THE TAXATION OF ILLEGAL INCOME IN SOUTH AFRICA: THE BASIS ON WHICH PROCEEDS FROM A UNILATERAL TAKING SHOULD BE TAXED

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ABSTRACT

In South Africa, income tax is levied in terms of the Income Tax Act, 58 of 1962, and the calculation of a taxpayer's taxable income and ultimately the tax liability commences with considering what constitutes the taxpayer's gross income. In terms of the definition of "gross income" a person can be taxed either on receipts or accruals. The definition makes no reference, however, to the legality of receipts or accruals. The main issue addressed in this thesis is the interpretation of the term "receipt" in relation to the proceeds from a unilateral taking (theft) and whether the concept of a receipt in relation to theft should be interpreted using the subjective approach used in *MP Finance Group CC (In Liquidation) v C:SARS*, or the objective approach. An interpretative research approach was used to provide clarity on the matter. The documentary data used for the research consists of South African tax legislation, case law, textbooks and journal articles. The thesis also analysed SARS' view in Interpretation Note 80 that *MP Finance Group CC (In Liquidation) v C:SARS* is authority for a unilateral taking being a receipt, and the correctness of this viewpoint. A brief comparative analysis was done of the basis on which illegal income flowing from a unilateral taking is taxed in Australia, New Zealand and America. These countries have legislative provisions that specifically deal with how the proceeds from theft in the hands of a thief should be treated for tax purposes. The thesis concludes that, although the court in *MP Finance Group CC (In Liquidation) v C:SARS* shed some light on the issue of the taxability of income from illegal activities, the basis on which proceeds from theft may be taxed, as opposed to the basis on which proceeds from other illegal activities like fraud are taxed, remains a grey area in our law. The thesis recommends the introduction of a legislative provision in order to provide a more unified, consistent and effective approach when taxing all illegal income.

Key words: South African Income Tax; gross income; received by or accrued to; illegal income; theft; unilateral taking; subjective *versus* objective approach

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CHAPTER 1: INTRODUCTION

1.1 Context of the research and problem statement

In *Ochberg v CIR* 1931 AD 215, 5 SATC 93 (at 240), Wessels JA, in his minority judgment, explained the principle underlying the Income Tax Act, 58 of 1962 (hereinafter referred to as the Act) as follows: "the principle which underlies the Income Tax Act is that the State takes a percentage of the moneys or moneys' value which has accrued to the taxpayer during the year of assessment. In other words, that he pays his tax not out of his capital but out of his incomings". The calculation of a taxpayer's taxable income and ultimately the tax liability of a taxpayer commences with considering what constitutes the taxpayer's "gross income" (Stiglingh, Koekemoer, van Schalkwyk, Wilcocks & de Swardt:2015). The definition of "gross income" is set out in section 1 of the Act as follows:

> (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 the Republic,
>
> during such year or period of assessment excluding receipts or accruals of a capital nature . . .

In terms of this definition it is clear that a person can be taxed either on "receipts" or "accruals". The definition of "gross income" makes no reference to the legality or illegality of "receipts" or "accruals" and the main issue for the purposes of this research is centred on the question of "receipt" in terms of the definition of "gross income" in relation to the proceeds of theft. This problem is based on the premise that if a person is conducting an illegal business, such as stealing cars and selling them, that person is not entitled to the proceeds from the stolen cars as he or she was never legally entitled to the ownership of the cars in the first place.

As the legislation does not provide any guidelines on the taxability of illegal income, in order to understand the taxation of illegal income derived from theft, how the courts have dealt with tax cases involving theft must be investigated. Over the past years the courts have not been consistent in their decisions when it comes to the taxability of illegal receipts (Croome,

Oguttu, Muller, Legwaila, Kolitz, Williams & Louw:2013). Certain courts have followed the objective approach, while other court decisions have been based on the subjective approach. The objective approach considers whether or not the taxpayer was, objectively speaking, entitled to receive a particular amount (in cash or otherwise) and, using this approach, the courts would conclude that the taxpayer could not be said to have received the amount in question (Stiglingh *et al.*, 2015). The rationale behind this line of reasoning was that when the taxpayer received the amount in question there was an immediate obligation upon him or her to repay the money (Croome *et* al., 2013). Proponents of the subjective approach, on the other hand, took the intention of the taxpayer into account and concluded that, because the taxpayer received the amount in question with the intention to benefit from it, the amount should be regarded as having been "received" for income tax purposes and should be included in the taxpayer's gross income (Stiglingh *et al.*, 2015).

In *COT v G* 1981(4) SA 167(ZA), 43 SATC 159, the Zimbabwean court followed the objective approach and held that the word "received" in a Zimbabwean income tax provision similar to the South African definition of "gross income" could not be interpreted widely to cover a unilateral taking such as theft, which does not invest a right of ownership on the taker of the property. In *ITC 1792*, (2005) 67 SATC 236, and *ITC 1810*, (2006) 68 SATC 189, the decision of the court in each case was based on the objective approach. In *ITC 1792* the issue was whether the secret profits received by an agent fell within the "gross income" of the agent. It was held that by law the taxpayer had not received the proceeds for the purposes of "gross income" as the proceeds were received in his capacity as an agent and therefore they did not belong to him. In *ITC 1810* the court had to decide whether the amounts received in an insolvent pyramid scheme were taxable in the hands of the investors in the scheme. The court held that the proceeds received were not taxable in the hands of the investors because, from the outset, the scheme was insolvent and any interest paid to investors was a disposition without value and would have to be returned when the payer was placed in liquidation.

The role of a taxpayer's intention was taken into consideration in court decisions in cases such as *ITC 1545*, (1992) 54 SATC 464, and *ITC 1624*, (1996) 59 SATC 373. In these cases, the courts followed a broader approach by paying attention to the unilateral intention of the taxpayer in dealing with illegal receipts. The words "an amount received for own benefit" in the context of illegal receipts were interpreted to mean any amount that a person received with the intention to benefit from it. This interpretation is in line with what was held in

Geldenhuys v CIR 1974 (3) SA 256 (C), 14 SATC 419 (at 266), that the words "received by" mean "received by the taxpayer on his or her own behalf and for his or her own benefit".

The Supreme Court of Appeal (SCA) in *MP Finance Group CC (in liquidation) v C:SARS* 2007 (5) SA 521 (SCA), 69 SATC 141, when presented with an opportunity to clear the uncertainty with regard to the taxability of illegal income, gave a decision which was inconsistent with the decision of the court in *COT v G*. The taxpayer in *MP Finance Group CC (In Liquidation) v C:SARS*, a case involving an illegal pyramid scheme, argued that it had not received the money in view of the fact that it had to refund the investors. In rejecting this argument, the court followed the subjective approach and held that the illegal proceeds were indeed received by the taxpayer for its own benefit because the taxpayer intended to benefit personally from the deposits. Thus, the money paid to the taxpayer by the investors was regarded as amounts received and taxable. This was irrespective of the fact that in law the money was immediately repayable.

The court's subjective approach in *MP Finance Group CC (In Liquidation) v C:SARS* was criticised by certain authors. For example, Goldswain (2008) argues that the decision may be constitutionally attacked on the ground that the owners of the property will be unlawfully deprived of their property by the State as a result of the imposition of tax on the proceeds, which is a violation of section 25 of the Constitution of the Republic of South Africa, 1996. Stiglingh *et al.* (2015) submit that, although the court's subjective approach has been criticised, the legal position remains that an amount will be regarded as having been received by a taxpayer for purposes of income tax if he or she intended to receive it for his or her own benefit.

In some foreign judicial decisions, it has been stated that the power of the Commissioner to tax illegal business cannot be limited by the legislature declaring an activity illegal (*Minister of Finance v Smith* 1927 AC 193). The Australian court in *Partridge v Mallandaine,* 1886 2 TC 179, held that receipts from activities where the elements of a business are present are income irrespective of whether the activities are legal or illegal. In the United States, gross income means all income derived from whatever source (United States Internal Revenue Code, 1939: s61). Furthermore, in New Zealand the courts have accepted that the proceeds from illegal activities are taxable. In the case, *D 57* (1980) 4 NZTC 60,852, the court held that in taxing income it was immaterial whether business or other income was legal or illegal.

In Interpretation Note 80 (South African Revenue Service:2014), the South African Revenue Service (SARS), relying on *MP Finance Group CC (In Liquidation) v C:SARS*, took the view that a thief will be taxed on stolen proceeds because those proceeds constitute a "receipt". It follows that SARS will regard proceeds from a unilateral taking as gross income and thus taxable. On the taxation of illegal income, Williams (2009) concludes that in deciding whether illegal receipts are taxable one has to consider the nature of the "receipts" and how the taxpayer treats such "receipts". If the taxpayer treats such "receipts" as if they are in the nature of income, then it will be a receipt within the meaning of "gross income".

It is submitted that SARS may be wrong in regarding *MP Finance Group CC (In Liquidation) v C:SARS* as authority for a unilateral taking being a "receipt" as, in the case of *MP Finance Group v C:SARS*, there was a transaction. A transaction constitutes both giving and receiving and in the case of theft, no transaction takes place (Haupt:2015). The court in *MP Finance Group CC (In Liquidation) v C:SARS* did not make it clear that their decision is applicable in every case of proceeds from a unilateral taking (theft). It follows that the issue was not fully settled by the SCA in the case of *MP Finance Group CC (In Liquidation) v C:SARS*. It is therefore important that an analysis of the decision of the SCA and the implications of the application of a subjective approach is carried out to determine whether this approach can be used to subject proceeds from a unilateral taking to tax in all cases.

1.2 Goals of the research

The main goal of this research is to investigate the basis on which proceeds from a unilateral taking are taxed in South Africa and whether the taxation of illegal income flowing from a unilateral taking should be based on the subjective approach currently applying. In achieving the main goal of this research, the research addressed the following sub-goals:

1. an investigation into whether the concept of a "receipt" should be interpreted using the subjective approach;
2. an appraisal of the subjective interpretation approach used in *MP Finance Group CC (In Liquidation) v C:SARS* and its appropriateness when taxing illegal income flowing from a unilateral taking;
3. an analysis of SARS' view in Interpretation Note 80 (South African Revenue Service: 2014) that the *MP Finance Group CC (In Liquidation) v C:SARS* case is

authority for a unilateral taking being a receipt, and the correctness of this viewpoint;

4. a discussion of the implications for property rights of the subjective approach applied in *MP Finance Group CC (In Liquidation) v C:SARS;*
5. a comparative analysis of the basis on which illegal income flowing from a unilateral taking is taxed in Australia, New Zealand and America; and
6. a recommendation regarding the approach to be applied in South Africa to tax illegal income in the case of a unilateral taking, based on the approach adopted in Australia, New Zealand and America.

1.3 Methods, procedures and techniques

In achieving the main purpose of this thesis, the research considers whether applying the subjective approach to the interpretation of the concept of "receipts" is warranted. Consequently, an interpretative research approach was adopted for the present research as it sought to understand and describe the taxation of illegal income (Babbie & Mouton:2010). The research methodology that was applied can be described as a doctrinal research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to the taxation of illegal income from a unilateral taking), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar:2008). The documentary data used for the research consisted of tax legislation, South African case law, textbooks, journal articles and SARS' Interpretation Note 80.

For comparative purposes, the research also briefly discusses the basis on which illegal income flowing from a unilateral taking is taxed in foreign countries such as Australia, New Zealand and America. These countries were used for comparative purposes because they adopted the subjective approach under a different concept known as the doctrine of claim of right. The doctrine of claim of right is similar to the approach applied in MP Finance Group CC (In Liquidation) v C:SARS.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions were ensured by:

1. adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
2. placing greater evidential weight on legislation and case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
3. discussing opposing viewpoints and concluding, based on preponderance of credible evidence; and
4. the rigour of the arguments.

As all the data are in the public domain, no ethical considerations arise in relation to the use of the data. Interviews were not conducted and opinions were considered in their written form.

1.4 Structure of the thesis

The thesis is divided into five chapters and chapter one of the research serves as an introduction to the thesis. Chapter two discusses the definition of "gross income", the taxation of legal and illegal "receipts" in South Africa and what constitutes a "receipt" for the purposes of "gross income" when taxing income flowing from legal and illegal activities in South Africa. Chapter three discusses the objective and subjective approach and provides an appraisal of the subjective interpretation approach used in *MP Finance Group CC (In Liquidation) v C:SARS*, its appropriateness when taxing illegal income flowing from a unilateral taking and whether the subjective approach should be used to interpret the term "receipt". Chapter four discusses the basis upon which income from theft is taxed in New Zealand, Australia and America and provides a comparative analysis of the basis upon which income from theft is taxed in these three foreign countries. The final chapter, chapter five, concludes the thesis and also provides a recommendation regarding the approach to be applied in South Africa to tax income from theft, based on the approach adopted in Australia, New Zealand and America.

CHAPTER 2: "RECEIPT" FOR THE PURPOSES OF GROSS INCOME

2.1 Introduction

A taxpayer pays tax on his or her taxable income, which is defined in section 1 of the Act as:

> . . . the aggregate of –
>
> (a) the amount remaining after deducting from the income of any person all amounts allowed . . . to be deducted from or set off against such income . . .

"Income" is defined in section 1 of the Act as ". . . the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax . . .". It follows that the calculation of a taxpayer's taxable income and ultimately the tax liability of a taxpayer commences with considering what constitutes the taxpayer's gross income. A taxpayer's gross income as defined in section 1 of the Act includes both receipts and accruals.

This chapter will briefly discuss the definition of "gross income". It will also discuss the taxation of legal and illegal income in South Africa. As the main focus of this research is on "receipts", sections 2.3 and 2.4 (dealing with the taxation of legal and illegal income in South Africa) will focus on what constitutes a "receipt" for the purposes of "gross income" when taxing legal and illegal income in South Africa.

2.2 "Gross income" definition

In order for a taxpayer's income to be subjected to tax, it has to fall within the definition of "gross income" in section 1 of the Act. "Gross income" is defined in section 1 as follows:

> (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 the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature . . .

In order for an amount to be included in the gross income of a taxpayer it has to meet all the components of the "gross income" definition in section 1 of the Act. As the legislation does not provide the meaning of the words or phrases included in the "gross income" definition, in order to understand the meaning of these words or phrases, how the courts have interpreted the words or phrases in the "gross income" definition must be investigated. Courts give a judicial interpretation to legislation based on the set of facts before them. The definition of "gross income" and related case law will now be briefly discussed.

<u>The total amount in cash or otherwise</u>

According to the statutory definition of "gross income", a person is taxed on his or her total amount (of receipts or accruals), whether in cash or otherwise. The court, in *WH Lategan v CIR* 1926 (CPD) 203, 2 SATC 16 (at 203), held that the word "amount" includes "not only money which has been received by the taxpayer or which has accrued to him, but all forms of property which he has received or which has accrued to him, whether corporeal or incorporeal, which has a monetary value, including debts and rights of action". The court in *CIR v Butcher Bros (Pty) Ltd* 1945 (AD) 301, 13 SATC 21, and *CIR v Delfos* 1933 (AD) 242, 6 SATC 92, confirmed the court's ruling in *WH Lategan v CIR* and emphasised that the word "amount" includes proceeds which have a monetary value. It follows that the word "amount" incorporates both monetary and non-monetary items and if the proceeds are something without a monetary value or cannot be turned into money, they cannot be included in the taxpayer's "gross income" (Williams:2009).

The court, in *C:SARS v Brummeria Renaissance (Pty) Ltd and Others* 2007 (6) SA 601 (SCA), 69 SATC 205, dismissed as incorrect the *obiter dictum* in *CIR v Delfos* (at 251) that ". . . tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money's worth or cannot be turned into money, it is not to be regarded as income . . .". The court, in *C:SARS v Brummeria Renaissance*, held (at 603) that "the question whether a receipt or accrual in a form other than money has a money value is the primary question and the question whether such receipt or accrual can be turned into money is but one of the ways in which it can be determined whether or not this is the case". According to *Lace Proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349, if the proceeds received by the taxpayer are not in cash, the proceeds will be valued at their market value on the date they were received or when they accrued to the taxpayer. Thus, the court will use an

objective valuation as opposed to the subjective valuation in determining the value of an amount received in a form otherwise than in cash. A thief may steal either cash or something other than cash. If the thief takes anything other than cash and if the proceeds meet the other requirements of the "gross income" definition, the court will use an objective valuation to determine the value of the proceeds in the hands of the thief.

The amount to be taxed must actually have been received by or accrued to the taxpayer before there can be any question of "gross income" arising (Stiglingh *et al.*, 2015). There is no place for imputation of amounts or notional amounts (Stiglingh *et al.*, 2015). The amount must not only exist, but the Commissioner has the onus to establish that some ascertainable amount has accrued to or has been received by the taxpayer; if no amount can be established, there can be no inclusion in "gross income" (*CIR v Butcher Bros*). On the other hand, in terms of section 102 of the Tax Administration Act, 28 of 2011 (referred to as the Tax Administration Act), the burden of proof that any amount is not subject to tax rests with the taxpayer. It follows that, for the purposes of this research, a taxpayer will have the burden of proving that his or her proceeds from theft are not subject to tax.

Received by or accrued to a person

The definition of "gross income" in the Act applies to both receipts and accruals. The word "received" has various meanings and not every obtaining of physical control over money or money's worth constitutes a "receipt" for the purposes of the definition of "gross income" (*CIR* v *Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113). This was made clear in the case of *Geldenhuys v CIR*, where the court had to decide whether the proceeds from the sale of a flock sheep by a taxpayer who held a usufructuary interest in the flock could be included in her "gross income". The court (at 266) held that the words "received by" means "received by the taxpayer on his or her own behalf and for his or her own benefit". The court held that although the taxpayer had received the proceeds she had not received them for her own benefit, but for the benefit of the bare dominium holders and that they belonged to the bare dominium holders. In deciding this case, the court had regard to the common law of obligation and the property rights of the usufructuary. Stiglingh *et al.* (2015) submit that for an amount to be assessed for tax purposes, a person need not have received a benefit. According to Stiglingh *et al.* (2015:24) "the presence or absence of a benefit to the taxpayer from something that passes into his possession does not provide a proper test in applying the

definition of gross income. The test is whether the taxpayer, objectively speaking, received an amount. The value is then calculated objectively".

The court, in *WH Lategan v CIR,* interpreted the word "accrual" to mean "entitled to" and thus if a taxpayer is entitled to an amount, he or she will be taxed on that amount in the year of entitlement even if the amount has not been received. The SCA in the case of *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9, referred with approval to the decision of the court in *WH Lategan v CIR* and held that the amount which was outstanding to the taxpayer in question had accrued to him even when such amount was due and payable the following year. The court made this ruling in view of the fact that the taxpayer was entitled to the amount in question. This indicates that the physical receipt of the amount and its enforceability is irrelevant to the question of taxation (Stiglingh *et al.*, 2015). However, the court in *Mooi v SIR 1972* (1) SA 675 (A), 34 SATC 1, held that for a taxpayer to be taxed on what he is entitled to there has to be an unconditional entitlement; if there is any condition to the right there can be no accrual. "Accrual" can only take place after the condition has been fulfilled as the taxpayer is not entitled to the amount until the condition has been fulfilled *(Mooi v SIR)*. The taxpayer's subjective intention is therefore irrelevant to the question of "accrual" (Stiglingh *et al.*, 2015).

In the case of *SIR v Silverglen Investments (Pty) Ltd* 1969 (1) SA 365 (A), 30 SATC 199, it was held that a person is taxed on the earlier of "receipt" or "accrual". If an amount has accrued to the taxpayer in a year of assessment and is received in a later year of assessment, the Commissioner is bound to include that amount in the taxpayer's gross income in the year of accrual and not the year of receipt. It follows that the Commissioner does not have the right to elect whether to tax a person in the year of accrual or receipt.

The main issue for the purposes of this research is centred on the question of "receipt" in terms of the definition of "gross income" in relation to the proceeds from theft. This question is based on the premise that if a person is conducting an illegal business, such as stealing cars and selling them, that person is not entitled to the proceeds from the stolen cars, as he or she was never legally entitled to the ownership of the cars in the first place. Thus, if tax is to be levied on the proceeds from theft, it will have to be done in the year of receipt.

2.3 Taxation of legal income in South Africa

The term "receipts" in the context of legal activities carried out in South Africa has not elicited much controversy in court decisions or among tax scholars. Decisions delivered by the courts over the past years indicate that there is a general consensus on the interpretation of the word "receipt" in respect of income from legal activities. The term "receipt" has been interpreted to mean received by the taxpayer on his or her own behalf and for his or her own benefit (*Geldenhuys v CIR*). It follows that if a person receives amounts on behalf of someone else those proceeds will not be taxed in the hands of the recipient, but will be taxed in the hands of the beneficiary. In *CIR v Friedman and Others NNO* 1993 (1) SA 353 (A), 55 SATC 39, Botha JA referred to this principle as the "benefit formula".

The "benefit formula" was applied in the case of *CIR v Cape Consumers (Pty) Ltd*, 61 SATC 91. In this case the taxpayer was a buy-aid organisation which acted as a mutual buying organisation with the object of obtaining benefits for its buyers and, accordingly, as described in the annual directors' report, all income received belonged to the buyers and was received on their behalf and similarly all expenses incurred were so incurred on behalf of the buyers. The Commissioner for Inland Revenue, in assessing the respondent's liability to tax, had included in its taxable income certain income received by the respondent and placed into the buyers' reserve fund. The court confirmed the "benefit formula" and held that the legal relationship between the taxpayer and the buyers obliged the taxpayer to credit the income earned to the buyers' reserve fund. Accordingly, the court held that such income was not for the benefit of the taxpayer but for the benefit of the buyers and that the income was not received by nor did it accrue to the taxpayer within the "gross income" definition. It follows that if a taxpayer receives an amount as an agent of someone else, the amount would not have been received by the agent for the purposes of "gross income".

In the case of *SIR v Smant* 1973 (1) SA 754 (A), 35 SATC 1, the taxpayer sold his shares in a company to one Plank for a sum of R100 000 on condition that, from the date of sale, the taxpayer would have no claim to the payments made to him for the shares. The taxpayer accordingly had ceded his rights to the payments made by the company for his shares. The court held that when the taxpayer ceded his rights he divested himself of his right to receive future payments before they accrued to him and vested that right in Plank. It follows that, although the taxpayer received the payments, in law he was never the true owner of the

payments as he did not have any legal entitlement to the amounts. Thus, the later payments made to the taxpayer by the company were never received by the taxpayer for the purposes of "gross income" because he was antecedently obliged to transmit them to Plank if he received them from the company. Accordingly, the payments were not received by the taxpayer for his own benefit and never formed part of his "gross income".

The cases of *Geldenhuys v CIR* and *SIR v Smant* indicate that the word "receive" with reference to income from legal activities has been interpreted to mean that the recipient of an amount becomes entitled to the amount or becomes the owner of the amount. Thus, the term "receipt" is interpreted with reference to property rights and entitlements. This interpretation is supported by the case of *CIR* v *Genn*. In this case Schreiner JA, in the course of delivering a judgment dealing with the tax deductibility of commissions paid as raising fees on short term loans obtained in order to finance the purchase of trading stock, expressed the following *obiter dictum* (at 301) on the subject of receipts and accruals in the context of money or goods borrowed:

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

Thus, according to the court *CIR* v *Genn*, what is borrowed will only be "received" by the borrower for the purposes of "gross income" if there is a change of ownership in the actual things borrowed (which eliminates the obligation to repay). Goldswain (2008) states that in cases of stolen goods, the ownership of the goods remains in the hands of the person from whom the goods were stolen. However, in cases of stolen cash, he states that theft of cash may result in ownership of the money stolen passing to the thief. It is submitted that the requirement for ownership to be passed in all goods, whether monetary or non-monetary, is the same. In order for there to be a passing of ownership the owner of the thing (transferor) must have the intention and be capable of passing ownership (Badenhorst, Pienaar &

Mostert:2004). It follows that one cannot differentiate the passing of ownership in stolen goods from the passing of ownership in stolen cash.

The obligation to return an amount has been held by some courts not to have an effect of preventing an amount from being a receipt for the purposes of "gross income". In *ITC 1346*, (1981) 44 SATC 31, the taxpayer, a pathologist employed at a university, was granted paid and research leave. During his leave period he resigned from his university post. It was a term of his employment that, should he not continue in his post for a period of six months after his leave ended, the university would be entitled to require him to refund the whole or part of the salary he had received while on leave. Pursuant to his terms of employment, the university required him to refund the sum of R6 930, being six months' salary received while on leave. The court held that the R6 930 had been received and retained as his own by the taxpayer and that the contingent liability to repay the university did not exclude the said sum from the taxpayer's gross income for that year.

In *ITC 1669*, (1999) 61 SATC 479, the court had to decide whether rebates which had been granted by the taxpayer company to its shareholder formed part of the taxpayer's "gross income". The taxpayer company was formed in order to process raw hides on behalf of its shareholders. The taxpayer company granted rebates to its shareholders and showed these rebates in its financial accounts as a deduction arising from the purchase of materials. The Commissioner argued that the amount of the rebates granted by the taxpayer company constituted income in the hands of the taxpayer and not expenditure incurred by the company. The court held that, notwithstanding the fact that there was an agreement between the taxpayer company and its shareholders, the fact that the taxpayer company paid part of the amount it received did not exclude the amounts paid by the taxpayer company to its shareholders from its "gross income". Thus, the rebates that had been paid to the shareholders constituted "gross income". The court held that there was no obligation on the taxpayer company to repay to the shareholders any part of the costs they paid for the processing of hides. The court in *MP Finance Group CC (In Liquidation) v C:SARS* held that a contractual obligation to return an amount does not affect the relationship between a taxpayer and the *fiscus*. It follows that, in situations where the taxpayer receives an amount and retains that amount as his, the obligation to return the amount will not taint the nature of that amount as being a receipt under the "gross income" definition. The court, in such situations, will regard

the amount as having been received by the taxpayer on his own behalf and for his own benefit.

In *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A), 14 SATC 295, the taxpayer manufactured fruit squashes and other foodstuffs which it sold in glass containers to licenced dealers only. It did not sell by retail to the general public. During the course of its business the taxpayer changed its system and began to require the payment of a deposit for each glass container delivered to its customers. If a similar container was thereafter returned by the customer, the taxpayer refunded the customer the amount of the deposit on it. However, there was no obligation on the part of the customer to return the container. The court had to decide whether the amount paid to the taxpayer on the containers should be included in its "gross income". The taxpayer argued (at 977) that "the deposits were not receipts because amounts which are received as security or amounts which are held in trust for someone or for some purpose are not received in the sense in which that word is used in the definition".

The court decided that the taxpayer was not a trustee holding the deposits on account of the customers as security for the return of the bottles and that the fact that there was an obligation to pay back to the customers an amount equivalent to the deposit did not create a trustee relationship with regard to the deposits. Thus, in law there was no trustee relationship between the customers and the company. According to the court (at 983) this was because "there was no obligation to return the container resting on the customer and the deposit was not security in the nature of a pledge given to secure performance of such an obligation. Consequently the seller was in no sense a trustee or pledgee". The absence of an obligation on the customers to return the containers meant that when the taxpayer received the deposits, the deposits became the property of the taxpayer. It follows that the court's decision was based on the principle of entitlement.

Similar to *CIR v Brookes Lemos* is the case of *Greases (SA) Ltd v CIR* 1951 (3) SA 518 (A), 17 SATC 358. In this case the taxpayer's books of account did not reflect the deposits on the containers as sales and the deposits were credited to a suspense account, debiting this account with amounts refunded to customers. However, the taxpayer also, like the taxpayer in *CIR v Brookes Lemos*, did not put the deposits into any trust account, but used them in its ordinary business and the Commissioner included those amounts in the taxpayer's "gross income". The court held that the case is not distinguishable from the *Brooks Lemos* case and that the

amount should be taxed because there was no absolute obligation upon the customers to return the containers to the taxpayer. The decisions of the Appellate Division in *CIR v Brooks Lemos* and *Greases (SA) Ltd v CIR* were followed in *ITC 1346*. The court in *ITC 1346* held (at 32) that ". . . once the taxpayer receives an amount as his own during a tax year, the fact that, in terms of a contract, the taxpayer may have to repay any amount later does not have the effect of excluding these amounts from gross income for the year in which the taxpayer received them".

The deposit cases (*CIR v Brooks Lemos* and *Greases(SA) Ltd v CIR*) discussed above show that "the liability to refund a portion of the purchase price of an article sold, which liability is dependent upon whether a part of the article sold is returned to the seller, is clearly distinguishable from the obligation falling upon a borrower [discussed in *CIR* v *Genn*], at the same moment that he is given possession, to repay the loan advanced to him" (Muller, 2007:179).

In the case of *CIR v Witwatersrand Association of Racing Clubs* 1960 (3) SA 291 (A), 23 SATC 380, the taxpayer, on Coronation day, organised and sponsored a race meeting in aid of two charitable organisations to which the net proceeds of the meeting, an amount of 7 906 pounds, were duly paid. The Commissioner included this sum in the taxpayer's "gross income" for the year in question. Counsel for the taxpayer agreed that an amount is received by a taxpayer if such amount is received for the benefit of the taxpayer. However, he argued that an amount is received by a taxpayer for his or her benefit if the right to the amount "is absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment" (at 293). The court held (at 306) that: "although it was throughout contemplated that no portion of the prospective profits would remain with the taxpayer, and that all profits should go to the two charities, the taxpayer is not thereby relieved from tax liability: a moral obligation to hand over the proceeds to the charities did not destroy the beneficial character of the receipt of those proceeds by the taxpayer". Accordingly, the proceeds from the horse racing event were held to have been "received" for the benefit of the taxpayer for "gross income" purposes and taxable in the hands of the taxpayer, notwithstanding that they were handed over to the charities. The court applied the concept of entitlement in deciding this case.

The cases discussed above show that the underlying law of obligations played an important role in the interpretation and application of the term "receipt". Thus, if a taxpayer was entitled to an amount, the courts would regard the physical control of the amount by the taxpayer as a "receipt for his own benefit" (Stiglingh *et al.*, 2015:20). The intention of the taxpayer did not influence how the courts in these cases dealt with the issues before them. It follows that, in interpreting the term "receipt" in the context of income derived from legal activities, the courts followed an objective approach. How the courts have interpreted the term "receipt" in the context of illegal income will now be analysed.

2.4 Taxation of illegal income in South Africa

The illegality of a source of income cannot be used by a taxpayer as a defence against an assessment raised by the Commissioner (Stiglingh *et al.*, 2015). The definition of "gross income" previously discussed above does not make any reference to the legality of the source of income in order for a tax liability to be raised by the Commissioner against a taxpayer's "receipts" or "accruals" under the Act. It appears that all income in the hands of a taxpayer will be taxed irrespective of the legality of the source of the income. As the legislation does not provide any guidelines on the taxability of illegal income, in order to understand the taxation of illegal income, how the courts have dealt with tax cases involving illegal income must be investigated.

In *CIR v Delagoa Bay Cigarette Co. Ltd* 1918 TPD 391, 32 SATC 47, the taxpayer received proceeds from the operation of an illegal scheme under which it sold packets of cigarettes worth 6d for 10s, each such packet containing a numbered coupon. The company undertook to set aside two thirds of the amount received from such sales as a prize fund from which a monthly distribution would be made to such purchasers. The monthly distributions were to be made according to the discretion of the directors of the company. Two such monthly distributions had been made and a third distribution had been advertised to take place, but meanwhile criminal proceedings had been instituted against the officials of the company on the grounds that they were running a lottery. The Commissioner issued an interim assessment on an estimated basis for the period in question, requiring payment of the tax assessed forthwith. The taxpayer argued that the business of the company was illegal and the state was not entitled to collect tax on the profits of illegal transactions.

The court held that the source of income, whether legal or illegal, is immaterial to the question of the liability of the taxpayer to income tax. Bristowe, J (at 394) stated this 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 leviable on all incomes exceeding the specified minimum ... The source of the income is immaterial. This was so held in *Partridge* v *Mallandaine* [18 QBD 276] where the profits of a betting business were held to be taxable to income tax; Denman J saying that 'even the fact of avocation being unlawful could not be set up against the demand for income tax'.

Furthermore, the court held that the Income Tax Act does not differentiate between legal and illegal income for tax purposes and that courts should not differentiate between legal and illegal income for income tax purposes. The court, in interpreting the phrases "received by" or "accrued to" or "in favour of" a person, followed a simple approach without subjecting these phrases to any technical or linguistic analysis (Classen:2007). The case of *CIR v Delagoa Bay Cigarette Co. Ltd* makes it clear that illegal receipts are taxable and in practice the revenue authorities endeavour to collect tax on illegal receipts if they know about them (Goldswain: 2015). However, the law appears to be somewhat unclear in relation to stolen monies or goods. In *ITC 1199*, (1973) 36 SATC 16 (at 19), it was held that "the tax collector has cast his net wide enough to catch all income so that once a receipt or accrual is held to constitute income it is taxable in terms of the Income Tax Act, irrespective of whether it is legal or illegal income".

The estate of the perpetrators of illegal activities grows once they are in possession of the proceeds from the illegal activities. This growth is income in their estate and the possessor of this income should be liable for income tax on this income. However, over the previous years, income from illegal activities has been excluded from income tax on the basis that such income did not constitute a "receipt" under the statutory definition of "gross income". The courts that followed this approach regarded proceeds from illegal activities as not having been received by the perpetrator within the true legal sense of the word "received". This approach is called the objective approach (discussed in section 3.2 of chapter three). The courts have been inconsistent in their interpretation of the word "receive". Certain courts have interpreted it with reference to the taxpayer's subjective intention. This approach is

called the subjective approach (discussed in section 3.3 of chapter three). The courts that have used this approach have regarded amounts from illegal income to have been received for income tax purposes.

One of the courts that followed the objective approach is the Appellate Division of the Zimbabwean High Court in the case of *COT v G*. Although the court's judgment referred to the intention of the taxpayer, the judgment was based on an objective approach, coupled with the underlying entitlement of the taxpayer to the money (Croome *et al*., 2013). In *COT v G* the Zimbabwean court dealt with a set of facts which involved misappropriation of government funds by the taxpayer (Goldswain:2015). Over a period of four years the taxpayer was in a position of responsibility with the Rhodesian government (now the Zimbabwean government) which entailed him being entrusted with funds for secret operations. He took advantage of his position to obtain from the government from time to time more money than was legitimately required for official purposes and to appropriate this for himself, either by putting it in his own bank account or by using it to buy goods for himself. He was convicted and sentenced to imprisonment, a part of which was suspended on condition of repayment.

Notwithstanding the fact that the whole amount was repaid by the taxpayer, he was assessed for tax on the amounts he stole as the Commissioner contended that "gross income" as defined in the Zimbabwean Tax Act means every amount received by or accrued to or in favour of a person in every year of assessment, and that what the taxpayer stole he received in terms of that definition. On appeal it was argued on behalf of the taxpayer that the money he took never became his, despite his intention to treat it as his own, and that it was therefore never received by him within the meaning of the word "received" in the gross income definition and he should not be taxed on the amount he stole.

The Appellate Division of the Zimbabwean High Court in *COT v G*, like the court in *Geldenhuys v CIR*, accepted that the term "receive" in a provision similar to the South African definition of "gross income" meant received by the taxpayer for his or her own benefit. The court held that whether or not there is a receipt depends not only on the intention of the recipient but also on the intention of the giver. The court in *COT v G* further held that stolen money would seem never to become the property of the thief, just as borrowed money

does not become the property of the borrower (except in a technical sense) because of the co-equivalent obligation to repay it which arises from the moment it comes into his possession. The court held further that it matters not that the proceeds were acquired illegally, as his possession of them was not such as to make them received by or accrued to him, for he really was possessing someone else's money. However, the court pointed out that this does not mean that all illegal money or assets will not at some point be "gross income" because it will depend on whether or not the proceeds have actually accrued to the taxpayer or can effectively be claimed by someone else.

On the facts of the case, it was held that it was never the intention of the government for the money to be received by the taxpayer on his own behalf and for his own benefit. Accordingly, the court held that the money had not been received by the taxpayer for tax purposes and could not be taxed in the hands of the taxpayer. Williams (2009) argues that the decision of *COT v G* misconceives the underlying issue. He submits that the question whether a thief is taxable on what he steals does not turn on whether there was a "receipt", but on whether stolen property possesses the quality of income in the thief's hands.

After the decision in *COT v G* the role of a taxpayer's intention came under consideration in court decisions in cases such as *ITC 1545* and *ITC 1624*. The courts followed a broader approach by paying attention to the unilateral intention of the taxpayer in these cases dealing with illegal receipts. The words "an amount received for own benefit" in the context of illegal receipts were interpreted to mean any amount which a person received with the intention to benefit from it.

In *ITC 1545* the court dealt with a set of facts where the taxpayer derived income from different illegal activities. The taxpayer knowingly bought and sold for a profit stolen diamonds. The Commissioner included proceeds derived by the taxpayer from these sales in the taxpayer's gross income. It was argued on behalf of the taxpayer (at 466) that "he was liable to the owner for the return of the diamonds or their value and that this liability was an inseparable and necessary concomitant of the trade of dealing in stolen diamonds." It was further argued that as this liability arose immediately with each transaction it constituted deductible expenditure in terms of section 11(a) of the Act for each of the years in which a profit was made.

In deciding this case, the court differentiated the facts of *COT v G* from the facts of the case before it and held that in the present case there was no mere taking by the taxpayer. In other words, the taxpayer in *ITC 1545* operated a business of selling stolen diamonds, whereas the taxpayer in *COT v G* merely took money from the government. The court held that the taxpayer's conduct amounted to theft. Without any argument being presented, it was accepted by both the court and the taxpayer that the proceeds of such sales amounted to receipts and accruals for the purposes of "gross income". However, the court did not allow a deduction on the ground that the liability of the taxpayer to return the diamonds or their value was dependent upon the true owner of the diamonds becoming aware of the theft.

The taxpayer in *ITC 1545* was also involved in a pyramid scheme where he, through his company, sold milk cultures to the members of the public (the growers), who used activators to grow the milk cultures, which they then dried (the crop) and sold back to the company. The taxpayer also participated in the scheme in his personal capacity as a grower. The Commissioner included the profits derived by the taxpayer in his "gross income". It was argued on behalf of the taxpayer that, because the scheme was an illegal lottery in terms of the Gambling Act, the transactions carried on under the scheme were therefore void *ab initio*. Consequently, the taxpayer argued that he was not entitled to the profits.

In addressing the taxpayer's argument, the court separated the concept of "receipt" from the concept of "accrual" (in the sense of entitlement). The court held that the illegal proceeds could not be regarded as having accrued to the taxpayer. This view appears to be in line with the court's decision in *COT v G* that the stolen property never becomes the property of the thief. The court referred with approval to the decisions of the court in the cases of *Geldenhuys v CIR* and *SIR v Smant*, but it went a step further in its analysis of the taxpayer's argument and emphasised that an amount will be included in a taxpayer's "gross income" if it was "received by or accrued to" the taxpayer.

The court held that the use of the word "or" in the "gross income" definition shows that there may be a "receipt" without an "accrual". It follows that, according to the court, the legislature intended there to be a clear and significant difference between the words "received" and "accrued" in the "gross income" definition. This difference in the meaning of the words "received" and "accrued" may be a justification for the different treatment accorded by the courts to legal and illegal income. The courts, on one hand, tax legal income using the

principle of entitlement (accrual) while, on the other hand, tax illegal income using the "benefit formula" (receipt). As an example to show that there may be a "receipt" without "accrual", the court in *ITC 1545* held that situations may arise where a person may receive his or her salary prior to earning it. However, the court held that an amount received on behalf of someone else cannot be regarded as having been received for the purposes of "gross income". It is submitted that there is nothing in the Act which prohibits this kind of interpretation of the term "received" in the definition of "gross income". In interpreting the term "received" the courts should not restrict the meaning of this term "to amounts that are received in circumstances where a taxpayer is also entitled to the amounts" (Classen, 2007:543). Restricting the meaning of the term "received" only to amounts to which the taxpayer is entitled will not give room to the courts to bring proceeds from illegal activities under the Act and will put illegal income beyond the Commissioner's reach. It has been correctly stated by Muller (2007:176) that:

> It is trite law that the meaning of accrual relates to the taxpayer's entitlement to such an amount (*Commissioner of Inland Revenue v People's Stores*). Strictly speaking, if the meaning of "receive for own benefit" should also imply entitlement, the concept would seem superfluous. It is submitted that the wider and more subjective approach of attaching importance to the intention of the taxpayer, is laudable.

The court in *ITC 1545* accepted what was stated in *Geldenhuys v CIR* that the words "received by" mean a receipt by the taxpayer for his own benefit. In line with this it was held (at 474) that an "amount, received in pursuance of a void transaction, constitutes an amount received for own benefit within the ordinary literal meaning of the word and that because a contract is prohibited by statute and therefore void *inter partes* does not mean it should be totally disregarded and all the consequences flowing from it ignored". Accordingly, it was held that the illegal income from the pyramid scheme constituted gross income of the taxpayer.

It has been often argued by taxpayers in possession of stolen amounts that the amount cannot be regarded as having been "received" for "gross income" purposes in view of the fact that they had to refund the victims of the crime. This argument has been rejected by the court in *MP Finance Group CC (In Liquidation) v C:SARS*, which held that illegal income is taxable if it has been received by the taxpayer for his or her own benefit. This was irrespective of the

fact that in law the money in question was immediately repayable. In *ITC 1624* (referred to above) the taxpayer, a customs clearing agent, fraudulently overcharged customers. The issue which the court had to decide was whether or not an amount which the taxpayer had fraudulently overcharged a customer constituted an amount "received". The taxpayer argued that the amount in question had not been received by him for the purposes of gross income because he had not received the amount "on [his] own behalf and for [his] own benefit" and that he had not received the amount in circumstances that made him become entitled to it. The taxpayer further argued (374) that "on receiving the said money, [he] had become subject to a simultaneous and corresponding liability to repay it as [his] client A was entitled to recover it by means of a *condictio indebiti* or, presumably, some other action *in personam*". The court did not treat the fraudulent charges by the taxpayer as theft and after having quoted from the case of *COT v G*, but without dealing with the issue of mutual intention, the court held that the taxpayer had received the money for purposes of gross income, because he intended to receive it as part of his business operations. Accordingly, the court included the amount from the fraudulent overcharges in the taxpayer's gross income.

Drawing from the court's decision in *ITC 1624*, if a taxpayer fraudulently cheats his or her customers during the course of a trade, such receipts are to be included in the taxpayer's gross income for tax purposes. In *ITC 1624*, Wunch J differentiated the situation in which a person steals money (as in the case of *COT v G*) from the situation where a taxpayer, in the course of his trading activities, fraudulently overcharges his customers. In the latter case it was held that the taxpayer receives such an amount or intends to receive the amount as part of his business income and in the course of his business. Consequently, it was held that an amount received in such circumstances falls within the taxpayer's "gross income". It is submitted that, for the purposes of determining whether an amount is taxable, a distinction cannot be drawn between the proceeds of one kind of crime involving incidental breaches of the criminal law (such as not complying with statutory requirements in the course of business) and a trade which is *per se* illegal, such as drug-dealing or theft. Both crimes are conducted with a view to making a profit, irrespective of what the motive for the profit is and no person commits crimes like fraud, theft or burglary without the intention to benefit from the proceeds of these crimes (Williams:2009).

Although there is a general consensus that a taxpayer is taxed if he or she has received an amount on his or her own behalf and for his or her own benefit, the question of whether a

taxpayer has received an amount on his or her own behalf and for his or her own benefit is not always clear cut. In direct conflict with *ITC 1624* are *ITC 1792* and *ITC 1810*. In these cases the decision made by the court was based on the objective approach. The facts of *ITC 1792* and *ITC 1624* have some similarities in that in both cases the agents defrauded their principal; however, the *modus operandi* of the frauds were different. The court in *ITC 1624* did not focus on the relationship between the taxpayer and the defrauded person as the unilateral intention of the taxpayer seems to have been conclusive (Stiglingh *et al*., 2015).

In *ITC 1792*, the taxpayer was a member of a stockbroking firm. He accepted instructions from clients to buy and sell securities on their behalf and for their benefit and in so doing he acted as an agent for the benefit of his clients, pursuant to a mandate given to him. He later became involved in a syndicate with dealers and portfolio managers employed by his client. The object of the syndicate was to manipulate certain share transactions. The syndicate knew beforehand which shares the client intended to purchase and the syndicate, with this knowledge, bought the shares in the name of an entity called “X Finance” for which an account in the taxpayer’s stockbroking firm had been opened, “warehoused” the shares and thereafter resold them at a profit to the taxpayer’s client. The syndicate realised profits of about R10 million of which the taxpayer’s share amounted to some R1,7 million. The taxpayer was convicted of fraud and sentenced to imprisonment but had made full restitution of the illegal profits to his client, with interest.

The issue which the court had to decide was whether the secret profits received by an agent fell within the “gross income” of the agent. The court held that illegal income was subject to tax, notwithstanding the fact that it was tainted with illegality or was received from illegal activities, but this was not the issue in this case as the issue to be determined was whether the receipt of secret profits by an agent fell within the “gross income” of the agent. In deciding the issue of whether secret profits received by an agent could be taxed in the hands of the agent, the court looked at the law of agency. It was held (at 239-240) that:

> . . . in order for there to be a receipt the money must be ‘received by the taxpayer on his own behalf and for his own benefit’ and in this matter the subjective intention of the syndicate and appellant was to receive the secret profits for themselves, but this, however, did not mean that legally they had received the profits for their own benefit and to understand the distinction an examination of the law of agency is required. The shares

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

The court referred with approval to the cases of *CIR* v *Genn* and *Geldenhuys v CIR,* which followed an objective approach disregarding the taxpayer's intention, and it was concluded that by law the taxpayer had not "received" the proceeds for the purposes of "gross income" as they did not belong to him. The court differentiated the case before it from the case of *COT v G*. It was held that on the facts of the case before the court there was no "taking" as set out in *COT v G*, as the taxpayer had received the proceeds of the sale as well as the original shares and his act was not a unilateral act as in the case of *COT v G*. Moreover, it was held that on the evidence before the court, the syndicate and its members intended to "receive" the profits for themselves, but this intention was disregarded by the court. According to Classen (2007), the principle of legality, viewed in its broad or indirect sense, was required by the court in *ITC 1792* for the proceeds to be taxable. Thus, "the mere physical receipt of the profits was not sufficient to render it taxable. Entitlement to it was still required in addition to the physical receipt of the amounts" (Classen, 2007:538). Stiglingh *et al* (2015) submit that the fact that the taxpayer reimbursed the defrauded principal may have played a significant role in the court's decision.

It is submitted that the decision of the court in *ITC 1792* may have lost its legal effect since the decision of the court in *MP Finance Group CC (In Liquidation) v C:SARS* (discussed in detail in section 3.3.1 of chapter three), where the court stated that the relationship between a scheme and an investor is different from the relationship between a scheme and the *fiscus.* The court distinguished the relationship between contracting parties (the commercial relationship) and the relationship that a taxpayer has with the *fiscus* and it was held that the tax consequences flow from the relationship with the *fiscus* rather than from the commercial relationship (Goldswain:2015). Thus, the legal relationship between the perpetrator of a crime and the victim of the crime and the consequences that flow from that relationship will not affect the tax liability of the perpetrator. It follows that, if *ITC 1792* were to be reconsidered in the light of what was said in *MP Finance Group CC (In Liquidation) v C:SARS*, the agent in *ITC 1792* is likely to be held liable for tax on the secret profits he received. This is because, from the moment the agent starts to receive secret profits for him-

or herself and not for the benefit of the principal, he or she will be regarded as having received the secret profits for his or her own benefit. The intention of the agent to receive the profits for his or her own benefit is what will be the deciding factor for income tax purposes.

The court in *ITC 1810* also considered the law of insolvency in deciding whether the proceeds from an insolvent pyramid scheme were taxable in the hands of the taxpayer. The taxpayer in *ITC 1810* had invested a sum of money in a pyramid scheme, operated by one A, with the hope of receiving interest on the money invested. The pyramid scheme was later sequestrated and it was common cause that no interest had been paid to the taxpayer by the pyramid scheme. The taxpayer submitted a claim to the trustees of the insolvent estate of A for the interest he ought to have received under his investment. The Commissioner issued an assessment to the taxpayer on the claims submitted to the insolvent estate of A. The taxpayer argued that the interest did not form part of his gross income because he never had an unconditional right to claim interest from A.

The court in *ITC 1810* accepted the taxpayer's argument and held that the proceeds received were not taxable in the hands of the investors because, from the beginning, the scheme was insolvent and any interest paid was a disposition without value, voidable in terms of the law of insolvency and was subject to return when the payer was placed in liquidation. This amounted to a legal condition attached to the "receipt" or "accrual". This line of reasoning is in line with what was stated in *Mooi v SIR* (discussed above) that all the conditions attached to an amount need to be fulfilled before a person can be taxed. The court in *ITC 1810* stated (at 192) that it was never "the intention of the legislature to have a person taxed on income that he never got or, if he obtained it, would lose it in terms of other legislation".

Furthermore, as a result of the illegal nature of the contract in *ITC 1810*, the court applied the "*ex turpi causa* rule", which means that "an illegal contract cannot be enforced" (Classen, 2007: 339). It was held that the interest had not accrued to the taxpayer as he had no legal right to force the pyramid scheme to pay it. The court referred to the decision of the SCA in *Fourie NO v Edeling NO & Others,* 2005 (4) SA 393 (SCA), where it was held (at 410) that "an undertaking by the operators of a pyramid scheme to pay returns to investors was a nullity because the investors obtained no unconditional legal right to enforce the payment of such returns". It follows that the court also applied the principle of entitlement in deciding whether the taxpayer was liable for tax and, as the taxpayer was not entitled to the proceeds,

it was held that there was no tax liability on his part. It is submitted that the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* (discussed in section 3.3.1 of chapter three), may also have the effect of overturning the decision of the court in *ITC 1810*.

2.5 Conclusion

The calculation of a taxpayer's taxable amount commences with the "gross income" of the taxpayer. The definition of "gross income" is provided in section 1 of the Act. This definition provides that a taxpayer can be taxed on either "receipts" or "accruals". The courts have interpreted the term "accrual" with reference to the principle of entitlement (*WH Lategan v CIR)*. Thus, if a taxpayer was entitled to an amount he or she will be deemed to be liable for tax on the basis of accrual. The concept of an "accrual" has been used by courts when dealing with income from legal but not illegal activities. The reason for this is that a taxpayer who is in possession of illegal proceeds does not become entitled to these proceeds. Entitlement remains with the true owner.

In the context of legal income the term "receipt" has been interpreted to mean received by the taxpayer on his own behalf and for his own benefit (*Geldenhuys v CIR*). The courts dealing with legal income have interpreted the term "receipt" with reference to entitlement. Thus, if a taxpayer was entitled to an amount, the courts would regard the physical control of the amount by the taxpayer as a "receipt for his own benefit" (Stiglingh *et al.*, 2015:20). The intention of the taxpayer did not have a bearing on how the courts interpreted the term "receive" in relation to income from legal activities.

It is clear that illegal income is taxable because the revenue authorities have cast their nets wide so as to include in the taxpayer's "gross income" all proceeds that constitute income (*ITC* 1199, 1973 36 SATC 16). The court will not look at the legality of the income when deciding whether or not a taxpayer is liable for income tax. The legality of the source of income has been held to be immaterial in the question of the liability of the taxpayer for income tax (*CIR v Delagoa Bay Cigarette Co. Ltd*) and in practice the revenue authorities endeavour to collect tax on illegal receipts if they know about them (Goldswain:2015).

In the past the courts have not been consistent in their interpretation of the term "receive" when it comes to illegal income. Some courts, such as the court in the cases of *ITC 1810* and

ITC 1792, regarded the proceeds from illegal activities as not having been received by the perpetrator in the true legal sense of the word "received". These courts interpreted the term "receive" with reference to the concept of entitlement. This approach led to the exclusion of illegal income from the "gross income" of the taxpayer.

In other cases, such as *ITC 1545* and *ITC 1624,* the courts have interpreted the word "receive" with reference to the taxpayer's subjective intention and have held that the taxpayer will be regarded as having received an amount for tax purposes if he or she had the intention to benefit from it. Using this approach the courts have managed to bring illegal income within the ambit of the "gross income" definition. The argument that a taxpayer who is in possession of illegal income had not received the income, in view of the fact that he or she had to compensate the victims of the crime, has been held to be irrelevant when deciding the obligations of a taxpayer to the *fiscus*.

The following chapter will discuss the subjective and objective approaches used by the courts to determine the taxability of illegal income.

CHAPTER 3: THE OBJECTIVE AND SUBJECTIVE APPROACH

3.1 Introduction

It has been established that all income from illegal activities is taxable, because all income that falls within the definition of "gross income" is taxable regardless of the legality or illegality of the source of income. However, over the past years the courts have not been consistent in their decisions when it comes to the approach to be used in taxing income from illegal activities (Croome *et al.*, 2013). On the one hand, some courts have followed the objective approach and, on the other hand, other court decisions have followed the subjective approach. As a result of the subjective approach applied in the recent SCA case of *MP Finance Group CC (In Liquidation) v C:SARS*, it appears that there is now general consensus on the basis on which income from illegal activities is taxed.

This chapter discusses the objective and subjective approaches and whether the term "receipt" should be interpreted using the subjective approach that is currently being applied to tax income from illegal activities. The chapter discusses the case of *MP Finance Group CC (In Liquidation) v C:SARS* and South African Revenue Service (SARS) Interpretation Note 80 (South African Revenue Service:2014), and considers whether *MP Finance Group CC (In Liquidation) v C:SARS* should be used as authority for the approach to be used when taxing all proceeds of theft (whether in the form of cash or property). The chapter will also discuss how the term "receipt" has been generally interpreted in South African law. Finally, the chapter discusses the implications of the decision in *MP Finance Group CC (In Liquidation) v C:SARS* for property rights and considers the court's decision from a public policy perspective.

3.2 The objective approach to interpreting a "receipt"

The objective approach considers whether or not the taxpayer was, objectively speaking, entitled to "receive" the amounts from his or her illegal activities and using this approach the courts would conclude that the taxpayer could not be said to have "received" the amount in question for the purposes of "gross income" (Stiglingh *et al.*, 2015). The rationale behind this line of reasoning was that when the taxpayer received the amount in question there was an immediate obligation upon him or her to repay the money (Croome *et al.*, 2013). Under the

objective approach, the "benefit formula" (discussed in section 2.3 of chapter two) was connected to the underlying legal entitlement of the taxpayer to the amount he or she has received. In other words, for an amount to be taxed the proponents of the objective approach require the amount to be the taxpayer's own to deal with as he or she pleases. In *COT v G* the court held that the amount that had been stolen by the taxpayer had not been "received" by him for the purposes of "gross income", as objectively, the amount was not the taxpayer's own to deal with as he wished

Stein (1998) is of the view that an amount derived from theft is analogous to an amount that has been borrowed by the taxpayer. This view is based on the premise "that stolen money or property can never belong to or become the property of a thief. It, like borrowed money, is only received by the felon in the broadest sense of the term; and the moment possession is taken of the stolen item, an obligation immediately arises to repay or return it. The criminal cannot therefore be said to have 'received' the money in the way in which the term is used in the 'gross income' definition" (Venter, Uys & van Dyk, 2015:130). An obligation on the taxpayer to pay back the amount, either based on a contractual obligation or on any other action in terms of any law, was an indication pointing to the fact that the amount in question had not been received by the taxpayer for "gross income" purposes (Muller:2007). It follows that the proponents of the objective approach, when interpreting the word "receive", focused on property law rights and they regarded the presence or absence of a property right as a major factor indicating that an amount had or had not been received for the purposes of income tax. Thus, according to the objective approach, the taxation system is centred on the legal rights and obligations of a taxpayer (Williams:2009).

In deciding whether or not to apply the subjective or objective approach the courts have had regard to the rules of statutory interpretation. The courts that favoured the objective approach did not apply the literal rule of statutory interpretation which the proponents of the subjective approach claimed to be using when interpreting the word "receipt" (Chawira:2011). Proponents of the objective approach applied the purposive rule of statutory interpretation. This rule of statutory interpretation is used by the courts to ascertain what the intention or will of the legislature was when a piece of legislation was enacted (Botha:2012). The judiciary, as it seeks to understand what the legislation wanted to accomplish in the legal order, looks at the words used by the legislature to convey its intention, will or thoughts (Botha:2012). It follows that when the objective approach proponents interpreted the term

“receipt” they looked at the intention of the legislature and not the intention of the taxpayer. In *COT v G*, it was stated that when an Act provides for the taxation of income, the intention of the legislature will be to tax what is earned or gained by a taxpayer from another. The court stated that a thief takes rather than receives anything from another person and agreed with the remarks, albeit *obiter*, of Lord Denning in *Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd*, 1963 AC 1, that a gang of burglars is not involved in a trade. According to Goldswain (2015) it appears that Lord Denning avoided the problem of deciding if a robber receives an amount by stating (at 20) that when a gang of burglars carry out its activities “it is burglary and that is all there is to say about it . . .”.

Courts which followed the objective approach, such as the court in *COT v G*, in *ITC 1792*, and in *ITC 1810*, refused to interpret the word “receipt” using the literal rule of statutory interpretation because for them to do so would be giving the word a meaning that was wide and never intended by the legislature. These courts were of the view that interpreting the word “receipt” using the literal rule would end up subjecting “individuals acting in a fiduciary capacity to tax on the receipt of amounts that belong to their principals and avoided this absurdity by applying a purposive rule” (Chawira, 2011:3-4). This view is in line with what was decided in the case of *Geldenhuys v CIR*, a case decided in the context of income from legal activities, where the court held that using the literal rule of statutory interpretation to interpret the words “received by” would result in a farmer being taxed on proceeds received upon disposal by him of any livestock or produce on behalf of another. The court stated that this could never have been the intention of the legislature. The court departed from the literal rule of interpretation in favour of the purposive interpretation that takes into account a taxpayer’s property ownership rights or legal rights to the amount in his or her hands. Although the literal rule of interpretation was regarded as the primary rule of statutory interpretation, if interpreting the statute using the literal rule would result in a meaning that was never intended by the legislature or would lead to absurd results, the court can depart from the ordinary grammatical interpretation to avoid such an absurdity (*Venter v Rex*, 1907 TS 910 and Botha:2012). This departure from the primary rule of statutory interpretation is the consequence of applying the golden rule of statutory interpretation (Botha:2012).

Fieldsend CJ, in *COT v G*, in interpreting the meaning of the word “received”, held (at 162) that “it was common cause that the word ‘received’ was not to be given its ordinary wide meaning and that it had to be limited at least to meaning ‘received as part of the recipient’s

patrimony'". Although the decision of the court in *COT v G* is not binding on South African courts, the case provides a clear illustration of the reasoning behind the objective approach and it was adopted in certain court decisions in South Africa which followed the objective approach. The court held that the word "received" could not be interpreted widely to cover theft, which did not invest a right of ownership on the taker of the things. It was held that to interpret the word "received" in such a wide way as to cover theft would be to give the word a meaning that cannot be justified on any rational construction of the Act as a whole. During the course of giving its judgment, the court made reference to the example of a person who borrows a lawnmower from his neighbour. It was held that he receives it in the broadest sense of the term but would clearly not receive it within the meaning of the word in the definition of the Zimbabwean Income Tax Act. It was further stated that if the borrower genuinely intends to return it to the owner he does not receive the mower in his own right and neither does a person who fraudulently induces his neighbour to lend him his mower intending to keep it for himself. The court held that intention of the taker cannot of itself result in him receiving the thing in his own right. It follows that the taker can only receive the thing in his or her own right if the giver intends that result as well.

The court, in *COT v G*, refused to regard proceeds from embezzlement as having been "received" by the taxpayer, because he had no legal right to the amount. It follows that, according to the court, a "receipt" takes place in situations where there is a transfer of a right of ownership from the owner to the taxpayer. Beadle CJ in *Lonrho Ltd v Salisbury Municipality*, 1970 (4) SA 1 (RA), stated (at 4) that:

> When, in a technical statute . . . the Legislature uses words which . . . have been recognised as having a specialised technical meaning, it must be assumed that the Legislature intended to use the words in their recognised technical sense and not in their popular sense, unless, of course, it appears from the context in which the words are used that the Legislature intended to depart from the proper technical meaning.

Under the objective approach, the word "received" as used in the statutory definition of gross income "cannot – and was never intended to – be given its widest, everyday meaning" (Venter *et al.*, 2015:129). For example, the Appellate Division, now the SCA, in *CIR v Genn & Co (Pty) Ltd* in the context of income from legal activities (money or goods borrowed) held that a farmer who has borrowed a tractor is viewed, in the ordinary sense of the word

"received", as having received the tractor. The same applies if a person borrows money from a bank; he or she is also regarded has having "received" the money within the context of the normal usage of the word "received" (*CIR v Genn & Co (Pty) Ltd*). However, it was pointed out that this was not the interpretation to be given to the word "received" in the definition of "gross income" because as soon as the object or amount borrowed is received by the borrower, there is a corresponding obligation that is placed on the borrower to return the object or repay the amount. The court held (at 301) that "what is borrowed does not become [the property of the borrower], except in the sense irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed". It is submitted that the court, through this statement, acknowledged that there needs to be a passing of ownership for there to be a "receipt" for the purposes of income tax.

It is submitted that, if the interpretation of the word "received" is focused on property law rights, the whole point of income tax would be missed because income from illegal activities such as theft will not be taxed and yet the Income Tax Act, as its name suggests, is centred on taxing all income (except income that is specifically excluded by the Act), whether legal or illegal. Income is anything that comes into the estate of a person. Proceeds from theft are income in the hands of the thief and they treat such proceeds as income; his or her estate grows once he or she is in possession of such proceeds. This view is in line with what Williams (2009) states: the manner in which taxpayers treat the proceeds should be considered when deciding whether proceeds in the hands of taxpayers are taxable; if they treat the proceeds as income, it is taxable. Furthermore, as stated by Stiglingh *et al.* (2015), it is absurd to interpret the word "receive" with reference to entitlement or property rights, given the fact that the word "accrual" has been interpreted by the courts with reference to entitlement or property rights. The word "or" in the "gross income" definition requires that the words "receive" and "accrual" be given a different interpretation.

3.3 The subjective approach to interpreting a "receipt"

In deciding whether proceeds from illegal activities fell within the ambit of the "gross income" definition, the courts that followed the subjective approach took into consideration the intention of the taxpayer. The role of a taxpayer's intention came under consideration in court decisions in cases such as *ITC 1545* and *ITC 1624* (discussed in chapter two). The courts, in these cases, followed a broader approach that focuses on the subjective intention of

the taxpayer in receiving an amount. The reason for following the subjective approach is summed up by Muller (2007:177), a supporter of the subjective approach, as follows:

> By following the subjective approach all illegal income will fall into the tax net if the taxpayer intends to benefit from the proceeds, except where the taxpayer received the income as an agent (in the broad sense) on behalf of another. This approach will also be consistent with public policy. Surely it is not in the interest of public policy that a trader who cheats his customers in the course of his business should be subject to income tax, while one who actually steals from them should enjoy exemption from tax. If the subjective approach was followed in *COT v G* the court may well have found that the thief indeed received the stolen property.

It follows that the rationale behind the subjective approach may be public policy and creating equity between legal and illegal income earners. Along similar lines of reasoning, the court in *Sullivan v United States*, 15 F.2d 809 (4th Cir. 1926), stated (at 811) that "it does not satisfy one's sense of justice to tax persons in legitimate enterprises, and to allow those who thrive by violation of the law to escape. It does not seem likely that [the Legislator] intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the burdens of others lawfully employed". Ogunsanwo (2013:16) is of the view that "tax neutrality plays an important role in any tax regime and can therefore not be overlooked on the basis of legality of certain transactions". This approach seems to be contrary to the words of Rowlett J in the case of *Cape Brandy Syndicate v Inland Revenue Commissioners; CA*, [1921] 1 KB 64, (at 68) that "in a taxing Act one has to look merely at what was clearly said. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used". The result of Rowlett J's words is that the court will not read something into or make assumptions from the words of the legislature written in a statute as a way of trying to bring equity between legal and illegal income earners. Following Rowlett's approach and the objective approach, which does not consider public policy in interpreting the word "receive", would result in illegal income earners creating their own tax haven in South Africa, which is beyond the reach of the tax Commissioner. It is submitted that this result could not have been intended by the South African legislature, which seeks to tax all income (whether legal or illegal) that flows into the estate of a person.

The words "an amount received for own benefit" in the context of "receipts" from illegal activities were interpreted with reference to the taxpayer's subjective intention by the subjective approach proponents. The subjective approach proponents interpreted the words "an amount received for own benefit" to mean an amount which a person received with the intention to benefit from it. This interpretation is in line with what was held in *Geldenhuys v CIR*, (at 266) that the words "received by" mean "received by the taxpayer on his or her own behalf and for his or her own benefit". Using this interpretation, the subjective approach proponents would conclude that, because the taxpayer "received" the amount in question with the intention to benefit from it, the amount should be regarded as having been "received" for income tax purposes and should be included in the taxpayer's gross income (Stiglingh *et al.*, 2015). As a result of this interpretation, an agent collecting rental money on behalf of his or her principal may be regarded as having not "received" the rental money because it is not "received on his or her behalf or for his or her own benefit" (Croome *et al.*, 2013).

In interpreting the word "received" in the definition of "gross income", the subjective approach proponents did not consider the taxpayer's property rights or the entitlement of the taxpayer to the proceeds. A taxpayer's mere claim to proceeds for his or her own benefit, without any reference to the taxpayer's legal rights and entitlement to the proceeds, has been the focus of subjective approach proponents (Stiglingh *et al.*, 2015). This approach is different from the objective approach which makes the income tax system dependent upon the taxpayer receiving a right to property and not upon a mere claim to property (even when this is not a legal claim).

The subjective approach proponents, as opposed to the objective approach proponents who used the purposive rule, argued for the use of the literal rule of interpretation in interpreting the word "received". In *ITC 1545* the court held (at 467) that "the fact that the scheme had no legal substance did not alter" the fact that the amount in question had been received by the taxpayer. As far as the court was concerned (at 467), there was "no reason for holding that such an amount is not 'received' within the definition of gross income in section 1, if that word is to be given its ordinary literal meaning". The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, also claimed to be using the literal rule of statutory interpretation and referred to the taxpayer's subjective intention in deciding whether the taxpayer had "received" the amount for the purposes of income tax.

The starting point of an interpretation process is to give words of the legislation their ordinary meaning without attaching any artificial meaning to the text (Botha:2012). The literal rule of statutory interpretation means giving the words in a statute subject to interpretation their ordinary grammatical meaning (Botha:2012). The rule requires the interpreter to concentrate on the literal meaning of the words to be interpreted and to equate the legislature's intention with the plain meaning of the words in a statute (*Principal Immigration Officer, Appellant v Another, Respondents*, 1936 AD 26). The subjective intention test is mainly applied by courts in criminal or delict cases to determine the criminal liability or fault of a person. The interpretation of the word "received", using the literal rule of statutory interpretation together with the subjective intention of the taxpayer, has raised the question as to whether the literal rule of statutory interpretation gives room for the court to make reference to a person's subjective intention when interpreting a statute (Chawira:2011).

The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, did not provide an explanation as to how the subjective intention of the taxpayer is linked to the literal rule of statutory interpretation. It seems that the court in *MP Finance Group CC (In Liquidation) v C:SARS* just "camouflaged the subjective approach as an influential concept that could interpret a statute under the literal rule" without explaining how the two are inter-related (Chawira, 2011:24). Although there is no indication as to how the subjective intention of the taxpayer is linked with the literal rule of statutory interpretation, the current standing legal position in South Africa, as given by the SCA in *MP Finance Group CC (In Liquidation) v C:SARS,* is that the court will have regard to the subjective intention of the taxpayer in deciding whether proceeds from illegal activities have been "received" by the taxpayer (Classen:2007). This interpretation means that if there is a theft of money or any property, the thief will be regarded as having "received" it for the purposes of "gross income" if he or she has the intention to benefit from it.

It is submitted that the court should always treat a taxpayer's subjective intention with caution because it is difficult to establish the subjective intention of a person. Courts often use objective factors to determine a person's subjective intention and, if the objective factors are in conflict with what the taxpayer says is his or her intention, reliance by the court on the taxpayer's *ipse dixit* is usually minimal (Classen: 2007). In deciding what the subjective intention of the taxpayer was, the court in *MP Finance Group CC (In Liquidation) v C:SARS* had regard to who used and derived a benefit from the money which had been paid by the

investors. The case of *MP Finance Group CC (In Liquidation) v C:SARS* is discussed in the following section.

3.3.1 The court's decision in *MP Finance Group CC (In Liquidation) v C:SARS*

The different approaches (subjective and objective approach) gave rise to the question as to "whether the term 'received' refers to rights in the form of entitlement or just a mere holding of an amount with the intention of benefiting from it?" (Chawira, 2011:4). The SCA in *MP Finance Group CC (In Liquidation) v C:SARS*, when presented with an opportunity to clear the uncertainty with regard to the taxability of income from illegal activities and state the correct approach to be followed, passed a decision which differed from the decision of the Zimbabwean court in *COT v G*.

The facts in *MP Finance Group CC (In Liquidation) v C:SARS* were as follows (Goldswain:2015): the taxpayer operated an illegal and fraudulent investment enterprise commonly called a pyramid scheme and received deposits from investors without complying with the statutory requirements applicable to deposit-taking institutions. The scheme was conducted by way of successively created entities, incorporated and unincorporated, all of which eventually became insolvent. The scheme readily parted investors from their money by promising irresistible (but unsustainable) returns on various forms of ostensible investment and it paid such returns for a while before finally collapsing, owing many millions. By order of the High Court, these entities were, for ease of administration and legal practicality, consolidated into a single entity named MP Finance. The evidence revealed that most of the money received by the scheme was kept in cash and not banked in trust for the investors, but applied to pay others. However, substantial amounts of the money were appropriated by the taxpayer and her accomplices and some investors received payment of their investments, plus returns, but the majority received less or nothing. The perpetrators of the scheme knew that it was insolvent, that it was fraudulent and that it would be impossible to pay all investors what they had been promised. The Commissioner included the deposits received from investors in the taxpayer's gross income and insisted that the taxpayer had "received" and applied the amounts for its own benefit. The legal representative of the taxpayer argued that the taxpayer had not "received" the money, in view of the fact that the scheme was liable in law immediately to refund the deposits to the investors. The issue before the court was whether

the amounts paid by the various investors could be said to have been "received" by the taxpayer as "gross income" within the meaning of section 1 of the Act.

In deciding the issue, the court held that it is necessary to look at the essential nature of the "receipt" before a determination can be made as to whether it ought to form part of "gross income". Furthermore, the court held that the relationship between an investor and a taxpayer and the relationship between a taxpayer and the *fiscus* was different. The court held (at paragraph 12) that:

> This case is about the relationship between scheme and *fiscus*. Even if, as correctly stated in that matter, with respect, the scheme was legally obliged to repay an investor immediately on receipt that was because of the legal principles applicable to the parties to an illegal contract, as between themselves. An illegal contract is not without all legal consequences; it can, indeed, have fiscal consequences. The sole question between scheme and *fiscus* is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Unquestionably they did. They were accepted by the operators of the scheme with the intention of retaining them for their own benefit. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act. In other words it does not matter for present purposes that the scheme was not entitled, as against the investors, to retain their money. What matters is that what they took in was income received and duly taxable. The assessments were correctly raised.

The court did not follow the objective approach. It followed the subjective approach in the context of illegal earnings and held that the proceeds from the illegal activities were indeed "received" by the taxpayer for its own benefit because the taxpayer intended to personally benefit from the deposits. Through this decision the SCA overturned the decisions of the Special Court in *ITC 1792* and *ITC 1810*. The SCA followed the decision of the court in *ITC 1624,* which followed the decision of the court in *CIR v Delagoa Bay Cigarette Co. Ltd.* The decision of the SCA also makes it clear that where a taxpayer, during the course of his or her trade, fraudulently cheats his or her customers an amount derived as a result of such a fraudulent activity will be regarded as having been "received" for the purposes of "gross income".

The court made it clear that, when it comes to tax issues, the relationship between the taxpayer and the *fiscus* is what is important. This means that any contractual obligations that a taxpayer may have to a third party will not prevent the Commissioner from raising an assessment for income tax on an amount "received by" the taxpayer. The court's decision in *MP Finance Group CC (In Liquidation) v C:SARS* calls into question the dictum of Schreiner JA in *CIR v Genn & Co (Pty) Ltd* that "it certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. . . . At the same moment that the borrower is given possession he falls under an obligation to repay". If a borrower receives an amount with the fraudulent intent of not returning it and keeping it for his or her benefit, it is likely that, as a result of the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS*, he or she will be deemed to have "received" the amount for the purposes of "gross income".

When it came to how the word "received" should be interpreted, the court in *MP Finance Group CC (In Liquidation) v C:SARS* stated that it would use the literal meaning of the word. The court went on to apply the literal rule of statutory interpretation and concluded (at 45) that "the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act. In other words, it does not matter for present purposes that the scheme was not entitled . . . to retain the money". It is submitted that, for the court to state that a literal meaning of the word "received" must be followed and conclude the case without providing an analysis of what the literal approach entails, does not provide the much needed clarity on how future courts and litigants should interpret the word "received" for the purposes of "gross income", especially in the context of proceeds from theft. It follows that the court did not address the issue of whether proceeds from theft constitute a "receipt" under the Act (the reason for this may be because the court was not called upon to decide this issue). According to Classsen (2007:550) the decision of the court ". . . almost leaves one with the impression that this amount was taxed for considerations of equity or as a further punishment for the involvement in illegal activities".

One of the duties of the court is to interpret the legislation enacted by the legislature and when the court is carrying out this duty it has to give each word in a statute its own meaning (Botha:2012). The court also "has a duty to give meaning to a defining section" (Du Plessis, 2002:212). Classen (2007) is of the view that the SCA in *MP Finance Group CC (In*

Liquidation) v C:SARS did not fulfil this duty placed upon it because it did not give a clear meaning to the definition of "gross income" written in the defining section of the Act. Furthermore, Classen (2007) argues that the court also did not state whether or not the term "receive" should be interpreted with reference to a taxpayer's entitlement to an amount. It is submitted that, although the court did not give an express finding stating that entitlement (a legal claim or property right) is not a requirement for an amount to be regarded as having been received for the purposes of "gross income", such a finding may be indirectly inferred from the court's decision.

3.4 SARS Interpretation Note 80

Stealing an amount has income tax implications not only for the victim, but also for the perpetrator of the crime. For the purposes of this thesis, the focus is on the perpetrator of the crime. Palmer (2014:14) quoting Plato states that, "when there is an income tax, the just man will pay more and the unjust less on the same amount of income. But a thief, who undoubtedly falls into the latter category of the unjust, will be taxed on stolen money if such money falls within the thief's gross income". In light of the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* and Interpretation Note 80 (South African Revenue Service:2014), stolen amounts will undoubtedly be regarded by SARS and the courts as falling within the thief's "gross income". In Interpretation Note 80 (South African Revenue Service:2014), SARS sets out its practice in dealing with the taxation of stolen amounts in the hands of the perpetrator and the non-deductibility of such amounts when repaid. SARS, relying on *MP Finance Group CC (In Liquidation) v C:SARS,* took the view that a thief will be taxed on stolen proceeds because those proceeds are a "receipt". Furthermore, SARS in Interpretation Note 80 (South African Revenue Service, 2014:15) states that:

> . . . the receipt of stolen money comprises gross income and is thus taxable. While the *MP Finance* case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means. The key issue is whether the thief intended to benefit from the stolen funds. If so, the requisite ingredients for a receipt have been met and there is no justification for the view taken in G's case above that a thief "takes" rather than

> "receives". The issue is not whether the victim intended to part with the money but rather whether the thief intended to benefit from it.

It follows that SARS, using the principle laid down by the SCA in *MP Finance Group CC (In Liquidation) v C:SARS*, will regard an amount from theft activities as an amount "received" for the purposes of "gross income" and thus taxable if the thief has taken the amount with the intention of keeping it for his or her benefit. It is submitted that whether or not SARS' view in the Interpretation Note above is correct, will depend on whether the case of *MP Finance Group CC (In Liquidation) v C:SARS* provides an all-encompassing decision on the approach to be followed when taxing income from all illegal activities. In other words, the question is whether SARS can *cut and paste* the subjective approach used by the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* in deciding on cases dealing with proceeds from theft where there is a unilateral taking by the thief. Before answering this question, it is necessary to understand what the term "received" is understood to mean in South African law and whether this term should be interpreted using the subjective approach.

3.5 The term "received" in South African law and whether this term should be interpreted using the subjective approach

Before the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS*, the decision of the appellate division of the Zimbabwean High Court in *COT v G* has been the *locus classicus* on the taxability of proceeds from theft. Although this decision is only persuasive and not binding on South African courts, it was adopted by some courts in South Africa before the SCA's decision in *MP Finance Group CC (In Liquidation) v C:SARS* was passed. It is submitted that, since the court in *MP Finance Group CC (In Liquidation) v C:SARS* did not provide clarity on what the literal approach or literal meaning of the word "received" entails, the case of *COT v G* remains as the case (albeit not binding in South Africa) in which the court made an attempt to provide an analysis of what the word "received" entails. The court, in deciding on the taxability of stolen amounts, stated that the word "received" should be given its ordinary dictionary meaning. It held (at 169F-G and 171A-C) that:

> The obvious starting point in the enquiry is the ordinary meaning of the words 'to receive'. The first and principal meaning given in the Shorter Oxford Dictionary is: 'To

> take into one's hand, or into one's possession (something held out or offered by another); to take delivery of (a thing) from another either for oneself or for a third party.' Subject to a qualification in regard to taking delivery for a third party, I can see no justification for giving the word any different meaning in s 8. . .. This conclusion is reinforced by a case such as *Geldenhuys v Commissioner for Inland Revenue* 1947 3 SA 256 (C) in which it was held that a usufructuary did not receive the money as part of his 'gross income' for the purpose of the equivalent South African tax legislation. Steyn J at 260 held that 'received by' must mean 'received by the taxpayer on his own behalf and for his own benefit'. Whether or not the respondent in this appeal received the money on his own behalf and for his own benefit must depend not only on his own intention but on the intention of the person who passed the money on to him.

It follows that the court in *COT v G* was of the view that the ordinary meaning of the word "received" shows that the act of receiving is inextricably linked to the act of giving. In other words, for there to be a receiver there needs to be a giver. In the case of theft there is a unilateral taking that takes place; an amount is not given but it is taken (Olivier:2008). This shows that if an amount has not been given it cannot be "received". The act of receiving only occurs after there has been delivery of an amount from someone else.

Haupt (2015:21) submits (it is submitted correctly) that in South African law the term "receipt" "does not envisage a unilateral receipt. There have to be two parties, a giver and a recipient". This means that in South African law the term "received" is understood in the same sense as the court in *COT v G* stated (that the term constitutes of giving and receiving and there has to be a giver and receiver). It follows that a "receipt" only occurs in situations where there is a transaction or a contract taking place. In the case of theft no transaction takes place. Proceeds from theft are different from proceeds from other illegal activities, such fraudulent or Ponzi scheme businesses, because in these illegal activities transactions will be taking place. Thus, in illegal activities such as fraud there will be a "receipt" (a giving and receiving occurring), though clouded in misrepresentation.

In *MP Finance Group CC (In Liquidation) v C:SARS* the investors gave their deposit amounts to the scheme so that the amounts could be invested by the taxpayer on their behalf. In other words, the investors intended the scheme to receive the amount. It follows that there was a transaction or an agreement (albeit clouded in misrepresentation) between the investors and the scheme, which led to the scheme receiving the amounts that the Commissioner

sought to tax. It is submitted that it is only when there is a transaction similar to that in *MP Finance Group CC (In Liquidation) v C:SARS* can the term "received" be interpreted using the subjective approach and the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* was justified to hold that the amount in that case constituted a "receipt". Thus, the term cannot be interpreted using the subjective approach in cases where there is no transaction. The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, did not make it clear whether or not their decision is applicable in the case of proceeds from theft. It is submitted that it is only in circumstances where there is a transaction such as the one that occurred in *MP Finance Group CC (In Liquidation) v C:SARS* that SARS can interpret the term "received" with reference to the subjective intention of the taxpayer in taxing proceeds from theft.

In the case of *ITC 1545* the court held that the ordinary meaning of the word "receipt" should be followed. It was further stated (at 466) that "where an amount is received by a taxpayer on his own behalf and for his own benefit, but in pursuance of a void transaction, there appears to be no reason for holding that such amount is not 'received' within the meaning of the definition of gross income in s 1, if that word is to be given its ordinary literal meaning". Furthermore, the Special Tax Court in *ITC 1624* stated (at 375) that "where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business". The judge in *ITC 1624* was able to distinguish the situation in which a person steals money, from the situation in which a person, in the course of his trading activities, fraudulently overcharges his customers. In the first case the amount is not "received" by the taxpayer and does not fall into his "gross income", because there is no transaction (contract). In the second, the amount is "received" and does fall into his "gross income", as it has been received by virtue of a contract (agreement) (Haupt:2015). It follows that, in cases where there has been a transaction and an amount has been received by a taxpayer from another party as a result of the existence of the transaction and execution of that transaction, the amount may be regarded as having been "received" by a taxpayer "on his or her own behalf and for his or her own benefit" for the purposes of income tax or "gross income". The purpose for which the amount was given to the receiver by the giver (or for that matter the absence of a mutual intention between the parties), it is submitted, does not affect the fact that a transaction which results in a "receipt" taking place occurred if the term "received" is to be

interpreted in the way suggested by Haupt (that the term received requires a giver and a receiver).

One exception to the rule that there must be a giver and receiver in order for there to be a "receipt", which a court can interpret with reference to the subjective intention of a taxpayer when there has been a unilateral taking (no giving and receiving has occurred), is where a taxpayer takes possession of property not owned by any person. Under the South African common law it is possible for a person to gain ownership of an object from a unilateral taking through occupation (Badenhorst *et al*., 2004). This occurs, for example, in circumstances where the real owner of the object abandons the object and another person discovers and appropriates the object. In such a case the person who has appropriated the object is regarded as having gained a property right on the unclaimed object through occupation (Badenhorst *et al*., 2004). It is submitted that in these circumstances the court is justified in interpreting the word "received" with reference to the subjective intention of the taxpayer even when there is a unilateral taking that has taken place and no giving has occurred. It should be noted that this type of interpretation should be adopted only when there has been a property right or ownership taken by the taxpayer. Thus, the taxpayer can be taxed on the value of the abandoned object if he or she intends it to form part of his or her estate or patrimony. This is because in such a case there would have been an income (increase) in the estate of the taxpayer.

3.6 Should the court's decision in *MP Finance Group CC (In Liquidation) v C:SARS* be used as authority for taxing proceeds from theft?

The SCA decision in *MP Finance Group CC (In Liquidation) v C:SARS* is a landmark decision in South African tax law. The decision of the court is a "catch–all" decision when it comes to the question of whether income from illegal activities is taxable. Although this case is a landmark decision on the taxation of income from illegal activities, it has often been stated by tax scholars like Classen (2007) that the reasons and rationale behind the court's decision are not very clear. Classen (2007:553) goes on to state that:

> . . . the reasons for and reasoning behind its decision could have been valuable tools for students, academics, practitioners and the Commissioner and could have been relied on in future cases based on the same or similar facts. Yet, although the Court in principle

reached a correct result, it does seem that this was one decision where the end result did not necessarily justify the means required to reach it.

It is submitted that, although there may be debates concerning the clarity of the court's reasons for or the reasoning behind its decision, the court managed to shed some light on the issue of the taxability of income from illegal activities. Thus, there is now no room for differentiating between income from illegal activities and income from legal activities for tax purposes. However, whether or not this decision is the basis on which all income from illegal activities may be taxed is questionable, especially in light of the fact that the court did not state that their subjective approach is to be adopted in cases dealing with income from other illegal activities such as theft. The reason for this may be that the case of *MP Finance Group CC (In Liquidation) v C:SARS* dealt with proceeds from fraudulent activities which do not constitute a unilateral taking (theft) and the court was not called upon to decide the treatment of proceeds from theft. It follows that the issue of the taxation of "receipts" from all illegal activities was not fully settled by the SCA in *MP Finance Group CC (In Liquidation) v C:SARS*. It is submitted that this issue, namely, the basis on which proceeds from theft (theft of money or goods) may be taxed, as opposed to the basis on which illegal proceeds from fraud are taxed, remains a grey area in our law which has not been fully addressed by our courts.

In deciding whether or not the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* forms the basis upon which income from all illegal activities should be taxed, the decision of the court has to be examined in the light of other cases dealing with the same subject and decided before it. The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, followed the same approach that was used in *ITC* 1545 where the court held that, although the sales of the crop by the growers were void *ab initio*, the amounts which the growers received for their milk cultures were amounts "received" by the growers in terms of the definition of "gross income". The rationale of the court behind this decision was that the fact that a contract is prohibited by the law and therefore void *inter partes* does not mean that the contract and all the consequences flowing from it should be disregarded or go unnoticed. Furthermore, the case of *ITC 1624* makes it clear that where a taxpayer during the course of his or her trade fraudulently cheats his or her customers, income arising as a result of the fraudulent activities is "received" for the purposes of "gross income" and is thus taxable. This was also the approach of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS*. If

the proceeds from sales of the stolen diamonds in *ITC 1545* are analysed using this same approach, it is likely that even if it had not been accepted by the taxpayer that such proceeds amounted to "receipts" and "accruals" (it was accepted by both the court and the taxpayer, without any arguments being presented, that the proceeds of such sales amounted to receipts and accruals for the purposes of gross income), the court would hold that the proceeds are taxable. This is for the reason that the amount derived from the sale of the stolen diamonds was "received" as a result of a transaction between the seller (the taxpayer) and the buyer.

The cases above indicate that amounts arising as a result of fraud, negligence or misrepresentation that was perpetrated during the course of carrying on a business will be regarded by the court as having been "received" and taxable. This is because in these cases the amount is received as a result of a transaction having occurred. The difficulty arises in situations of theft, such as an employee systemically stealing cash from his or her employer. In these circumstances it is difficult to apply the approach used in the cases above due to the absence of a transaction occurring between the employer and employee. Perhaps if the test is applied, as suggested by Williams (2009) that if the taxpayer treats the proceeds as if they are in the nature of income then there will be a "receipt" within the meaning of "gross income", an attempt can be made to bring proceeds from theft within the decisions of the courts in the cases discussed above (that is to regard the proceeds as having been "received" by the taxpayer for income tax purposes).

If the term "received" is to be regarded as constituting of a transaction (giving and receiving) as suggested by Haupt (2015), it is submitted that it may be incorrect to assume or conclude from the decision delivered the by SCA in *MP Finance Group CC (In Liquidation) v C:SARS* that proceeds from any illegal activities are to be regarded as having been "received" and included in a taxpayer's "gross income", irrespective of whether there was no giving on the part of the victim of the crime. Thus, it may be incorrect for SARS to regard proceeds from theft as having been "received" in situations where there is no transaction occurring. It follows that SARS cannot apply the approach of the court in *MP Finance Group CC (In Liquidation) v C:SARS* to income from all illegal activities. Thus, although the case of *MP Finance Group CC (In Liquidation) v C:SARS* can be described as a final decision on the taxability of all income from illegal activities, the basis on which amounts from theft can be taxed is still a grey area in our law and the case of *MP Finance Group CC (In Liquidation) v*

C:SARS) may not be the appropriate case which SARS may use as precedent or authority for the basis on which such proceeds may be taxed.

3.7 Implications of the court's decision in *MP Finance Group CC (In Liquidation) v C:SARS* on property rights

Section 2 of the Constitution of the Republic of South Africa, 1996 (hereinafter referred to as the Constitution), states that "this Constitution is the supreme law of the Republic; law or conduct inconsistent with it is invalid, and the obligations imposed by it must be fulfilled". It follows that the Constitution is the yardstick with which the appropriateness of any action (including judicial interpretation of any piece of legislation) is measured. Thus, any law enacted and its subsequent interpretation and application by the courts should be consistent with the values, norms and principles set out in the Constitution for it to be valid. Chapter two of the Constitution, which contains the Bill of Rights, sets out the principles of the Constitution. These principles are centred on the rights of the people of South Africa. These rights affirm the values of dignity, equality and freedom of the people. The supremacy of the Constitution means that, although the case of *MP Finance Group CC (In Liquidation) v C:SARS* dealt with the interpretation and application of the provisions of the Act, the court's decision and its appropriateness should be viewed in light of the provisions of or rights protected by the Constitution.

The court's subjective approach in *MP Finance Group CC (In Liquidation) v C:SARS* received some criticism from different authors. For example, Goldswain (2008) argues that the decision may be constitutionally attacked on the ground that the owners of the property will be unlawfully deprived of their property by the state as a result of the imposition of tax on the proceeds in the hands of an (insolvent) investment scheme (as there will be a diminution of the funds available to pay investors), which is a violation of section 25 of the Constitution. Section 25 of the Constitution provides everyone with the right to property and guarantees this right's protection by stating that "no one may be deprived of property except in terms of law of general application, and no law may permit arbitrary deprivation of property".

The right to property means that a person is entitled ". . . to use his or her assets (including cash) as he or she pleases. If a person loses his or her property without the intention to

transfer ownership, he or she has certain remedies to reclaim that property" (Venter *et al.*, 2015:133). It follows that, in situations where a person invests in a scheme like the one in *MP Finance Group CC (In Liquidation) v C:SARS,* he or she is entitled to receive the money back that he or she has invested if the scheme goes insolvent or is dissolved. The decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS,* which authorises the Commissioner to tax proceeds obtained from the investors, has the potential of reducing the amount which the investors may be able to recover from the scheme when it becomes insolvent. This has been argued to be an infringement on the right to property found in the Constitution and an unlawful and arbitrary deprivation of property by the state (Venter *et al.*, 2015). Goldswain (2008:146) states that "the same could be said of proceeds arising as a result of theft and fraud due to overcharging when the thief or fraudster becomes insolvent as a result of the tax liability arising on the proceeds so obtained". In relation to stolen amounts, the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* may also result in the state being unjustifiably enriched because, if the thief becomes insolvent, the amount on which the Commissioner will levy income tax belongs to the owner of the property who has been unlawfully deprived of his or her property.

It is submitted that whether or not the argument will stand that the SCA's decision in *MP Finance Group CC (In Liquidation) v C:SARS* violates the rights set out in section 25 of the Constitution depends on whether the limitation placed on the section 25 property right will withstand the test set out in section 36(1) of the Constitution. It follows that the argument that the decision of the court in *MP Finance Group CC (In Liquidation) v C:SARS* case infringes on the right to property should be looked at in the light of section 36(1) of the Constitution which states that:

> The rights in the Bill of Rights may be limited only in terms of law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including: (a) the nature of the right; (b) the importance of the purpose of the limitation; (c) the nature and extent of the limitation; (d) the relation between the limitation and its purpose; and (e) less restrictive means to achieve the purpose.

Section 36(1) of the Constitution recognises that the rights written in and guaranteed by the Constitution are not without bounds and that these rights are subject to certain acceptable

limitations, such as the collection of income tax by the Commissioner (Venter *et al.*, 2015). The levying of income tax by SARS on proceeds derived from investments made in an illegal scheme may be argued to be reasonable and justifiable in an open and democratic society, especially if this argument is considered in light of what was said by the court in *Metcash Trading Limited v C:SARS and Another* 2002 (4) SA 317 (CC), 63 SATC 13, that the role of SARS is to collect tax which is used to finance the South African government's expenditure. Thus, the purpose of levying tax on the scheme at the expense of the investors and the benefits derived from it may be regarded as far outweighing the right of the investors not to be deprived of their property. However, Venter *et al.* (2015:134) state that "as imposing tax on illegal transactions differs materially from the normal principles relating to the raising of taxes and levies, the reasonableness of the tax burden resulting from the decision in *MP Finance* must be measured against the constitutional obligation of both the *fiscus* and taxpayers alike to respect each other's fundamental right to property". The weighing of the role of SARS to levy tax against the Constitutional right to property in fraud or theft cases remains a case to be argued before the courts. Stiglingh *et al.* (2015) submit that although the court's subjective approach has been criticised, the legal position is that an amount will be regarded as having been "received" by a taxpayer for purposes of income tax if he or she intended to receive it for his or her own benefit.

3.8 Analysis of the court's decision in *MP Finance Group CC (In Liquidation) v C:SARS* from a public policy perspective

From a public policy perspective, it has been argued that through the court's decision "SARS would now be in a position (in circumstances where the perpetrator becomes insolvent) to collect tax from the insolvent estate at the expense of and to the detriment of the people who had been defrauded by the taxpayer (as a consequence of the preference awarded to the South African Revenue Service in terms of the insolvency legislation)" (Croome *et* al., 2013:70). Thus, SARS will be able to take "the first bite" at the residue of funds held by the insolvent pyramid scheme entity, thereby diminishing the proceeds available to pay the claims of the cheated investors (Croome *et al.*, 2013). If this argument is correct it may mean that the same public policy which has been argued by authors such as Muller (2007), discussed in section 3.3 of this chapter above, to be the reason and justification for subjecting income from illegal activities to tax, is violated by the decision of *MP Finance Group CC (In Liquidation) v C:SARS*.

It is submitted that it is problematic to defend or criticise the decision made or the approach taken by the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* solely on the basis of public policy. This is because public policy is a problematic principle to rely on solely as it is uncertain and dependent upon the values and mores of the society, which are constantly changing and evolving. The Court of Appeal for the Fifth Circuit in the United States in *Dixie Machine Welding & Metal Works, Inc., Appellant, v. United States of America, Appellee,* 315 F.2d 439 (5th Cir. 1963), compared public policy to an unruly horse and stated (at 318) that "... once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all but when other points fail". Following public policy may result in uncertainties in the law of tax and in the consequences of certain taxpayer conduct (Mtshawulana:2008).

Additionally, Williams (2009) argues that it will be repugnant to public policy for the state to become involved in the crime by taking a share of the criminal proceeds received by the taxpayer by levying tax on the proceeds. In the case of *Mann v Nash (Inspector of Taxes),* 1932 1 KB 752, the court correctly addressed the issue of the state profiting or benefiting from the proceeds of illegal activities through tax when it stated (at 758) that "the State was not coming forward to take a share in the profits of unlawful gaming or condoning this practice, but it was merely attempting to tax individuals who receive income". In the case of *Dixie Machine Welding & Metal Works, Inc., Appellant, v. United States of America, Appellee*, the court (at 318) stated that "[Moral] turpitude is a very poor criterion for taxability and in the interests of good tax administration, Uncle Sam shall take his taxpayers as he finds them, exact his normal share of their net income, and let someone specifically charged with the job punish them for their sins". Thus, it cannot be argued that the state, through tax, is becoming involved in the crime, because the Commissioner is entitled to levy income tax on any income (whether legal or illegal) that flows into the estate of any taxpayer.

Williams (2009) also suggests that the proper way to deal with illegal receipts is to let the criminal justice system handle proceeds from criminal activities through fines and forfeiture of the property used to commit the crimes. It is submitted that this blanket solution of leaving the problem to the criminal justice system does not appear to be valid because what would happen in cases where the illegal dealers are not caught by the South African Police? Or worse still, if they go to court and are not convicted by the court due to lack of evidence or a

mistrial (or the state fails to discharge the heavy burden upon it of proving a case beyond reasonable doubt)? In these situations, the illegal dealers will be allowed to operate freely without paying any of the costs placed upon the government relating to their operations. Thus, the taxation of "receipts" from illegal activities cannot be made dependent upon the criminal justice system or the conviction of the offender by a court of law. It has been correctly argued that "the issue of taxation, in theory, knows no morality, the Commissioner will tax any income within the scope of the Income Tax Act . . . it is not, in theory, an issue of . . . morality but of statutory application and that is the same for the taxpayer earning income from criminal activities which constitute business as it is of the ordinary legitimate taxpayer" (Gupta, 2008:106).

3.9 Conclusion

Over the past years the courts have not been consistent in their decisions when it comes to the basis on which to tax "receipts" from illegal activities. Some courts applied the objective approach whilst other courts applied the subjective approach. The objective approach defines the term "received" with reference to the taxpayer's entitlement to proceeds. Thus, the objective approach proponents would consider whether or not the taxpayer was, objectively speaking, entitled to receive the proceeds. Using this approach, the courts which followed the objective approach would hold that a taxpayer who is in possession of proceeds from illegal activities has not "received" the proceeds because at the moment the taxpayer gains possession of the proceeds he or she has an immediate obligation to return the proceeds to their true owner. On the other hand, proponents of the subjective approach would argue the opposite of the objective approach and state that a taxpayer in possession of proceeds from illegal activities has "received" the proceeds for the purposes of "gross income" because of the taxpayer's subjective intention to benefit from the proceeds. Thus, proponents of the subjective approach follow a broader approach that focuses on the subjective intention of the taxpayer for receiving an amount.

The SCA in *MP Finance Group CC (In Liquidation) v C:SARS,* when presented with the opportunity to clear the uncertainty with regard to the correct approach to be followed when taxing income from illegal activities, followed the subjective approach. In passing its decision the court stated that it would follow the literal meaning of the word "received". The court did not provide an analysis of what the literal approach entails and concluded that the amounts

that had been paid by the investors to the scheme came within the literal meaning of the word "received" in the Act. The court stated that the taxpayer had "received" the deposits for the purposes of "gross income" because it had received the deposits on its own behalf and for its own benefit. This decision of the court received some criticism from various authors. For example, Goldswain (2008) argued that the decision violates the right to property envisaged by the Constitution in section 25. It is submitted that the success of this argument will depend on whether or not the limitation being placed on the property rights is justifiable in terms of section 36 of the Constitution. Furthermore, from a public policy perspective it has been argued that by taking a share of the proceeds from the illegal investment scheme, the state will become involved in the crime. This has been argued to be repugnant to public policy. It is submitted that it may be wrong to criticise the SCA decision based solely on public policy. This is because public policy is uncertain as it is always changing and evolving and relying on public policy arguments may create uncertainties in tax law.

Using the decision of the court in *MP Finance Group CC (In Liquidation) v C:SARS* as authority, SARS, in its Interpretation Note 80 (South African Revenue Service: 2014), states that proceeds from theft will be regarded as having been "received" by the taxpayer. SARS in its Interpretation Note 80 (South African Revenue Service, 2014:15) states that "while the *MP Finance* case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means".

It is submitted that SARS many not be correct in using the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* as authority for the approach to be followed when taxing proceeds from theft. This is because, in South Africa, a receipt occurs in circumstances where a transaction has taken place. A transaction constitutes of both giving and receiving and, in the case of theft, no transaction takes place (Haupt:2015). Haupt (2015:21) is of the view that in South Africa "the term receipt does not envisage a unilateral receipt. There have to be two parties, a giver and a recipient". In *MP Finance Group CC (In Liquidation) v C:SARS* there was a transaction which led to the scheme receiving the amounts which the Commissioner sought to tax. The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, did not make it clear that their decision is applicable in cases dealing with proceeds from theft (where a transaction has not occurred). It follows that it is only in cases where there is a transaction such as the one that occurred in *MP Finance Group CC (In*

Liquidation) v C:SARS that SARS can interpret the term "received" with reference to the subjective intention of the taxpayer and tax proceeds from theft using the subjective approach.

The following chapter will provide a comparative analysis of the basis on which illegal income flowing from a unilateral taking is taxed in Australia, New Zealand and America.

CHAPTER 4: EXAMPLES OF APPROACHES FOLLOWED IN TAXING INCOME FROM THEFT IN AUSTRALIA, NEW ZEALAND AND AMERICA

4.1 Introduction

Two of the goals of the present research are to address the question on what basis illegal income flowing from a unilateral taking is taxed in Australia, New Zealand and America, and whether the approach followed in these countries could be adopted in South Africa. This chapter therefore provides a comparative analysis and discusses the basis upon which income from theft is taxed in New Zealand, Australia and America. New Zealand and Australia will be discussed under one section and America will be discussed in its own section, because the former two follow similar doctrines, whereas America follows a different doctrine.

4.2 The basis of taxation of income from theft in New Zealand and Australia

Unlike in South Africa in the past, the courts in New Zealand and Australia have had little difficulty in deciding and holding that proceeds flowing from illegal activities are taxable. However, there appears to be little authority explaining the basis upon which such proceeds were being held to be taxable, and the basis upon which proceeds from illegal activities were being taxed appears to have been taken for granted by some courts in New Zealand and Australia (Gupta:2008). This is demonstrated by the New Zealand case of *D 57* and the Australian case of *Partridge v Mallandaine*. In case *D 57*, Martin J simply stated (at 852), in response to an argument that illegal profits should not be taxed, that "[i]t would be an absurd situation should the Commissioner be unable to assess income simply because a taxpayer's activities were illegal". The taxpayer in case *D 57* had been convicted on charges of possessing and selling heroin. In deciding whether the profits from these illegal activities were taxable, the court held that in taxing income it was immaterial whether business or other income was legal or illegal (Black:2005). In *Partridge v Mallandaine*, one of the early cases to be decided when the Australian legislation was silent on the taxation of income flowing from illegal activities, Justice Denman stated (at 181) that:

> In my opinion if a man was to make a systematic business of receiving stolen goods, and to do nothing else, and he thereby systematically carried on a business and made a profit of £2,000 a year, the Income Tax Commissioners would be quite right in assessing him as

> if it were in fact his vocation. There is no limit as to its being a lawful vocation, nor do I think that the fact that it is unlawful can be set up in favour of these persons as against the rights of the revenue to have payment in respect of the profits that are made.

Justice Martin's and Justice Denman's words are in line with what was stated by the South African court in *CIR v Delagoa Bay Cigarette Co. Ltd* that the source of income, whether legal or illegal, is immaterial to the question of the liability of the taxpayer to pay income tax. The Australian court, in *Minister of Finance v Smith*, stated that the power of the Commissioner to tax illegal business cannot be limited by the legislature declaring an activity illegal. This means that in Australia, as in South Africa, the legality of the source of income does not affect the tax liability of a taxpayer.

Currently the Australian Income Tax Assessment Act, 1997, and New Zealand Income Tax Act, 2007, include provisions that deal specifically with the tax consequences of the loss that falls on victims of theft and how the proceeds from theft in the hands of a thief should be treated for tax purposes (Gupta:2008). Before these legislative amendments were made, the existence of the doctrine of constructive trust in New Zealand and Australia prevented the taxation of amounts from theft activities. The application of the doctrine of constructive trust by the New Zealand and Australian courts meant that if a taxpayer has an unconditional obligation to pay back an amount or pay it over to another person, he or she will not be taxed on that amount because the amount was not that of the taxpayer (Olivier:2008). This also explains why a recipient of a loan is not taxed on the amount received.

The doctrine of constructive trust was applied in the New Zealand case of *CIR v A Taxpayer* (1996) 17 NZTC 12,574 (discussed in detail below) and the Australian case of *Zobory v Federal Commissioner of Taxation* (1995) 30 ATR 412. The application of the doctrine of constructive trust in these two cases prevented the amounts that had been obtained from embezzlement from being regarded as income of the embezzler and being taxed (Gupta:2008). This was because the embezzlers in the two cases had an obligation to pay back the amounts to the true owners. In *Zobory v Federal Commissioner of Taxation* the taxpayer had embezzled an amount of $1 million from his employer and invested the money, which resulted in interest being earned over a period of two income years (Gupta:2008). In his income tax return for the first income tax year, the taxpayer showed the interest earned on the misappropriated money as income derived. The embezzlement activities of the taxpayer

were discovered by the time of the second year income tax return and all the interest which the taxpayer had earned during this period was shown as the property of the employer (Gupta:2008). According to Black (2005), from the reported case it appears as if it was never argued by the Commissioner that the embezzled funds were income and the only issue which came before the court was whether the interest which the taxpayer had derived in year one should be regarded as his income for tax purposes. In deciding this issue, Burchett J relied on the Australian tax authority of *MacFarlane v Federal Commissioner of Taxation* (1986) 17 ATR 808. The case of *MacFarlane v Federal Commissioner of Taxation* is the Australian *locus classicus* for the principle that "a constructive trust is fully effective to divert the liability to tax to the beneficiary of the trust" (Black, 2005:455).

It has been argued by Black (2005) that whether or not a constructive trust is immediately created in the case of embezzlement is not obvious. Burchett J in his decision held that a constructive trust is created in cases of embezzlement upon the act of misappropriation and that the interest which had been derived by the taxpayer from the investment of the embezzled funds in year one, though received by the taxpayer, was not income of the taxpayer but rather income of the beneficiary of the constructive trust, who was the employer in this case (Gupta:2008). It follows that, where the embezzler is a fiduciary of the victim of embezzlement, such as was in *Zobory v Federal Commissioner of Taxation*, the obligations which are created by the doctrine of constructive trust may be "triggered". However, in the case of simple theft the decision of Burchett J in *Zobory v Federal Commissioner of Taxation* indicates that some disagreement exists on the issue of whether a constructive trust is created (Black:2005). The Australian Tax Office (Australian Tax Office Taxation Ruling, 93/25 1993) issued a public ruling which stated (at 5) that "what is normally accepted as income is determined according to ordinary usages and concepts of mankind. Receipts from a systematic activity where the elements of a business are present are income irrespective of whether activities are legal or illegal". In terms of section 25-15 of the Australian Income Tax Assessment Act, 1997, the proceeds from criminal activities are to be regarded as ordinary income, and therefore subject to income tax (Gupta:2008). It follows that, according to the public ruling issued by the Australian Tax office and section 25-15 of Income Tax Assessment Act, 1997, arguments concerning whether or not a constructive trust is created in cases of simple theft are irrelevant in determining the taxability of proceeds from theft. Proceeds from all illegal activities are deemed to be ordinary income in Australia and people who earn income from theft are not given the advantage of being free from income tax simply

because a constructive trust may be created in cases of simple theft. Section 25.45 of the Income Tax Assessment Act, 1997, provides a deduction for loss caused by theft.

The decisions of the courts in *CIR v A Taxpayer* and *Zobory v Federal Commissioner of Taxation* indicate that the New Zealand and Australian courts relied on the doctrine of constructive trust and before tax legislative amendments were made in these two countries the doctrine was a critical factor in determining whether amounts derived from theft or embezzlement should be regarded as income for tax purposes (Black:2005). However, the courts in America have effectively disregarded the doctrine of constructive trust and have reached different conclusions on the taxation of amounts from embezzlement (DePass:2012). The American cases on the taxation of income from theft will be briefly discussed below in section 4.3.

As stated above, the Australian Income Tax Assessment Act, 1997, and the New Zealand Income Tax Act, 2007, include provisions that deal specifically with the tax consequences created by theft. The decision of the court in *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 (CA) led to the amendment of tax legislation in New Zealand. The facts of the case are (Gupta:2008) as follows: a taxpayer employed as an accountant systematically embezzled over $2 million from his employer. The taxpayer used the embezzled funds to speculate in the futures market. The taxpayer was not successful in his futures trading and made some losses on his investments. He was eventually caught and had to pay back the full amount of the embezzled funds, of which he paid only half. The Commissioner issued an assessment on the embezzled funds and income that the taxpayer had derived from his trading activities. The Commissioner, however, did not allow a deduction for the loss incurred from the trading activities.

The taxpayer objected to the assessment and a case was stated. In the New Zealand Taxation Review Authority Court, Willy J found in favour of the taxpayer and reversed the Commissioner's assessment. The Commissioner appealed to the High Court only on the issue of assessability of the stolen amounts. In presenting their arguments before Morris J in *CIR v A Taxpayer*, both the taxpayer and the Commissioner argued the issue of ownership and whether the obligation to repay stolen amounts affects the taxation of such amounts. The taxpayer argued that the embezzled funds were received by him subject to an obligation upon him to repay the amount stolen to his employer and therefore were in the nature of a loan,

albeit involuntary. The Commissioner, in presenting his argument on the nature of stolen amount in the hands of the thief, relied on numerous Canadian and American court decisions and argued that the taxation of stolen amounts is not affected by the obligation on the thief to repay the amount to its true owner or any concept of a constructive trust. Morris J (at 578) held that:

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

It was concluded that the stolen monies did constitute income and were assessable for income tax. Morris J held that stolen monies are taxed in the hands of the thief based on how the thief holds and treats the funds and not on how the funds were acquired. In other words, if the thief treats the funds as his or her own, he or she will be liable to pay income tax on the stolen funds and the fact that there is an obligation upon him or her to return the funds to the owner remains irrelevant to the question of his or her liability to income tax. Smith (1952) states that the four canons of taxation include equity and Gupta (2008:115), taking into account the equity principles discussed by Smith, argues that "in equity a constructive trust arises at the time the thief commits the act that obliges him or her to account to the rightful owner of property. This equitable remedy ensures the thief does not acquire beneficial ownership of the property stolen. It is the lack of constructive trust that distinguishes the property interests involved for different forms of illegal activities". It is submitted that, in the case of simple theft, the thief cannot be deemed to be in a fiduciary position that is present in the case of embezzlement and which creates a constructive trust.

The reasoning and conclusion of Morris J above appears to be similar to the approach that was adopted by the court in *MP Finance Group CC (In Liquidation) v C:SARS* and by the proponents of a subjective approach. In *MP Finance Group CC (In Liquidation) v C:SARS*

the court held that, despite the fact that there was an obligation upon the investment scheme to return the proceeds to the investors who were the true owners, the proceeds from the investment scheme were subject to tax because the taxpayer had "received" the proceeds for its own benefit and treated the proceeds as its own. Furthermore, the approach of Morris J also appears to be similar to the North American doctrine of claim of right. The doctrine of claim of right is discussed in section 4.3, but in general the doctrine allows the Commissioner to ignore any constructive trust issues or any obligation on the thief to return the stolen amount to its true owner and to treat the stolen amount as income taxable in the hands of the thief (Gupta:2008). It follows that the doctrine of claim of right allows the Commissioner to impute a beneficial ownership to the thief for the stolen amount for income tax purposes (Glover:1996). As Morris J stated (at 576) "when a person receives money, whether it's lawful or not, if there is no consensual recognition of a right to repay, then income has been received even if it must be repaid. The receiver has had the benefit of the money so must pay tax on it. This would mean a person could be taxed on gains even if they have no right to ownership of the gain".

On appeal, the court in *A Taxpayer v Commissioner of Inland Revenue* decided in favour of the taxpayer, preferring the Australian case of *Zobory v Federal Commissioner of Taxation* (discussed above) as being more consistent with the New Zealand law on determining whether or not income has been received. In delivering its judgment the Court of Appeal rejected any reliance upon the economic reality of the situation and based its decision upon the application of property and trust concepts (Black:2005). Referring to the Australian High Court decision in *Arthur Murray (NSW) Pty Ltd v C of T* (1965) 114 CLR 314 (where it was held that sums for pre-paid dance lessons could not be regarded as income until the services for which the sums were paid were performed), the majority of the Court of Appeal in *A Taxpayer v Commissioner of Inland Revenue* held (at 358-359) that:

> The Court obviously considered that sums received subject to a trust or charge did not have the quality of income derived by the recipient. In principle, an embezzler is liable to return or repay the stolen property and the innocent party to embezzlement retains the right to trace the property or its proceeds into the hands of the embezzler . . . the embezzler does not have any claim of right to the stolen property. In the absence of a specific statutory provision allowing for a re-characterisation or different characterisation of the misappropriation receipt for tax purposes, the ordinary rules apply. Legal rights and

obligations cannot be ignored. There is no gain to a taxpayer unless the receipt is derived beneficially by the taxpayer. Taxation by economic equivalence is impermissible.

The Court of Appeal's decision rejects the doctrine of claim of right that may have influenced Morris J in his decision and this rejection is firmly based on the ordinary approach of income being a benefit to the person receiving it and not subject to some other beneficial interest (Black:2005). In giving weight to its decision that the stolen amounts should not be treated as income, the Court of Appeal also relied on public policy arguments and held (at 359) that ". . . to exclude the stolen money or other property from the tax net is consistent with wider public policies. The imposition of a fine is the traditional means of hitting felons in their pockets by requiring payment to the public purse and the purpose of the Proceeds of Crime Act 1991". It should be noted that the Court of Appeal acknowledged that there is no public policy justification for defeating or reducing the victim's call on the funds available by an intermediate tax claim.

Gupta (2008:117), an Australian author, drawing from the appeal court's decision, argues that:

> . . . it is passing of beneficial ownership that determines, in part, whether a receipt is taxable as the approach in *A Taxpayer* confirms. Thus the proceeds of drug trafficking, gambling and poaching can be seen to be beneficially derived by the taxpayer (and thus taxable), whereas the proceeds of burglary or embezzlement [or theft] are not beneficially derived (whether as a result of a constructive trust or a right of restitution) and therefore not taxable. Consequently the application of ordinary concepts of property rights is a component in determining whether or not the taxpayer has received a gain. It is submitted that this offers a more consistent test to determining which taxable activities give rise to assessable income than the "incidental illegality" test.

It is submitted that the sole concern of the Commissioner is the assessing of all income in the hands of the taxpayer and there is no need to concern itself with issues of property rights. The New Zealand parliament responded swiftly to the decision of the Appeal Court in *A Taxpayer v CIR* that, unless stolen money was made subject to income tax by an express legislation provision it was not taxable. The Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill, 1998, was introduced and as a way to protect the tax base, the Bill proposed an amendment to the definition of "gross income" contained in the New Zealand Income Tax

Act, 1994, (Black:2005). The Bill included property obtained without colour of right to the definition of "gross income". The main aim of the amendment proposed by the Bill was to prevent people from characterising their income as stolen income and in so doing evade income tax (Gupta:2008). The New Zealand tax officials' report on the Bill stated that by taxing stolen property the state is no way allowing or providing a legal sanction to theft or like activities (Black:2005). The report further stated that by not taxing stolen property, the tax system will be creating a tax haven in New Zealand for thieves and subsiding those who choose to conduct theft or like conduct (Black:2005).

Following on from the Taxation Bill, 1998, the New Zealand Parliament made proceeds derived from embezzlement, fraud, misappropriation and theft taxable by enacting an amendment which introduced section CB 32 in the New Zealand Income Tax Act of 2007 (Gupta:2008). Section CB 32 is equivalent to section CD 6 of the New Zealand Income Tax Act, 1994, and section CB 28 of Income Tax Act, 2004. Section CB 32 of the New Zealand Income Tax Act of 2007, states that "if a person obtains possession or control of property without claim of right, an amount equal to the market value of the property is income of the person". This means that section CB 32 achieves the taxation of income from theft by disregarding any constructive trust doctrine and including in a taxpayer's "gross income" any amounts of which the taxpayer has taken possession. In other words, if a thief steals property he or she will be taxed on the basis that he or she has taken possession of the property or regarded and treated the property as his or her own. The approach introduced by section CB 32 ignores any property rights and appears to be similar to the "benefit formula" referred to by Botha JA in *CIR v Friedman and Others NNO* and applied by the court in *CIR v Cape Consumers (Pty) Ltd* (discussed in section 2.3). Gupta (2008:118) submits (it is submitted correctly) that:

> Although this is inconsistent with the common law treatment . . . the Court of Appeal recognised the need for statutory authority to make stolen funds income. It cannot be doubted that Parliament has the authority to cut across any constructive trust or possibility of restitution imposed by the operation of equity, which the section expressly does at CB 32(3). In making such an amendment Parliament can be taken to have considered the underlying public policy issues and determined that the taxability of the gain in the hands of the criminal overrides any restorative property reservations that equity would impose

on the receipt of the sum. It should also be noted that there is a corresponding deduction for any restitution made of stolen funds at s DB 44 ITA 07.

As will be suggested below in section 5, South Africa, like New Zealand, needs to adopt tax legislation that amends the definition of "gross income" in the Act so as to provide and ensure a more unified and clear approach in taxing income from all illegal activities.

4.3 The basis of taxation of income from theft in America

According to the court in America in *Commissioner v Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), there are two important principles underlying the income tax. The first principle is the Code (the Income Tax Act) which is the decisive basis of tax law, and the second principle is the term "gross income" which is the single most important definition that underpins every single realisation of wealth by a taxpayer, irrespective of its source (Muller:2007). At one stage (before the legislation was amended) the American income tax legislation made specific reference to the legality of the source of income when defining the taxable net income of a person. The legality of the source of taxpayer's income was mentioned in section IIB 38 Statute 114, 167 of the American Income Tax Act, 1913, which stated that the net income of a taxable person includes gains, profits and income from transactions of any lawful business carried on for gain or profit (Black:2005). The section was later amended under section 61(a) of the United States Internal Revenue Code of 1954 (discussed below) to omit the term "lawful" from the section and this amendment made it possible for income derived from all illegal activities to fall within taxable income. But before this amendment came into force, there were some inconsistencies between the decisions of the courts regarding the treatment for tax purposes of proceeds derived from illegal activities (Black:2005). These inconsistencies created some uncertainty in the "tax world" on how illegal income earners should be treated. The uncertainty was as a result of two arguably contradictory decisions of the courts in *Commissioner v Wilcox,* 327 US 404 (1946) and *Rutkin v United States*, 343 US 130 (1952).

In *Commissioner v Wilcox* the taxpayer embezzled money from his employer and the issue to be decided by the court was whether embezzled money constituted taxable income under the then section 22(a) of the United States Internal Revenue Code of 1939 (DePass:2012). Section 22(a) in defining "gross income" included gains, profits and income derived from any

source whatever. The court, affirming the Ninth Circuit decision, held that section 22(a) did not include in a taxpayer's "gross income" wrongfully acquired embezzled money (DePass:2012). The court (at 408) held that "a taxable gain is conditional upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain". This means that an embezzler (or thief) cannot, in the "eyes" of the court in *Commissioner v Wilcox*, be regarded as having received taxable income because he or she does not have a *bona fide* legal claim to the embezzled or stolen funds and has an unqualified duty to return the amount to its true owner. This approach is similar to the objective approach that was once followed in South Africa and discussed in section 3.2. The objective approach regarded amounts from illegal actives as not having been "received" by the taxpayer due to the presence of an immediate obligation on the taxpayer to repay the amount.

On the other hand, the court in *Rutkin v United States,* departing from the approach adopted in *Commissioner v Wilcox,* held that amounts received by way of extortion are taxable income. The court, in reaching its decision, adopted the control-dominion theory and economic benefits approach. The control-dominion theory and economic benefit approach ask the question whether "the taxpayer has such control over ill-gotten gains that, as a practical matter, he derives readily realizable economic value from it" (Muller, 2007:181). If the answer to this question is positive, the taxpayer will be regarded to have received taxable income. The court, in a contentious decision of 4-5, held that when a taxpayer exercises enough control over an ill-gotten amount such that he or she derives readily realisable economic value from it, the amount will be regarded as a taxable "gross income". This means that when a taxpayer obtains an amount which he or she has freedom to deal with as he or she wishes, the amount is taxable income despite the fact that another person may have a superior claim of right to it (DePass:2012).

The legislation was later amended under section 61(a) of the United States Internal Revenue Code of 1954 to exclude the term "lawful" from the definition of the taxable income of a taxpayer (Black:2005). Three Supreme Court decisions that helped to refine the meaning of income are: (i) *Commissioner v Glenshaw Glass Co,* which listed three elements of income as (a) accession to wealth, (b) clearly realised income and (c) complete dominion; (ii) *Rutkin v United States,* which held that income is to be treated as taxable "gross income" if a taxpayer exercises control and derives realisable economic value from it and (iii) *North American Oil*

Consolidated v Burnet, 286 U.S. 417, 424 (1932), which held that a taxpayer is to be regarded as having obtained taxable income even though he or she may not be entitled to the money and has an obligation to repay it to its true owner (Muller:2007). Section 61 of the United States Internal Revenue Code 1954 now defines "gross income" as follows: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items . . . (2) Gross income derived from business . . .".

The Supreme Court in *James v United States* 366 US 213 (1961) was given the opportunity to clear the uncertainty over the taxability of income from illegal activities created by *Commissioner v Wilcox* and *Rutkin v United States* and to decide whether section 61(a) covered income from illegal activities. The taxpayer in *James v United States* was a union official who embezzled funds from his employer union and an insurance company. Having not disclosed such amounts in his tax returns for the relevant years, he was convicted of tax evasion and given a custodial sentence (Black:2005). The Supreme Court overturned the decision of the court in *Commissioner v Wilcox* and held that the decision of the court in *Rutkin v United States* should be followed in cases that deal with embezzled funds and amounts from extortion. It was held that the decision of the court in *Rutkin v United States* vitiated the rationale of the court in *Commissioner v Wilcox* (DePass:2012). It was further held that the language of the Internal Revenue Code in section 61 that "all income from whatever source derived" covers all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" (at 219). Interpreting the legislature's intent behind the amendment under section 61, the United States Supreme Court held (at 218) that "this revealed, we think, the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest labourer taxed and gains of the dishonest immune".

The relevant section as it stood in *James v United States* was section 22 of the United States Internal Revenue Code of 1939, which has been carried into the current Internal Revenue Code as section 61 (Muller:2007). The section 61 definition of "gross income" has been referred to by DePass (2012) as a *sweeping* definition because it seeks to tax all income from whatever source. This means that all income from illegal activities is regarded as "gross income" under section 61 and, in relation to stolen amounts, the funds are deemed to form

part of the thief's "gross income" and must be declared in the tax year in which they were stolen.

During the course of delivering its judgment, the court in *James v United States* referred with approval to the decision of the Supreme Court in *North American Oil Consolidated v Burnet* and held (at 219) that "when a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition . . . of an obligation to repay, and without restriction as to their disposition," he or she must be deemed to have received taxable income regardless of any legal obligation to return the money. The Supreme Court then concluded that the embezzled funds were properly included in the "gross income" of the embezzler under section 22(a) of the Code of 1939 and section 61(a) of the Code of 1954. The case of *James v United States* is regarded as the "key" authority for the doctrine of claim of right, a doctrine which has been used by courts as the basis for taxing amounts obtained through illegal activities in America (DePass:2012). Under the doctrine of claim of right income includes "amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition" (DePass, 2012:775).

After the decision of the court in *James v United States* there were a number of cases that held that proceeds from theft constituted "gross income" of a taxpayer and were taxable. One of the cases which so concluded is *Wood v Commissioner*, 102 TC.M. (CCH) 146, 147, 2011 TC.M. (RIA) 1 2011-190. The taxpayer in *Wood v Commissioner* had embezzled a substantial amount of money from his employer over a period of nine years and used the amount for personal expenditures, paying credit card bills and to support a store he owned (DePass:2012). The court ordered the taxpayer to pay $200 to his employer after pleading guilty to stealing over $300 from his employer. The taxpayer was assessed in the amount of the tax deficiencies and the Commissioner issued accuracy-related penalties as a result of the taxpayer's failure to include any of the misappropriated funds in his income tax returns for 2001, 2002 and 2003 (DePass:2012). The court (at 1305) held that the definition of "gross income" under section 61(a) "includes income derived through illicit means including embezzlement, regardless of how the money is used and although the embezzler may have to repay the embezzled funds".

In delivering its decision, the court in *Wood v Commissioner* tracked the language from *Commissioner v Glenshaw Glass Co* and reasoned that because the taxpayer had dominion

over the embezzled funds and spent them as he wished, the funds formed part of his “gross income” for the years in question and thus were taxable. The court accordingly sustained the tax deficiencies assessment and accuracy penalties issued by the Commissioner. This means that, in America, proceeds from theft are taxed on the basis of the thief’s claim of right to the stolen amounts (the claim of right doctrine has now been incorporated into the section 61 definition of “gross income which seeks to tax income from whatever source”). This approach seems to ignore any property right issues when deciding what constitutes a taxpayer’s “gross income”. The approach is also similar to the approach taken and conclusion reached in *MP Finance Group CC (In Liquidation) v C:SARS*. In this case, the court held that the invested amounts formed part of the taxpayer’s “gross income” and that the scheme had “received” the amounts for tax purposes irrespective of the obligation upon it to repay the amount to the investors. This was because the scheme had received the amounts on its behalf and had retained and used the amounts as its own.

4.4 Conclusion

The current New Zealand and Australian tax legislation discussed above seems to have moved away from the idea that the state, by taxing illegal proceeds, condones the activity from which these proceeds originate, to the idea that the state should not allow the wrongdoer to benefit from advantages which are denied to the honest businessman. Before legislative amendments in New Zealand and Australia, the existence of the doctrine of constructive trust in New Zealand and Australia prevented the taxation of amounts derived from the activity of theft. The application of this doctrine meant that if a taxpayer has an unconditional obligation to pay back an amount or pay it over to another person, he or she will not be taxed on that amount. Unlike America, the New Zealand and Australian courts had far more respect in the past for the doctrine of constructive trust. In America, the courts developed the doctrine of claim of right as the basis for taxing income from illegal activities. The doctrine allows the Commissioner to ignore any constructive trust issues or any obligation on the thief to return the stolen amount to its true owner and to treat the stolen amounts as income taxable in the hands of the thief (Gupta:2008). The doctrine of right of claim is now covered by the new definition of “gross income” in section 61 of the Internal Revenue Code.

Currently, the Australian Income Tax Assessment Act, New Zealand Income Tax Act and American Internal Revenue Code have provisions that specifically deal with how the

proceeds from theft in the hands of a thief should be treated for tax purposes. This means that in Australia, New Zealand and America the legislation is the basis upon which income from theft is taxed. This basis has managed to provide a more clear and unified approach on the tax treatment of amounts from all illegal activities.

The following chapter will be the concluding chapter of the thesis and will make a recommendation regarding the basis upon which income from theft should be taxed in South Africa.

CHAPTER 5: CONCLUSION

The main issue for the purposes of this research was centred on the question of "receipt" in terms of the definition of "gross income" in relation to the proceeds of theft. This question was based on the premise that if a person is conducting an illegal business, such as stealing cars and selling them, that person is not entitled to the proceeds from the stolen cars as he or she was never legally entitled to the ownership of the cars in the first place. In the context of income from legal activities, the term "receipt" was interpreted with reference to entitlement. Thus, if a taxpayer was entitled to an amount, the courts would regard the physical control of the amount by the taxpayer as a "receipt for his own benefit" (Stiglingh *et al.*, 2015:20). The intention of the taxpayer did not have a bearing on how the courts interpreted the term "receipt" in relation to income from legal activities. This approach was only changed by the courts when they were presented with cases dealing with income from illegal activities. When it came to taxing income from illegal activities, the courts interpreted the term "receipt" with reference to the intention of the taxpayer.

This research aimed to investigate the basis on which proceeds from theft are taxed in South Africa and whether the taxation of illegal income flowing from theft should be based on the subjective approach currently applying. In addressing the main issue of this thesis, the research presented an appraisal of the subjective interpretation approach used in *MP Finance Group CC (In Liquidation) v C:SARS* and considered whether applying the subjective approach to the interpretation of the concept of "receipts" is warranted. The thesis also aimed to provide a comparative analysis of the basis on which illegal income flowing from theft is taxed in Australia, New Zealand and America and providing a recommendation regarding the approach to be applied in South Africa to tax income from theft, based on the approach adopted in Australia, New Zealand and America.

The principle underlying the Act, as explained by Wessels JA in *Ochberg v CIR* (at 240), is that ". . . the State takes a percentage of the moneys or moneys' value which has accrued to the taxpayer during the year of assessment. In other words, that he pays his tax not out of his capital but out of his incomings". This means that the calculation of a taxpayer's taxable income and ultimately the tax liability of a taxpayer commences with considering what constitutes the taxpayer's "gross income". The definition of "gross income" as set out in section 1 of the Act makes it clear that a person can be taxed either on "receipts" or

"accruals". Even though the definition of "gross income" makes no reference to the illegality of "receipts" or "accruals", it is clear that income from illegal activities is taxable because the legality of the source of income has been held to be immaterial in the question of the liability of the taxpayer for income tax (*CIR v Delagoa Bay Cigarette Co. Ltd*). The revenue authorities have cast their net wide so as to include in the taxpayer's "gross income" all proceeds that constitute income and in practice the revenue authorities endeavour to collect tax on illegal "receipts" if they know about them (Goldswain:2015).

But a review of the early South African cases on the taxation of proceeds from illegal activities has shown that, when it came to taxing income from illegal activities, the courts were not always consistent on the approach to be followed and on how the term "receipt" should be interpreted in the context of income from illegal activities. Certain earlier court decisions have followed the objective approach, while other court decisions have been based on the subjective approach. The objective approach considered whether or not the taxpayer was, objectively speaking, entitled to "receive" the amounts and using this approach the courts regarded the proceeds from illegal activities as not having been received by the perpetrator in the true legal sense of the word "received" (Stiglingh *et al.*, 2015). The rationale behind this line of reasoning was that when the taxpayer received the amount in question there was an immediate obligation to repay the money (Croome *et al.*, 2013). This means that under the objective approach, the term "receipt" was interpreted with reference to the concept of entitlement.

Proponents of the subjective approach, on the other hand, took the intention of the taxpayer into account and concluded that, because the taxpayer "received" the amount in question with the intention to benefit from it, the amount should be regarded as having been "received" for income tax purposes and should be included in the taxpayer's "gross income". (Stiglingh *et al.*, 2015). The argument that a taxpayer who is in possession of illegal income had not received the income, in view of the fact that it had to compensate the victims of the crime, has been held to be irrelevant when deciding the obligations of a taxpayer to the *fiscus*. Using this approach the courts have managed to bring income from illegal activities within the ambit of the "gross income" definition.

The different approaches (subjective and objective) gave rise to the question whether the term "received" refers to rights in the form of entitlement or a mere holding of an amount by the

taxpayer with the intention of benefiting from it. The SCA in *MP Finance Group CC (In Liquidation) v C:SARS*, when presented with an opportunity to provide an answer to this question, followed the subjective approach and held that the taxpayer had "received" the deposits for the purposes of "gross income" because it had received the deposits on its own behalf and for its own benefit. In Interpretation Note 80 (South African Revenue Service:2014), SARS set out its practice in dealing with the taxation of stolen amounts in the hands of the perpetrator and the non-deductibility of such amounts when repaid. SARS, relying on *MP Finance Group CC (In Liquidation) v C:SARS,* took the view that a thief will be taxed on stolen proceeds because those proceeds are a "receipt". SARS in its Interpretation Note 80 (South African Revenue Service, 2014:15) states that "while the *MP Finance* case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means".

When it came to how the word "received" should be interpreted, the court, in *MP Finance Group CC (In Liquidation) v C:SARS*, stated that it would use the literal rule of statutory interpretation. The rule requires the interpreter to concentrate on the literal meaning of the words to be interpreted and to equate the legislature's intention with the plain meaning of the words in a statute (*Principal Immigration Officer, Appellant v Another, Respondents*). The subjective intention test is mainly applied by courts in criminal or delict cases to determine the criminal liability or fault of a person. The court, in *MP Finance Group CC (In Liquidation) v C:SARS*, did not provide an explanation as to how the subjective intention of the taxpayer is linked to the literal rule of statutory interpretation. The use of the subjective intention test, together with the literal rule of statutory interpretation by the court in interpreting a piece of legislation, gives rise to the question as to whether the literal rule of statutory interpretation gives room for the court to make reference to a person's subjective intention when interpreting a statute. For the court to state that a literal meaning of the word "received" must be followed and conclude the case without providing an analysis of what the literal approach entails does not provide the much needed clarity on how future courts and litigants should interpret the word "received" for the purposes of "gross income", especially in the context of proceeds from theft.

The answer to the question why the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* adopted the subjective approach as an influential concept to interpret a statute when applying the literal rule of statutory interpretation, without explaining how the two are inter-

related, may be found in other foreign jurisdictions. The approach that was adopted by the court in *MP Finance Group CC (In Liquidation) v C:SARS* is similar to the foreign doctrine of claim of right, a doctrine which was constructed in America. The doctrine ignores any property rights issues and it imputes a beneficial ownership to the thief for the stolen proceeds for income tax purposes. The doctrine allows the Commissioner to ignore any obligation on the thief to return the stolen property to its true owner and to treat the stolen proceeds as income taxable in the hands of the thief (Gupta:2008). The doctrine of claim of right came into existence after a legislative amendment was made in America. The legislative amendment omitted any reference to the legality of the source of income when defining the taxable net income of a person. This means that in America the subjective approach was adopted only after a legislative amendment was made that moved away from legal rights.

In New Zealand the court in *A Taxpayer v Commissioner of Inland Revenue* stated that in the absence of a specific statutory provision allowing the doctrine of claim of right (a doctrine which is similar to the subjective approach) to be the test for determining whether a stolen amount has been "received" for tax purposes, property rights remained a consideration in determining whether or not a taxpayer has "received" a gain. Following on from the decision of the court in *A Taxpayer v Commissioner of Inland Revenue,* an amendment was made to the definition of "gross income" in the New Zealand Income Tax Act. The amendment included property obtained without the colour of right in the definition of "gross income". It follows that the American and New Zealand taxation law has managed to define a taxable income without making any reference to the taxpayer's property rights. This has cleared any uncertainties about how stolen amounts (which are derived as a result of a unilateral taking) should be treated in the hands of the thief.

It is submitted that possibly the time has come for the South African legislature to define the term "received" in the definition of "gross income" in the Act in such a way that it is distinguished from the term "accrual" in the sense of a right to an amount. This will provide clarity on how the term "received" should be interpreted in the context of income from illegal activities, especially with reference to income from theft.

The decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* makes it clear that all illegal "receipts" are taxable and the revenue authorities are allowed to collect tax on all illegal "receipts". Although the case of *MP Finance Group CC (In Liquidation) v C:SARS*

provides an all-encompassing answer to the question of whether income from illegal activities is taxable, whether or not the decision of the SCA in this case is the basis on which the revenue authorities may tax all income from illegal activities is questionable, especially in light of the fact that the court did not state that their subjective approach is to be adopted in cases dealing with income from other illegal activities such as theft. In South Africa, it has been claimed that an amount is not "received" in circumstances where unilateral taking has taken place; there has to be a giver and a receiver in order for a "receipt" to take place (Haupt:2015). This means that a "receipt" occurs in circumstances where a transaction has taken place. A transaction constitutes both giving and receiving and, in the case of theft, no transaction takes place (Haupt:2015).

The case of *MP Finance Group CC (In Liquidation) v C:SARS* dealt with proceeds from fraudulent activities which do not constitute a unilateral taking (theft). The investors in *MP Finance Group CC (In Liquidation) v C:SARS* gave their deposit amounts to the scheme so that the amounts could be invested by the taxpayer on their behalf. It follows that the investors intended the scheme to receive the amount. This means that there was a transaction or an agreement (albeit clouded in misrepresentation) between the investors and the scheme, which led to the scheme receiving the amounts that the Commissioner sought to tax. It is submitted that in light of the fact that *MP Finance Group CC (In Liquidation) v C:SARS* did not deal with proceeds from a unilateral taking and of the fact that the SCA did not did not make it clear whether or not their decision is applicable in the case of proceeds from theft, the basis on which amounts from theft can be taxed is still a grey area in our law and the case of *MP Finance Group CC (In Liquidation) v C:SARS)* may not be the appropriate case to use as precedent or authority for the basis on which such proceeds may be taxed.

In the absence of a more unified approach to be followed in taxing income from all illegal activities, a more consistent and effective approach will be achieved in South Africa, it is submitted, by simply adopting a legislative reform remedy. It is furthermore submitted that, in the absence of a specific statutory provision allowing for a different and specialised definition of the word "received" for tax purposes, the word "received" cannot simply be interpreted with reference to the subjective intention of the taxpayer in situations where a transaction has not taken place.

It follows that that unless stolen money is made subject to income tax by an express provision in the Act, currently there is no legislative basis on which SARS can tax it. As argued by Classen (2007:553), focusing much on how the term "received" should be interpreted, will make "one end up arguing in circles, and get caught up in linguistic contradictions which lead to unrealistic practical results". The taxation system should, where possible, provide certainty and consistency in its application (Black:2005). Therefore, it is submitted that a legislative intervention may be warranted to clarify the issue of how the term "received" should be interpreted in the context of income from illegal activities, especially with reference to stolen amounts. Rules of statutory interpretation do not prohibit a specific meaning to be given to words and the legislature needs to give the term "received" a specific meaning that gives effect to the purpose of the Act as a whole. A legislative reform will help taxpayers and courts with certainty as to how property in the hands of a thief should be taxed. Furthermore, a legislative reform has the immediate attraction of being simple and straightforward. It also provides an explicit acknowledgement on behalf of the legislature that the state seeks to impose tax on all income, regardless of its source and it also effectively removes the presence of property rights as a requirement for income to be taxed.

As the focus of the Act is to tax all income, whether from illegal activities or legal activities, the focus for the present, before a legislative amendment has taken place, should be on what Williams (2009) has stated – the Commissioner should look at whether what is in the hands of the taxpayer is being treated as income and if so, then it is taxable. This, it is submitted, should be the solution until the legislature intervenes and offers a statutory definition of the terms contained in the "gross income" definition. The arguments that: (i) income from illegal activities should be taxed because not to tax it whilst taxing income from legal activities violates public policy, and the opposing contention (ii) that the decision of the SCA in *MP Finance Group CC (In Liquidation) v C:SARS* violates public policy because it allows the state to take "a bite" from the proceeds of criminal activities, illustrate the competing public policy issues. On one hand, income from illegal activities is taxed for public policy reasons (creating fairness between illegal and legal income earners) while, on the other hand, the results of taxing it violate public policy (Ogunsanwo:2013). This conflict raises the question of what public policy is to be preferred. Gupta (2008:106) argues (it is submitted correctly) that: "If there is to be a 'ranking' of the importance of those public policies, perhaps it should be done by the legislature".

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