141 (referred to as the *MP Finance Group* case) is a later case that may provide clarity on the issue relating to illegal receipts and theft, and overturns the principles established in earlier cases. In the case of *MP Finance Group,* the taxpayer ran an illegal pyramid scheme. She promised investors fantastic returns on their money invested, but in fact, the perpetrators of the scheme knew that they were insolvent, that the scheme was fraudulent and they had no intention of repaying the investors. The company recorded the amounts received as deposits and took the view that these amounts had never been received for income tax purposes. The Supreme Court of Appeal held that the receipts were taxable in the hands of the taxpayer (Goldswain: 2010a).

The Supreme Court of Appeal overturned the decision of the Special Court in *ITC 1792* and the decision in the *MP Finance Group* case effectively followed the decision in *ITC 1624*. The Special Court of Appeal considered the nature of receipt and how the taxpayer treated the receipt. In *ITC 1624,* the judge considered whether a transaction occurred between the individuals. Overcharging customers during the ordinary course of business activities resulted in a transaction between the taxpayer and the customer, and thus the amount received was included in the taxpayer's gross income.

The *MP Finance Group* case is a later case and guidance can be taken from this case to provide clarity on the issue of theft and illegal activities. *ITC 1545*, 54 SATC 464 (referred to as the *ITC 1545* case) is an important case as it deals directly with the issue of stolen diamonds. In this case, the taxpayer was involved in the purchasing and selling of stolen diamonds. The taxpayer knew that he was purchasing stolen diamonds and his conduct amounted to theft. Without any argument, it was accepted by both the court and the taxpayer that the proceeds of such sale of the stolen diamonds amounted to receipts for the purpose of gross income as the taxpayer was conducting these activities during the course of carrying on a trade, and therefore the receipt possessed the quality of income. However, counsel then argued on behalf of the taxpayer that if the amount did constitute gross

income, then any expenditure relating to the receipt should be deductible in terms of section 11(a) of the Act (Goldswain: 2010a). The deductibility of expenditure will be dealt with in the next chapter.

There is therefore no clear answer to the question of whether a stolen diamond will be a receipt in terms of the "gross income" definition.

3.3 Conclusion

Blood diamonds, illegal diamond trading and theft have been ongoing issues in South Africa for many years, and continue to be issues today. Loopholes in the Kimberley Process Certification Scheme have allowed blood diamonds to enter the diamond industry in legitimate countries where they are passed off as conflict-free. The illegal diamond trade is another prevalent problem in South Africa. Individuals involved purchase illegal diamonds from illegal miners and dispose of these diamonds on the legal market with an allegedly falsified authentication certificate. The taxpayer either purchases the blood diamonds and illegal diamonds ignorant of the fact that they are purchasing illegal diamonds, or knowingly purchases the blood or stolen diamond. When the taxpayer disposes of the illegal diamond, the issue then arises as to whether the proceeds received from the sale of the diamond will be taxable.

Theft is another problem in South Africa and the issue then arises of whether the stolen diamonds will be "received by" the thief and included in his or her gross income.

All elements of the "gross income" definition need to be met in order for the amount to be included in the taxpayer's gross income. The underlying issue relating to the illegal diamond transactions was to determine whether the proceeds received from the illegal diamond transactions have been "received by or accrued to" the taxpayer.

A total amount in cash or otherwise must be received by the taxpayer in order for an amount to constitute gross income. Proceeds received from the sale of illegal diamonds whether in cash or not, amount to an "amount", as long as the proceeds have a monetary value.

A stolen diamond received by a thief is not in a monetary form but in terms of the principle established in the *Lategan* case, as long as the stolen diamond has a monetary value, then an "amount" has been received by the thief. The issue then arises of how the stolen diamond will be valued. The principles established in the *Brummeria Renaissance* case and

the *Lace Proprietary Mines* case can be applied to stolen diamonds, and it can be concluded that the stolen diamond will be included in the thief's gross income at its open market value, subject to the other elements of the "gross income" definition being met.

Income received must be of a revenue nature to be included in the taxpayer's gross income. To determine whether income received from the sale of illegal diamonds and the value of a stolen diamond are capital or revenue in nature, the true intention of the taxpayer needs to be considered in terms of the intention of the taxpayer and the objective factors of each individual case.

It was concluded that proceeds received from the sale of illegal diamonds are revenue in nature, while stolen diamonds can be revenue or capital in nature. The first step is to determine the intention of the thief when he or she first acquired the stolen diamond. If the thief acquired the stolen diamond to resell it, then the diamond is revenue in nature. If the stolen diamond is acquired to hold as a capital asset, then it can be argued that the stolen diamond is capital in nature.

The next step is to determine whether the thief has had a change in his or her intention. The original intention of the thief will be considered in light of the objective factors of the situation. As a result, the stolen diamond can either be capital or revenue in nature.

Income can either be "received by or accrue to" the taxpayer. The words "received by or accrued to" are not defined in the Act and therefore case law was considered. If the other relevant elements of the "gross income" definition have been met, then the amount received from the illegal diamond transactions will be included in the taxpayer's gross income at the earlier date of receipt or accrual.

As previously stated, the underlying issue relating to illegal diamond transactions is to determine whether the amount has been "received by" the taxpayer. The problem discussed was to determine whether the proceeds received from the sale of illegal diamonds will be included in the taxpayer's gross income. The principle established in the *Geldenhuys* case is that an amount has to be received by taxpayers on their own behalf and for their own benefit. Specific case law relating to income from an illegal source was considered.

In the *Delagoa Bay Cigarette* case it is made clear that illegal receipts are taxable in practice, and the fact that they are illegal does not change their nature and the fact that they are

taxable. When the taxpayer disposes of blood diamonds or stolen diamonds, the proceeds received from the sale of blood diamonds will be received by the taxpayer on his or her own behalf and for his or her own benefit. The principle established in the *Delagoa Bay Cigarette* case can be applied in this instance, and the fact that the diamond sold was from an illegal source does not change the nature of the receipt. Income tax will still be payable on the proceeds received from the sale of the diamond, irrespective of the receipt being illegal income as all the elements of the "gross income definition" have been met.

The second issue discussed is whether stolen diamonds are gross income in the hands of a thief. The question was whether a thief has "received" a stolen diamond in terms of the "gross income" definition. The Act does not provide clarity with regard to theft and therefore case law relating to stolen monies was discussed to provide clarity. In *COT v G,* the issue of possession was considered, and it was held that stolen property will never become the property of the thief. If the thief is caught he or she will be required to return the property, and therefore the property is not "received by" the thief. The same concept applies to a thief who has stolen diamonds. The thief will be obliged to return the diamonds if he or she is caught and therefore the diamonds will not become his or her property. In turn, the stolen diamond will not be "received by" the thief.

In the case of *Griffiths*, the court pointed out that the Act provides for taxation on income that is earned by the taxpayer. A thief takes, rather than earns, when stealing a diamond. As a result, the stolen diamond is not earned by the thief and therefore is not "received by" the thief.

ITC 1624 follows a similar concept to *COT v G.* The judge followed the principle that stolen goods cannot be a receipt in terms of the "gross income" definition as no transaction has occurred between the taxpayers. A transaction has not taken place between the thief and the individual from whom the thief has stolen. Therefore, a stolen diamond cannot be a receipt in terms of the "gross income" definition.

In *ITC 1792,* the court originally followed the principle established in the *Genn & Co.* case and the *Geldenhuys* case. It was held that the secret profits realised by the agent were "received by" the agent on his own behalf and for his own benefit, and thus included in his gross income. However, then the court considered the law of agency. It was held that the agent had not received the secret profits on his own behalf and for his own benefit as the

secret profits would never become the property of the agent, and thus were not "received by" the agent.

The principle followed by the court in *ITC 1792* is similar to *COT v G*. However, the *MP Finance Group* case, which is a later case, provides clarity on the issue. It overturned the principle established in *IT 1792* which followed *COT v G.* In the *MP Finance Group* case, the Supreme Court of Appeal effectively followed a similar approach to *ITC 1624*, and considered whether the transaction possessed a quality of income. The nature of the receipt and how the taxpayer treated the receipt was considered.

The issue involving theft is a grey area in our law. In an attempt to find a conclusion as to whether stolen diamonds are taxable in the hands of the thief, guidance can be taken from the *MP Finance Group* case. The nature of the receipt and the way the transaction occurred in each individual situation should be the deciding factor of whether the stolen diamond will be taxable in the hands of the thief or not, subject to the other elements of the "gross income" being met.

The question then arises: if the amounts received in relation to the illegal diamond transactions are included in the taxpayer's gross income, will the expenses relating to such income be deductible in terms of the "general deduction" formula? This will be discussed in the chapter that follows.

Chapter 4

The deductibility of expenditure relating to the illegal diamond trade

4.1 Introduction

As discussed in chapter 3, proceeds from the sale of blood diamonds and stolen diamonds will be included in the taxpayer's gross income as the taxpayer has received the proceeds on own behalf and for own benefit. The question therefore arises as to whether the expenses incurred in earning such income will be deductible in terms of the preamble to section 11 of the Act, section 11(a) and section 23(g) (known as the "general deduction formula") or in terms of any other provision in the Act.

The tax consequences of theft, however, were not as clear. The Supreme Court of Appeal in the *MP Finance Group* case considered the nature of the receipt and how the transaction occurred in order to determine whether the amount possessed the quality of income.

If it were to be concluded that a stolen diamond possessed the quality of income in the hands of the thief and was therefore taxable, it must be determined whether the expenses incurred in dealing in stolen diamonds would be deductible in terms of the "general deduction formula" or in terms of any other provision in the Act.

For an amount to be allowed as a deduction, it has to meet the requirements of the "general deduction formula" (the preamble to section 11, section 11(a) and section 23(g)) or any other provision in the Act. Section 11(a) sets out expenses that may be allowed as deductions, whereas section 23(g) stipulates expenses that may not be deducted. Section 11 of the Act requires a taxpayer to be carrying on a trade before the expenses will be allowed as a deduction and therefore no amount can be claimed as a deduction under the "general deduction formula" unless the taxpayer is carrying on a trade (Stiglingh *et al*: 2014). Whether the theft of diamonds or the buying and selling of "blood" or stolen diamonds can be classified as "carrying on a trade", must be determined.

4.2 The definition of trade

Whether or not the person who disposes of stolen or blood diamonds is carrying on a "trade" is the first requirement to be established when determining whether any related expenditure qualifies as an allowable deduction in terms of the general deduction formula. The opening words of section 11 state that a deduction is only available to a person who is carrying on a trade in the Republic.

The Act defines "trade" as follows:

> every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act (57 of 1978), or any designed as designed in the Designs Act (195 of 1993), or any trade mark as defined in the Trade Mark Act (194 of 1993), or any copyright as defined in the Copyright Act (98 of 1978), or any other property which is of a similar nature.

Trade covers a wide variety of activities and includes a "business". In other words, to determine whether an activity or transaction amounts to a trade, it is necessary to determine whether the operations of the activity or transaction are carried out in the same way as they would be in a business venture (Williams: 2006).

A trade implies active involvement in an activity, as opposed to earning passive income. Trade has a wide meaning and it can be said that it includes any activity or transaction undertaken by the taxpayer that occupies his or her time with the intention of making a profit (Stiglingh *et al*: 2014).

The Act does not refer to morality, legality or public policy when defining the concept of trade. Because of the broad definition of trade, it can be argued that an illegal activity like the buying and selling of "blood" or stolen diamonds amounts to a trade. *ITC 368* (1936) 9 SATC 211 (referred to as *ITC 368*) referred to a "venture" as a transaction in which a person risks something with the object of making a profit. The buying and selling of "blood" or stolen diamonds is associated with risk. The person involved in the illegal transaction is at a risk when either buying or selling the "blood" or stolen diamonds. The object of the transaction is clearly to make a profit from the sale of the "blood" or stolen diamond. The buying and selling of "blood" or stolen diamonds will therefore amount to a trade as the individual is involved in a "venture".

4.3 The meaning of carrying on a trade

The preamble to section 11 of the Act requires a "trade" to be carried on before an expense can be allowed as a deduction in terms of the general deduction formula.

As previously discussed the buying and selling of "blood" or stolen diamonds amounts to a trade. The question is whether the individual involved in the buying and selling of "blood" or stolen diamonds is "carrying on a trade".

The courts in the United Kingdom rely on "badges of trade" to determine whether a particular transaction executed by an individual constitutes the carrying on of a trade. The South African courts do not recognise badges of trade in determining whether a trade is carried on. The Margo Commission Report of Inquiry into the Tax Structure of the Republic of South Africa (1987) did not support the use of badges of trade as criteria to determine whether a trade is carried on. The badges of trade highlight specific circumstances that are typical to trading. Certain elements of the badges of trade are useful in South Africa and reference can be made to these, together with the application of South African case law, to determine whether a trade is carried on (Williams: 2006).

Two elements need to be present for the individual to be carrying on a trade. Namely, continuity in his or her activities, and a long-term objective to generate a profit (Stiglingh *et al*: 2014). In *Burgess* v CIR 1994 SA (A), 55 SATC 185 (referred to as the *Burgess* case), the court considered the taxpayer's motive to make a profit and the continuity of his activities. If either is absent, this could result in a trade not being carried on (Stiglingh *et al*: 2014).

The first element considered by the court in the *Burgess* case is "continuity". In most instances, trading involves the continuity of activities. Consider *ITC 1529* (1991) 54 SATC 252 (referred to as *ITC 1529*), where it was held that the letting of property constitutes the carrying on of a trade only if there is a plan disclosing a degree of continuity or regularity in the taxpayer's operations (Williams: 2006). On the other hand, is it always necessary for there to be continuity in the taxpayer's activities for him or her to be carrying on a trade? Is recurrence or continuity essential to a trade, or can a single or isolated transaction constitute a trade? In CIR v *Strathmore* Exploration Ltd 1956 (1) SA 591 (A), 22 SATC 213 (referred to as the *Strathmore Exploration Ltd* case), Centlivres CJ stated:

> Continuity, although a necessary element in certain circumstances in the case of an individual, is not a necessary element in the case of a company.

In CIR v *Scott* 1928 AD 251 262 (referred to as the *Scott* case) Wessels JA stated:

> If you are dealing with a company one of whose objects is to buy and sell land, then the company might well be considered to be doing the business of selling and buying land even though it carries out only a single transaction.

In CIR v *Leydenburg Platinum Ltd* 1929 AD 137 (referred to as the *Leydenburg Platinum* case), Stratford JA quoted this statement by Wessels, JA, and added:

> So that 'continuity' (as it has been called) is a necessary element in carrying on of a business in the case of an individual but not of a company ...

Reference can also be made to *Stephan* v CIR 32 SATC 54 1919 WLD 1 (referred to as the *Stephan* case), where the court held that even though the company was only involved in one operation, it did amount to carrying on a trade due to the numerous business transactions and the employment of capital (Williams: 2006).

In relation to the buying and selling of "blood" or stolen diamonds, the factor of continuity may depend on the "person" involved in the transaction. If an individual is involved in the buying and selling of "blood" or stolen diamonds, regularity or continuity in the buying and selling of the "blood" or stolen diamonds would probably be required for a trade to be carried on. If the person involved in the buying and selling of "blood" or stolen diamonds is a company, the lack of regularity and continuity may not prevent a trade being carried on. In the *Strathmore Exploration Ltd, Leydenburg Platinum* and the *Stephan* cases, continuity was not the deciding factor in determining that a trade was being carried on. An isolated or single transaction did not mean that the taxpayer was not carrying on a trade. With reference to these cases, it can be argued that a company involved in the buying and selling of "blood" or stolen diamonds can be carrying on a trade whether they are involved in an isolated transaction or whether the company has done so on a continuous and regular basis.

The second element considered in the Burgess case, is the taxpayer's profit motive. The court held that there must be a profit motive present for the taxpayer to be carrying on a trade (Stiglingh *et al*: 2014). There should be an expectation or intention for the taxpayer to make a profit. In *De Beers Holdings v CIR* 1986 (1) SA 8 (A) (referred to as the *De Beers* case), it was held that profits are not the infallible litmus test for the existence of a trade. A lack in profit or the intention to make a profit will not result in the taxpayer not carrying on a trade (Williams: 2006). In ITC *1274*, 40 SATC 185 (referred to as *ITC 1274*), the court held

that there is no requirement in the Act that requires the taxpayer to be aiming at a net profit in his trading operations (Goldswain: 2010c).

On the other hand, a different view was taken in *ITC 1292* (1979) 41 SATC 163 (referred to as ITC *1292*). The principle established was a lack in the taxpayer's intention and a lack in profit motive may result in a trade not being carried on. (Goldswain: 2010c).

In *Smith v Anderson* (115 ChD 258) (referred to as the *Smith* case), Jessel MR suggested the following:

> The word "business" meant anything which occupies the time and attention of a man for the purpose of a profit.

The decision was reversed on appeal, but the decision was never queried. Jessel MR suggested an intention to make a profit should be present, otherwise the lack thereof could result in a trade not being carried on (Williams: 2006).

The majority judgement in *CIR v Pick 'n Pay Share Purchase Trust* 1992 4 SA 39 (A), 54 SATC 271 (referred to as the *Pick 'n Pay Share Purchase Trust* case) held that, while the profit motive is not essential, its presence or absence is an important factor in determining whether or not a trade is carried on (Goldswain: 2010c).

The decisions by the courts differ as to whether a profit motive must be present or whether an intention to make a profit or not is sufficient for the taxpayer to be carrying on a trade. A taxpayer involved in the buying and selling of "blood" or stolen diamonds must have an intention or expectation of making a profit but may not make a profit from the very first sale of the "blood" or stolen diamond. With reference to *ITC 1292* and the *Pick 'n Pay Share Purchase Trust* case, the taxpayer's intention to make a profit is all that needs to be present for the taxpayer to be carrying on a trade.

The buying and selling of "blood" or stolen diamonds therefore amounts to the carrying on of a trade.

4.4 Expenses incurred in carrying on an illegal trade

The buying and selling of "blood" or stolen diamonds can amount to the carrying on of a trade. The buying and selling of diamonds, whether "blood" diamonds or stolen diamonds, constitutes an illegal trade. Therefore, it is necessary to determine whether the expenses incurred while carrying on an illegal trade will be deductible.

South African case law can be used to determine whether a taxpayer is carrying on a trade. However, no reference is made to illegal trading activities in these cases, in the definition of "trade" or in section 11. O*biter* observations in case law, together with Interpretation Note 80 (SARS: Online) and section 23(o) of the Act will be discussed to determine whether expenses relating to an illegal trade will be deductible. Reference can be made to the English case of *Partridge v Mallandaine* 18 QBD 276 (referred to as the *Partridge* case), and Denman J's *obiter* observation:

> even the fact of a vocation being unlawful could not be set up against the demand for income tax.

The observation made by Denman J was followed by Bristowe J in the *Delagoa Bay Cigarette* case. The *obiter* observation made by Bristowe J was as follows:

> 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 inevitable on all income exceeding the specified minimum...The source of the income is immaterial...

Neither Denman J nor Bristowe J considered that the legality of the business activity should prevent the inclusion in "gross income" derived from trade or the deduction of expenses incurred. If the income received from an illegal source is taxable, then equally the expenses incurred in performing such trade should be deductible, irrespective of their illegal nature.

Hoexter JA in CIR v *Insolvent Estate Botha* (1990) ZASCA 2, 1990 (2) SA 548 (referred to as the *Insolvent Estate Botha* case) pointed out the following:

> It is not to be inferred that because an agreement is illegal a court will in all circumstances and for all purposes turn a blind eye to its conclusion; or deny its very existence.

Further, Hoexter JA stated (as quoted in the *ITC 1545* case):

> To the conclusion of such illegal agreements the law accords recognition for particular purposes. That they are void inter parties does not rob them of all legal result.

The *obiter* observation in *Insolvent Estate Botha* case was that the courts cannot turn a blind eye to an illegal agreement, and the law will recognise the particular agreement. The *obiter* observation by Hoexter JA was that the law will recognise an illegal agreement for the relevant purposes necessary, such as its income tax treatment.

In all of the case law discussed in relation to the taxability of the income from illegal activities, no principle was established relating to the deduction of associated expenses. Bristowe J made an *obiter* observation in the *Delagoa Bay Cigarette* case, that if the income received from an illegal source is taxable, then equally the expenses incurred in performing such trade should be deductible, irrespective of their illegal nature Watermeyer AJP was of a different opinion and made an *obiter* observation in *Port Elizabeth Electric Tramway Co Ltd* v CIR 1936 CPD 241, 8 SATC 13 (referred to as the *Port Elizabeth Tramway* case) that if the act performed by the taxpayer is unlawful or negligent, and the expense incurred is a result of the unlawfulness or negligence of the taxpayer, then the expenses would probably not be deductible (Williams: 2006).

Guidance can also be obtained from Interpretation Note 80 (SARS: Online), which discusses the income tax treatment of stolen monies. An important aspect of Interpretation Note 80 is the deductibility of repayments of stolen monies. The issue was whether the thief is entitled to a deduction in respect of the stolen monies refunded to the rightful owner. In terms of Interpretation 80 (SARS: Online), if a thief is required to repay the stolen monies, a deduction in relation to this expense will be prohibited on the grounds that theft, embezzlement and fraud do not constitute a trade.

The issue of whether unlawful and corrupt payments qualify for a deduction under the Income Tax Act has always been an issue due to the moral dimension of the state being complicit if it shares in such payments by taking a share of the income by way of taxes, or allows the expense as a deduction (Williams: 2006). Thus section 23(o) was introduced into the Act in 2005. In terms of section, no deduction will be allowed for the any expenditure as a result of corrupt activities in terms of Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004, or any fines, penalties and bribes.

From the consideration of the *obiter* observations made by the courts in the cases referred to and the guidance in Interpretation Note 80, there is no clear answer to whether the expenses relating to an illegal trade, such as buying and selling of “blood” or stolen diamonds, are deductible.

4.5 The deductibility of expenses in terms of section 11(a)

Will the expenses relating to the trade in illegal diamonds qualify for deduction in terms of section 11(a) read together with section 23(g)?

Section 11(a) of the Act provides for deductions as follows:

"expenditure and losses actually incurred in the production of income, provided that such expenditure and losses are not of a capital nature".

In the case of an individual involved in the buying and selling of "blood" or stolen diamonds, two types of expenditure can arise. The first type is the day-to-day business expenditure the taxpayer may incur during the trade of dealing in illegal diamonds. If this expenditure is actually incurred (*Edgar's Stores* Ltd v CIR 1988 (3) SA 876 (A), 50 SATC 81) by the taxpayer as a result of the buying and selling of "blood" or stolen diamonds (and is therefore incurred in the production of income in terms of the decision in the *Port Elizabeth Tramway* case), and is not of a capital nature (*New State Areas Ltd* v CIR 1946 AD 610, 14 SATC 155), it will be deductible in terms of section 11(a) in the year of assessment it incurred.

The second type of expenditure that may arise is the return of the stolen diamond or the payment of its value to the rightful owner. The expenditure in the form of cash or the value of the diamond will actually have been incurred by the taxpayer. For an expense to be deductible, it must be actually incurred by the taxpayer. An expense has been actually incurred when the taxpayer has paid the expense or when there is an unconditional obligation to pay the amount in question (Williams: 2006).

Reference can be made to *ITC 1545*. This case deals directly with a taxpayer who bought and sold stolen diamonds. The counsel argued on behalf of the taxpayer that he was liable to return the stolen diamonds or value therefore to the rightful owner, and hence the expense is deductible in terms of section 11(a) (Goldswain: 2010c).

Scott J stated:

> It is well established that in order for expenditure to be deductible it must have been incurred in the year of assessment concerned. In order to be deductible the liability must be one which is definite and absolute and not one which is merely contingent.

The expense was disallowed as a deduction as there was no absolute and definite liability for the taxpayer to return the stolen diamond. If the victim had to obtain judgement against

the individual, only then would there be a definite and absolute liability for the taxpayer to repay the victim. At this point the repayment of the stolen diamond will be actually incurred and a deductible expense in terms of section 11(a), subject to the other elements of section 11(a) being met.

An individual involved in the buying and selling of stolen diamonds may be under the obligation to return the diamonds to the rightful owner or compensate him or her for the diamonds. With reference made to principle established in *ITC 1545*, there is no absolute or definite liability for the taxpayer to return the diamonds or the value thereof until the victim obtains judgement against the individual for the "blood" or stolen diamond. As a result there will be no unconditional obligation for the taxpayer to return the diamonds or their value to the rightful owner until the victim obtains judgement against the taxpayer. At this point the expense will be actually incurred.

There is no guarantee that the taxpayer will repay or return the stolen diamonds. With guidance taken from *ITC 1545*, expenditure relating to the repayment of the stolen diamonds is only actually incurred if there is judgement against the taxpayer to repay to victim, or if the taxpayer voluntarily repays the victim. At this point the expense will be actually incurred. Subject to the other elements of section 11(a) being met, the repayment of the "blood" or stolen diamonds will be deductible in terms of section 11(a).

Section 23(g) must be read together with section 11(a). Section 23(g) disallows any non-trade expenditure as a deduction (Stiglingh *et al*: 2014). The liability to return the stolen diamonds is an inseparable and necessary expense for a taxpayer dealing in illegal diamonds, and thus is an expense that relates directly to his or her trade.

4.6 Diamonds on hand at year end

Assuming that expenses incurred in an illegal trade are deductible (refer to the earlier discussion), the acquisition cost of "blood" diamonds acquired by the taxpayer will be deductible in terms of the "general deduction formula". However, the value of stolen diamonds cannot be deducted in terms of the "general deduction formula" as they are acquired for no consideration (Stiglingh *et al*: 2014).

In some instances the taxpayer may not have sold all the illegal diamonds at the end of the year of assessment and will have illegal diamonds on hand at year end. The issue is how will the taxpayer account for the diamonds at year end? Two situations arise. The first is how

will the taxpayer account for "blood" diamonds on hand at year end? The second is how will the taxpayer treat stolen diamonds on hand at year end as they have been acquired for no consideration?

Section 1 of the Act defines trading stock as follows and includes:

> Anything produced, manufactured, construed, assembled, purchased or in any manner acquired by the taxpayer to use in manufacturing, to be sold or exchanged by the taxpayer or on the taxpayer's behalf...

The diamonds on hand at year end, whether "blood" diamonds or stolen diamonds, will be treated as closing stock in terms of section 22(1) of the Act. "Blood diamonds will be included in the taxpayer's taxable income at the cost of the diamonds, less any amount considered by the Commissioner as representing the amount by which the value of the diamonds has diminished due to damage, decrease in market value or any other reason satisfactory to the Commissioner (Stiglingh *et al*: 2014).

Stolen diamonds, on the other hand, will be included in the taxpayer's taxable income as closing stock at the current market value at the date they were acquired in terms of section 22(4) of the Act , but cannot be included as opening stock for that year of assessment (Stiglingh *et al*: 2014). However, in practice the South African Revenue Services has allowed the amount to be included as opening stock in the taxpayer's taxable income in the year it was acquired in terms of section 22(2) of the Act as well, and the net effect of the taxpayer's taxable income is nil (Stiglingh *et al*: 2014).

However, this was not the case in *Ernest Bester* v CSARS 70 SATC 151, 2008 SCA (referred to as the *Ernest Bester* case) The principle established in the *Ernest Bester* case went so far as to over-rule the principles applied by the South African Revenue Services in practice and disallowed the inclusion of the value of the sand as opening stock. This is a similar situation to stolen diamonds. The farmer did not acquire the sand, it formed part of his land and thus there was no consideration paid for the sand. In the same way the taxpayer will not have paid for the stolen diamond. If the principle established by the court in the *Ernest Bester* case is applied to a taxpayer who has stolen diamonds on hand at year end, then it can be argued that the taxpayer cannot include the value of the stolen diamonds as opening stock in the year he or she acquired them. However, the taxpayer will still be required to account for the stolen diamonds at market value as closing stock in terms of section 22(4) of the Act.

The issue of whether the stolen diamonds will be included in opening stock during the year they were acquired is therefore unclear.

4.7 Conclusion

If an amount is included in a taxpayer's gross income from an illegal source, such as the buying and selling of "blood" or stolen diamonds, it is equally fair that the expenses incurred against such amount should be allowed as a deduction. For an amount to be allowed as a deduction, it has to meet the requirements of the "general deduction formula" (the preamble to section 11, section 11(a) and section 23(g)).

The opening words of section 11 state that a deduction is only available to a person who is carrying on a trade in the Republic. Therefore the first step is to consider the term "trade". The definition of trade is broad and includes the term "venture". *ITC 368* referred to a "venture" as a transaction in which a person risks something with the object of making a profit. A person who buys and sells "blood" or stolen diamonds is involved in an activity that involves risk. He or she also has the intention of making a profit from such activity. Therefore, it can be argued that the buying and selling of "blood" or stolen diamonds amounts to a trade as the person is involved in a "venture".

The preamble to section 11 of the Act requires a "trade" to be carried on by a person for an expense to be allowed as a deduction in terms of the general deduction formula. As previously discussed, the buying and selling of "blood" or stolen diamonds amounts to a trade. The next step is to determine whether the person involved in such activities is carrying on a trade. South African case law, together with certain elements of the "badges of trade" can be used to determine whether the person involved in the trade of "blood" or stolen diamonds is carrying on a trade. Two elements of the "badges of trade" were considered: the continuity in the taxpayer's activities and whether the taxpayer has the intention to make a profit. Each element was considered in relation to South African case law.

The courts had different views in relation to the term "continuity". By taking into account the factors of each case, it can be argued that the continuity factor depends on the person involved in the transaction. In relation to an individual who is trading in "blood" or stolen diamonds, there will have to be regularity or continuity in the buying and selling of the "blood" or stolen diamonds for a trade to be carried on. In relation to a company, continuity or regularity in the taxpayer's activities is not essential for a trade to be carried on. In the

Strathmore Exploration Ltd, Leydenburg Platinum Ltd and the Stephen cases, continuity was not the deciding factor in determining whether a trade was being carried on.

The buying and selling of "blood" or stolen diamonds amounts to an illegal trade. Therefore, it is necessary to determine whether expenses incurred while carrying on such trade will be deductible. The case law discussed to determine whether the taxpayer is carrying on a trade makes no reference to illegal trading activities. For this reason, it is necessary to consider the *obiter* observations of judges in relevant case law, Interpretation Note 80 and section 23(o) of the Act.

According to the *obiter* observations made by Denman J in the *Partridge* case and Bristowe J in the *Delagoa Bay Cigarette* case, the legality of the business activities do not prevent the deduction of associates expenses. The *obiter* observation in the *Insolvent Estate Botha* case also held that expenses relating to the buying of "blood" or stolen diamonds should be allowed as a deduction.

On the other hand, in the *Port Elizabeth Tramway* case, Watermayer AJP was of a different view. Any expenses incurred as a result of an unlawful act would not be deductible. The buying and selling of "blood" or stolen diamonds is unlawful, and as a result will not be deductible.

The *obiter* remarks made in the cases referred to did not provide certainty as to whether the expenses incurred from an illegal trade are deductible. Interpretation Note 80 prohibits the deduction of expenditure relating to fraud, theft or embezzlement, as this is not regarded as a trade.

There is clearly still no answer as to whether expenses incurred in carrying on an illegal trade, such as trading in "blood" or stolen diamonds, will be deductible. However, in terms of section 23(o) of the Act, any bribes, penalties and fines incurred while performing such activities, will not be deductible.

A taxpayer trading in illegal diamonds may be obliged to return the stolen diamonds or repay the victim the value thereof. The question is whether this expense has been actually incurred by the taxpayer. Guidance can be taken from *ITC 1545*. If the victim obtains judgment against the taxpayer to return the diamonds or repay him or her their value, the expense will only be actually incurred at this point, as this is when the liability is absolute

and definite. Before this happens, there is no guarantee that the taxpayer will have to return the diamonds.

"Blood" diamonds on hand at year end will be included in the taxpayer's taxable income as closing stock at cost in terms of section 22(1) of the Act. Stolen diamonds acquired for no consideration, however, are included in the thief's taxable income as closing stock at market value in terms of section 22(4) of the Act. In practice the South African Revenue Services allowed the taxpayer to deduct the value of the stock as opening stock in terms of section 22(1) of the Act, and as a result there would be a nil effect on the taxpayer's gross income. This practice was over-ruled in the *Ernest Bester* case, and thus the issue of opening stock of stolen diamonds is unclear.

Income tax is not the only tax that can be affected when carrying on an illegal activity, such as dealing in "blood" or stolen diamonds. The VAT consequences of illegal activities will be discussed in the next chapter.

Chapter 5

The application of Value-Added Tax relating to the illegal diamond trade

5.1 Introduction

The trade in illegal diamonds has been a problem in South Africa for many years. The Supreme Court of Appeal ruled in the *MP Finance Group* case that amounts received in respect of illegal transactions, such as illegal diamond sales, will be included in the taxpayer's income irrespective of their illegal nature (Stiglingh *et al*: 2014). Can this principle be applied in respect of VAT? And, further, should the person who is a diamond dealer register for VAT and declare output tax on the sale of illegal diamonds? And if the dealer is registered, would he or she be entitled to claim input tax on qualifying expenses incurred by the enterprise.

VAT is an indirect tax levied at fourteen per cent or zero percent, in terms of section 11 of the VAT Act, and is a direct cost to the consumer who purchases the taxable supplies. However, the person is only required to account for VAT on the taxable supplies if he or she is registered as a VAT vendor (Stiglingh *et al*: 2014). If the person is required to register as a VAT vendor, he or she will be required to account for output tax on any taxable supplies made in the course or furtherance of any enterprise carried on, and may claim input tax in respect of qualifying expenses (Stiglingh *et al*: 2014).

In order to determine whether VAT should be levied on the sale of "blood" or stolen diamonds, the starting point will be to determine whether the person involved in the buying and selling of "blood" or stolen diamonds should be registered as a VAT vendor with the South African Revenue Services.

5.2 The registration for Value-Added Tax and the levy of output tax on the sale of illegal diamonds

5.2.1 The definition of an enterprise

In terms of section 23(1)(a) of the VAT Act, if a person carries on an enterprise or business in South Africa (or partly in South Africa), and generates taxable supplies or services in excess of R1 million during the preceding twelve month period, the person is required to register

for VAT. A person can register voluntarily for VAT if he or she is carrying on an enterprise or business in South Africa and generates taxable supplies in excess of R50 000.00 during the preceding twelve month period (Stiglingh *et al*: 2014). A person can only register for VAT if he or she is carrying on an enterprise within the Republic (or partly within the Republic). The term "enterprise" has been defined in section 1 of the VAT Act as follows:

> in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by a person in the Republic or partly in the Republic and in the course of furtherance of which goods or services are supplied to any other person for a consideration, whether or not for a profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club.

In order to register as a VAT vendor, a person must be carrying on an enterprise. For a person to be carrying on an enterprise, the following elements of the definition need to be present (Stiglingh *et al*: 2014):

1. the activity or enterprise must be carried on on a continuous or regular basis;
2. the activity or enterprise must be carried on within the Republic;
3. there must be a supply of goods or services to another person; and
4. the supply of goods or services must be for a consideration.

The first element of the definition of an enterprise is that the activity or enterprise must be continuous or occur on a regular basis. A person involved in the buying and selling of "blood" or stolen diamonds, who only buys or sells the diamonds once or on a rare occasion, will not be carrying on an enterprise as there is no continuity or regularity in the person's activities. However, a person who is involved in the buying and selling of "blood" or stolen diamonds on a continuous basis will be carrying on an enterprise as his or her activities are performed on a continuous and regular basis.

As long as the activities involved in buying and selling of the "blood" or stolen diamonds are conducted in the Republic (or partly in the Republic), the person is carrying on an enterprise. The place of supply is irrelevant. Further, it is also irrelevant whether or not the person is a South African resident. However, it must be noted that if the person is not a South African resident, he or she must have a South African bank account and a permanent establishment within the Republic in order to register for VAT (Stiglingh *et al*: 2014).

There must be a supply of goods or services to another person. The VAT Act defines the term "goods" as follows:

> corporeal moveable things, fixed property, and any real right in any such thing or fixed property...

A stolen or "blood" diamond is a corporeal movable thing, and therefore meets the definition of goods in terms of section 1 of the VAT Act. There must be a supply of a "blood" or stolen diamonds by one person to another. When the person initially purchases the "blood" or stolen diamond, there is a supply of goods from the seller to the purchaser. When the person disposes of the "blood" or stolen diamond, there is once again a supply of goods to another person, being the purchaser. The purchase or sale of the "blood" or stolen diamond must be for a consideration. This is the last element that must be present for an enterprise to be carried on.

Section 1 of the VAT Act defines a consideration as follows:

> in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain: Provided that a deposit (other than a deposit on a returnable container), whether refundable or not, given in respect of a supply of goods or services shall not be considered as payment made for the supply unless and until the supplier applies the deposit as consideration for the supply or such deposit is forfeited

From the definition of "consideration", read together with the definition of an enterprise, it is clear that there should be some sort of *quid pro quo* when the goods are delivered. The definition of a consideration includes any payment in cash or otherwise, or any act or forbearance in respect of such goods received. The consideration received can be voluntary or involuntary. It is irrelevant whether a profit or income is earned. There simply needs to be a link between the goods supplied and the consideration received to attract VAT. When the person initially purchases the "blood" diamonds, it must be for a consideration. In turn, when the person disposes of the "blood" or stolen diamonds, they must be disposed of for a consideration. The consideration for the "blood" or stolen diamonds does not have to be in

the form of cash. As long as the person makes or receives some sort of consideration, whether it is voluntary, involuntary, monetary or a payment in kind, it will be regarded as consideration.

For a person to be carrying on an enterprise, the elements discussed above need to be present. The person involved in the buying and selling of "blood" or stolen diamonds must perform his or her activities on a continuous or regular basis, and they must take place within the Republic (or partly in the Republic). However, the buying and selling of the diamonds can be to or from a source outside the Republic. A "blood" or stolen diamond meets the definition of goods, and therefore goods have been supplied from one person to another when the diamonds are purchased or sold. Lastly, the buying and selling of "blood" diamonds and the selling on stolen diamonds must be for consideration. The consideration does not have to be in a monetary form, as long as there is a link between the supply of the diamonds and the consideration, the person will be carrying on an enterprise.

5.2.2 Registration for Value-Added Tax

In terms of section 23(1)(a) of the VAT Act, if a person is carrying on an enterprise he or she is liable to register for VAT if his or her taxable supplies were greater than R1 million during the preceding twelve month period. A person involved in the buying and selling of "blood" or stolen diamonds will be required to register for VAT if the sale of the diamonds exceeds R1 million during the preceding twelve month period. If the sales are more than R50 000.00 in the preceding twelve month period, the person can register voluntarily for VAT. According to the provisions in the VAT Act, the person must have a fixed place of business in the Republic, a South African bank account and proper accounting records, in order to be eligible to register for VAT. Section 22 of the Tax Administration Act states that the person has twenty-one days to register for VAT once he or she has become liable to register. The onus rests with the person to register for VAT (Stiglingh *et al*: 2014).

5.2.3 Registration for Value-Added Tax by a person carrying on an illegal enterprise

A person involved in selling "blood" or stolen diamonds, and having taxable supplies in excess of R1 million who is carrying on an enterprise in the Republic is liable to register for VAT. However, must a person who is carrying on an illegal enterprise within the Republic register for VAT?

As is the case with the Income Tax Act, none of the definitions or provisions in the VAT Act makes reference to the legality or illegality of the enterprise that is being carried on. There is also no VAT case law that deals specifically with the supply of illegal goods for consideration.

For output tax to be charged on the sale of "blood" or stolen diamonds, section 7(1) of the VAT Act requires goods, including the stolen or "blood" diamonds, to be supplied for a consideration in the furtherance of the course of the person's enterprise. Section 7(1) of the VAT Act is not concerned with the beneficial intention of the person, as considered by the courts for income tax purposes. The definition of consideration includes any payment in cash or otherwise, or any act or forbearance in respect of such goods received. The consideration received can be voluntary or involuntary. As long as the person receives consideration in cash or in kind for the sale of the diamonds, he or she will be receiving consideration. It is clear from the definition of consideration that the intention of the person to "receive" the amount for his or her benefit, as is the case with income tax, is irrelevant.

In terms of the definition of an enterprise, the legality of the taxable supplies is not an issue. What is necessary is that all the elements of the definition are present. The illegality of the transaction may result in the agreement between the seller and purchaser being void, but this does not change the fact that VAT is due on the transaction. A person involved in the selling of "blood" or stolen diamonds is carrying on an enterprise and is duly liable to register for VAT if all the elements of the definition of an enterprise are present and his or her taxable supplies are greater than R1 million in the preceding twelve month period.

Once a person has registered for VAT, he or she will be required to account for output tax on the taxable supplies, being the sale of the "stolen" or blood diamonds, supplied. Output tax is levied on all goods and services supplied by the vendor in the furtherance of his or her enterprise (Stiglingh *et al*: 2014). The person acts as an agent on behalf of the South African Revenue Services and collects the output tax on the diamonds, and in turn pays this over to the South African Revenue Services.

5.3 Input tax on expenses relating to illegal diamonds

If a taxpayer is required to pay output tax on the sale of "blood" or stolen diamonds, then should he or she be entitled to claim input tax on the expenses incurred?

In terms of section 16, and read together with section 17 of the VAT Act, input tax is the VAT component of the payment for goods supplied to the vendor for the purpose of making taxable supplies. In order to prevent double taxation, a VAT vendor is entitled to deduct input tax paid on the purchase of goods supplied for the purpose of making taxable supplies, from their output tax liability (Stiglingh *et al*: 2014). However, can a person who is carrying on an illegal enterprise within the Republic claim input tax on the qualifying expenses incurred by the enterprise?

5.4 Conclusion

The Supreme Court of Appeal ruled in the *MP Finance Group* case that amounts received in respect of illegal transactions, such as the sale of "blood" or stolen diamonds, will be included in the person's income for income tax purposes, irrespective of their illegal nature (Stiglingh *et al*: 2014). The issue is whether this principle can be applied in respect of VAT, and further should the person register for VAT, declare output tax on the sale of illegal diamonds and claim input tax on qualifying purchases?

The starting point is to determine whether the person involved in the selling of "blood" or stolen diamonds should register for VAT. A person can only register for VAT if he or she is carrying on an enterprise within the Republic. According to the definition of an enterprise, the activity performed by the person must be carried on within the Republic (or partly in the Republic) on a continuous basis, and a supply of goods or services must be made to another person for a consideration. The person who trades in "blood" or stolen diamonds must carry on these business activities on a regular or continuous basis. The sale can be made to a non-resident. A "blood" or stolen diamond is a supply of goods and as long as the transaction has been made for a consideration, the person will be carrying on an enterprise within the Republic.

In terms of section 23(1) (a) of the VAT Act, the person will be liable to register for VAT if his or her taxable supplies of diamonds exceed R1 million in the preceding twelve month period, or can voluntarily register for VAT if the taxable supplies of diamonds exceeds R50 000.00 in the preceding twelve month period. The person will have twenty one days to

register once he or she becomes liable to register for VAT and the onus rests on the person to register.

The buying and selling of "blood" or stolen diamonds is an illegal trade therefore the issue is whether a person carrying on an illegal enterprise can or must register for VAT. For income tax purposes, for an amount to be taxable, the person must receive the amount for his or her own benefit and on his or her own behalf, irrespective of its illegal nature. The question is whether the same principle can be applied to the expression "for a consideration" for VAT purposes.

Section 7(1) of the VAT Act is not concerned with the beneficial intention of the person. The definition of "consideration" is concerned with whether the person receives some sort of *quid pro quo* for the sale of the diamonds, whether monetary payments, payments in kind or any other form of payment It is clear from the definition of a consideration that the beneficial intention of the person to "receive" the amount for his or her benefit is irrelevant. The definition of an enterprise makes no reference to the legality of the taxable supplies. If all the elements of the definition of an enterprise are present, the issue of legality will not affect the registration for VAT purposes. Output tax will be levied on the supply of goods and services within the Republic, by the person while carrying on his or her enterprise. A diamond meets the definition of goods, and a person involved in the selling of "blood" or stolen diamonds is carrying on an enterprise. Therefore, the sale of "blood" or stolen diamonds within the Republic will attract output tax. The person will be required to declare the diamond sales to the South African Revenue Services and pay the output tax on the sale of the blood or stolen diamonds.

Output tax is payable on the sale of illegal diamonds. In turn it is only logical that the taxpayer is entitled to claim input tax on any qualifying expenses incurred. In terms of section 16, read together with section 17 of the VAT Act, a VAT vendor is entitled to claim input tax on the purchase of goods supplied to the VAT vendor for the purpose of making taxable supplies.

Thus any qualifying expenses incurred by the taxpayer during the buying and selling of "blood" or stolen diamonds will be allowed as an input tax deduction against the output tax payable to the South African Revenue Services.

If output tax is not paid on the sale of "blood" or stolen diamonds, this would constitute tax evasion. This will be discussed in the chapter that follows.

Chapter 6

Tax Evasion and its consequences in relation to the illegal diamond trade

6.1 Introduction

The proceeds from the sale of "blood" or stolen diamonds are included in the taxpayer's gross income as the taxpayer has received the amount for his or her own benefit and on his or her own behalf. The inclusion of proceeds from theft, on the other hand, is not as clear, but in terms of the *MP Finance* case, these proceeds will be included in gross income. Liability for VAT may also be affected by the sale of "blood" or stolen diamonds. If the person is carrying on an enterprise in the Republic (or partly in the Republic) and disposes of the diamonds for a consideration, output tax will be charged on the sale and will be payable to the South African Revenue Services.

These transactions result from an illegal source and the person involved may not disclose the income received for income tax or VAT purposes to the South African Revenue Services.

6.2 Description of tax evasion

Tax evasion involves deliberately avoiding a tax burden by not declaring to the South African Revenue Services all income earned for the particular year of assessment. This is illegal and if the person is found guilty of tax evasion, this results in a fines and penalties in terms of the Tax Administration Act, as it is a criminal offense (Stiglingh *et al*: 2014).

If a person involved in the sale of "blood" or stolen diamonds does not declare the proceeds received from the sale of diamonds to the South African Revenue Services in the year of assessment, he or she is deliberately avoiding the income tax and VAT payable on the sale of the diamonds. If a thief does not declare the value of stolen diamonds as closing stock, or their sale, he or she is also deliberately avoiding the income tax and VAT payable. This is tax evasion. If the person is found guilty, he or she will be subject to penalties and interest in terms of the provisions of the Tax Administration Act. This is discussed below.

6.3 Consequences of tax evasion

In terms of section 235 of the Tax Administration Act, if a person is found guilty of tax evasion, he or she will be subject to fines and penalties, or imprisonment for a period of up to five years, once convicted. A South African Revenue Services official may lay a complaint in relation to the tax evasion with the National Prosecuting Authority or the South African Police Services (Stiglingh *et al*: 2014).

If the person is convicted of tax evasion, he or she will be subject to both a fixed amount non-compliance penalty in terms of section 210 of the Tax Administration Act and an understatement penalty in terms of section 223.

Every person is required to submit an income tax return annually to the South African Revenue Services and declare any income earned for that year of assessment. If a person fails to submit their income tax return and declare the proceeds from the sale of illegal diamonds, the South African Revenue Services may impose a fixed amount penalty. The penalty that may be imposed on the taxpayer is based on the person's taxable income for the preceding year. The preceding year means the year of assessment immediately prior of the year of assessment during which the penalty is assessed. The South African Revenue Services will impose a fixed amount penalty on all previous income tax returns outstanding from 20 November 2009 to date. The administration penalty regulations came into effect from 1 January 2009; however the South African Revenue Services delayed the implementation of the penalties to allow taxpayers sufficient time to rectify any non-compliance. Failure to submit the income tax returns after thirty days will result in a second fixed amount penalty being imposed, and so forth for every month of non-submission (Stiglingh *et al*: 2014). A fixed amount penalty is calculated as follows (Stiglingh *et al*: 2014).

1. An assessed loss for the preceding year: R 250
2. Taxable income from R 0 to R 250 000 for the preceding year: R 250
3. Taxable income from R 250 001 to R 500 000 for the preceding year: R 500
4. Taxable income from R 500 001 to R 1 000 000 for the preceding year: R 1 000
5. Taxable income from R 1 000 001 to R 5 000 000 for the preceding year: R 2 000
6. Taxable income from R 5 000 001 to R 10 000 000 for the preceding year: R 4 000
7. Taxable income from R 10 000 001 to R 50 000 000 for the preceding year: R 8 000
8. Taxable income above R 50 000 001 for the preceding year: R 16 000

The person will also be required to pay the income tax or VAT due, as well as an understatement penalty. Penalties in respect of tax evasion vary and are percentage-based, depending on the nature of each case. The penalties are as follows (Stiglingh *et al*: 2014):

1. Voluntary disclosure of tax evasion before an audit or investigation is performed: 10 per cent of the unpaid taxes;
2. Voluntary disclosure of the tax evasion after an audit or investigation is performed: 75 per cent of the unpaid taxes;
3. A standard tax evasion case: 150 per cent of the unpaid taxes;
4. Obstructive behaviour or a repeat case of tax evasion: 200 per cent of the unpaid taxes.

The penalty is calculated by applying the highest applicable penalty percentage in accordance with the above rates to each shortfall in relation to each understatement in a return (Stiglingh *et al*: 2014).

6.4 Conclusion

If a person deliberately does not declare the VAT or income from the sale of "blood" or stolen diamonds, this will constitute tax evasion. In addition, if a thief does not declare the value of stolen diamond as income, he or she will also be deliberately evading tax. This is a serious offence, and if the person or thief is found guilty he or she will be subject to penalties. The first is a fixed amount non-compliance penalty in terms of section 211 of the Tax Administration Act. The second is an understatement penalty in terms of 223 of the Tax Administration Act, of up to 200 per cent of the unpaid taxes. In serious cases, tax evasion can even lead to imprisonment.

Chapter 7

Conclusion

7.1 Goals of the research

The goal of the research was to determine the taxability of the illegal diamond trade in South Africa and to identify the consequences of not declaring income from the illegal diamond trade to the South African Revenue Services. As a result, the core focus areas were the South African diamond industry (chapter 2), inclusion of illegal income in gross income (chapter 3), deductibility of expenses incurred in respect of this illegal trade (chapter 4), the VAT consequences of the supplies made and supplies received in respect of this illegal trade (chapter 5) and the consequences of non-disclosure of this illegal income, which would amount to tax evasion, and the resulting penalties that would be imposed (chapter 6).

7.2 Findings of the thesis

Chapter 2 involved an analysis of the history and current situation of the South African diamond industry, as well as the diamond industry regulators and how they have developed over the years. Further, a discussion was included of the illegal diamond industry in relation to the effect of "blood" diamonds and theft on the diamond industry. In 1871 Kimberley, South Africa, produced 95 per cent of the world's diamonds. To date, this rate has decreased to only 14 per cent. However, even with the decrease in production, South Africa is still producing some of the highest value diamonds around the world. The diamond industry regulators have developed from the introduction of the South African Diamond Board in 1987. The introduction of the Kimberley Process Certification Scheme has been a major milestone for the diamond industry in that the diamond industry is now approximately 99.8 per cent conflict free. Since the introduction of the Kimberley Process Certification Scheme in 2002, the mining of "blood" diamonds has decreased, and is slowly becoming something of the past. However, there are still some countries that mine "blood" diamonds, including the Central African Republic, Zimbabwe and Angola. Although South Africa may not have a major problem with "blood diamonds", other than their being illegally imported into the country, the illegal diamond trade and theft is a major problem.

An interpretation of the Income Tax Act in respect of the legal rules relating to the inclusion in gross income (in terms of the definition in section 1 of the Income Tax Act) of an amount "received" by a taxpayer was provided in chapter 3. All the elements of the gross income definition need to be met in order for an amount to be included in the taxpayer's gross income. In relation to illegal diamond transactions, the underlying issue was to determine whether an amount has been "received by" the taxpayer. The first question discussed was whether the proceeds received from the sale of illegal diamonds will be included in the taxpayer's gross income. The principle established in the *Delagoa Bay Cigarette* case held that the fact that the diamond sold was from an illegal source does not change the nature of the receipt. The proceeds received from the sale of illegal diamonds will be included in the taxpayer's gross income, subject to the other elements of the "gross income" definition being met. Amounts received from illegal diamond sales represent an "amount" received and are also of a revenue nature. Thus all the elements of the "gross income" have been met and the dealer in illegal diamonds will be duly taxed on that amount.

The second issue discussed is whether stolen diamonds are gross income in the hands of a thief. Analysis of case law reveals that the issue of theft is a grey area in our law. As a result, guidance can be taken from the *MP Finance Group* case in an attempt to reach a conclusion. As a result, the nature of the receipt, the way the taxpayer dealt with the amounts fraudulently acquired and the way the transaction occurred in each individual situation, should be the deciding factor of whether the stolen diamond will be taxable in the hands of the thief. In the case of stolen diamonds it will be necessary to determine whether the amount is capital or revenue in nature. Depending on the intention of the thief and the objective factors of the situation, the stolen diamond can either be capital or revenue in nature.

Chapter 4 involved an interpretation of the Income Tax Act in relation to the "general deduction formula" (the preamble to section 11, section 11(a) and section 23(g)) to determine whether expenses relating to the sale of diamonds, whether stolen or "blood" diamonds, will be deductible. An interpretation of section 11, together with guidance from case law, indicates that the buying and selling of "blood" or stolen diamonds amounts to a trade. The issue was whether expenses relating to an illegal trade would be deductible. There is no specific case law that makes reference to illegal trade activities, thus the *obiter* observations in case law was considered, together with Interpretation Note 80 (SARS: Online). As a result, there still is no clear answer as to whether expenses incurred while

carrying on an illegal trade, such as trading in "blood" or stolen diamonds, will be deductible. In terms of the provisions of section 23(o) of the Act, however, any bribes, penalties and fines incurred as a result of such activities, will not be deductible.

The discussion went further to analyse section 11(a) and section 23(g), if it were to be assumed that expenses relating to an illegal trade are deductible. Guidance was taken from *ITC 1545* and the *Nationale Pers* case. If the victim obtains judgment against the taxpayer to return the diamonds or to repay him or her for the value thereof, the expense will only actually be incurred at this point, and would be deductible subject to the elements of section 11(a) being met. Any "blood" diamonds on hand at year end will be included in the taxpayer's taxable income at their cost as closing stock in terms of section 22(2), and purchase of the "blood" diamonds will be deductible in terms of section 11(a). Stolen diamonds acquired for no consideration will be included in the thief's taxable income at market value as closing stock in terms of section 22(4). However, the issue of whether the thief can include this value as opening stock as well is still unclear, as the principle established in the *Ernest Bester* case went as far as to over-rule the practice of the South African Revenue Services.

An interpretation of the VAT Act and a discussion of the provisions relating to the need to register for VAT purposes and the payment of VAT relating to illegal enterprises were provided in chapter 5. The buying and selling of "blood" or stolen diamonds is an illegal trade and therefore the issue is whether a person carrying on an illegal enterprise can or must register for VAT. The definition of an enterprise makes no reference to the legality of the taxable supplies. If all the elements of the definition of an enterprise are present, the issue of legality will not affect registration for VAT purposes. Output tax will be levied on the supply of goods and services within the Republic by the person while carrying on his or her enterprise. The taxpayer will be required to pay the output tax to the South African Revenue Services, minus any input tax, in terms of section 16 of the VAT Act.

Lastly, chapter 6 analysed the consequences of tax evasion relating to income tax and VAT in respect of illegal diamond dealing and the non-disclosure of income and supplies subject to VAT. It was established that, if a person deliberately does not declare the income from the illegal trade or the supplies made in respect of the VAT legislation, this will constitute tax evasion. This will result in penalties or even imprisonment. The person will be subject to a fixed amount non-compliance penalty in terms of section 211 of the Tax Administration Act,

and an understatement penalty in terms of section 223 of the Tax Administration Act, of up to 200 per cent.

7.3 Concluding remarks

The South African diamond industry has changed over the past years, with the production of diamonds decreasing to 14 per cent of the world market. However, some of world's largest and highest-valued diamonds are stilled mined in South Africa. South Africa is known for the development of two famous diamond shapes known world-wide. The South African diamond industry regulations have been developed and improved by the introduction of the Regulator and Kimberley Process Certification Scheme. As a result, the diamond industry is approximately 99.8 per cent conflict free. The introduction of the Kimberley Process Certification Scheme was a major milestone for the diamond industry, as the mining of "blood" diamonds has decreased in African countries, except for a small number of countries still involved. "Blood" diamonds are not the only issue the diamond industry is facing, theft and illegal diamond trade is still an on-going issue.

The question addressed in this thesis was whether the proceeds received from illegal diamond transactions are taxable.

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