

***Mores, fault and fides: are these
acceptable criteria when income tax
deductions are claimed?***

Thesis submitted in partial fulfilment of the requirements
for the degree of

MASTER OF COMMERCE TAXATION

of

RHODES UNIVERSITY
Department of Accounting

by

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ESTIMATED SUBMISSION DATE:
15 DECEMBER 2006

ABSTRACT

The two “pillars” on which taxable income is based are the definition of “gross income” in section 1 of the Income Tax Act, 58 of 1962, and the “general deduction formula” comprising the preamble to section 11, section 11(a) and section 23(g) of the Act. Many of the terms used in these sections are not defined in the Income Tax Act. Case law in relation to these sections reveals that morality issues, the negligence of taxpayers and the good faith of taxpayers have from time to time been treated as relevant considerations by the courts, both abroad and in South Africa, in allowing or disallowing deductions from the gross income of taxpayers. In some instances this occurred apparently unwittingly. In other instances, earlier decisions were followed without a thorough consideration of the correctness of the underlying reasoning or of the criteria which were applied in the earlier decisions.

In relation to the definition of “gross income”, however, *fides*, *mores* and fault have not been a consideration. In *CIR v Delagoa Bay Cigarette Co Ltd 1918 TPD 391* Bristowe, J stated: “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.” There were a number of cases heard in relation to income from illegal activities (for example, *COT v G, 1981 (4) SA 167 (ZA)*, *43 SATC 159*, and *ITC 291, 7 SATC 335*, which related to the misappropriation of funds, *ITC 1545, 54 SATC 464*, which dealt with the proceeds of the sale of stolen diamonds and *ITC 1624, 59 SATC 373*, which dealt with overcharging customers). In these cases, the question turned on whether or not the amounts were received by the taxpayers for their own benefit and therefore to be included in gross income, or whether the taxpayers incurred a concomitant liability to repay the amounts, and did not involve the question of *fides*, *mores* or fault.

The research concludes that, providing an even-handed approach is applied to both income and expense considerations, *fides* and *mores* may continue to play a role as a useful yardstick in this context. However, that fault, particularly the causal negligence of taxpayers in the process of sustaining a loss or incurring expenditure whilst conducting their income generating operations, has effectively been jettisoned as an irrelevant consideration, is a salutary development which has contributed to legal certainty.

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CHAPTER ONE: INTRODUCTION

1.1 CONTEXT

The income tax payable by a taxpayer is based on “*taxable income*”, defined in section 1 of the Income Tax Act, 58 of 1962 (referred to as “the Act”), as:

. . . the aggregate of:

- (a) the amount remaining after deducting from the *income* [own emphasis] of any person all the amounts allowed . . . to be deducted from or set off against such income . . .

“*Income*”, in its turn, is defined in section 1 of the Act as:

. . . the amount remaining of the *gross income* [own emphasis] of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax . . .

Certain amounts are exempt from normal tax on the basis of either the nature of the person (for example, public benefit organisations, the government and provincial or local authorities), or on the basis of the nature of the income (for example, disability pensions or grants or social pensions). “*Gross income*” is defined in section 1 of the Act as:

. . . the total amount, in cash or otherwise, received by or accrued to or in favour of a resident [in the case of a non-resident, only amounts received or accruing from a source within, or deemed to be from a source within the Republic] . . ., excluding receipts or accruals of a capital nature [which are included directly in taxable income] . . .

Allowable deductions are provided for in various sections of the Act, but the main sections governing deductibility are found in what is referred to as the “*general deduction formula*” comprising the preamble to section 11, section 11(a) and section 23 (g) of the Act, as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature; . . . (section 11(a))

No deductions shall in any case be made in respect of the following matters, namely –

- (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade; . . . (section 23)

It is clear that the two “*pillars*” on which taxable income is based are the definition of “*gross income*” and the “*general deduction formula*”. Many of the terms used in these sections are not defined in the Income Tax Act. Case law interpretations of these sections reveals that morality issues, the negligence of taxpayers and the good faith of taxpayers have from time to time been treated as relevant considerations by the courts, both in England and South Africa, in allowing or disallowing deductions from the gross income of taxpayers. In some instances this occurred apparently unwittingly. In other instances, earlier decisions were followed without a thorough consideration of the correctness of the underlying reasoning or of the criteria which were applied in the earlier decisions.

Whilst the wording of the general deduction formula is contained in the Act, the definitions of the elements of the two subsections jointly comprising the general deduction formula are defined in such circumscribed or narrow a manner that a wider examination of the material facts is often inevitably necessary. To determine whether the legal elements prescribed by these two subsections have been satisfied on the facts, the courts have over the years *inter alia* regarded the negligence of taxpayers in the conduct of their income generating operations as a relevant consideration, resulting in the disallowance of expenditure or losses claimed by them. Some judgments reflect that public policy principles had influenced the reasoning of the judges, whether deliberately or as part of their motivation or reasoning advanced in support of their judgments. The good faith of taxpayers has also been *treated* as a relevant consideration by the courts. Insofar as these concepts have been treated as relevant considerations, even though the general deduction formula itself does not render these concepts relevant *per se*, should this development be welcomed, or does it detract from legal certainty?

In relation to the definition of “*gross income*”, however, *fides, mores* and fault have not been a consideration. In *CIR v Delagoa Bay Cigarette Co Ltd 1918 TPD 391* Bristowe, J stated:

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.

There were a number of cases heard in relation to income from illegal activities (for example, *COT v G, 1981 (4) SA 167 (ZA), 43 SATC 159*, and *ITC 291, 7 SATC 335*, which related to the misappropriation of funds, *ITC 1545, 54 SATC*

464, which dealt with the proceeds of the sale of stolen diamonds and *ITC 1624, 59 SATC 373*, which dealt with overcharging customers). In these cases, the question turned on whether or not the amounts were received by the taxpayers for their own benefit and therefore to be included in gross income, or whether the taxpayers incurred a concomitant liability to repay the amounts, and did not involve the question of *fides, mores* or fault.

In contrast, these questions formed the basis of many cases heard in relation to the deductibility of expenses. *Fides*, or whether expenses were *bona fide* incurred for the purpose of the production of income, was an important consideration in *Port Elizabeth Electric Tramway Co v CIR 1936 CPD 241*. The presence of negligence (or fault) denied a deduction for the payment of damages in *Joffe & Co (Pty) Ltd v CIR 1946 AD 157*. Deduction of the amounts paid as fines or penalties was denied on the basis that to allow such amounts to be deducted would be *contra bonos mores (ITC 1490, 53 SATC 108)*.

1.2 GOAL OF THE RESEARCH

The goal of the research is to establish whether or not *mores*, fault and *fides* are acceptable criteria to be applied when the granting of income tax deductions are considered? In particular, the research aims to determine which of the concepts or considerations of *mores*, fault or *fides* should legitimately be regarded as relevant considerations and which of these concepts or considerations should have no role to play as measuring tools or criteria in allowing or disallowing deductions from the gross income of taxpayers.

The role played by these abstract, common law concepts during casuistic developments against the background of income tax legislation, is investigated, and the future role which might be played by these considerations, is assessed.

1.3 METHODS, PROCEDURES AND TECHNIQUES

As a point of departure, the object of the taxation dispensation in South Africa is considered. The approach to widen the tax net (on the receipt/accrual side), is contrasted with the approach which is followed when deductions are claimed. The correctness of an approach which has allowed the introduction of moralistic, subjective or judgemental considerations, particularly on the deduction side, necessitates firstly, a review of the provisions of the Income Tax Act itself. The Income Tax Act itself has to be reviewed to determine whether there are any express indications in the said Act regarding the question whether these considerations should play any part in determining whether expenditure or losses claimed as deductions should be permitted or not. Moreover, the possible effect which the Constitution of South Africa may have, whether directly or indirectly, upon the issue as defined in the provisional title, is considered. Once the content of the Income Tax Act itself has been considered, as well as the aforementioned contextual background, the reasoning which has been adopted over the years in case law is critically analysed. The soundness of *rationes* adopted in earlier Southern African decisions are tested against logic, and contrasted against more recent decisions. The role which these common law concepts should play, have to some extent been elucidated in more recent decisions. Whilst it is understandable that the tax net should be widened as much as possible in South Africa, it may well be asked whether moralistic issues or human error should continue to disqualify actual expenditure or losses incurred, when morals, fault and *fides* apparently play no role on the accrual/receipt side?

The approach to this thesis therefore essentially entails an analytical and critical assessment of the soundness of this partly historic, partly ongoing casuistic development and the manner in which these abstract considerations or concepts have been applied in reported decisions.

The reference framework includes a brief analysis of the purpose of taxation; the wording of the legislation, including the Act itself; the *ad hoc* treatment of these concepts in our case law and the gradual elucidation by the Courts of the roles which these concepts should play, if any, in the evaluation process.

1.4 OVERVIEW OF THE THESIS

Chapter two briefly analyses the purpose of taxation. It is recognized that the tax net should be cast as widely as possible to include all forms of income generated by the application of capital or labour, including the wits, skill and labour of the citizens of the Republic of South Africa, but questions whether deductions allowable against this income should be restricted by considerations of fault, *fides* or *mores*.

Chapter three evaluates the relevant sections of the Act to determine whether the Act itself provides any express *indiciae* that community morals, good faith or fault are considerations when determining whether expenditure or losses are permitted as deductions from income. The common law background and the current constitutional dispensation are also briefly considered.

Chapter four discusses the role played by the courts in the Republic of South Africa, the erstwhile Rhodesia (Zimbabwe), England, Canada and the United

States of America in establishing the principles of *mores*, *fides* and fault as relevant considerations when allowing deductions against income, for tax purposes.

Chapter five concludes the thesis, summarising the principles established during the research process and assesses the continuing relevance of the considerations of *mores*, *fides* and fault in the revenue to be included in taxable income and the deductions allowable against income in arriving at the taxable income on which normal tax is levied.

CHAPTER TWO: THE PURPOSE OF TAXATION

In this thesis, the relevance of fault, *fides* and *mores*, in the context of the deductibility of expenditure or losses, is investigated. If these concepts or criteria are deemed to be relevant, is it permissible that they are only regarded to be of relevance when consideration is given to the question whether certain receipts or accruals should fall in the tax net, or should the same criteria not be similarly relevant when the deductibility of expenditure incurred or losses sustained, is evaluated? This thesis considers to what extent these criteria and principles of policy have been regarded as relevant by the courts over the years, from a critical perspective. Whether the criteria have been applied consistently, both on the accrual/receipt side and on the deduction side, is also considered. Whether the approach is correct to treat fault, *fides* and *mores* as relevant criteria, is also investigated.

2.1 FUNDING STATE EXPENDITURE

As a point of departure, it is necessary to consider the object or purpose of taxation. Taxes provide income for the government to manage society and to provide essential services for the inhabitants of the country. The levying of taxes requires a balancing act, because the income generating activities of the residents are directly affected by the imposition of taxes. The *fiscus* should not make too drastic inroads upon the daily income earning activities of society, yet should collect sufficient taxes from society to ensure that the budgetary requirements of the government of the day are met. This is particularly apposite in the South African situation, where the trading account balance (that is, the difference between exports and imports) is more readily affected by macro-economic factors than the trade balances of countries with larger economies, or countries which

function within a trading block with one common denominator, such as those countries which form part of the European Union.

Tax has a direct effect upon a taxpayer: the taxpayer's disposable income is reduced, resulting in a reduction in his available income to spend on necessary services, but also on products generated by society. The levying of taxes has the effect that the taxpayer has less disposable funds to spend on the daily social needs of his family, to save for possible ill health, incapacity or for retirement and accordingly not only has a personal effect, but also has a collective effect on society.

Collected taxes are, to a certain extent, ploughed back into society. Infrastructural spending usually has direct and indirect benefits, *inter alia* upon the employment of residents who are remunerated, which remuneration is then partly ploughed back into the economy through consumer spending and so forth. In theory, permanent jobs are also created by the need to maintain existing facilities and infrastructure. Taxes are also used for the creation and maintenance of systems which are necessary for the operation of society, such as transport systems (road; rail; air); telecommunication (post; telephone; radios); the provision and maintenance of security and control (defence forces; police and traffic police).

2.2 THE TAX BASE

Nonetheless, the government must always keep in mind the relatively narrow tax base of taxpayers in South Africa, compared to the total population of South Africa. The 2006 mid-year population was estimated at approximately 47.4 million

individuals.¹ There are 1 276 157 active registered close corporations and 415 990 active registered companies in South Africa.² According to an official publication of the South African Revenue Service³ there were 4.86 million individual registered taxpayers in South Africa registered for the 2005/06 financial year. The Revenue Office (with 14 800 employees) had processed 14.8 million returns in total. Of particular relevance is the inevitable question: who are in the tax network and who are outside the tax network? Should a tax system act as a *stimulus*, for example to enhance the standard of living of society? Should it merely be a *passive mechanism*, for example a mechanism utilised to simply collect enough money to meet necessary expenses? Should it rather be aimed at *ameliorating* the inherently unfair concept of taking money away from the public by way of forced payments, collected on a rigid tariff or scale, without any option on the part of taxpayers to pay? Is this idea of *amelioration* the reason why deductions from the taxable income of taxpayers are allowed? The underlying rationale for the allowance of deductions could also be explained by ascribing it to the realisation that economic activity should be stimulated, rather than stifled, by a successful tax system. The “*carrot-in-front-of-your-nose*” approach then goes hand in hand with the amelioration concept (“*we feel sorry for you*”). The allowing of deductions may also be perceived as a form of a *reward* for the income generator (“*well done, you have generated so much, you are now entitled to some money back for your efforts!*”).

The analysis of the make-up of the South African taxpayer base is of relevance to the topic under discussion. It could be asked: In what way? It might be contended

¹ **Executive Summary**, approved by Pali J Lehohla, Statistician-General, 27 July 2006. www.statssa.gov.za. **Statistics South Africa**.

² **Media Statement**, 23 May 2005. Cape Town: www.sars.gov.za.

³ **SARS Annual Report 2005/06 (HTML Version)**, **SARS at a Glance**. February 2006. www.sars.gov.za.

that in modern day society, neither fault nor morality should constitute factors relevant in determining which persons fall within the tax net, and which persons fall outside the tax net; who have to pay taxes and who are exempt; and what should be the extent of the taxes which have to be paid. However, these two factors or considerations have often been treated as relevant in certain scenarios. This assertion will be demonstrated by referring to the casuistic development in South African courts over the years.

The calculated widening of the tax net is a realistic and common sense objective of the *fiscus*. A typical example is the current tax amnesty which is being offered to small businesses in South Africa. That this approach is sound, is self-evident: South Africa has a small tax base compared to its total population, whilst the socio-economic health, welfare and developmental demands of the South African society are massive. Gross Domestic Product (“GDP”) in South Africa currently amounts to R 418,116 billion per year⁴. Gross domestic expenditure has consistently exceeded gross domestic product over the last two years, and the current account of the balance of payments has recorded a deficit over the ten past completed quarters, at the end of the 2005 fiscal year.⁵ The demands of society clearly cannot be met simply by income generated from exports and imports, or from international trade. The imposition of taxes is essential to balance the books of the South African *fiscus*.

At the commencement of the twentieth century, Africa was largely undeveloped, save for certain exceptions in the North, the extreme South and certain ports in Western and Eastern Africa. Europe was substantially developed and more

⁴ Press statement by the Minister of Finance, **Trevor A Manuel on the Preliminary Revenue Results for the Fiscal Year 2005/2006**. www.sars.gov.za. The amount mentioned was the total at midnight on 31 March 2006.

⁵ **Annual Report. Revenue Collection**. www.sars.gov.za.

advanced, as were certain parts of the East. The New World was developing rapidly. Within a century, Africa, and for purposes of this project, South Africa, is nonetheless expected to compete on the international trade market. Whilst the population of South Africa has grown steadily since the nineteen-hundreds, unfortunately, primarily by reason of political and socio-economic policies which were followed and enforced, the development of the individual, intellectual ability of *all* citizens, was not a priority. Particularly the neglect or suppression of education standards of the blacks, which predictably led to group resistance and the development of a protest-society, was hardly conducive to the development of hard-working, wealth aspiring and hence, income generating taxpayers. The development of entrepreneurial skills and financial self-dependence amongst potential taxpayers was not prioritised.

Whilst the extent and total sum of taxes collected by the South African Revenue Services has over the last few years exceeded all expectations, the demand for essential State expenditure has not subsided. One only has to cite the lack of available funds to address the aids pandemic as an example, which is already identifiable as a silent strangler of economic growth. Infrastructural spending on hospitals is clearly required, as is the case with respect to inadequate transport systems and networks.

The relevance of this socio-economic and political background lies herein: in considering the research topic, the harsh South African reality should not and cannot be ignored. On the one hand, care must be taken not to tax the registered tax base unduly. On the other hand, the tax net should be widened rather than narrowed. Once the taxpayer or entity finds himself, herself or itself within or under the net, then the question arises: should moralistic issues or value judgments

play a part when relief is offered to the entrapped taxpayers in the net by way of deductions, or should it not play any part?

Does the Income Tax Act 58 of 1962 (hereinafter referred to as the “*Income Tax Act*”), through its non-moralistic formulation of the accrual and receipt concepts and the definition of “*gross income*” (in section 1), not implicitly suggest that the net should as far as possible be spanned indiscriminately over taxpayers: whether they are preachers, prostitutes, bankers or loan sharks (not used synonymously); doctors and sangomas (traditional healers), assuming the differentiation remains valid; cricket players, match-fixers and gamblers? If an inner city sangoma, or downtown scheming bookmaker, are welcomed as competent taxpayers under the tax net: can the sangoma not claim a travel deduction for having collected his muti (herbs, plants and other ingredients of traditional medicine) somewhere in the hills of his hinterland? Can the bookmaker not claim the actual cost to him, of the bottles of single malt whiskey which he regularly bestows upon trainers, team managers or team captains for “*inside*” information? If not, why not? And what about the costs incurred by the loan-shark who regularly treats department heads and employers on lavish lunches, should he not be allowed the benefit of direct, electronic loan repayments by way of deductions from employees’ salaries? Where should the line (or lines) be drawn? Do societal values not inescapably come into the equation? If so, in which manner, or under what guise? Is it not inevitable that societal *mores* will permeate the legal adjudication process, whether through canons of construction, guidelines of interpretation or by way of the application of substantive common law legal principles, or in some other way? And what about fault? If a taxpaying company generates its income by offering high risk adventure activities, such as bungee-jumping, rafting, scuba-diving or flights by micro-light, should losses actually sustained or damages claims actually

paid by such company, be disallowed simply because the company was negligent, perhaps even grossly negligent in the process?

The need to broaden the tax base in order to raise the tax revenue to be used to meet the social-economic needs of the country would suggest that all types of revenue-generating activities should fall within the tax net, irrespective of questions of morality or legality. Once within the tax net, the question can be asked whether societal values or norms should be used to decide whether or not expenditure incurred in producing the revenue should be disallowed as deductions in arriving at taxable income.

2.3 CONCLUDING COMMENTS

It will be shown in this thesis that the Income Tax Act itself does not provide any clear-cut answers to the topic under discussion. The courts are usually primarily concerned with interpretational issues within a specific statutory context. More often than not, the courts have to decide whether the language of the Income Tax Act allows a particular deduction or not. The broader, quasi-philosophical or theoretical questions usually do not have to be addressed. Not surprisingly, a rather mechanistic approach is usually followed. Admittedly, our courts are not supposed to fulfil the role of academics or economists and do not unnecessarily become embroiled in theoretical issues, particularly when the applicability of a statute is at stake. Nonetheless, the courts have postulated various tests or criteria over the years which have *inter alia* involved principles of morality, *fides* and fault, which are then used to evaluate whether certain expenditures which have been incurred, should be allowed as deductions or not. How satisfactory are these tests or criteria which have, directly or indirectly (or intentionally or

unintentionally) involved *mores*, fault and *fides*? This vexed question is discussed in the chapters that follow.

CHAPTER THREE: INDICATORS IN THE INCOME TAX ACT

The concepts of *mores* and fault are notoriously difficult to define. Fault is largely a common law concept, involving a subjective element, but calling for an objective assessment of the “*directing intention*” or “*mind*” of the subject under evaluation. The *mores* of a taxpaying community does not entail a static concept – it is invariably a dynamic concept which fluctuates and evolves as the community changes and develops. In South Africa, the community *mores* are no longer assessed in the abstract, simply by way of an “*armchair approach*” of a judge (whose own personal background, training and beliefs might differ materially from the beliefs of his brethren or those held by the general public), but are measured against, if not determined by, the Constitution.⁶ However, the community *mores* also constitute a well-known common law concept. In the pre-constitutional era, contracts or arrangements which infringed upon the good morals or values held by society were held to be unenforceable.⁷

3.1 COMMON LAW PRINCIPLES

Before the Income Tax Act itself is evaluated to determine whether any express *indiciae* are provided in the Act regarding the question whether the good morals of a community, or fault (*dolus* or *culpa*) should play any part in determining whether expenditure or losses claimed as deductions, should be permitted or not, it is important to refer to the broader, principled common law background and the current constitutional dispensation. In the constitutional era, a constant re-assessment of existing common law principles is necessary, to ensure that common law principles remain congruent with the principles enshrined in the Constitution.

⁶ The Constitution of the Republic of South Africa, Act 108 of 1996.

⁷ *Sasfin (Pty) Ltd v Beukes 1989 (1) SA 1 (A)*.

In the constitutional setting, all statutory provisions are subject to the supremacy of the Constitution.

At common law, the question whether any particular conduct or arrangement was *contra bonos mores* usually required an assessment of the particular contextual setting of the conduct or arrangement in issue. This is apparent from the judgment in *Ismail v Ismail 1983 (1) SA 1006 (A)*, at 1025 – 1026, where the following self-explanatory passage appears:

Although the phrase *contra bonos mores* is ordinarily used with reference to conduct which is regarded as immoral or sexually reprehensible, it really has a far wider meaning (cf *Grotius* 3.1.42-43, Van der Linden *Koopmans Handboek* 1.14.2; *Aquilius* “Immorality and Illegality in Contract” 1941 SAL vol 58 at 337). *Mores* or *boni mores* (Dutch: “zeden” or “goede zeden”; English: “morals” or “morality” and Afrikaans: “sedes” or “goeie sedes”) can be defined as meaning

“the accepted customs and usages of a particular social group that are usually morally binding upon all members of the group and are regarded as essential to its welfare and preservation”

(see Lewis and Short *Latin Dictionary* sv “*mos*”; Webster’s *Third New International Dictionary* and *The American Heritage Dictionary of the English Language* sv “*mores*”; *Oxford English Dictionary* sv “moral and morality”; Van Dale *Groot Woordeboek der Nederlandse Taal* sv “zede”; Kritzinger and Labuschagne *Verklarende Afrikaanse Woordeboek* sv “sede”; and *Seedat’s* case *supra* at 309 where Innes CJ refers to the “principles and institutions” of our society). I would not regard a polygamous union solemnised under the tenets of the Muslim faith, and the customs related thereto, as being *contra bonos mores*, in the narrower sense in which the expression is ordinarily used, ie as immoral (see *Ngqobela v Sihele* (*supra* at 352) and *Docrat v Bhayat* (*supra* at 127)), but such a union can be regarded as being *contra bonos mores* in the wider sense of the phrase, ie as being contrary to the accepted customs and usages which are regarded as morally binding upon all members of the society or, as Innes CJ said in *Seedat’s* case at 309 “as being fundamentally opposed to our principles and institutions”.

The Constitution not only has a direct effect upon the State, its organs and citizens, but also has an indirect or so-called “*radiating*” effect upon legal relationships in a democratic society. In *Napier v Barkhuizen*⁸ the Supreme Court of Appeal made it clear⁹ that the Constitution and its value system do not confer on Judges a general jurisdiction to declare contracts invalid because of what *they* perceive as unjust. Cameron JA also emphasised that judges do not have the power to decide that contractual terms cannot be enforced on the basis of “*imprecise notions of good faith*”. Yet, it was emphasised that courts will invalidate agreements offensive to public policy, and will refuse to enforce agreements that seek “*to achieve objects offensive to public policy*”. The said Cameron JA continued:

Crucially, in this calculus ‘public policy’ now derives from the founding constitutional values of human dignity, the achievement of equality and the advancement of human rights and freedoms, non-racialism and non-sexism.¹⁰

If one accordingly has regard to the Income Tax Act itself, particularly to the question whether specific expenditure which was incurred in an alleged “*trade*”, (whether perceived to be of a dubious nature or not) should be allowed or not, the answer may be affected by the “*radiating*” effect of the Constitution. Consequently, whilst certain expenditure might not have been admissible as a deduction twenty or thirty years ago, it is conceivably possible that by reason of the new constitutional values, such expenditure may now constitute a legally permissible deduction. In particular, the Constitution emphasises principles of equality, freedom of activity (subject to the limitation clause) as well as tolerance and accommodation of individuals.

⁸ **2006 (4) SA 1 (SCA).**

⁹ In paragraph 7 on page 6 of the judgment.

¹⁰ Paragraph 7 on page 7 at B of the judgment.

3.2 THE INCOME TAX ACT

Not surprisingly, the Income Tax Act itself does not contain any direct reference to the fault-concept. Fault remains largely a well-established, common law concept. By its very nature, the “*mores*”-concept is not readily defined in statutes, with the exception of the Constitution, which contains certain fundamental rights and minimum community values. The present Income Tax Act (58 of 1962) consolidated the income tax legislation dating from 1941 to 1961. The Income Tax Act, as amended, not only levies income tax (including Secondary Tax on Companies), but also donations tax¹¹ and capital gains tax.¹² The income tax payable by a taxpayer is based on “*taxable income*”, defined in section 1 of the Act as:

. . . the aggregate of:

- (b) the amount remaining after deducting from the *income* [own emphasis] of any person all the amounts allowed . . . to be deducted from or set off against such income . . .

“*Income*”, in its turn, is defined in section 1 of the Act as:

. . . the amount remaining of the *gross income* [own emphasis] of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax . . .

Certain amounts are exempt from normal tax on the basis of either the nature of the person (for example, public benefit organisations, the government and provincial

¹¹ Donations tax is levied in terms of Part V of the Income Tax Act.

¹² Capital gains tax and losses are determined in the manner as is prescribed in the Eighth Schedule to the Income Tax Act.

or local authorities), or on the basis of the nature of the income (for example, disability pensions or grants or social pensions). “*Gross income*” is defined in section 1 of the Act as:

. . . the total amount, in cash or otherwise, received by or accrued to or in favour of a resident [in the case of a non-resident, only amounts received or accruing from a source within, or deemed to be from a source within the Republic] . . ., excluding receipts or accruals of a capital nature [which are included directly in taxable income] . . .

Receipts or accruals are either of an income or capital nature.¹³ This distinction, as well as the various instances of exempt income specified in the Act, are not considered in this thesis. Private or household expenses are very real expenses in daily life, which are undoubtedly “*actually*” incurred by all and sundry. However, section 23(a) and section 23(b) make it clear that the costs of maintaining “*any taxpayer, his family or establishment*” as well as “*domestic or private expenses*” are not allowed as deductions.

The phrase “*carrying on any trade*” forms the core element of section 11(a). Section 11(a) provides as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

(b) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature; . . .

¹³ “*There is no half-wayhouse*” vide: ***Pyott Ltd v CIR 1945 AD 128*** at 135.

For purposes of determining the taxable income derived by a taxpayer from carrying on any trade,¹⁴ before one has regard to the individual elements contained in section 11(a) of the Act, the question therefore needs to be asked: what does the concept “*trade*” entail? “*Trade*” is defined as follows:

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

It is clear from this definition that it is a wide concept which has not been exhaustively defined (this is apparent from the use of the word “*includes*”). In ***Burgess v CIR 1993 (4) SA 161 (A)***, the Appellate Division held that if a taxpayer pursues a course of conduct which constitutes the carrying on of a trade, the taxpayer would not cease to be carrying on such trade merely because one of the taxpayer’s purposes, or even his main purpose, in doing what he does, is to obtain some tax advantage; if he carries on a trade, his motive for doing so is irrelevant. Thus, the test is essentially one of fact. The definition should not be interpreted restrictively, but should rather be given the widest possible interpretation. The trade may even be carried on in the knowledge that losses may result.¹⁵

On the income or revenue side, the Act does not provide express indications that the common law concepts of *mores*, *fault* and *fides* are of relevance in evaluating

¹⁴ As defined in section 1 of the Act. There is allowed as a deduction from the income so derived “*expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature*”.

¹⁵ ***CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A)***.

whether receipts of accruals constitute gross income. As will be shown below, particularly in respect of the so-called theft cases, issues of moral turpitude and fides have had to be considered on evaluating the question whether proceeds from dubious sources or origin constitute gross income. However, fault, particularly negligence, is usually entirely irrelevant on the revenue side. If certain activities *prima facie* generated receipts or accruals of a revenue nature, this will *prima facie* have to be accounted for as gross income. The “*gross income*” definition contains a generalised widely formulated introductory part and “*without in any way limiting the scope of this definition*” identifies numerous specific receipts or accruals which also fall under the definition of “*gross income*”, namely in subparagraphs (a) to (m) of the definition of “*gross income*”.

Insofar as the legislature has used the words “*cash or otherwise*”, this is a clear indication that a disclosed benefit which may be turned into money, or has a value in money, will also constitute income. The definition does not exclude receipts, whether “*cash or otherwise*”, or accruals of an illegal or unlawful nature. To the contrary, *ex facie* the wording of the Act, the definition would be operative irrespective of the fact that the proceeds are derived from an activity, business or scheme which is unlawful or in contravention of a specific prohibition. This approach is born out by the decisions in *CIR v Delagoa Bay Cigarette Company Ltd 1918 TPD 319*, and *Morrison v CIR 1950 (2) SA 449 (A)*, which decisions are discussed in chapter four of this thesis.

The definition of “*gross income*” in section 1 of the Income Tax Act is a lengthy one. However, the definition provides little or no indication of the possible relevance of the *mores*-concept, or of the possible relevance of fault. The amount of gross income which is received by, or has accrued to a resident, whether in cash or otherwise, constitutes the resident’s gross income. In the case of any person

other than a resident, the total amount in cash or otherwise received by or accrued to, or in favour of such person from a source within or deemed to be within the Republic, constitutes gross income. Receipts or accruals of a capital nature are excepted. However, amounts which are received irrespective of whether the amounts are of a capital nature or not, as described in paragraphs (a) – (n) of the definition, are included in the concept of gross income. *Ex facie* the Income Tax Act, an objective, factual inquiry is called for to determine whether expenditure or losses incurred constitute permissible deductions in terms of the Act, in terms of section 11(a) as read with section 23(g) of the Act. It is during the interpretation process, and the application in particular factual settings of the provisions of the Income Tax Act, that principles of morality, *fides* and the fault concepts might become, or have already been regarded, as being of relevance.

Allowable deductions are provided for in various specific sections of the Act. The main sections of the Act which govern deductibility are found in what is referred to as the “*general deduction formula*”, comprising the preamble to section 11, section 11(a), already quoted above, and section 23(g) of the Act. Section 23(g) of the Act provides as follows:

No deductions shall in any case be made in respect of the following matters, namely –

- (h) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade; . . . (section 23)

Neither the word “*expenditure*”, nor the word “*losses*” have been defined in section 1 of the Act. **Meyerowitz**¹⁶, paragraph 11.31, correctly contends that the

¹⁶ Meyerowitz, D. (2005, 2006 Ed) *Meyerowitz on Income Tax*. Cape Town: The Taxpayer,

distinction between the two words is of no particular importance in relation to deductions. Emphasis must be placed on the word “*any*”, which precedes the concepts “*expenditure and losses*”. The manner in which the expenditure or losses were incurred, *prima facie* appear to be irrelevant, as long as the expenditure and losses were *actually* incurred. The legislature did not state that the expenditure or loss should have been incurred in a profit generating trade, or by an efficient business. To the contrary, as long as the expenditure or losses were actually incurred, it would *prima facie* meet the requirement postulated by section 11(a) of the Income Tax Act. This requirement is particularly relevant to the topic under consideration.

Before any deduction of expenditure or losses may be allowed, such expenditure or losses should have been incurred “*in the production of income*”, as defined. The corollary to section 11(a) is section 23(g), which provides expressly that no deduction of any monies is admissible which have not been laid out or expended “*for the purposes of trade*”. Both requirements must accordingly be satisfied. It has already been pointed out above that the expenditure may still qualify as a deduction, even though the taxpayer does not expect to make a profit in regard to a particular expenditure. However, in such an event, the taxpayer will have to establish that the expenditure incurred was so connected with the pursuit of the taxpayer’s trade, to justify the conclusion that despite the lack of profit motive, the monies paid out under the transaction were expended for the purposes of trade.¹⁷

The requirement that a particular expense or loss should have been incurred “*in the production of the income*” has been further interpreted and “*fleshed out*” by the

paragraph 11.31.

¹⁷ *De Beer’s Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A)*.

Courts. Three well-known, and often quoted, decisions are of particular relevance to the topic of this dissertation, namely:

Port Elizabeth Electric Tramway Company Limited v CIR 1936 CPD 241,

Joffe & Company (Pty) Ltd v CIR 1946 (AD) 157,

Sub-Nigel Limited v CIR 1948 (4) SA 580 (A).

In the *Port Elizabeth Electric Tramway Company Limited* decision, Watermeyer AJP expressed the view that the *nexus* between the expenditure and the act concerned will be sufficiently close if the expenses had been incurred as part of the performance of a business operation *bona fide* conducted for the purpose of earning income. Such expenditures would be deductible, provided they are so closely connected with the required purpose, that the expenditure or loss may be regarded as part of the cost of performing it. Neither fault nor the *mores* of the community were identified as being relevant criteria, but *fides*, particularly *bona fides* in the sense as used above, was elected as the yardstick. This decision is further evaluated below. In the *Joffe* decision, Watermeyer, now CJ, stated that the expenditure, or the act which gave rise to the expenditure, had to be a “*necessary concomitant*” of the business operation. Upon a careful reading of this judgment, it is clear that the fault of the taxpayer, a construction company, which negligently caused the death of workman through faulty construction, did play a decisive role in the judgment. Watermeyer CJ implicitly did regard fault as a relevant criterion in assessing whether the particular expenditure was deductible. On the facts, he held that his newly postulated test was not satisfied, as there was insufficient evidence to show that the taxpayer’s method of conducting its business necessarily led to accidents.

In the *Sub-Nigel* decision, *supra*, a more factual or objective criterion was applied. It was held that expenditure actually incurred would still qualify as a deduction, even though no income was produced. Provided that the expenditure was incurred “*for the purpose of earning income*” the requirement could be satisfied.

The last element of section 11(a) provides that the expenditure and losses are not allowed if such expenditure and losses are of a capital nature. This requirement is of lesser relevance to the topic under discussion.

Section 23(d) expressly forbids the deduction of any tax, duty, levy, interest or penalty imposed under the Act, any additional tax imposed under section 60 of the Value-Added Tax Act 89 of 1991, any interest or penalty payable in consequence of the late payment of any tax, duty, levy or contribution imposed in terms of specific enactments. In this respect, the negligence or perhaps the deliberate default of taxpayers are directly addressed.

The *mores* of the community, as well as policy principles, clearly played a role in the introduction of section 23(o), which came into effect from 1 January 2006 and which provides as follows:

23 No deductions shall in any case be made in respect of the following matters, namely –

- (o) any expenditure incurred –
 - (i) where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No 12 of 2004); or

- (ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic.

The prohibition in section 23(o)(i) might be regarded as being superfluous, in the light thereof that the *contra bonos mores* principle should stand in the way of any deduction claimed of the nature as specified. Quite understandably, the legislature, however, wanted to leave no room for any doubt to prevail in this regard, by inserting this particular subsection.

The wording of section 23(o)(ii) is significant. It should be noted that only a “*charged fine*” or a “*penalty imposed*” are specified. The subsection does not refer to any other expenditure which might otherwise have been actually incurred in the process of conducting an unlawful business or “*trade*”. It would have been a simple matter for the legislature to have expressly ruled out an unlawful activity or business as constituting a “*trade*” for purposes of the Act. This has not occurred. Hence, it is submitted that in terms of ordinary principles of interpretation, insofar as only “*finis charged*” or “*penalties imposed*” have been referred to, that other expenditure or losses which were actually incurred “*in the production of income*” and which are not of a capital nature, but which otherwise meet the legal requirements, are still claimable, irrespective of the fact that such expenditure or losses may have been incurred during the course of an unlawful activity.

The interpretation of the concepts “*a fine charged*” or “*penalty imposed*” (“*as a result of an unlawful activity*”) in section 23(o)(ii) will foreseeably result in future court disputes. None of the individual words – which all appear to have a relatively straightforward meaning when used independently or separately – are defined in section 1 of the Act. Contextually, what is the meaning of the concept

“*a fine charged*” and which meaning should be given to “*a penalty imposed*”? Is a formal process and specifically a court process presupposed, or not?

The word “*charged*” seemingly suggests some form of a formal indictment, but not necessarily an actual conviction. It was held in *Bate v Regional Magistrate, Randburg 1996 (7) BCLR 974 (W)*, that the word as used in section 25(3) of the 1993 Constitution (Act 200 of 1993), is not restricted to the official notification given to an accused by a competent authority, but the word used in that context relates to an arrested person’s right to be charged or informed of the reason for his detention. A more narrow interpretation of the word, used in the same context as mentioned before, was given by the court in *Du Preez v Attorney-General, Eastern Cape [1997] 1 All SA 713 (E)*. It was held that the plain meaning of the word refers to a “*formal accusation upon which a person is brought to trial*” and that a person is only so “*charged*” when informed that a competent authority has decided to prosecute him.

Two rules of interpretation may come into the equation during the interpretation process. The *contra fiscum* rule may come into conflict with the so-called “*mischief rule*”. The *contra fiscum* rule represents an interpretational aid in the event of the ambiguity of a statutory provision which makes inroads on the rights of the individual. In such an event, the ambiguity must be resolved in favour of the individual (or taxpayer) whose rights are thereby diminished. The “*mischief rule*” applies to any statutory provision designed to suppress a particular form of mischief which the legislature perceives as harmful to the public interest (see: **Steyn, L.C, (Fifth Edition). Die Uitleg van Wette**, chapter II, page 22 and further).

It is submitted that the intention of the legislature is at least clear in one material respect: only specific “*finer*” and specific “*penalties*” which were “*charged*” or “*imposed*” as a result of unlawful activities are prohibited. The deduction of all “*finer*” and all “*penalties*” are not so prohibited. The particular “*fine*” or “*penalty*” (which words themselves are also open to more than one meaning) should constitute a fine or penalty of a specific nature, namely the fine should have been “*charged*” and the penalty should have been “*imposed*”, not for any general reason, but specifically “*as a result of an unlawful activity*”. It is submitted that the lastmentioned words suggest that some adjudicator or judicial body should have concluded or have arrived at a finding that a “*fine*” had to be “*charged*” or that a “*penalty*” had to be “*imposed*” as a result of an unlawful activity as envisaged. Should the adjudicating body responsible for the imposition of the penalty or the charging of the fine, be a court of law, or is this not necessary? It may further be questioned whether the payment of a fine or a penalty consequent upon the receipt of a written demand or notice (for example, the notification of an alleged offence completed by an official on a pre-printed form or summons) would bestow upon such fine or penalty the status of being a “*fine charged*” or a “*penalty imposed*”?

More than a hundred years ago, Field J held, in the (English) decision of ***R v D'Eyncourt (1888) 21 QBD 109*** at 119, DC, as follows:

I am of the opinion that the word “*charged*” must be read in its known legal sense, namely, the solemn act of calling before a magistrate an accused person and stating, in his hearing, in order that he may defend himself, what is the accusation against him.

The involvement of a court was therefore required in such context in which the word “*charged*” was used, even at the preliminary stage, before any adjudication process had taken place.

The ordinary meaning of the word “*fine*” is that a fine is a financial penalty which is imposed for a crime that has been committed. The legislature created this form of punishment mainly as a punishment for lesser offences and as an alternative to imprisonment. The purpose of a fine is to be found in the fact that it punishes the offender without detaining him. It is usually imposed with alternative imprisonment, in other words imprisonment which becomes operative upon failure to pay the fine (see: **Du Toit, E, *et al.* Commentary on the Criminal Procedure Act: Cape Town, Juta**, particularly the commentary on section 287).

A penalty, the amount of which was arbitrarily fixed by an official after the contravention of a regulatory by-law (which may well constitute an unlawful activity), does not in the view of the writer constitute a penalty “*imposed*” as a result of an unlawful activity, within the meaning of section 23(o)(ii) of the Act. In the context of section 23(o)(ii), a formal court process is in the view of the writer contemplated, resulting in the imposition of the penalty. It is accordingly submitted that in the context of section 23(o)(ii), the penalty which is being contemplated, is not merely a penalty which may have been imposed by an administrative official, but a penalty which was imposed by a court of law.

Especially in the light of the material fact that the legislature did not prohibit the deduction of all fines and all penalties relating to, or in connection with, unlawful activities generally, a narrow and technical interpretation of these concepts are in the writer’s view called for, particularly as they appear in a revenue statute. It is submitted that a court, or at least an official judicial tribunal, must first be interposed to decide upon the link with the unlawful activity, whereafter the contemplated fine should be “*charged*” or the penalty be “*imposed*”.

That a causal *nexus* must have been found to exist “*resulting in*” the “*fine charged*” or the imposition of the penalty, is a further necessary element which must be satisfied, before this particular statutory prohibition of deductions of this nature, is activated.

In principle therefore, as long as the business or activity which is conducted constitutes a “*trade*” as is envisaged by the preamble of section 11, it can still give rise to valid claims for deductions. However, the *contra bonos mores* concept also remains alive and well in South Africa. Although the Act therefore does not expressly or generally rule out the deductibility of losses or expenditure actually incurred during the course of unlawful trading activities, the courts may bring this well established common law concept or limitation into the equation.

Indubitably however, section 23(o) does introduce or impact upon considerations of morality and good (or bad) faith.

However, *ex facie* the Act itself, the deductions permitted by the current statute are not made to depend on the question of legality or illegality, which is also the position with respect to the treatment of receipts or accruals.

In the context of avoidance provisions, fault or intention, as well as morality are clearly relevant, which is apparent even from a cursory perusal of the wording of section 103. However, the *fiscus* must bring itself within the ambit of the language used in the Income Tax Act, to rely upon the anti-avoidance provisions, such as the provisions of section 103 of the Income Tax Act. Subsection 103(1)(b) is of some relevance to this study, and provides:

Whenever the Commissioner is satisfied, that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including transaction, operation or scheme involving the alienation of the property) -

a)

b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out-

i) was entered into or carried out-

(aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question.

The application of the business purpose test to a particular set of facts necessarily introduces the concept of *fides*, which in turn immediately renders considerations such as the community convictions and morality, relevant. The normality or abnormality test also invariably renders principles of good faith and the Court's *perception* of established business norms, relevant. The arm's length criterion contained in subsection 103(1)(b)(ii), also inevitably calls for a moralistic, judgmental assessment. In this sense, the Income Tax Act itself contains provisions which impact *directly* upon principles of morality and *fides*.

3.3 CONCLUDING COMMENTS

However, it has been shown above that the definitions of direct relevance to the income or revenue side, such as the definitions of “*gross income*”, “*income*” and the undefined concept of a “*trade*”, do not expressly incorporate or exclude accruals or receipts which emanate from either illegal or unlawful activities. Whether the *modus operandi* of a thief constitutes a “*trade*” giving rise to taxable income, is a more complex question. In principle, the definition of “*trade*” includes every profession, trade, business, employment, calling, occupation or venture. In South Africa, the revenue authorities have in practice certainly not turned a blind eye to irregular activities or illegal schemes. Whether or not profit was *bona fide* being pursued, or whether a “*trade*” was still being conducted even though a loss was actually foreseen, are also irrelevant, from a purely interpretational perspective. On the deduction side, the legislature has also elected not to expressly refer to morality issues, fault or good faith. Imprudence, negligence or bad faith, are not addressed at all in section 11. With the exception of section 23(d) and the recently introduced section 23(o) which do impact upon morality and *fides* considerations, these considerations are also not directly addressed in section 23 of the Act.

In the next chapter, the role which the courts have played in rendering these societal values or considerations contextually relevant is accordingly discussed.

**CHAPTER FOUR: HAVE THE COURTS REGARDED *MORES, FIDES*
OR FAULT AS RELEVANT WHEN DEDUCTIONS ARE CLAIMED?**

In the previous chapter, it was shown that the Act itself is essentially silent (with the exception of certain specific provisions contained in section 23 of the Act), on the question whether *mores*, fault and *fides* are relevant factors from a deduction perspective. It accordingly becomes necessary to evaluate the role which the courts have played in rendering or treating these considerations as relevant. As will be shown below, the negligence and honesty or dishonesty of taxpayers or their employees, morality issues and the good faith of taxpayers, have been *treated* as relevant considerations by the courts. This has occurred both in England and in South Africa.

4.1 CASE LAW RELATING TO INCOME

In the context of avoidance mechanisms, it is clear that English income tax cases reflect that morality, particularly the *mores* of community as interpreted by the Law Lords or judges, have played a major role in this regard. Lord Greene MR, stated in the decision of *Lord Howard De Walden v Inland Revenue Commissioners [1942] 1 KB 389*¹⁸ that:

For years a battle of manoeuvre has been waged between the legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle the legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present appellant has not been the least successful. It would not shock us in the least to find that the legislature has determined to put an end to the struggle by imposing the severest of penalties. It

¹⁸ At page 397.

scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.

In 1943 Viscount Simon LC, in the case of *Latilla v Inland Revenue Commissioners* [1943] AC 377,¹⁹ said:

My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are “entitled” to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres.

In 1949, Lord Normand, in the case of *Vestey’s (Lord) Executors & another v Inland Revenue Commissioners* [1949] 1 All ER 1108²⁰, made the following comment:

Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be

¹⁹ At page 380 and 381.

²⁰ At page 1120.

the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved.

However, examples can also be cited of decisions in the United Kingdom in which a less moralistic approach was followed. In *Mann v Nash* [1932] 1 KB 752; [1932] All ER Rep 956 the taxability of profits derived from illegal amusement activities was in issue. In the course of his business as an amusement caterer, the Applicant had provided licensed victuallers and others with automatic machines, to be used in unlawful gaming. It was found that although the profits derived from the transactions constituted the profits from an illegal trade, they were nonetheless taxable. The profits that were realised from the resale of certain of the machines, were also held to be taxable on the somewhat tenuous ground that only the use of the machines, and not their possession, was illegal.

Another example of the unmoralistic approach, is the decision in *Southern v AB*, *Southern v AB Ltd* [1933] 1 KB 713; [1933] All ER Rep 916. The Respondents in this matter had carried on betting businesses which were unlawful. The Court held that they were engaged in a “trade” within the meaning of the 1918 (English) Income Tax Act. That being the case, the fact that the trade was illegal did not prevent the profits arising therefrom from being assessable to income tax.

In the interesting matter of *IRC v Aken* [1990] 1 WLR 1374; [1990] STC 497, the assessment of a prostitute’s earnings for income tax was in issue, albeit in a very specific procedural context. Procedurally, an agreement had been reached pursuant to the Taxes Management Act 1970, section 54, regarding the amount payable. The agreed amount was however, not paid by the prostitute and judgment was entered against her. On appeal, the issues were twofold, namely whether the taxpayer was entitled, in collection proceedings, to raise the defence that the profits of prostitution were not chargeable to tax. Secondly, if she was entitled to raise

such a defence *after* judgment had been entered, during collection proceedings, whether such a defence constituted a sound defence in law? It was held that the agreement which had been reached constituted a binding agreement for good consideration which was accordingly enforceable as such. The contention that the inspector had acted *ultra vires* because he was allegedly not entitled to have raised the assessments, was dismissed. It was found that this argument should have been raised on appeal against the assessment and could not be raised after judgment, during the collection proceedings. In proceedings such as those that were before the Court, it was only very exceptionally open to a taxpayer to bring a challenge which would then involve judicial review. The Court furthermore found that prostitution was not itself illegal. Therefore, it was not necessary for the Court to decide whether profits from an illegal trade were taxable. The appeal of the taxpaying prostitute failed in the circumstances²¹.

In the erstwhile Rhodesia, MacDonald JP moralistically agreed that the avoidance of tax is “*an evil*” in the decision of *COT v Ferera 1976 (2) SA 653 (RAD)*. After quoting with approval from the above decisions, he states as follows:

I endorse the opinion expressed that the avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the *fiscus*, but the effect must necessarily be to cast an additional burden on taxpayers who, imbued with a greater sense of civic responsibility, make no attempt to escape, or lacking the financial means to obtain the advice and set up the necessary tax-avoidance machinery, fail to do so. Moreover, the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that ‘good citizens’ will always fare badly.

²¹ If only all South African prostitutes would have been so patriotic as **Aken**, who seemingly did her bit for Queen and country.

While undoubtedly the short term effects of the practice are serious, the long term effects could be even more so.²²

It was pointed out in the previous chapter that the Act itself contains a wide, non-moralistic definition of “*gross income*”. The Act does not, for example, prohibit the taxation of income generated by prostitutes, loan-sharks, pyramid-scheme operators, gamblers or professional mercenaries. The “*allowances*” received by professional soldiers venturing into Sierra Leone or Liberia, are as taxable as the income generated by “*call-girl*” agencies. That statutory provisions or the common law may have been contravened in the process of generating income from such nefarious practices, is largely immaterial from an accrual/receipt perspective. The *fiscus* is not a moralist and will insist upon his pound of flesh, so to speak, irrespective of whether the particular activity which generated the receipt or accrual, might have transcended the law. This is certainly not a modern day development.

As long ago as 1921, Rowlatt J stated in the decision of *Cape Brandy Syndicate v IRC (1921) 1 KB 64* that:

[I]n a taxing act, one has to look merely at what is clearly said: There is not room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

23

²² Page 656 at F.

²³ On page 71 of the decision. This dictum was *inter alia* approved in *CIR v Frankel 1949 (3) SA 733 (A)* at 738.

In *CIR v Simpson*²⁴, Centlivres JA reflected upon the aforementioned dictum in the *Cape Brandy Syndicate* case, *supra*, and stated that the rule should perhaps be qualified by saying that even in taxing statutes, something may have to be implied by necessity. In the matter of *CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A)*, Corbett JA stated²⁵, after referring to the foregoing assertion that “*there is no equity about a tax*”, that a measure of satisfaction is still to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the *fiscus* and that it could be inferred that such a result would be in conformity with the intention of the legislature.

That income derived from an unlawful source does not result in the non-taxability of such income, is aptly demonstrated by the decision in *Commissioner of Inland Revenue v Delagoa Bay Cigarette Company Ltd 1918 TPD 391*. The said cigarette company had sold packets of cigarettes which included coupons entitling purchasers to take part in certain monthly distributions of prizes or dividends. Winning vouchers were advertised and the distributions included prizes ranging from £ 2000 to £ 2. The Commissioner (who was the applicant) was of the opinion that the prize dividends were taxable income. On behalf of the cigarette company, it was argued that the amount available for each monthly distribution constituted a trust fund which did not form portion of the company’s assets. It was pertinently contended on behalf of the cigarette company that the business of the company was illegal and that “*the Applicant cannot come to court and ask to participate in an illegal business or lottery. Income tax is only claimable in respect of a legal business*”.²⁶

²⁴ *CIR v Simpson 1949 (4) SA 678 (A)* at 695, and see also *Dibowitz v CIR 1952 (1) SA 55 (A)* at 61.

²⁵ At page 958 of the judgment in *Nemojim*, *supra*.

²⁶ See the summary of argument of the legal representative for the cigarette company, on page 393 of the judgment.

Bristowe J was not persuaded and found as follows on page 394:

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, and after making the prescribed calculations and deducting the exemptions, abatements and deductions enumerated in the statute. The source of income is immaterial. This was so held in *Partridge v. Mallandaine* (18 Q.B.D. 276), where the profits of a betting business was held to be taxable to income tax; DENMAN, J., saying that “even the fact of a vocation being unlawful could not be set up against the demand for income tax”. If the income itself is taxable it follows I think that if the prizes would have been a legitimate deduction if the business is illegal, they would equally be a legitimate deduction if the business is legal. The deductions permitted by our statute are not made to depend on any question of legality or illegality; and in *Partridge v. Mallandaine* it was not suggested that betting losses could not be deducted. Indeed it seems common sense that if illegal profits are taxable they must be subject to the same deductions as if they were legal.

These sentiments are logical and straightforward. However, as will be demonstrated further below, it is submitted that an equitable, even-handed approach has not consistently been demonstrated with respect to the admissibility of deductions, as contrasted with the welcoming manner in which revenue receipts originating from moralistically questionable sources have been accommodated under the tax net.

An appellant’s winnings which had arisen from betting activities which formed part of his racing business, also attracted normal tax, “*super*” tax and excess profits duty in the decision of *Morrison v Commissioner for Inland Revenue 1950 (2) 449 (AD)*. The Appellate Division approved of the approach which had been adopted by the court *a quo*, which apparently “*went straight to the definition of*

gross income, without considering whether his betting activities constituted a 'trade, business ... calling, occupation or venture' within the definition of 'trade' in sec. 7 of the prevailing Act". Schreiner JA, who delivered the judgment on behalf of the full bench of the Appellate Division, approved of this straightforward approach, as follows:

The learned JUDGE-PRESIDENT concluded that because monies which the appellant received from making bets were the proceeds of the employment of wits and his money they were not of a capital nature and therefore fell within the definition of "gross income". It was only when it came to considering the appellant's liability to pay the Excess Profits Duty that the learned JUDGE-PRESIDENT investigated the question whether the appellant's betting activities constituted a "trade"; and he then held that they did. It is difficult to find fault with this line of approach, which, logically, has much in its favour. There is, however, the disadvantage that it might involve, unnecessarily, consideration of the question whether money won by isolated bets does not also fall within the definition of "gross income", in which event it would perhaps be difficult to escape the conclusion which might be inconvenient, that no account could be taken, in the taxpayer's favour, of his isolated betting losses. This appeal can, and in my opinion should, be decided without examining the question whether in all circumstances monies won by betting constitute "gross income", because if the appellant's betting activities fell within the definition of "trade" it is not in dispute that he was correctly assessed for Normal and Super Tax and for Excess Profits Duty.²⁷

Since these decisions, a number of cases have been decided which relate to income derived from illegal activities. The matters of *COT v G 1981 (4) SA 167 (ZA)* and *ITC 291, 7 SATC 335* both related to the misappropriation of funds. *ITC 1545, 54 SATC 464* dealt with the proceeds of stolen diamonds, whilst *ITC 1624, 59 SATC 373* (which decision is discussed more fully below) dealt with a matter in which customers of the taxpayer had been overcharged. In these cases, the main question

²⁷ On page 454.

turned on whether or not the amounts were received by the taxpayers for their own benefit and therefore had to be included in gross income, or whether the taxpayers incurred a concomitant liability to repay the amounts and did not directly involve considerations of *fides, mores* or fault.

The sentiments expressed by the President of the Court, Scott J, in *ITC 1545, 54 SATC 464* are nonetheless relevant to this thesis in a number of respects. The Appellants were the trustees in the insolvent estate of the taxpayer. During the trial of the taxpayer on charges of theft and dealing in uncut diamonds, a revenue inspector had sat in Court and had taken notes and later obtained copies of certain portions of the typed record of the proceedings. The admissibility of the record of the criminal court proceedings in the Special Income Tax Court, constituted one of the major evidential points in issue. On the basis of the evidence of some of the witnesses who had testified at the trial, the Commissioner for Inland Revenue had issued additional assessments for three tax years, in which he had included an amount representing the profits which were realised from the buying and selling of stolen diamonds. In respect of two different financial years, the Commissioner had included in the taxpayer's taxable income an amount of R 1 000 000.00, being the profit which the taxpayer had made from the sale of dried milk cultures to a company which he controlled. As far as the taxpayer's profit derived from the purchase and sale of stolen diamonds was concerned, it was common cause at the hearing that the taxpayer was aware of the fact that the diamonds which he had purchased and sold at a profit, had been stolen and that his conduct amounted to theft. It was also common cause that the proceeds of the sales amounted to a "*receipt or accrual*" within the meaning of the definition of "*gross income*" in section 1 of Act 58 of 1962. This was accordingly not a case in which there had been no receipt, but merely a "*taking*" by a thief. Somewhat ingeniously, it was submitted on behalf of the taxpayer that by reason of his conduct which had

amounted to theft, he had rendered himself liable to the owner of the diamonds for the return of the diamonds or their value. This liability, so it was argued, constituted an inseparable and necessary concomitant of the “*trade*” of dealing in stolen diamonds. It was further contended that as this liability had arisen immediately at the time of 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 this regard, it is relevant to point out that the owner of the diamonds did indeed institute proceedings against the taxpayer arising out of the transactions in question.)

It was contended on behalf of the taxpayer that the Commissioner could only assess the Appellant once the *quantum* of the owner’s claim had been determined. The Commissioner disagreed and contended that whatever the taxpayer’s liability to the owner of the diamonds might turn out to be, such liability would not constitute deductible expenditure incurred in the relevant years of assessment. The point was made that in order to be deductible, the liability had to be one which is definite and absolute and not one which is merely contingent. This contention succeeded. In the circumstances, the potential liability did not constitute “*expenditure....actually incurred*” within the meaning of section 11(a) of the Act. The implicit acceptance by the representatives of both parties and by the Court that the illegal nature of the income and the immoral manner in which such income was realised, did not detract from the taxability of the profits and could *in principle* also give rise to valid deductions, is the real point of significance for this thesis.

With respect to the profits which were generated from the dried milk culture scheme, it was contended that this scheme constituted a “*lottery*” in terms of section 2(1) of the Gambling Act 51 of 1965. It was accordingly contended that the sales in pursuance of which the “*growers*” were paid for their crop, were void

ab initio. It was held by the Court that the amounts which were paid to the growers for their “*milk culture*”, nevertheless constituted amounts “*received*” by them in terms of the definition of “*gross income*” as defined in section 1 of the Act.

After emphasising the distinction between “*receipts*” and “*accruals*”, and referring to the requirement that a “*receipt*” by a taxpayer implies a receipt on his own behalf and for his own benefit, Scott J proceeded as follows²⁸:

Indeed, it could never have been intended that an amount received on behalf of another should fall within the gross income of the recipient. Where, however, an amount is received by a taxpayer on his own behalf and for his own benefit but in pursuance of a void transaction there seems to me to be no reason for holding that such amount is not ‘received’ within the meaning of the section, if that word is to be given its ordinary literal meaning. Not to do so could lead to anomalies. It would mean, for example, that if a trader were to sell his goods on a Sunday in breach of a local by-law, the price paid to him would not be ‘received’ by him and would not form part of his gross income. I can find nothing in the Act to justify such a construction; nor was any basis suggested by counsel for limiting the meaning of the word ‘received’ in this way. The mere fact that the receipt was the consequence of a void transaction is no reason for ignoring it. Indeed, it does not follow that because a contract is prohibited by statute and therefore void *inter partes*, it is to be totally disregarded and all the consequences flowing from it ignored.

It was accordingly held that the amounts which had been paid by the company to the “*growers*” for their “*milk culture*”, constituted amounts “*received*” by them as envisaged by the definition of “*gross income*” in section 1 of the Act.

In *COT v G*, *supra*, the *obiter* distinction between “*taking*” (or appropriating) something and “*receiving*” something, which was drawn by Lord Denning in

²⁸ On page 474.

Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd 1963 AC 1, was referred to with apparent approval. The validity of such a distinction is questionable.

A thief who steals money appropriates such moneys for himself. He acts not only deliberately, with *dolus*, but also has the *animus dominandi* (that is, to act as owner of the stolen moneys). The finding of Fieldsend CJ in *COT v G*, (*supra*) (with whose judgment Baron JA and Goldin AJA concurred), that the word “received” cannot be extended to cover a unilateral act such as theft, is in my view unsatisfactory. No explanation or reasoning is furnished, from an interpretational perspective. The implicit imputation to the Legislature of such a restrictive legislative intent, is not properly motivated. Even more unsatisfactory is the view expressed by Fieldsend CJ²⁹, that:

(W)hether or not the respondent in this appeal received the money on his own behalf and for his own benefit must depend not only on his own intention but on the intention of the person who passed the money to him.

(own emphasis)

No one “passes” money to a thief. More importantly, the suggestion that the giver must intend the result (of appropriation as well) seems contrived. Even the Shorter Oxford Dictionary³⁰ meaning of the concept “to receive” quoted in the Court’s decision, calls for a mere objective, face value test. Obviously, whether the receipt is of an income or capital nature, might necessitate a more “subjective” evaluation of the receipt and of the intention of the recipient taxpayer. (*CIR v Leydenberg Platinum 1929 AD 137*).

²⁹ At page 171 B to C.

³⁰ At page 169 F of the *COT v G* judgment.

The purported reliance by the Zimbabwean Court of Appeal in *COT v G, supra*, on the decision in *Geldenhuis v CIR 1947 (3) SA 256 (C)*, was also misplaced, as the position between a usufructuary who knows that she is a mere holder of a servitudinal right, and not the owner, and has no intention to steal or appropriate the proceeds of a sale – which the Court found were not sold by her *qua* usufructuary – cannot be equated with a thief who steals the funds for himself.

The words “*received by or accrued to*” do require, according to various decisions, a receipt by, or an accrual to, the taxpayer on his own behalf or for his own benefit. *Vide: Secretary for Inland Revenue v Smant 1973 (1) SA 754 (A)* at 764 B – C. However, it is submitted that this requirement was satisfied by the thieving taxpayer in *COT v G, supra*. If the emphasis is placed on the question whether the receipt or proceeds of the illegal activity has the quality of “*income*” in the hands of the scheming taxpayer or thief, instead of concentrating on public policy principles or societal values, the difficulty to tax such receipts or proceeds might well fall away.

It appears from the foregoing cases that the particular facts may be decisive in determining whether the illegal activities concerned should be regarded as constituting a “*trade*” or not, so that each case should therefore be separately adjudged.

In *ITC 1624, 59 SATC 373*, the Appellant was a close corporation which carried on business as custom clearing and freight forwarding agents. The Appellant rendered services to a customer, which included the making of payments to the harbour authority of certain wharfage fees on behalf of the client, which it was

entitled to recover from the client. Through the efforts of a former member, but without knowledge of the managing member, accounts were rendered by the close corporation to the client reflecting wharfage fees disbursed by it in excess of the actual expenditure incurred. An excessive amount was accordingly recovered from the customer. One disgruntled, but apparently honest employee reported this irregularity to the client and to the Receiver of Revenue. A contention on behalf of the Appellant that the moneys had constituted loans in the nature of capital receipts which had not been received by the Appellant “*on its own behalf and for its own benefit*”, was rejected by Wunsh J. It was held that where a trader received a payment of money in the course of carrying on its trade, which it obtains by making fraudulent or negligent misrepresentations to a customer, it nonetheless receives such moneys as part of its business income and in the course of its business.

An example was given by the court of a dishonest attorney who recovers from his client a sum for a witness fee, but corruptly negotiates with the witness to accept a lesser sum than he or she had charged, so that he or she could retain the balance. Wunsh J asserted that in such circumstances, it cannot be suggested that the attorney had not received in the tax sense, the overcharged amount. He found that the same reasoning applied to the disputed sum which had been obtained by the Appellant who had overcharged his client in the case before him. The dishonesty or immorality, which were involved in the process, did not change the fact that the receipt was taxable.

4.2 CASE LAW RELATING TO DEDUCTIONS FROM INCOME

The court, in *ITC 1624, 59 SATC 373*, then had reason to consider whether the same amount could be deducted as expenditure actually incurred in the production

of the income. It was contended on behalf of the Appellant that the amount was so deductible as the Appellant had allegedly become subject to a simultaneous and corresponding liability to repay the amount. However, the court held that the mere fact that the Appellant had an obligation to restore what it had unlawfully taken did not satisfy the legal requirements to constitute a permissible deduction. *Obiter*, it was stated that “*it may well be that if it paid the amount it would incur a loss which would be treated as having been incurred in the production of its income as a necessary concomitant of the trade dishonestly carried on by it. But that has not happened*”.³¹ The fact that the amount was never repaid, weighed heavily with the court in finding that the disputed sum did not constitute expenditure or a loss actually incurred in the production of income in the particular year of assessment.

Of specific relevance to this dissertation, is the vexed question which was touched upon by Wunsh J in *ITC 1624, SATC 373*, namely whether morality, fault or *fides* have a role to play with regard to the general deduction formula, and if so, which role? In this regard, it also is necessary to refer to the role which has been played by our Courts in the interpretation of statutory provisions, in particular, factual scenarios over the years.

That morality and fault, particularly *dolus* (in the sense of fraud having been committed), was regarded as relevant by Lord Brightman J in the matter of *Bamford (Inspector of Taxes) v A T A Advertising Ltd [1972] 3 All ER 535 ChD*, is apparent from the reasoning of the learned Judge. Brightman J described the principal question in this appeal as being “*whether a company could deduct for tax purposes, a sum of which it was robbed by one of its directors*”. The other directors were unaware of the misappropriation of the funds by the errant director, a Major Newnham. Whether that loss was deductible as having arisen out of, or in

³¹ At page 381 of the judgment.

connection with the company's trade (advertising and publicity work), was in issue. Section 137 of the (English) Income Tax Act 1952, *inter alia* provided that no amount could be deducted if such amount was not wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation and furthermore if such loss was not connected with or arising out of the trade, profession or vocation. Relying on an earlier decision, the counsel for the taxpaying company contended that there was no logical distinction to be drawn between petty theft by a subordinate and massive defalcation by a director (in an earlier decision, petty theft by an employee had been allowed as a deduction). To this contention, Brightman J responded, in my view somewhat unconvincingly, as follows:³²

In my view, there is a distinction. I can quite see that the commissioners might find as a fact that a £5 note taken from the till by a shop assistant is a loss to the trader which is connected with and arises out of the trade. A large shop has to use tills and to employ assistants with access to those tills. It could not trade in any other way. That, it seems to me, is quite a different case from a director with authority to sign cheques who helps himself to £15,000, which is then lost to the company. I find it difficult to see how such a loss could be regarded fairly as 'connected with or arising out of the trade'. In the defaulting director type of case, there seems to me to be no relevant *nexus* between the loss of the money and the conduct of the company's trade. The loss is not, as in the case of the dishonest shop assistant, an incident of the company's trading activities. It arises altogether outside such activities. That, I think, is the true distinction. In my view, the decision in the *Roebank* case did not depend on the absence of fraud. I consider that it is a decision which I should follow. I therefore reject counsel for the taxpayer company's submission that the loss of the £15,000 is within the subject-matter of para (e) of s 137.

Whilst Brightman J attempted to motivate his distinction on a factual basis ("*it arises altogether outside such activities*"), it appears that morality as well as the

³² At page 544 of the judgment.

deliberate, fraudulent conduct (namely, the direct intention or *dolus* of Major Newnham) did influence his reasoning. It is unconvincing to premise the distinction between theft committed by a shop assistant and theft committed by a director upon the amount involved. Whether £5 is stolen, or £15,000 is stolen, is neither here nor there. The principle remains the same. Moreover, the mere fact that the shop assistant and the director may occupy positions at markedly different levels of employment is also, in the writer's view, not a valid distinction. Perhaps, the distinction might lie in the premeditated, calculated nature of the conduct? However, such a purported distinction will also be invalid: on the postulated facts, both the shop assistant who steals £5 as well as the director who steals £15,000, will be acting with the same thievish intent or *dolus*. Both would have the same intention, namely to deliberately misappropriate funds. Another possible reason for the distinction could perhaps have been found in the judge's assessment of the convictions of the community, if such *communi mores* are hypothetically applied to the facts. Alternatively, the judge could also have relied on public policy principles, in disallowing the deduction, should the deduction not *otherwise* have been found to fall outside the ambit of the provisions of the relevant Act. In conclusion, the reasoning of the learned judge of the Chancery Division in the said English decision, as well as the conclusion reached, namely that the conduct of the director amounted to a frolic of his own, but not the conduct of a stealing shop assistant, are unconvincing.

Shortly after the end of the Second World War, one Macnaghten J found it necessary to deal with an altogether different war, namely a war of words, in the unexpected domain of tax law. In the matter of *J.L. Fairrie v J.M. Hall (Inspector of Taxes)* [1947] 2 141 KBD the taxpayer, a sugar broker, had published a malicious libel against the chairman of a rival company. The taxpayer was the selling agent for a company which produced sugar in Cuba. He accused a

Mr Rook, the chairman of Czarnikow, Ltd, a company of “*very high standing in the city of London*” who acted as selling agents for various sugar producers throughout the world, of having abused his official position as a Deputy Director of Sugar Supplies at the Ministry of Food in order to advance the interests of his own company. The decidedly aggrieved Mr Rook instituted a libel action for damages against the taxpayer. The defence which was raised that the occasion of the communication of the libel was privileged because it was made in the defence of the interests of the Cuban company for whom the taxpayer represented, did not impress the jury. It accordingly failed. Mr Rook was awarded £550 damages and the taxpayer was also directed to pay the costs of the action. The taxpayer contended that these sums ought to have been deducted from the assessment made of him in respect of his profits as a sugar broker. It was held that the damages and costs, although in one sense connected with the taxpayer’s trade in that his object in publishing the libel was to increase his own profits, were not a loss “*connected with or arising out of*” his trade within the meaning of the (English) Income Tax Act, 1918. It was also held that these expenses did not constitute disbursements or expenses which were laid out exclusively for the purposes of the trade and that they could accordingly not be deducted from the assessment. The matter was decided on the basis that the loss was “*too remotely connected*” with the taxpayer’s trade as a sugar broker. That the taxpayer’s conduct might have been actuated by malice or bad faith was not pertinently discussed. The causality issue was only peripherally addressed. It is enlightening, however, that the judge relied substantially upon the decision of the House of Lords in *Strong & Company Ltd v Woodfield [1906] A.C. 448*. In that judgment, an apparently moralistic distinction was drawn between losses sustained by railway companies which had compensated passengers who were injured whilst they were transported (which expenditure could be deducted) and a loss arising from a grocer’s shop window which had fallen on a passer-by, resulting in a damages claim, which, according to Lord

Loreburn, L.C, could not be deducted. The explanation that the nature of the trade was decisive was unconvincing on the facts. It rather appears that an imprecise morality assessment, or a policy driven motivation, underlay the *ratio*.

Public policy grounds clearly influenced the following comment of Lord Denning in the well-known matter of *Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd 1963 AC 1*:³³

[T]ake a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any detail that it lacks. But still it is not a trade, nor an adventure in the nature of trade. And how does it help to ask the question: If it is not a trade, what is it? It is burglary and that is all there is to say about it.

Williams and Louw, the authors of the work **Income Tax and Capital Gains Tax in South Africa: Law and Practice**³⁴, pose the following question in the aforementioned regard:

*On the other hand, is it not equally distasteful from a public policy view point to accord criminals' exemption from tax?*³⁵,

and proceed to assert on the same page that:

³³ At page 20.

³⁴ Williams, R.C, assisted by Louw, C (3rd Edition). **Income Tax and Capital Gains Tax in South Africa: Law and Practice**. Durban: LexisNexis Butterworths, page 137.

³⁵ *ibid*

[I]n practice SARS regards the proceeds derived from illegal activities such as the keeping of a brothel, illicit diamond dealing and drug dealing as subject to income tax.

Closer to home, the writer has already referred to the decisions in *Port Elizabeth Electric Tramway Company Ltd*, the *Joffe* decision and to the decision in *Sub-Nigel*. The authors of **Broomberg Tax Strategy**, Kruger and Scholtz³⁶ state that the following two propositions “*at least emerge*” from these decisions:

- a) the taxpayer, in order to succeed in his claim for a deduction of the amount paid as damages, must be able to show that the risk of his having to make payment of compensation is a necessary concomitant of his trading operations;
- b) that the act to which the payment of compensation is attached was undertaken by the taxpayer for the purpose of producing income; and that the payment of compensation is closely linked to that act.

The aforementioned authors submit that the tests are too mechanical and contrived to be applied in the hard reality of commerce and industry. They assert that the test laid down by Mason J in *Lockie Bros Ltd v CIR 1922 TPD 42* was to be preferred. In the said decision, it was held that an expense would be allowed as a deduction if the expense was incurred in the course of, or by reason of the ordinary operations conducted by the taxpayer in the carrying on of his trade. The two aforementioned authors contend, with justification, that had this test been applied in the *Port Elizabeth Electric Tramway Company Ltd* and *Joffe* decisions, *supra*, both taxpayers would have qualified for the deduction. In their view, that would have been the correct answer.

³⁶ Kruger, D, and Scholtz, W. (Fourth Edition) **Broomberg on Tax Strategy**. Durban: LexisNexis Butterworths, page 223.

Much of the difficulty which one has with the *Port Elizabeth Electric Tramway Company Ltd* case arises from certain *obiter* or unnecessary comments made by Watermeyer AJP during the course of his judgment. The judge refers to two English decisions, namely *CIR v Thompson 1935 TPD 166* and *Usher's Wiltshire Brewery v Bruce 1915 AC 433*, and concludes that the House of Lords had allowed various expenses because the expenses had all to some extent been attendant upon the ownership of certain tied houses and the acquisition of ownership was an act done for the purpose of more efficiently selling the beer brewed by the company. He continues as follows:

It follows that provided the act is bona fide done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible,³⁷

It appears that the judge however did regard fault or morality as relevant considerations, in his further *obiter* comment:³⁸

It seems, however, that this statement may require qualification in one respect. If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or possibly the negligence of the act, then probably it would not be deductible.

There are two English cases which point that way. In the case of *Commissioners of Inland Revenue v von Glehn and Company Ltd 1920 (2) KB 553* a trader in the course of his business traded with the enemy and became liable to a fine, it was held that he could not deduct such fine. In the case of *Strong and Company of Romsey v Woodifield 1906 AC 448* an innkeeper incurred liability towards a guest in his inn owing to the collapse of a chimney and it was held that this expense could not be deducted. In this case the Judges differed in their reasons and the judgments are not very helpful, but the Lord

³⁷ At page 245.

³⁸ *ibid*

Chancellor suggested that possibly a railway company which had to compensate injured passengers could deduct such compensation – presumably on the ground that payment of compensation in such cases was an expense attendant upon the operations of railway transport, and because no amount of care could prevent it arising from time to time, it was so closely connected with such operations as to form part of the cost of performing them. There is in fact a decision of the Special Court to that effect in the case of a tramway company reported at 1 SATC 57. I shall not, however, deal further with the question of unlawfulness of a business operation or negligence in carrying out because they do not arise in this case.

These references to the possible relevance of lawfulness and fault (negligence) detract from the *bona fide* test postulated. A person who is negligent, is not necessarily a person who is not acting in good faith. Moreover, the fact that a particular action might constitute a contravention of a statutory prohibition and might be unlawful, does not necessarily mean that such conduct or act committed was not performed *bona fide*. Illegality of conduct, or so called “*unlawfulness*” used in a technical sense, may obviously constitute an objective limitation. However, expenditure actually incurred in circumstances when statutory prohibitions were contravened, should not automatically or necessarily result in the disqualification of such expenditure as a deduction. The relevant enactments which contain the prohibitions, may themselves provide for the imposition of fines or other penalties, which, from an interpretational perspective, may suffice as a sanction suggested by the Legislature.³⁹

In *ITC 1490 (1990), 53 SATC 108 (T)* Melamet J emphasised that his decision to disallow the deduction of traffic fines from the income of a company which carried on business as a carriage company, was premised on public policy. The Appellant

³⁹ Compare: *Pottie v Kotzé 1954 (3) SA 719 A.D.* and see generally: **Steyn, L.C. (Fifth Edition) Die Uitleg van Wette. Cape Town: Juta & Company Ltd**, Chapter VI, pp 192 to 202.

owned fifteen trucks and had a turnover of R 7 000 000.00. In respect of certain financial years it claimed as deductible expenditure, moneys which had been paid in respect of traffic fines, which were however disallowed by the Commissioner for Inland Revenue. The Appellant contended that such expenditure was properly deductible in terms of section 11(a) of the Act, in that it was incurred in the production of income and as an inevitable concomitant of the Appellant's trade. Melamet J referred to the Road Transportation Act as well as the Road Traffic Act, which contain specific provisions relating to the commission of offences in connection with the driving of the trucks. A circular was sent by the Appellant to its customers in which they were advised that fines for overloading and additional costs incurred to rectify overloaded vehicles would be charged to the client, consignor or principal concerned. Overloading often occurred because of the requirements of the authorities that the mass of the loads be equally distributed over the truck. However, certain customers could not avoid overloading the trucks. The drivers would then telephone the office of the Appellant to inform the Appellant that the particular truck was overloaded, but in many instances the customer was in the country districts and it would have been uneconomical to send out another smaller truck to transport the excess load. The Appellant accordingly undertook a deliberate risk to retain the business. In so doing, the risk of the detection of an offence was accepted as a concomitant of keeping the business of the customer. If the drivers were then charged with overloading, the fines would be paid by the Appellant, who then recovered the fines from the customer by way of an additional fee raised for conveying the load. If the Appellant was charged, the matter was defended unless the charge was changed to one permitting a fine only, without the risk of confiscation of the truck. The fine was then paid.

The managing director of the Appellant, who gave evidence, was of the view that the risk of a fine was always present for a transport operator. He testified that it

was not possible to conduct a transport business without committing these offences. Importantly, he later changed his position to assert that it was possible to conduct a business without committing these offences, but not practical to do so. He conceded that he could have used a second smaller truck or obtained a temporary permit for an abnormal load. Nonetheless the Appellant contended that in the circumstances of the case, the fines which had been paid by the Appellant in connection with the overloading of its vehicles on the instructions or at the request of its customers, did qualify for a deduction.

Melamet J referred to the reasoning which had been adopted by Margo J in *ITC 1199, 36 SATC 16*, in which Margo J had preferred the following interpretation which was given by the Australian High Court in *Herald & Weekly Times Ltd v Federal Commissioner of Taxation 2 ATD 169*⁴⁰ to the judgments in the English cases of *CIR v Warnes 12 TC 227 (KB)* and *CIR v Alexander von Glehn & Co Ltd 12 TC 232 (CA)* namely:

The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader.

Melamet J also cited with approval from another Australian decision, *Mayne Nickless Ltd v Federal Commissioner of Taxation 15 ATR 752*, which was heard in the Supreme Court of Victoria during 1984. In that matter, the Victoria Supreme Court dismissed an appeal against the disallowance of deductions for fines which had been imposed, on grounds of public policy. Melamet J quoted the

⁴⁰ At page 172.

following passage of the aforementioned Australian judgment delivered by Ormiston J⁴¹:

From this I can only conclude that the “public policy” inherent in these cases and *dicta* either may have been thought to be a fundamental distinction by which fines and penalties were separated from other deductible outgoings or it may have been predicated upon some unstated concept of preventing the frustration of the law by diluting those fines and penalties. For present purposes I care not which approach be taken. They each lead to the same conclusion. For reasons I have already expressed the cases and *dicta* are of sufficient authority for me to consider that I should follow them. The critical feature of fines and penalties are that they are imposed for purposes of the law in order to punish breachers thereof and that makes it undesirable that they should be deductible, whether for serious or minor offences and whether they are imposed directly on the taxpayer or on its employees or third party contractors. In the latter case the policy of law ought not to differ whether or not the money was originally paid by, or the original liability fell on, persons other than the taxpayer.

Although I think either basis of this public policy leads to the same conclusion, I prefer to reach it by holding that the policy of the law denies the right to claim these deductions on the ground that it would frustrate the legislative intent in that the punishment imposed would be, or would be seen to be, diminished or lightened.⁴²

The *Mayne Nickless* judgment of the Supreme Court of Victoria was approved and applied by the full court of the Federal Court of Australia in *Madad Pty Limited v Federal Commissioner of Taxation 15 ATR 1118*. The relevant *dicta* of the Federal Court were quoted as follows:

The approach may well have its origins in public policy. In any event, it has been of long standing, and having in mind the application it must have had over many years, we

⁴¹ At page 773 of the *Mayne Nickless Ltd* decision, *supra*.

⁴² This passage as quoted appears on page 114 of *ITC 1490*.

should not disturb it, for reasons similar to those stated by Dixon CJ in *Lunney's* case, *supra*.

A consideration which may be regarded as tending against this result is the deductibility of expenses incurred in conducting illegal activities. Starting price betting, or brothel-keeping, may be examples. The fact is, however, that the income from such sources is regarded as taxable (see *Minister of Finance v Smith* (1927) ACT 193), and deductibility of expenses flows almost necessarily. Fines imposed for conducting these activities would not, however, be deductible.⁴³

After quoting with approval from these Australian decisions, Melamet J held as follows in *ITC 1490*:

I am in agreement with the conclusion and reasoning of Margo J in *ITC 1199*, *supra*, but I would prefer to base my conclusion on the basis that to allow fines imposed for an infraction of the law to be deducted as an expense in terms of s 11(a) and 23(g) of the Income Tax Act, would be contrary to public policy in that it would frustrate the legislative intent and allow a punishment imposed to be diminished or lightened.

On the facts of the present case, I am of the opinion that the fines do not play any actual part in the earning of the income as the income had already been earned by charging a higher fee for the increase in the load to provide for the risk of a possible fine. It was conceded by the witness that it would be possible, although in his view impractical to conduct a transport business without contravening the provisions of the statutes as to overloading. It would, therefore, appear that incurring such fines is not an inevitable concomitant of the business of a cartage contractor.

We are of the opinion, therefore, that the appellant has not established that the Commissioner for Inland Revenue was wrong in disallowing the deductions claimed in respect of the fines imposed.

⁴³ *ibid.*

In the said decision the Court accordingly made it very clear that public policy principles, or the *boni mores* of the community, had a role to play when the deductibility of expenditure of this nature was considered.

It could possibly be contended that on the facts of the case, the deliberate acceptance of the risk of overloading and of contravening road transportation legislation was indicative of an absence of good faith on the part of the taxpayer. The Court did *not* consider the issue of fault as a relevant consideration, which is to be welcomed. However, *if* fault was a relevant consideration (and it is not submitted that it should have been) then clearly the taxpayer could not allege that his conduct displayed mere negligence. On the contrary, the taxpayer's conduct manifested *dolus*⁴⁴. The rationale that the allowance of such a deduction could undermine the road transportation system as well as public safety, does have merit. However, it is a *non sequitur* that all statutory offences (particularly those of which the elements are satisfied upon proof of negligence and not proof of *dolus*), should automatically result in the disqualification of expenditure incurred in respect of fines or penalties.

The view that public policy could be invoked, even in the absence of statutory language permitting such an intervention by the Court, was the position adopted by the United States Supreme Court in *Tank Truck Rentals, Inc. v Commissioner of Internal Revenue, 356 U.S. 30 (1958)*. As was also the situation in *ITC 1490, supra*, a carriage company again played the main role. At issue was whether fines imposed for the operation of trucks in violation of state maximum weight laws

⁴⁴ The consequence of committing the offences was foreseen, with which the taxpayer had reconciled himself. The taxpayer accordingly knew that such a particular consequence was wrongful and illegal.

were “*ordinary and necessary*” business expenses under article 23(a)(1)(A) of the Internal Revenue Code of 1939. The Court held:⁴⁵

A finding of “necessity” cannot be made... If allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof....

...It is clear that assessment of the fines was punitive action and not a mere toll for use of the highways: the fines occurred only in the exceptional instance when the overweight run was detected by the police. Petitioner’s failure to comply with the state laws obviously was based on a balancing of the cost of compliance against the chance of detection. Such a course cannot be sanctioned, for judicial deference to state action requires, whenever possible, that a State not be thwarted in its policy. We will not presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy of a State. To allow the deduction sought here would but encourage continued violations of state law by increasing the odds in favor of noncompliance. This could only tend to destroy the effectiveness of the State’s maximum weight laws.

It should be pointed out that in 1969 the American Congress amended article 162 of the Internal Revenue Code to disallow, *inter alia*, the deduction of an “*any fine or similar penalty paid to government for the violation of any law*”.

In the leading Canadian decision on this issue, **65302 *British Columbia Limited v Canada* [1999] 3 S.C.R. 804**, the Supreme Court of Canada held that businesses operating in Canada were able to deduct fines or penalties levied for violating laws from their business income for tax purposes. The Court’s decision was based on the fact that the Canadian Income Tax Act did not explicitly state that such fines could not be deducted from business income. The Appellant had carried on a

⁴⁵ At pages 33 to 35.

poultry farm business in British Columbia. The Appellant was a registered egg producer and due to local market conditions, it decided to produce over-quota from 1984 to 1988. The over-quota layers were discovered and an over-quota levy raised, which the Appellant paid. When filing its returns under the Canadian Income Tax Act, the Appellant included the profit from its over-quota production in its income. In 1988 the Appellant deducted the over-quota levy as a business expense pursuant to sections 9(1) and 18(1)(a) of the Canadian Income Tax Act, which resulted in a non-capital loss which was carried back to its 1985 taxation year. In its 1989 taxation year, the Appellant deducted the interest paid on the unpaid balance of the levy and legal expenses incurred for representation, in respect of the over-quota levy. Upon reassessment of its 1985, 1988 and 1989 tax returns, the Minister of National Revenue disallowed the deductions of the over-quota levy, loss carry back, interest and legal expenses. In the Tax Court of Canada, the parties agreed that the deductibility of the loss carry back, interest and legal expenses depended upon the deductibility over the over-quota levy. The Tax Court held that the over-quota levy was deductible as a business expense and that this deduction was not prohibited by section 18(1)(b) of the Act. The Federal Court of Appeal set aside the Tax Court's decision. The central question in the appeal before the Supreme Court of Canada was accordingly whether the over-quota levy could be deducted as a business expense from the taxpayer's business income.

The appeal was successful. It was found that the over-quota levy constituted an allowable deduction pursuant to sections 9(1) and 18(1)(a) of the Canadian Income Tax Act. The levy was incurred as part of the Appellant's day-to-day operations and the decision to produce over-quota was a business decision made in order to realise income. The Court found that the characterisation of the levy as a "*fine*" or

as a “*penalty*” was of no consequence, because the Canadian income tax system does not distinguish between levies, fines and penalties.

Particularly thought-provoking and apposite to this thesis are the comments of Iacobucci J who emphasised the need for a neutral or even-handed approach on the income (taxability) side and on the deduction side. His point of departure was from the premise that public policy principles should not lightly be raised by Courts of law and is essentially a matter which should be pronounced upon by the legislature. According to Iacobucci J, who was supported by his brethren, “*public policy determinations are better left to Parliament*”⁴⁶. The said judge also stated⁴⁷ that:

...in calculating income, it is well established that the deduction of expenses incurred to earn income generated from illegal acts is allowed. For example, not only is the income of a person living from the avails of prostitution liable to tax, but the expenses incurred to earn this income are also deductible: *M.N.R. v. Eldridge*, [1964] C.T.C 545 (Ex. Ct.). See also *Espie Printing Co. v. Minister of National Revenue*, [1960] Ex. C.R. 422. Allowing a taxpayer to deduct expenses for a crime would appear to frustrate the *Criminal Code*, R.S.C., 1985, c. C-46; however, tax authorities are not concerned with the legal nature of an activity. Thus, in my opinion, the same principles should apply to the deduction of fines incurred for the purpose of gaining income because prohibiting the deductibility of fines and penalties is inconsistent with the practice of allowing the deduction of expenses incurred to earn illegal income.

The Canadian Supreme Court was furthermore not persuaded by an argument that to allow the deduction of penalties or fines would dilute the deterrent effect of the fine or penalty. If there was merit in that submission, it was the view of

⁴⁶ See paragraph 62 of the judgment.

⁴⁷ In paragraph 56 of the judgment.

Iacobucci J that the Court will then have to determine whether a particular fine or penalty was in fact meant to be deterrent in nature, or not. Of particular relevance are the following comments:⁴⁸

59 These difficulties outlined above demonstrate that the public policy arguments ask courts to make difficult determinations with questionable authority. Moreover, they place a high burden on the taxpayer who is to engage in this analysis in filling out his or her income tax return and would appear to undermine the objective of self-assessment underlying our tax system: see Hogg and Magee, *supra*, at p. 243. In addition, it is my opinion that the fundamental principles and provisions of the Act in the final analysis dictate that the rule be deductibility.

60 Tax neutrality and equity are key objectives of our tax system. Tax neutrality is violated by tax concessions, since the purpose of such concessions is to influence people's behaviour through the tax system by providing incentives for engaging in certain types of behaviour. For example, a deduction for an RRSP or a charitable contribution is a tax concession. This is to be distinguished from deductions allowed for the purpose of gaining an accurate picture of a taxpayer's net income. One of the underlying premises of our tax system is that the state taxes only net, rather than gross, income because it is net income that measures a taxpayer's ability to pay. As has been pointed out, this results in business-related fines being deductible: see Hogg and Magee, *supra*, at p. 243. Moreover, Hogg and Magee, at p. 40, "in a system that is generally related to ability to pay, the provisions that violate neutrality (tax concessions) tend also to violate equity by abandoning the criterion of ability to pay in favour of other policy objectives".

61 Business expenses allowed under s. 18(1)(a) are deductible because of the concern to tax only net income, not in order to provide tax concessions to businesses. Such deductions are therefore consistent with the principles of tax neutrality and equity.

⁴⁸ Paragraphs 59 to 62 of Iacobucci J's judgment.

The argument to disallow fines and penalties is thus an argument that the court should violate these principles in the name of public policy.

62 While various policy objectives are pursued through our tax system, and do violate the principles of neutrality and equity, it is my view that such public policy determinations are better left to Parliament. Particularly apposite is this Court's statement in *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411, at para. 112, that "a legislative mandate is apt to be clearer than a rule whose precise bounds will become fixed only as a result of expensive and lengthy litigation". This statement was approved of by the Court in *Canderel Ltd. V. Canada*, [1998] 1 S.C.R. 147, at para. 41, adding that "[t]he law of income tax is sufficiently complicated without unhelpful judicial incursions into the realm of lawmaking. As a matter of policy, and out of respect for the proper role of the legislature, it is trite to say that the promulgation of new rules of tax law must be left to Parliament".

Judge Iacobucci also deemed it necessary to comment on the judgment of his co-Judge Bastarache, who had recommended that the distinction between deductible and non-deductible levies had to be determined on a case by case basis. Iacobucci J disagreed:⁴⁹

In my view, such an approach would be quite onerous for the taxpayer who would be forced to undertake the difficult task of determining the object or purpose of the statute under which the payment was demanded whenever he or she filled out a tax return. Indeed, he or she would have to ascertain whether the specific purpose of the section was meant to be deterrence, punishment or compensation. Moreover, difficulties and uncertainties would undoubtedly arise where the purpose of the statutory provision is mixed. While a taxpayer must inevitably make various determinations in filing a return in order to report all relevant income and expenses and estimate the amount of tax payable, the statutory interpretation inquiry into the purpose of a statute is one which

⁴⁹ At paragraph 68 of the judgment.

even courts often find particularly challenging. Consequently, it is inevitable that disputes will often require courts to determine whether a particular levy can be deducted from his or her income. Undoubtedly, this would introduce a significant element of uncertainty into our self-reporting tax system. On the other hand, Parliament could expressly prohibit the deduction of fines and penalties in a way compatible with the objectives of self-assessment and ease of administration.

The judgment was concluded with an invitation to Parliament, formulated as follows:⁵⁰

To repeat, Parliament may well be motivated to respond promptly and comprehensively to prohibit clearly and directly the deduction of all such fines and penalties, if Parliament so chooses.

This judgment was regarded as a “*radical rewriting of Canadian tax law*”⁵¹ and even gave rise to a petition addressed to the Auditor General of Canada and to the Commissioner of the Environment and Sustainable Development.⁵² The petition related primarily to the deductibility of fines and penalties which were levied for violating environmental laws. It was contended that the tax deductibility of fines and penalties caused a serious reduction in the effectiveness of Canada’s environmental laws in deterring violations. It was argued that the awareness of the deductibility of fines and penalties encouraged businessmen to regard them as the mere cost of doing business. Shipping companies which had been fined for violating pollution provisions of the Canadian Shipping Act by spilling oil into the ocean apparently admitted that they had deducted large fines that were incurred in

⁵⁰ At paragraph 69 of the judgment, concluding sentence.

⁵¹ *Vide*: **Unnatural Law. (December 3, 2003) Updates/Articles.** <http://unnaturallaw.com>

⁵² *ibid.*

respect of chemical releases which harmed both human health and the environment, from their business income.⁵³

That the United States Supreme Court (which has a number of political appointees on its bench) was more readily inclined to raise public policy as a consideration which disqualified deductions, is evident from the decision already referred to above, namely *Tank Truck Rentals, Inc. v. Commissioner of Internal Revenue*⁵⁴. Tank Truck Rentals had paid several hundred fines imposed on it and its drivers for violations of state maximum weight laws. The main issue revolved around the deductibility of those payments as “ordinary and necessary” business expenses. The United States Supreme Court *inter alia* held that a finding that an expense is “necessary” cannot be made if allowance of the deduction would “frustrate sharply defined national or state policies proscribing particular types of conduct”⁵⁵, evidenced by some governmental declaration thereof. The fines which the taxpayer had wanted to deduct related to contraventions of legislation of several states by penal statutes which were enacted to protect the highways of those states from damage and to ensure the safety of all persons using them. A proviso was expressed, namely that the rule regarding the frustration of sharply defined national or state policies was not absolute. The Supreme Court was of the view that each case had to turn on its own facts, and the test for non-deductibility was the severity and immediacy of the frustration resulting from the allowance of the deduction. The view was expressed that to permit the deduction of fines and penalties imposed by a state for violations of its laws, would frustrate state policy in a severe and direct fashion, by reducing the “sting” of the penalties.

⁵³ *ibid.*

⁵⁴ *Tank Truck Rentals, Inc. v. Commissioner of Internal Revenue, 356 U.S. 30 (1958).*

⁵⁵ At paragraph 53 of Iacobucci J’s judgment.

In contrast, it should be pointed out that the same Supreme Court previously had no difficulty to confirm that profits which were generated illegally by a taxpayer constituted taxable income, even though the law might require such a taxpayer to repay the ill-gotten gains to the person from whom they had been taken. This was exactly the effect of the judgment in *James v United States*, 366 U.S 213 (1961)⁵⁶.

The Defendant, James, was an official in a labour union who had embezzled more than \$738, 000 in union funds and did not report these amounts on his taxes. He was tried for tax evasion and claimed in his defence that embezzled funds did not constitute taxable income because, like a loan, the taxpayer was legally obligated to return those funds to their rightful owner. James argued that the Supreme Court of America had previously made such a determination *in Commissioner v Wilcox*.⁵⁷ The trial Court did not uphold this defence. The pertinent issue which the United States Supreme Court had to decide upon was to determine whether embezzled funds constituted taxable income, even though an obligation to repay exists.

The Court was divided between several different rationales. The majority opinion was written by Chief Justice Warren. His view was that if a taxpayer receives income, legally or illegally, without consensual recognition of an obligation to repay, such income is taxable. The Court emphasised that the Sixteenth Amendment did not limit its scope to “lawful” income, a distinction which had been found in the 1913 Tax Act. The removal of this distinction indicated that the framers of the Sixteenth Amendment had intended no safe harbour for illegal income. The Court expressly overruled *Commissioner v Wilcox*, *supra*, and found

⁵⁶ http://en.wikipedia.org/wiki/James_v._United_States.

⁵⁷ 327 U.S. 404 (1946)

that James was therefore liable for the tax due on his embezzled funds. However, the Court also found that James could not be held liable for the wilful tax evasion, because it was not possible to wilfully violate laws that were not established at the time of the violation. James therefore succeeded to avoid a criminal sentence, but the effect of the majority opinion of the Court left James in a situation where he had to repay not only the embezzled \$738, 000 to the union, but also had to pay over half a million dollars in taxes on those funds, as though he had been able to keep them.

The effect of the judgment obviously operated in favour of the union and in favour of the United States Commissioner. To contend that public policy principles or a blinkered, patriotic perception of an equitable outcome for the United States did not play a role in the judgment, would be as naïve a contention as to suggest that Iraq's oil was irrelevant to President Bush when Saddam Hussein was toppled by invasion.

The difficulty which one has with the American judgments is the lack of even-handedness or consistency in respect of *both* the income/revenue side and the deduction side. It is submitted that the correct application of the *contra bonos mores* principle, which has been well-developed in our common law, has nothing to do with the national or state policies of the day and everything to do with community convictions in the true sense of the word. That constitutional principles (as embodied in an act, namely The Constitution of the Republic of South Africa, Act 108 of 1996) indubitably influence the present day *mores* of the community, must be conceded.⁵⁸ Political reasons, introduced under the guise of public policy, have to date fortunately not been allowed or sanctioned by our

⁵⁸ In its modern guise, public policy is also rooted in the Constitution and the fundamental values enshrined therein: ***Brisley v Drotzky 2002 (4) SA 1 (SCA)***.

highest courts as constituting legitimate disqualifying factors. Perhaps our courts should in future be especially careful not to raise or allow, for invalid reasons, so-called public policy principles in the sphere of income tax, particularly in circumstances where our Commissioner non-moralistically seeks to tax income from illegal sources.⁵⁹

A tax system should strive to be certain; consistent; neutral and largely non-moralistic. It is submitted that there is no reason why equity and even-handedness should not equally be striven for as legitimate goals. If Courts intervene unnecessarily on the basis of public policy, this might well cause legal uncertainty, as it could be unclear what public policy specifically entailed. It can be contended that once profits realised from an activity in the nature of a trade, albeit of an illegal nature, is taxed, then the expenditure and losses that were actually incurred in the production of such income should *in principle* be deductible. This will then be consistent with legitimate tax policy goals such as neutrality and equity.⁶⁰ There will certainly be claims for deductions which are so egregious or repulsive that to allow them, would obviously infringe upon public policy. Whether non-deductible claims should, however, be so narrowly described or categorised, is certainly debatable.

Our own legal system has had little difficulty in dealing with the *contra bonos mores* concept in our law, particularly in the field of contract. The concept has been applied by our courts in a very specific, circumscribed context. Accordingly,

⁵⁹ As an example, the **December 2006 edition of Noseweek**, edited by **Martin Welz**, published by **Chaucer Publications (Pty) Ltd**, reports that the South African Revenue Service has filed a claim of R183.6 million against the estate of the late Brett Kebble. The claim is reportedly based on an estimation by SARS of what Kebble had earned over a 10-year period. The proceeds *inter alia* relate to the fraudulent sale of shares that had been misappropriated from two listed companies.

⁶⁰ In line with the Canadian approach set out by Iacobucci J in **65302 British Columbia v Canada**, *supra*, at paragraph 56 of the judgment.

it is submitted that its field of application has *not* detracted from legal certainty. Revenue law is not an independent part of our body of law and requires no special treatment. Public policy principles will therefore continue to influence income tax issues in the same way that such principles will also continue to influence the law of delict, contract and criminal law.

The same sentiments cannot be expressed in respect of the treatment by our courts of fault as a relevant consideration in decisions delivered during the first half of the past century, in particular. In mitigation, it should immediately be stated that the influence of authoritative English decisions presumably played a much more persuasive role at the time of the *Port Elizabeth Electric Tramway* and *Joffe* decisions, than in the modern day South Africa.

Why fault was in any event brought into the equation in the factual context of the *Port Elizabeth Electric Tramway Company Limited* decision⁶¹, is unclear. Taxpayers are not faultless gods, but are either managed or operated by fallible human beings, or are in fact fallible human beings themselves, who make mistakes from time to time. To disqualify expenditure actually and *bona fide* incurred or losses actually sustained, simply because the conduct of the taxpayer or the conduct of its employees or agents may with hindsight be adjudged as having been *negligent* in the circumstances, amounts to the introduction of an unnecessary and inappropriate criterion. It could be argued that it is illogical to introduce the fault concept in the realm of revenue law. Particularly in the light of the straightforward, matter-of-fact definition of “*gross income*”, it seems hardly appropriate that lack of concentration levels, forgetfulness or other deviations from the conduct of the reasonable man on the part of the taxpayer or its employees,

⁶¹ *Port Elizabeth Tramway Co Ltd v CIR 1936 CPD 241.*

should result in the disallowance of a claim for a deduction of expenditure or loss actually incurred! Startlingly, the learned Judge contradicts his earlier *obiter* comments further on in the judgment,⁶² where he unequivocally acknowledges the fallibility of human nature:

In this case, the potential liability is there all the time and is inseparable from the employment of drivers – that is to say, inseparable from the carrying on of the business. Moreover, it is a potential liability that is bound, human nature being what it is, to become at intervals in greater or lesser degree an actual liability by the occurrence of accidents.....

It should be emphasised that the *Joffe* decision was largely decided in favour of the Commissioner by reason of an absence of evidence to prove that the negligence of the taxpayer, a company carrying on the business of reinforced concrete engineering, was a necessary concomitant of the income earning operations of a reinforced concrete engineer. The Court suggested that, had there been such evidence, namely that the negligence which occurred during the construction of the cantilever hood and the ensuing liability for damages would from time to time be inevitable, the decision could well have gone the other way. No doubt, this is ascribable to the fact that the matter was argued before the Court on a stated case basis.⁶³

Notwithstanding the sentiments expressed by Judge Watermeyer regarding negligence or fault in the *Port Elizabeth Tramway* and *Joffe* decisions, Roper J convincingly showed in *ITC 815, 20 SATC 487*, that:

⁶² On page 247 of the judgment.

⁶³ See page 165 of the *Joffe* decision: “*There is no suggestion in the stated case that negligence such as occurred when the cantilever hood was being constructed and the liability incurred thereby are the inevitable concomitants of the business of a reinforced concrete engineer*”.

[N]egligence in itself affords no reason why a loss caused by it should be held to be non-deductible. And there is no reason in principle why it should make any difference whether the negligence is that of employees or that of the taxpayer himself. Negligence is an element of inefficiency, and an inefficient taxpayer is taxed upon the income which he actually earns and not upon that which he should have earned had he been efficient. Whether or not a loss caused by negligence would be deductible would depend upon the facts of the particular case and upon such matters as the nature and degree of the negligence and the character of the business.

Roper J found in particular with respect to attorneys, that an attorney who goes into business with others is always subject to the risk that one of his partners may make a mistake of this kind and so involve him in loss.

Williams and Louw in their joint publication, **Income Tax and Capital Gains Tax in South Africa: Law and Practice**,⁶⁴ criticize the “*dubious*” logic of Watermeyer AJP in the *Port Elizabeth Electric Tramway* case, for having distinguished between liability arising from the employment of drivers and the payment of legal costs.

According to Williams, the reason why Watermeyer AJP honed in on the employment of drivers as the “*act*” in question rather than the driving of the tram, might have been that the judge wanted to skirt the problem of whether expenditure or loss which results from the commission of an unlawful act (the driving may well have been reckless or negligent) can be deductible. Williams points out that the door to the deduction of expenditure arising from negligence was not entirely closed, as such expenditure would still be deductible if, firstly, it is a “*necessary concomitant*” of the particular trade or profession and secondly, where the taxpayer “*has chosen to conduct his business in manner which necessarily leads to*

⁶⁴ Williams, R.C. assisted by Louw, C (3rd Edition) **Income Tax and Capital Gains Tax in South Africa: Law and Practice**. Durban: LexisNexis Butterworths, page 334.

accident". Williams (on p 335) is not impressed by this logic, for the reasons stated above. He states as follows, at p 335:

The logic is less than persuasive. Does the first proposition seriously suggest that there are some human activities, whether bricklaying or brain surgery, in which the possibility of negligence is not a necessary (by which is surely meant 'inherent') concomitant? The second proposition is even less convincing. It cannot seriously be suggested that damages caused by negligence are not tax-deductible for those who conduct their businesses responsibly but only for those who are wilfully indifferent to causing harm. In ITC 815 the decision in **Joffe** was explained away as having not laid down a principle but as being based on a lack of evidence as to the hazards of the taxpayer's business.

There is clearly merit in this criticism.

The English decision in *Bamford, supra*⁶⁵ has already been referred to. A comparable set of facts came before a Special Income Tax Court in *[155] ITC 1383 46 SATC 90*. The facts were as follows: A was employed by a bank as secretary and staff manager, holding a fairly senior position in the taxpayer's head office in Johannesburg. It was discovered that by systematic defalcations, A had stolen a total amount of R 140 600.00 from the taxpayer over a period of time. He had abused his authority to sign vouchers for the payment of salaries for members of staff in perpetrating the thefts. His *modus operandi* was to sign vouchers creating false credit entries and withdraw the money. With the assistance of two collaborators, the corresponding debits were kept in suspense, floating between head office and branches of the bank. To a lesser extent, he stole money by making fictitious deposit entries into his own account and the accounts of two personal friends. This matter was not heard on a stated case basis. The general manager of the taxpayer bank did give evidence. He testified that, in practice, the bank had no option but to rely on the integrity of its authorised signatories. A had

⁶⁵ See page 37 of this thesis.

sixteen years experience in banking and had come to the bank highly recommended. There was furthermore no evidence that the thefts had been facilitated by any negligence on the part of the taxpayer. The taxpayer's loss was nonetheless initially not allowed as a deduction and came before Hill AJ in the Special Court.

The representative of the Commissioner contended that no loss as a result of theft by an employee is deductible in the calculation of taxable income. In the alternative, he argued that before any fortuitous loss can be deducted, the taxpayer must show that the risk of the mishap which gives rise to the loss must be inseparable from, or a necessary incident of the carrying on of the particular business. Although it is not apparent from the judgment that the representative of the Commissioner had sought support in the *Bamford* decision, *supra*, it does appear that the representative of the Commissioner made a limited concession as part of his alternative argument, analogous to the *Bamford* scenario. He contended that thefts by servants may be deductible, but should then be limited to thefts by junior employees of small amounts, to which he referred to as “*run of the mill thefts*”. The Court could not find any logical reason for the concession to apply only to petty thefts by junior employees. The Judge remarked as follows:

Petty pilfering no doubt happens frequently in the course of business operations but thefts by senior employees are by no means rare occurrences and the risk of such thefts is, in my opinion, equally inseparable from or a necessary incident of the income-producing operations of a business. Thefts of this type are usually well planned, difficult to detect and involve large amounts.⁶⁶

⁶⁶ At page 94.

The taxpayer was a commercial bank, which in the ordinary course of its business necessarily had to allow its employees to handle large sums of money. However careful it could be expected to be in the selection and supervision of its staff, the risk of theft was an ever present factor in the administration of its business and was inseparable from it. The appeal was accordingly allowed.

Eloff AJP, in whose judgment Grosskopf J and Kirk-Cohen J concurred, held in *KBI v Van der Walt 1986 (4) SA 303 (T)* that the *Port Elizabeth Electric*

Tramway Company Ltd case essentially postulates the *bona fide* test.⁶⁷

In *[180A] ITC 1600 58 SATC 31*, Froneman J found that:

(T)he answer, in my view, to the possible abuse of the deduction provisions in the Income Tax Act, lies in the requirement of *bona fide* expenditure set out in the Port Elizabeth Electric Tramways case. If the expenditure was not made *bona fide* in the normal course of business to produce income it cannot qualify as deductible expenditure.

The acceptance or ratification of the *bona fides* of a taxpayer, which had incurred certain expenditure, is obviously not a decisive criterion. The legal requirements for expenditure to constitute deductible expenditure, must still be satisfied. However, the *bona fide* criterion has certainly been used as a type of sieve or measuring tool by the courts. The “*characteristics of deductible expenditure*” were

⁶⁷ At page 308, the learned Judge comments as follows: “As ons dan, by toepassing van Watermeyer WRP se woorde, dink aan nakoming van dienspligte eerder dan ‘business performance’ word daar nie meer van die betrokke geveg nie dan dat hy moet toon dat hy die betrokke uitgaaf bona fide aangegaan het vir die meer doeltreffende nakoming van sy dienspligte”.

summarised as follows by Conradie JA in the Supreme Court of Appeal decision in *Warner Lambert SA (Pty) Ltd v Commissioner, SARS 2003 (5) SA 344 (SCA)*:⁶⁸

Deductible expenditure has certain characteristics: it must be incurred in the production of income (s 11(a)) and will not be allowed as a deduction against gross income if it is not laid out or expended for the purposes of trade. Up to and including the 1992 year of assessment such moneys must have been ‘wholly or exclusively laid out or expended for the purposes of trade’ (s 23(g)). From the 1993 year of assessment onwards expenditure was not permitted as a deduction save ‘to the extent to which such moneys were...laid out or expended for the purposes of trade’.

In *Ticktin Timbers CC v Commissioner for Inland Revenue 1999 (4) SA 939 (SCA)* (1999 (11) JTLR 29) at 942F-G Hefer JA called the purpose for which expenditure was incurred, ‘the decisive consideration in the application of 23(g)’. He quoted the following passage from the judgment of Corbett JA in *Commissioner for Inland Revenue v Standard Bank of SA Ltd 1985 (4) SA 485 (A)* at 500H-J:

‘Generally, in deciding whether money outlaid by a taxpayer constitutes expenditure incurred in the production of income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed’.

As to how close this connection must be, the Court in *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue 1936 CPD 241* explained that

‘...income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided that they are so closely linked to such acts as to be regarded as part of the cost of performing them....The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible’.

⁶⁸ See page 350 of the judgment, paragraphs 7, 8 and 9.

A *bona fide* taxpaying company which spends money in order to advance the interests of a group of companies to which it belongs, will be unsuccessful in claiming such moneys as expenditure incurred in the production of income, because the link between the production of income and the expenditure is too tenuous. *Vide: Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue 1991 (2) SA 257 (A)*. Further, monies expended by a taxpayer from motives of pure liberality also fail to qualify as expenditure in the production of income.⁶⁹

On the facts in the *Warner Lambert* matter, the Appellant had claimed certain expenditure incurred as part of a social responsibility programme that had cost a considerable amount of money. The expenses claimed were those incurred in the furtherance of the Appellant's social responsibility programme, which it had complied with by reason of the United States Sullivan Code. The primary issue in the matter was whether the expenditure was incurred for a capital purpose, or for a revenue purpose. Importantly, the Supreme Court of Appeal found that the doctrine of dominant purpose only applies in the "*capital versus revenue contest*", but was "*inapplicable in any contest between expenditure for trade or for other purposes*".⁷⁰ The Court found that whilst the link between the Appellant's trade and the social responsibility expenditure was not particularly close and obvious, this does not mean that the connection was too remote. The absence of a direct profit motive was also, in terms of earlier authority, not decisive. Conradie JA proceeded as follows:⁷¹

⁶⁹ *Vide: Warner Lambert SA (Pty) Ltd, supra*, at page 351 E.

⁷⁰ See page 351 at I.

⁷¹ At pages 352 – 353.

A loss of the appellant's subsidiary status might have directly brought about the loss of all kinds of trade advantages. It was unthinkable that the appellant should not comply with the Sullivan Code at all. It was not certain what would become of it if it complied but failed to do so adequately; but the appellant was not obliged, and if the truth be told would not have been permitted, to take the risk of finding out. The Sullivan Code expenses were *bona fide incurred*⁷² for the performance of the appellant's income producing operation and formed part of the cost of performing it. The social responsibility expenditure was therefore incurred for the purposes of trade and for no other.

On the facts, the Court also found that the expenditure was sufficiently closely connected with the income earning operations of the Appellant that it could not be categorised as an expense of a capital nature. Conradie JA made the interesting comment in this regard, that “(W)here no new asset (for the enduring benefit of the trading operation) has been created any questioned expenditure naturally tends to assume more of a revenue character”.⁷³

It is apparent from this decision that a taxpayer which incurs expenditure, or suffers a loss as a result of expenditure incurred by reason of a liberality motive, or in order to advance the interest of a group of companies to which it belongs, will not be able to transform such expenditure into deductible expenditure merely because the expenditure or loss was *bona fide* incurred or sustained. The legal characteristics or requirements as reiterated by the Supreme Court of Appeal above, should still be satisfied. On the other hand, absence of a profit motive; imprudence or negligence will not *per se* disqualify the expenditure from being a permissible deduction.

⁷² Own emphasis.

⁷³ At page 353 at E.

In the context of this research, not much turns on the different interpretations which could be given to the words “*expenditure*” and “*losses*”. Generally the word “*expenditure*” has not caused problems of interpretation, although some doubt seemingly surrounds the interpretation to be given to the concept “*loss*”. The correct approach appears to be that expenditure signifies an outgoing resulting from a voluntary action on the part of the taxpayer, whereas a loss is an involuntary outgoing.⁷⁴ However, the concept of *fides* may perhaps also be useful in this regard: a loss which is deliberately caused, would hardly have been sustained *bona fide*. A voluntarily sustained loss, which implies a deliberate act, is hardly reconcilable with the conduct of a *bona fide* person. *A contrarii*, an involuntary outgoing caused by negligence cannot be equated with an absence of *bona fides*, for the simple reason that people who make mistakes might have done so whilst acting entirely *bona fide*.

The presence (or absence) of *bona fides* was also usefully applied as part of the “*screening test*”, some years ago, in the context of allegedly excessive expenditure in the Southern Rhodesian decision of *Tobacco Father v Commissioner of Taxes 1951 (1) 150 (SR)*. The Appellant in this matter was a trader and tobacco grower in the tobacco district. His son, Prospero (the father obviously had high aspirations for him) grew up on the tobacco farm. Prospero became interested in tobacco farming when he was a young boy. After leaving school at the age of 17 years, he was employed by his father, the Appellant, to manage two of the tobacco farms. The business literally prospered. It should therefore have come as little surprise that the father, (who must by then have been convinced that he had christened his son very aptly) had decided to reward Prospero more than adequately. The remuneration that had been agreed upon for the services of Prospero was a bonus

⁷⁴ Vide: *Joffe & Company Limited v CIR 1946 (AD) 157*;

Stone v SIR 1974 (3) SA 584 (A).

equivalent to 27 ½ % of the net profits of the tobacco grown during the particular season, in addition to free board and lodging. The Commissioner of Taxes was unimpressed with Prospero's remuneration, despite the productiveness of the father and son. It was his case that the bonus payment was not in fact a *bona fide* payment for services, or alternatively, that if the payment was *bona fide*, it was excessive.

Beadle J was impressed by the father and son as being candid and honest witnesses. In dealing with the Commissioner's first ground that the payment was not *bona fide*, which contention was rejected, he held that their evidence had persuaded him that ordinary business considerations of remuneration for services rendered applied at the time when they had entered into the agreement. Judge Beadle found that the agreement between the Appellant and his son was an ordinary commercial transaction and that the payment constituted a *bona fide* payment arising from a *bona fide* contract. The fact that the son had produced a "very fine tobacco crop which the returns show was of a better quality than the crop grown the previous year when the appellant himself and other servants were in charge of the farm" also played no minor role in persuading the judge to arrive at this finding. With respect to the alternative argument, that even if the payment might have been *bona fide*, it was excessive, Beadle J (whose salary was probably not that impressive) commented as follows:

Now, I may say right away that on reading the papers it is easy to understand the Commissioner's attitude in this case. It does produce, to say the least of it, a sense of surprise that a youth of the age of 17 could earn a salary of something approximating £2,000 in the first year after he left school, and it is easy to understand why the Commissioner adopted the attitude he did in this particular case. But it seems to me, however much surprised we might be to think that a youth of his age could earn such

large amount in his first year after leaving school, that it is not sufficient to justify the Commissioner in not allowing the deduction.

The father succeeded. No doubt, he and Prospero prospered even more after this finding in their favour.

A payment which was *not* made in good faith, or which was so excessive that it could not objectively be regarded as having been made *bona fide*, would in all likelihood have resulted in a different outcome. What is particularly relevant to this thesis, is the fact that the Court was at pains to ensure that moralistic standards or the views of members of the community did not unnecessarily cloud the real issue. In addition to the comments quoted above, Beadle J remarked in this regard as follows:⁷⁵

The industry offers very high inducements indeed for competent tobacco farm managers, because even if bonuses as high as 30, 40 or 50 per cent of the nett profits of the crop are paid, the remaining profits which accrue to the owner are still sufficiently high to make it well worth his while to offer these high wages. That being so, I feel that while to the ordinary man in the street and judge without reference to the tobacco industry this rate of remuneration certainly appears to be excessive and grossly extravagant, when this wage is measured against the wages prevailing in the tobacco industry to-day, I do not think that it can be held to be excessive.

Satisfied with the *bona fides* of the Appellant and his son, objective facts accordingly persuaded the judge - not moralistic, subjective armchair views of the public.

⁷⁵ At page 153 at A – C.

By 1965, Beadle J had become Beadle CJ as he was now the Chief Justice. It was in this capacity that he delivered the judgment of the Southern Rhodesian Appeal Court in *COT v Rendle 1965 (1) SA 59 (SRAD), 26 SATC 326*. On the facts, the Appellant had practised as a chartered accountant whose firm had been retained by two property-owning companies which had sold certain properties on instalments. Certain moneys which had been paid in by purchasers had not been banked. After an investigation was conducted which had cost a substantial amount, it appeared that an employee had misappropriated various amounts. After referring to various judgments of the Appellate Division, *inter alia*, *CIR v Genn & Co (Pty) Ltd*,⁷⁶ Beadle J postulated the standard test as follows:

All expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation.

Satisfied with the *bona fides* of the taxpaying company, which was the Appellant before him, he held that the risk of the “*mishap*” giving rise to the expenditure was sufficiently closely connected with the taxpayer’s business operation, as to be regarded as part of the cost of conducting the business operation. He found that there was no reason in principle why this test could not be applied to theft by an employee, as well as to theft by a third party.

Quite correctly, negligence did not disqualify the deductibility of a loss in the matter of *X v COT 1960 (2) SA 679 (SR)*. The Appellant was a firm of attorneys which was instructed to sell certain municipal stock on behalf of a deceased estate.

⁷⁶ *1955 (3) SA 293 (A)* at 299.

The stock was delivered to the firm and in due course, sold through a member of the local stock exchange. Through the negligence of an employee of the taxpayer, the scrip together with the duly completed transfer forms, were delivered to the stock exchange member before payment of the purchase price had been made to the taxpayer's firm. The stockbroker misappropriated the purchase price, thus committing theft. It was clear that the conduct of the firm of attorneys was tantamount to negligence, the negligent act having been the delivery of the scrip in a negotiable format without obtaining payment or its equivalent simultaneously or beforehand. If the correct and normal procedure had been followed, there would undoubtedly have been no risk of loss.

If fault or the convictions of the community had been regarded as material considerations, the taxpayer might not have succeeded with the appeal. However, the foreseeable possibility of negligence on the part of the attorneys working for the taxpayer was acknowledged. It was remarked by the Court that whilst such losses were of rare occurrence, it was inevitable that from time to time, an incautious step in the course of a transaction would result in a loss. MacDonald J went even further:⁷⁷

After careful consideration I am satisfied that there is no reason for distinguishing in law between such a loss and similar losses suffered in other walks of life. Where, as in this case, a loss arises directly out of a particular operation carried on for the purpose of gain the claim to deduct it is stronger *prima facie* than where the loss is not directly or closely linked with such an operation.

The emphasis in the aforementioned regard could also have been placed on *bona fides*. If the loss was sustained whilst a legitimate operation or trade was being

⁷⁷ On page 681.

pursued in order to generate profit, or, as the court had put it, “*for the purpose of gain*”, the loss would have been sustained in *bona fide* circumstances. The pursuance of a profit motive is not essential (as has been shown above). An assessment whether the taxpayer was negligent in the process, clouds the inquiry whether the language of the Act and the *relevant* legal requirements have been met. The decision in *X v COT* (*supra*) is noteworthy by reason of the apparent logic of the Judge in dismissing the negligence aspect as a possible disqualifying influence.

4.3 CONCLUDING COMMENTS

It was shown in the preceding chapter, chapter four, that the Act does not indicate expressly that these considerations or values are relevant to the question whether expenditures incurred are deductible from taxpayers’ gross income. However, it has been demonstrated in this chapter that the courts have on numerous occasions treated these considerations as relevant factors whilst applying the “*screening*” test. Is this casuistic development a positive and welcome development, or does it create legal uncertainty? This question is addressed in the next, concluding chapter.

CHAPTER FIVE: CONCLUDING DISCUSSION

In the realm of South African income tax law, it is well-known that sections 11(a) and 23(g) of the Income Tax Act constitute the so-called *general deduction formula*. Whether or not expenditure or losses incurred are deductible from a taxpayer's income necessitates an assessment of the question whether the losses or expenditure satisfy the legal elements contained in these two subsections. On face value, one might expect that concepts such as *mores*, fault and *fides* would have no place in the assessment process, to determine whether the particular expenditure or loss should qualify as a deduction. However, in evaluating the conduct of taxpayers in this regard, these considerations have often been *treated* as relevant considerations by the Courts. The negligence of taxpayers in the conduct of their income generating operations has contributed to the disallowance of expenditure or losses claimed by them. Community convictions or public policy have also been regarded as relevant considerations, whether deliberately or as part of the motivation of particular judgments. *Fides* or good faith has also been treated as a relevant consideration, particularly in circumstances where the deductions that were claimed fell in a grey area.

The goal of the research was to establish whether or not *mores*, fault or *fides* are acceptable criteria to be applied when granting income tax deductions. In achieving this goal, the thesis first discussed the need to cast the tax net as widely as possible in order to generate the tax revenue needed to meet the socio-economic obligations of the government. This appeared to indicate that these considerations should not be used to exclude income from "gross income" as defined in the Income Tax Act, but left open the question whether the deduction of expenses incurred in producing the income should be restricted by the considerations.

The lack of specific indicators in the Act itself regarding the relevance or irrelevance of these concepts was also considered. With the exception of section 23(o) of the Income Tax Act, which prohibits the deduction of expenditure in relation to an activity contemplated in the Prevention and Combating of Corrupt Activities Act, 12 of 2004, or fines or penalties imposed as a result of unlawful activities, the Act does not contain any specific indicators relating to the relevance of fault, *mores* or *fides* in granting deductions or allowances.

5.1 FAULT AS A CONSIDERATION

Fault (*dolus* and *culpa*), *fides* and *mores* (community convictions) have over the years often been regarded as relevant considerations by the courts in the process of deciding whether expenditure or losses should be allowed as deductions or not. Whilst the presence of *dolus* (direct intent) on the part of the taxpayer when a loss is sustained, might be indicative of an absence or want of good faith, the same cannot be said of *culpa* (negligence). Such an inference would be unwarranted in circumstances where the taxpayer's negligence had contributed to the loss, as has been shown.

However, there is little difficulty in asserting that a taxpayer should not be allowed to deduct an alleged loss as a deduction, if such a loss was intentionally caused. At common law, a Plaintiff who was merely part author of his own loss by reason of negligence could recover nothing at all.⁷⁸ On the one hand, the disqualification when intention (*dolus*) is involved, may be premised on the fact that such a loss would not have been involuntarily incurred and would thus not constitute a loss, if the voluntary or involuntary nature of the conduct constitutes a valid criterion.

⁷⁸ See: **Boberg, P.Q.R. (Volume 1, revised reprint 1989) The Law of Delict. Cape Town: Juta & Company Ltd.** This principle was ameliorated to some extent, by the development of the somewhat superficial "*last opportunity*"-rule.

However, the presence of direct intent or *dolus* may be an irrelevant and impractical measuring device, particularly if the deductibility of expenditure *other* than (a) loss(es) is at stake.

5.2 COMMUNITY CONVICTIONS AS A CONSIDERATION

Community convictions or the *boni mores* of society are well-known concepts in our law. A contract to reward a person for murdering or assaulting someone is *contra bonos mores*. Corruptive practices or conduct induced by fraudulent motives, are also *contra bonos mores*. Damages intentionally caused by one person, resulting in a loss to such person's patrimony, do not give rise to a legally enforceable cause of action. The determination of the limits or parameters of conduct or actions which are reconcilable with the convictions of the community may change, as the views and norms of society change. This is so, because normative values in society are not static or constant, but dynamic.

The disqualification of a loss or expenditure actually incurred, could also be premised on community convictions – it might be contended that any loss deliberately caused should not be allowed as a deduction, because the allowance of such a loss as a deduction would be in conflict with the convictions of the community. As was shown in the previous chapter, courts in Canada have, however, emphasised the resultant difficulty experienced by taxpayers in particular situations, when they have to determine what public policy actually entailed. To unnecessarily introduce public policy principles, especially for political or “*national*” reasons (which has happened in the United States of America, as previously demonstrated), might give rise to legal uncertainty. This foreseeable consequence of legal uncertainty, therefore calls for judicial caution.

Our law has developed progressively over the last number of years and the ambit of the *boni mores* has been clarified. Constitutional principles now have a direct bearing on the *mores* of the community. The Constitution constitutes the “supreme law”, and the Act itself is also subordinate to the Constitution.⁷⁹

5.3 GOOD FAITH AS A CONSIDERATION

It is submitted that the *bona fide* criterion may indeed be useful in evaluating whether expenditure or losses actually incurred should be allowed as a deduction. The criterion should (at least as far as is possible) be objectively applied. An absence of good faith – objectively and not (more problematically) subjectively assessed - might also indicate that the expenditure was not incurred “*in the production of income*”, or might even impact on community convictions. The law (the formal body of norms subscribed to by the community) disapproves of such an absence of good faith – objectively assessed – as it is a reflection of the taxpayer’s state of mind. The disapproval by law arises from the fact that the community which applies or adheres to the law, regards such conduct as unreasonable or even reprehensible.

The assessment of intention (*dolus*) almost invariably necessitates the application of a subjective test: what is the state of mind or directing will of the person concerned? Particularly in the field of revenue law, this is a problematic inquiry – one merely has to refer to the vast number of cases dealing with the revenue *versus* capital test in which the taxpayer’s intention had to be determined.

⁷⁹ Section 2 of **The Constitution of the Republic of South Africa**, Act 108 of 1996 provides as follows: “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”.

Would the application or use of the *bona fide* criterion be less problematic or not? Does it not also call for a partly subjective test? Both a “*yes and no*” answer can be suggested. If the emphasis is placed on actual outward manifestations, or on the conduct of the taxpayer concerned and not on the taxpayer’s own *ipse dixit* or subjective explanations, the application of the *bona fide* test should be less problematic than the test to determine the taxpayer’s true intention. The circumstances in which the expenditure was incurred, or the way in which the expenditure was incurred, or the manner in which the loss was sustained, might be such that the inference may (or will) arise that the taxpayer’s conduct was not *bona fide*. An objective assessment, instead of a subjective inquiry, is accordingly suggested, to ensure the meaningful and practical use of the *fides*-criterion. It is *not* suggested that evidence from the taxpayer regarding his alleged intention or motive should be regarded as entirely irrelevant. The evaluating Court should however, not conduct the evaluation from the point of departure that the determination of the taxpayer’s *fides necessarily* requires an investigation into the taxpayer’s mindset. The facts or external conduct might well speak adequately for themselves.

5.4 CONCLUSION

That the courts have, deliberately or incidentally, *en passant* or (apparently) as part of *ratio decidendi*, sensibly, logically and helpfully (to the readers of judgments) used the *fides* criterion, is a development to be welcomed. That fault, especially the negligence of taxpayers, has rationally been relegated to a largely irrelevant consideration in this context, was to be expected. It is submitted that this logical development has contributed to legal certainty.

Contra bonos mores conduct, or actions which offend against the convictions of the community, have consistently been disapproved of in our law. Indeed, the *mores* of the community constitutes a legal boundary. That the determination of the *communi mores* might at times be problematic, does not detract from the validity of this “*limiting*” consideration. Implications or sanctions follow if this threshold is crossed. Its continued application in our law, particularly in the Constitutional era where our Constitution has further supplemented and in some instances, superseded common law normative values, is not only welcome, but necessary. This normative limitation *correctly* applied, it is submitted, does not detract from legal certainty. To the contrary, the continued application of this criterion or yardstick is necessary and contributes to the maintenance of a civilized society which has subordinated itself to the rule of law.

As long as an even-handed approach is applied on both the accrual/receipt side and the deduction (expenditure/loss) side, in applying the *fides* and *mores* criteria, taxpayers should not have too much to complain about. Notwithstanding earlier sentiments which were expressed that there is no equity about tax, it is submitted that equity and neutrality should be legitimate goals of our South African tax system. The mere fact that deductions are claimed in respect of an immoral or *prima facie illegal* activity, should not *ipso facto* or *ipso iure* result in the disallowance of such expenditure: it would be inconsistent with the neutrality objective to tax income from an immoral or *prima facie illegal* source on a non-moralistic basis, yet to moralistically deny actually incurred deductions in respect of the selfsame activity. Admittedly, the very nature of the deduction claimed might be such that to allow the deduction would be *contra bonos mores*. The *communi mores* consideration should however, not be misused for political or “*nationalistic*” reasons.

What is the concluding assessment of the relevance of these considerations in the context of the admissibility of expenditure and losses claimed as deductions? *Culpa* has rightfully passed away; *mores* will remain (perhaps as a less mystic criterion than during the pre-Constitutional era) and *fides* should prosper as a useful criterion.

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