THE TAX CONSEQUENCES OF INCOME AND EXPENSES ARISING FROM ILLEGAL ACTIVITIES

By

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DECLARATION

Certificate

I certify that the attached mini thesis is my own work, except where specifically indicated otherwise by way of acknowledgement, accompanied by the appropriate reference. I am aware of the penalties for plagiarism.

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ABSTRACT

Income tax in South Africa is levied in terms of the Income Tax Act, 58 of 1962 (the South African Income Tax Act) on taxable income, which by definition, is arrived at by deducting from "gross income" receipts and accruals that are exempt from tax as well as deductions and allowances provided for in the Act. The South African Income Tax Act provides no guidance with regard to the taxation of income and expenditure from illegal activities. In this mini thesis, case law and legislation is reviewed in an attempt to provide clarity on the tax consequences of income and expenses arising from illegal activities. An overview is provided of the taxation of income and expenditure in respect of illegal activities in the United States of America, Australia and New Zealand. Similarities are found between the American, Australian, New Zealand and South African tax regimes in relation to the taxation of income earned from illegal activities, but there appears to be more certainty in America, Australia and New Zealand with regard to the deduction of expenses arising from illegal activities. In South Africa, taxpayers earning income from ongoing illegal activities will, in principle, comply with the definition of "trade" as defined in section 1 of the South African Income Tax Act. However, this is contrary to the view of the South African Revenue Service that illegal activities do not meet the definition of "trade", a viewpoint that may not hold if challenged in court. Recommendations are made for the amendment of the South African Income Tax Act to specifically provide for the inclusion in "gross income" of income from illegal activities and to prohibit the deduction of expenditure arising from illegal activities.

KEYWORDS

Taxation
Illegal activities
Taxation of illegal income
Deduction of illegal expenses
South African Income tax

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Chapter One: Introduction

1.1 Research context

The definition of "gross income" in section 1(1) of the Income Tax Act, 58 of 1962 (the South African Income Tax Act), contains a key requirement relevant to this research. For an amount to be included in "gross income" as defined, that amount must be "received by or accrue to" a taxpayer. The South African Revenue Services (SARS) (2014:13) states that the terms "received by" or "accrue to" are not defined in the South African Income Tax Act, but they have been the subject of judicial interpretation.

In *Geldenhuys v CIR,* 1947 (3) SA 256 (C) (14 SATC 419), Steyn J stated (at 430) that: "the words 'received by' as used in the definition of 'gross income' must mean received by the taxpayer on his own behalf for his own benefit". Chawira (2011:2) reports that the court applied an objective approach and focused on the legal rights and obligations of a taxpayer. In the Zimbabwean case *COT v G*, 1981 (4) SA 167 (ZA) (43 SATC 159), it was held that stolen money did not constitute gross income in the hands of the thief, because the money never became the property of the thief, despite his own intentions. The court held that money stolen by a thief was not "received" by him within the meaning of the Zimbabwean Tax Act as a thief "takes" rather than "receives" the money. This case also demonstrated the objective approach followed by the court, where the court considered the legal rights and obligations of the taxpayer, similar to the decision taken in the case of *Geldenhuys v CIR*.

The taxability of illegal receipts was dealt with in *CIR v Delagoa Bay Cigarette Company*, 1918 TPD 391 (32 SATC 47), where the court held that the legality or otherwise of the business productive of income was irrelevant to the question of the liability of that income for tax. The case of *MP Finance Group CC (in liquidation) v C: SARS,* 2007 (5) SA 521 (SCA) (69 SATC 141), dealt with money fraudulently received under an illegal contract. SARS (2014:15) confirms that the principles of this case are considered to apply equally to theft through robbery, burglary or other criminal means. Chawira (2011:1) states that in *MP Finance Group CC (in liquidation) v C: SARS*, the term "received by" was interpreted with reference to the subjective intention of the taxpayer, meaning that if a person retains an amount for his own benefit he has received it, regardless of the fact that the amounts do not belong to him and are repayable. SARS (2014:15) highlights that the key issue is whether the thief intended to benefit from what was stolen as, if so, the requisite ingredients for a receipt have been met and there is no justification for the view taken in the case of *COT v G* above, that a thief "takes" rather than "receives".

The words "accrued to" were held by Watermeyer J (at 20) in *WH Lategan v CIR*, 1926 CPD 203 (2 SATC 16), to mean "that to which he has become entitled". SARS (2014:13) states that "[i]n the context of stolen money there can be no accrual because a thief is not unconditionally entitled to the money. There can, however, be a receipt".

Although SARS (2014:16) is of the view that income received from illegal activities is taxable, the South African Income Tax Act is silent on the issue and makes no mention of the taxation of income derived from illegal activities. The issue is further complicated as some courts have followed an objective approach (*COT v G)* while others have followed a subjective approach (*MP Finance Group CC (in liquidation) v C: SARS)* in addressing the meaning of the term "received by" when making a decision with regard to the taxability of income from illegal activities.

The sections of the South African Income Tax Act that deal with the deduction of expenditure and losses are:

> Section 11. General deductions allowed in determination of taxable income —
> 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 the income, provided such expenditure and losses are not of a capital nature;
>
> Section 23. Deductions not allowed in determination of taxable income —
> 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;

Both sections require the taxpayer to conduct a trade and any deduction is limited to the extent that an amount is expended for the purposes of that trade. Section 1 of the South African Income Tax Act defines "trade" to include "every profession, trade, business, employment, calling, occupation or venture . . ." The South African Revenue Service (SARS)

(2014: 16) refers to *Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd*, 1963 AC 1, where Lord Denning (at 20) made the following *obiter* remarks:

> Take a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any 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.

SARS (2014:16) contends that, while certain elements of a trade may be present, for example, the intention to make a profit, repeated activities, planning and organisation, the thief's activities lack the key commercial character of a trade. SARS (2014:16) states that when it comes to the deduction of expenses or losses incurred in the earning of income from illegal activities, those activities do not meet the definition of "trade" as defined in section 1 of the South African Income Tax Act.

In *CIR v Delagoa Bay Cigarette Company,* Bristowe J (at 49) made the following *obiter* remark in relation to the deductibility of expenses incurred in carrying out illegal activities: "If the income itself is taxable, it follows I think that if, the prizes had been a legitimate deduction had the business been legal, they would equally be a legitimate deduction if the business is illegal." In *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241 (8 SATC 13), Watermeyer AJP stated (at 16-18):

> 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… 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.

He qualified this statement in an *obiter* remark:

> 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.

The *obiter* remark of Watermeyer AJP in the case of *Port Elizabeth Electric Tramway Company Ltd* runs contrary to the *obiter* opinion of Bristowe J in *CIR v Delagoa Bay Cigarette Company*. There are a few Tax Court decisions that confirm that expenditure relating to illegal activities is not deductible, although on grounds other than illegality. As these decisions do not create precedence, the position remains uncertain.

Bovingdon (1958:1) expresses the view that in the United States of America, the Revenue Act of 1913 purported to tax only gains, profits and income from the transaction of any lawful business, indicating that no question could exist about the deductibility of the expenses of such an enterprise. The early case of *United States v Sullivan*, 1927 (274 US 259), noted the deletion of the word "lawful". However, Bovingdon (1958:3) confirms that Attorney General Brownell, in his address at the 1953 annual meeting of the American Bar Association stated that the policy in the Department will henceforth be to "disallow all deductions for expenses incurred in illegal enterprise, and the Treasury Department has promised us its fullest cooperation."

Kahn and Bromberg (2016:211) clarify that the denial of a deduction for illegal business expenses is now contained in section 162(c)(2) of the Tax Reform Act of 1969. In the United States of America, taxation legislation therefore makes it clear that all income from illegal activities will be subject to taxation, but the legislation denies a deduction for illegal business expenses.

Gupta (2008:109-110) states that the taxability of illegal profits relies upon ascertaining whether or not a business is being undertaken. In *Partridge v Mallendaine*, 1886 (2 TC 179), Justice Denman stated (at 181):

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

As "profit" is arrived at after deducting expenses from income, this English case seems to suggest that expenses incurred in carrying on an illegal activity are deductible.

In the New Zealand case of *Grieve v Commissioner of Inland Revenue,* 1984 (CA) (1 NZLR 101), Richardson J stated (at 691) that "Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture or because that business is illegal." This appears again to suggest that expenses incurred in illegal activities are deductible.

In the Australian case of *Commissioner of Taxation v La Rosa*, 2003 FCAFC 125 (53 ATR 1), Hely J stated (at 55):

> The purpose of the Income Tax Assessment Act of 1936 is to tax taxable income, not punish wrongdoing. There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities. Punishment of those who engage in unlawful activities is imposed by the criminal law, and not by the laws in relation to income tax.

In response to *Commissioner of Taxation v La Rosa,* section 26.54 of the Australian Income Tax Assessment Act of 1997 was enacted to deny the deduction of expenses incurred in the course of an illegal activity. Gupta (2008:127) confirms that this provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to a physical element of an offence against Australian Law in respect of which a taxpayer has been convicted of an indictable offence. It seems to indicate that the punishment of those engaged in unlawful activities is not only imposed by criminal law, but also by the income tax provisions.

The research question is whether income received from illegal activities is or should be subject to tax and whether expenses incurred in generating income from illegal activities are or should be allowed as a deduction. Taxation legislation and decisions of the courts in South Africa over the years do not provide absolute clarity regarding the deduction of expenses incurred in relation to illegal activities, while in certain foreign jurisdictions legislation makes it clear that the expenses arising from illegal activities are not deductible for income tax purposes and in others it appears that these expenses are deductible. The principles applied in selected tax jurisdictions dealing with illegal activities will also be investigated in this study, in order to make recommendations on addressing the tax consequences of illegal activities.

1.2 Goals of the research

The main goal of the research is to explore from a South African perspective and the perspective of selected foreign jurisdictions whether income from illegal activities and expenses incurred in generating income from illegal activities are, or should be, subject to tax.

The sub-goals of the research are:

- to determine whether there is certainty in South African tax law regarding the taxation of income arising from illegal activities;
- to determine whether the definition of "trade" in section 1 of the South African Income Tax Act, applies to both legal and illegal activities;
- to establish, in relation to legislation and case law, if the general deduction formula (the preamble to section 11, and section 11(a) read with section 23(g)) of the South African Income Tax Act applies to expenses incurred in deriving income from illegal activities;
- to establish the principles applied in selected foreign jurisdictions relating to the taxation of income and deductibility of expenses arising from illegal activities; and
- to recommend whether an amendment should be made to the South African Income Tax Act to create certainty in relation to the taxation of illegal activities.

1.3 Methods, procedures and techniques

The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing the deductibility of expenses incurred when generating income from illegal activities in terms of the Income Tax Act and principles established in case law (McKerchar: 2008). The research will be conducted by analyzing the provisions in the South African Income Tax Act and relevant case law in South Africa, together with legislation and case law of the United States of America, Australia and New Zealand that deal specifically with illegally gained income and the related expenses. The research is based purely on documentary data. The research is conducted in the form of an extended natural language argument, supported by documentary evidence.

The documentary data to be used for the research consists of:

- taxation legislation and relevant case law in South Africa, the United States of America, Australia and New Zealand;
- South African Revenue Service Interpretation Note 80 (the Income Tax Treatment of Stolen Money);
- articles in accredited journals; and
- textbooks and other writings.

The scope of the research is limited to income tax, including a brief discussion on capital gains tax. The thesis will not discuss other taxes, including value-added tax.

The validity and reliability of the research and the conclusions will be ensured by:

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

1.4 Ethical considerations

As all the data are publicly available, no ethical considerations arise in relation to their use. Interviews will not be conducted; opinions will be considered in their written form. The researcher will not exaggerate or filter the data or results to support a particular viewpoint. Content will not be withheld or toned down. All sources of data will be appropriately acknowledged and full references provided.

1.5 Overview of the chapters in the thesis

This thesis is divided into five chapters. Chapter one serves as an introduction to the thesis. In this chapter, the research context, goals of the research, methodology and ethical considerations are set out and an overview of the thesis is presented. Chapter two focuses on the “gross income” definition and the meaning of the phrase “received by” for both legal and illegal proceeds in South Africa. The chapter shows how the courts have dealt with the cases brought before them. Chapter three investigates the deductibility of expenses incurred when earning income from illegal activities in South Africa. The chapter entails a detailed discussion of “trade” as defined in section 1 of the South African Income Tax Act and the requirements of the general deduction formula.

Chapter four investigates how the United States of America, Australia and New Zealand have dealt with the issue of the taxability of illegally derived income and the deductibility of expenses incurred in the production of illegal income. Chapter five concludes the research, summarises the findings and makes certain recommendations.

Chapter Two: The taxation of income derived from illegal activities in terms of South African Law

2.1 Introduction

Chapter two provides a detailed discussion in relation to the goal of the research, which is to explore from a South African perspective whether income earned from illegal activities is, or should be taxable. This entails a discussion of "gross income" as defined in section 1 of the South African Income Tax Act and its application to income earned from illegal activities.

Muller (2007: 174-175) reports that in cases that dealt with *legal* receipts the courts have clearly followed an objective approach. She states that according to the objective approach, any underlying obligation to repay an amount or redeliver an asset, either based on a contractual or delictual obligation (such as unjust enrichment), or for that matter any other action in terms of statutory or common law, should indicate that the amount is not received for purposes of gross income. However, the deposit cases heard in the South African courts (for example, *Pyott Ltd v CIR*, 1945 AD 128 (13 SATC 121) and *Brookes Lemos Ltd v CIR*, 1947 (2) SA 976 (A) (14 SATC 295)) disregarded the obligation to repay deposits on return of the containers involved, and included the full selling price in the taxpayers' gross income.

When analyzing the outcome of cases that dealt with the receipt of illegal income, it becomes clear from the discussion presented in this thesis that the courts have been inconsistent in their approaches as the objective approach of entitlement as well as the subjective approach of intention, have both been applied.

2.2 The definition of "gross income"

Mtshawulana (2008:17-18) explains that "gross income" is the starting point for the levying of tax because, for persons to be taxed, they need to have taxable income on which their tax would be calculated. She emphasises that in other words, if a person does not have "gross income" he or she cannot be liable to pay tax. "Gross income" is defined as follows in section 1 of the South African Income Tax Act:

> "gross income", in relation to any year or period of assessment, means —

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature.

Receipts or accruals that are capital in nature are excluded from the "gross income" definition, but the South African Income Tax Act provides for certain receipts and accruals, which can be capital in nature, to be included in terms of paragraphs (a) to (n) of the "gross income" definition. The South African Income Tax Act does not define the phrases and expressions used in the "gross income" definition and the judiciary, as interpreters of the law, has the duty to give meaning to these phrases and expressions in cases that come before them.

The definition of "gross income" in section 1 of the South African Income Tax Act does not refer to or differentiate between income received from a legal and an illegal source, which has resulted in dependence on the decisions of the courts. The components of "gross income", as they may relate to income from illegal activities, are discussed below.

2.2.1 Total amount in cash or otherwise

One of the first cases to deal with the meaning of the words "total amount" was *WH Lategan v CIR*, where the court had to decide what amount had to be included in the taxpayer's gross income. The court held that the term "amount" included "not only money, but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value". In *CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301 (13 SATC 21), the court concurred with the judgment in the *WH Lategan* case, that the term "amount" referred to something with a money value, and further stated that the amount should have "an ascertainable monetary value".

In *C:SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (4) ALL SA 1338 (SCA), 2007 (6) SA 601 (SCA) (69 SATC 205), the court approved the position in the case of *Ochberg v CIR*, 1931 AD 215 (5 SATC 93), that the way in which the valuation of a right received otherwise than in cash was to be made was to use an objective valuation (valuation in the market place) as opposed to a subjective valuation (what the right is worth to the taxpayer). Mtshawulana

(2008:20) elaborates that if a taxpayer steals property or defrauds a victim of property, the value of such property will be the amount for tax purposes. On applying the principle above to illegal income, it is evident that income in any form, including property, for example, the sale of drugs, the theft of cash or goods, embezzlement or smuggled goods, constitutes an amount in accordance with the "gross income" definition as it has an "ascertainable monetary value".

2.2.2 Received by or accrued to or in favour of

Classen (2007:536) is of the view that the proceeds of illegal activities would usually not be declared in the tax returns of the perpetrators of crime. Criminals would attempt to hide their illegal activities from SARS and other law enforcement authorities due to the illegal nature of the activity. Classen (2007:536) states that amounts obtained in an illegal manner have not always been considered as having been "received by" the perpetrator of the crime in the true legal sense of the word. For an amount to be taxable, it must have been received by the taxpayer for his own benefit (*Geldenhuys v CIR).*

The meaning of the phrase "received by" or "accrued to" or "in favour of" a person is not defined in the South African Income Tax Act and as a result case law is used to interpret the meanings. In the Zimbabwean case *COT v G*, it was held that stolen money did not constitute gross income in the hands of the thief, because the money never became the property of the thief, despite his own intentions. The court stated that the intention of the thief (recipient) is not conclusive. However, according to the South African Revenue Service (SARS) (2014: 13) a thief will be taxed on stolen money if it falls within the thief's gross income. The opening words of the definition of "gross income" in section 1 of the South African Income Tax Act contain a key requirement for an amount to be included in gross income. It is that an amount must be received by or accrued to or in favour of a taxpayer.

Claassen (2017) clarifies that the crime of theft can only be committed in respect of property capable of being stolen and it consists of the unlawful appropriation of such property of another by intentionally arrogating to oneself the rights of the owner with the further intention of depriving the owner permanently of the whole benefit of his property, as was held in *R v Sibiya*, 1955 (4) SA 247 (A) and *S v Van Coller*, 1970 (1) SA 417 (A). He reports that money, although not in cash, is capable of being stolen even if represented by a credit entry in books of account, as was held in the case of *S v Graham*, 1975 (3) SA 569 (A) and *R v Solomon,* 1953 (4) SA 518 (A) 522. Theft in Roman Dutch law is the wrongful taking of any movable property without the consent of the owner, with the intention on the part of the taker to appropriate it. In *R v Philander Jacobs*, 1876 (6 Buch 171), it was held that theft is a continuous crime so long as the property is in the physical possession of the thief.

In *R v Strydom,* 1952 (2) All SA 450 (T), 1952 (2) SA 397 (T), a distinction was made between the conduct required in the case of theft of money or funds and theft of an individual object. Joubert (2010) describes that in the first case the mere making of a book entry or the manipulation of cheques by way of an unauthorised deposition of another's funds in the accused's banking account is recognised as a sufficient act of appropriation, even though there is no physical handling of identifiable coins or notes representing the subject matter of the theft. He reports that in the second case, however, the courts still require "an actual physical dealing with the thing concerned or some conduct which is akin to physical dealing".

In *Geldenhuys v CIR,* Steyn J stated (at 430) that "the words 'received by' as used in the definition of 'gross income' must mean received by the taxpayer on his own behalf for his own benefit". In *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A) (20 SATC 113), the court was of the view that not every obtaining of physical control over money or money's worth constituted a receipt for the purposes of the definition of "gross income". The court held (at 301) that:

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

South African courts have not applied the meaning of the phrase "received by" consistently. As a result, taxpayers have relied on the meaning of the phrase "received by" as applied in *Geldenhuys v CIR*, to escape tax liability by arguing that they were not "entitled to" the amounts received for their own benefit. This principle, if consistently applied would create opportunities for taxpayers engaged in illegal theft activities. The taxpayers would state that their illegal income from theft would never be taxable, as they were never entitled to that income. If the principles of *CIR v Genn & Co (Pty) Ltd* were applied to illegal activities, once again opportunities exist for the taxpayer to argue that even though he or she may have obtained physical possession of the stolen property, he or she did not "receive" it. The taxpayer could argue that stolen property can be seen as a loan as there would be a requirement to repay the money or return the property if the taxpayer is convicted of the criminal offence.

The words "accrued to" were held by Watermeyer J (at 20) in *WH Lategan v CIR*, to mean: "that to which he has become entitled". SARS (2014:13) states that "[i]n the context of stolen money there can be no accrual because a thief is not unconditionally entitled to the money. There can, however, be a receipt".

The case of *CIR v Delagoa Bay Cigarette Co*, dealt with income flowing from illegal activities. The court held that the legality or illegality of the business which produced the income was irrelevant to the liability for income tax. Bristowe J stated (at 394) that: "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 ...". This case dealt with amounts received in terms of a lottery scheme and the taxpayer had contended that the fact that the lottery scheme was illegal meant that the amounts could not be included in income.

SARS (2014:14) reports that in *ITC 1545,* 1992 (54 SATC 464), the appellant had been taxed on the proceeds from the sale of stolen diamonds and the receipts from the growing and sale of dried "milk cultures". SARS confirms that the latter activity was described by the court as "a money-making racket" similar to a chain letter scheme and was accepted as amounting to an illegal lottery. SARS stated that the court held that the amounts were received by the taxpayer for the purposes of the definition of "gross income" notwithstanding that they were in pursuance of a void transaction. Scott J stated (at 474) that:

> 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 that section, if that word is to be given its ordinary literal meaning. Not to do so could lead to anomalies.

In *ITC 1789*, 2005 (67 SATC 205), Levinsohn JA held that, because the taxpayer intended to benefit and did benefit from the money received, it would be wrong to conclude that the amounts were not received for purposes of gross income merely because of the unlawfulness and availability of the *condictio*.

Mtshawulana (2008:22) illustrates that fraudulent schemes may take on many forms and one such form that was frequently the subject of court decisions is one where the perpetrator of the fraud enriches himself or herself out of moneys entrusted to him or her by others. *ITC 1624*, 1996 (59 SATC 373), was a case where a member of a close corporation, which paid wharfage fees on behalf of a client, fraudulently recovered amounts in excess of the amounts paid out on behalf of the client and misappropriated the amounts for his own benefit. The court held that where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business.

In direct conflict to *ITC 1624* is the case of *ITC 1792*, 2005 (67 SATC 236), which dealt with a stockbroker who was a member of a stockbroking firm on the Johannesburg Securities Exchange. He had become involved in a syndicate with dealers or portfolio managers acting on behalf of a client where the syndicate purchased shares, which it generally knew the client intended to purchase, and sold the shares at a profit to the client. The stockbroker's share of these illegal profits was the subject of an appeal against the Commissioner for SARS who included them in his "gross income", on the grounds that the amounts did not constitute part of his "gross income" as they were not beneficially received.

The court held that in order for there to be a “receipt” the money must be “received by the taxpayer on his own behalf and for his own benefit” and in this matter the subjective intention of the syndicate and appellant was to receive the secret profits for themselves, but this, however, did not mean that legally they had “received” the profits for their own benefit and to understand the distinction an examination of the law of agency was required. The court held that, by law, neither the shares originally bought nor the profits realised belonged to the syndicate or appellant and were never received by it or appellant in its or his own right or for its or his own benefit, but by the principal.

Goldswain (2016a: 23) is of the view that, although a fraud may be perpetrated by an agent on a principal, the way in which it is carried out could affect the tax consequences. In accordance with the law of agency, for the principal to have received the profits, the agent must have a mandate from the principal to receive profits on behalf of the principal. The agent must also have physical control over the profits with the intention to receive it on behalf of the principal.

In *ITC 1792*, the principal was unaware of the secret profits made by the agent. The agent received the profit with the intention of utilizing it for his own benefit and not for the benefit of the principal. The law of agency was no longer applicable as soon as the agent received the secret profits for his own benefit. He had physical possession, intention and entitlement to the secret profits. The judge in *ITC 1792*, because secret profits were made, went back to the law of agency to find the solution. This outcome, with respect, appears to be flawed, because the judge did not consider the subjective intention of the agent. This is similar to the position taken by the judge in *ITC 1810,* 2006 (68 SATC 189), in regard to "pyramid" schemes where he looked at the law of insolvency to establish whether interest paid in a pyramid scheme was taxable in the hands of the investor.

The latest case on illegal receipts and theft discussed below, provides some clarity and overturns the decisions in *ITC 1972* and *ITC 1810*.

The Supreme Court of Appeal case of *MP Finance Group CC (in liquidation) v C: SARS,* considered the question of whether deposits taken in an illegal and fraudulent pyramid scheme constituted amounts "received" within the meaning of "gross income". The evidence revealed that most of the money received by the scheme was kept in cash and not banked and this cash float provided the source of payments to investors.

However, substantial amounts of money were appropriated by the appellant and her accomplices and some investors received payment of their investments, plus returns, but the majority received less or nothing. What was of essential importance was that throughout the tax years in question, the perpetrators of the scheme knew that it was insolvent, that it was fraudulent and that it would be impossible to pay all investors what they had been promised. The issue was whether the amounts paid by the various investors could be said to have been received by appellant as "gross income" as defined in the South African Income Tax Act.

The taxpayer argued that because the scheme was liable in law to return the deposits there was no basis on which it could be said that they were "received" within the meaning of the South African Income Tax Act. The court rejected this argument, stating the following:

> An illegal contract is not without all legal consequences; it can, indeed, have fiscal consequences. The sole question as between scheme and fiscus is whether the amounts

> paid to the scheme in the tax years in issue came within the literal meaning of the Income Tax Act, 58 of 1962. Unquestionably they did. They were accepted by the operators of the scheme with the intention of retaining them for their own benefit. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Income Tax Act, 58 of 1962.

Goldswain (2016a:24) confirms that, effectively, the decision in this case followed the decision in *ITC 1624,* which in turn followed the *Delagoa Bay Cigarette* case, that is, look at the nature of the receipt and how the recipient treats such receipt; if he treats it as if it is in the nature of income then it is a receipt within the meaning of "gross income". Classen (2007:553) proposes that the fact that amounts paid to an illegal pyramid scheme are considered to be "received" for purposes of gross income, as decided in the case of *MP Finance Group CC (in liquidation) v C: SARS,* must be welcomed because the Court has managed to separate the requirement of entitlement, or accrual in the sense of a rightful claim, from the "receipt" of an amount.

SARS (2014: 15) states that the principle to be drawn from the above cases is that the receipt of stolen money comprises gross income and is thus taxable. SARS confirms that the case of *MP Finance Group CC (in liquidation) v C: SARS,* dealt with money fraudulently received under an illegal contract and the principles established in this case are considered to apply equally to the theft of money through robbery, burglary or other criminal means. SARS states that the key issue is whether the thief intended to benefit from the stolen funds. If so, the requisite ingredients for a receipt have been met and there is no justification for the view taken in *COT v G* that a thief "takes" rather than "receives". SARS emphasises that the issue is not whether the victim intended to part with the money but rather whether the thief intended to benefit from it.

2.2.3 Deposits

A taxpayer engaged in illegal activities may receive deposits to secure the supply of goods or services. As an example, a smuggler of precious metals may receive deposits from customers for the illegal procurement of those precious metals. It is essential to understand how deposits received are taxed in accordance with the definition of "gross income".

Goldswain (2016a:25) explains that the Appellate Division in the cases of *Pyott Ltd v CIR*, and *Greases SA Ltd v CIR*, 1951 (3) SA 518 (A) (17 SATC 358), the so called "deposit" cases, indicated that once the taxpayer has received an amount as his own during a year of assessment, despite the fact that in terms of a contract he may, in certain circumstances, have to repay the amount, it is included in his gross income. Goldswain emphasises that the courts have consistently held that the way in which a receipt or accrual is treated for accounting purposes does not affect the way in which it is treated for tax purposes.

In direct contrast to the decision of the courts in *Pyott Ltd v CIR* and *Greases SA Ltd v CIR* is the case of *C v COT*, 1984 (3) SA 210 (ZH) (46 SATC 57). In *C v COT*, the Supreme Court of Appeal held that the deposits did not constitute ordinary revenue income, but were "working capital" which might rightly be equated with a bank loan. Goldswain (2016a:27) clarified that the taxpayer succeeded in convincing the court that a deposit for petrol, which deposit was refundable when the customer closed his account, was akin to a loan and therefore should not be included in gross income.

The question before the Supreme Court of Appeal in the case of *MP Finance Group CC (in liquidation) v C: SARS*, was whether or not the deposits that had been obtained by the taxpayer could be regarded as having been "received by" it in terms of the definition of "gross income", notwithstanding the fact that the taxpayer had operated an illegal pyramid scheme and the deposits were received in the course of the running of such a scheme. The main argument on behalf of the taxpayer was that the deposits that had been received were loans to it by the investors which, were in law, repayable at the moment they were granted. The taxpayer argued that the deposits had never been "received" in terms of the South African Income Tax Act.

As authority for this argument, it relied on the decision in the case of *Fourie v Edeling*, 2005 (4) All SA 393 (SCA). The taxpayer argued that, as in *Fourie v Edeling*, it had not become entitled to the deposits because the amounts had not been "received by" it, nor had the amounts accrued to it. It argued further that the relationship between the parties would be exactly the same as in *Fourie v Edeling*, that the investors would have a claim in terms of the relevant *condictio*, and that the scheme would be liable to repay them immediately at the very moment of receipt of the deposits.

The Court rejected the contentions based on *Fourie v Edeling*. It held that the relationship between the operators of a scheme and the investors had been at issue in *Fourie v Edeling* and not the relationship between the scheme and the fiscus. For that reason, the case had to be distinguished. The Court found that an illegal contract was not always without consequences and that it could have fiscal consequences as was held in *Commissioner for Inland Revenue v Insolvent Estate Botha,* 1990 (2) SA 548 (A) at 556C-557B. The sole question between scheme and fiscus is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the South African Income Tax Act. Unquestionably they did. Therefore, the Supreme Court of Appeal held that the amounts taken by the illegal and fraudulent pyramid scheme constitute amounts "received" within the meaning of "gross income" in the South African Income Tax Act since the intention of scheme operator is not to contract with the investors but to appropriate their money to facilitate the fraud.

It appears, based on the decision in *MP Finance Group CC (in liquidation),* that should a taxpayer receive legal or illegal deposits, these would be included in his or her gross income. This is so notwithstanding that in law they are immediately repayable; they constituted receipts within the meaning of the South African Income Tax Act. However, had the court followed the decision in the case of *C v COT*, where the taxpayer succeeded in convincing the court that a refundable deposit for petrol was akin to a loan from a customer to the taxpayer; the decision of the court in case of *MP Finance Group CC (in liquidation)* could have been different.

2.2.4 Not of a capital nature

The definition of "gross income" in the South African Income Tax Act excludes receipts and accruals of a capital nature. The South African Income Tax Act contains no definition of the term "capital". From the many conflicting court decisions on the subject, it is obvious that a single test to distinguish between capital and income does not exist.

In *CIR v Visser*, 1937 TPD 77 (8 SATC 271), Maritz J stated (at 276) that: "Income is what capital produces, or is something in the nature of interest or fruit as opposed to principal or tree." In *CIR v George Forest Timber Company*, 1924 AD 516 (1 SATC 20), Innes CJ (at 23) referred to the distinction between fixed and floating capital as follows: "Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not, though it produces fresh wealth, it remains intact."

In *Elandsheuwel Farming (EDMS) BPK v SBI*, 1978 (1) SA 101 (A) (39 SATC 163), Judge Corbett stated (at 101) that "… the intention of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great and sometimes decisive importance ..." Haupt (2016:48) is of the view that the difference between fixed and floating capital depends on the reason why it was acquired. He elaborates that in finding this reason, one has to look at the intention of the taxpayer, where the intention is determined by looking at the surrounding facts and circumstances, such as why the taxpayer bought the asset, how he used it, and why he sold it. Van Niekerk (2016:14) confirms that it is clear that, should a taxpayer conduct an illegal business such as smuggling, racketeering or an illegal pyramid scheme, any amount received with the intention of making a profit or whilst conducting a business will be regarded as revenue in nature and will accordingly be included in the gross income of the taxpayer.

If the taxpayer's intention (*ipse dixit*) was to hold the goods that he had stolen as fixed capital it will be capital in nature. For example, where a taxpayer engaged in the theft of vehicles with the original intention to sell the vehicles in a scheme of profit making, changes his intention and decides to rent out the stolen vehicles instead of selling them, those vehicles will be capital in nature. If he held the stolen vehicles as floating capital (trading stock) with the intention to sell those vehicles in a scheme of profit making, then it would be revenue in nature and included in "gross income", irrespective of the illegal nature of the transaction.

2.2.4.1 Capital gains tax in relation to illegal income

Even though the definition of "gross income" excludes income of a capital nature, this does not mean that receipts and accruals of a capital nature are entirely free from income tax. A portion of the capital gain realised on the disposal of an asset (referred to as the taxable capital gain) is included in the taxpayer's taxable income and therefore subject to income tax. The income tax on taxable capital gains is referred to as capital gains tax. Taxable capital gains are determined in terms of the Eighth Schedule to the South African Income Tax Act and the gain so determined is added to taxable income in terms of section 26A of the South African Income Tax Act.

It is important to determine if capital gains tax will apply to capital income earned from illegal activities. "Taxable income" as defined in section 1 of the South African Income Tax Act is as follows:

> "taxable income", means the aggregate of —
>
> (a) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and
>
> (b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act;

The definition of "taxable income" does not differentiate between capital income that is legal and illegal. De Koker, Koekemoer and Williams (2017) clarify that to prevent a potential overlap between capital gains (or capital losses) and ordinary income of a revenue nature, the Eighth Schedule of the South African Income Tax Act expressly applies to all assets, but excludes gains that must be, or have been, included in gross income or that must be, or have been, taken into account in the determination of taxable income for normal tax purposes. He states that while the provisions in the Eighth Schedule of the South African Income Tax Act do not directly require an examination of the scope and purpose of a taxpayer's activities, but instead necessitates an inquiry as to whether there has been a "disposal" of an "asset", the scope and purpose must be examined indirectly to determine when gross income will apply or when capital gains tax will apply. According to the South African Revenue Services (SARS) (2015:39) the definition of "asset" is of importance because capital gains tax is not triggered until an asset is disposed of. SARS elaborates that a wide definition has been ascribed to the term, which includes all forms of property and all rights or interests in such property.

Section 1 of the Eighth Schedule of the South African Income Tax Act defines "asset" as follows:

> "[a]sset" includes —
>
> (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
>
> (b) a right or interest of whatever nature to or in such property;

Section 1 of the Eighth Schedule of the South African Income Tax Act defines the term "disposal" to mean "an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Schedule treated as the disposal of an asset, and dispose must be construed accordingly." SARS (2015:167) confirms that under some circumstances the cancellation of a contract can result in the original disposal being disregarded. This situation could arise when the initial disposal is incapable of performance because it is illegal. Paragraph 60 of the Eighth Schedule provides as a general rule that capital gains and losses arising from gambling, games and competitions will not be subject to capital gains tax. SARS (2015:452) is of the opinion that capital gains of this nature will be subject to capital gains tax if they are derived from illegal gambling, games and competitions in South Africa. SARS (2015:453) has based its opinion on the decision of the Supreme Court of Appeal in the case of *FirstRand Bank Limited v National Lotteries Board*, 2008 (4) SA 548 (SCA), where the court held that the bank's "Million-a-month" competition comprised an illegal lottery, therefore making it clear that winnings from illegal competitions are subject to capital gains tax.

The Eighth Schedule is silent on the issue of illegal capital gains. Both the definitions of "asset" and "disposal" do not differentiate between the disposal of assets held by a legal entity and those held by an illegal entity. Income earned from an illegal activity can be capital in nature. As an example, a taxpayer engaged in the illegal theft of fuel, may purchase assets that are used for the storage and transportation of the stolen commodity. These assets could be disposed of during the illegal operation. It appears that since the South African Income Tax Act makes no differentiation between the disposal of assets in a legal and an illegal entity, the disposal of the assets in an illegal entity would trigger the application of capital gains tax.

In *CIR v Delagoa Bay Cigarette Co,* the court held that the legality or illegality of the business which produced the income was irrelevant to the liability for income tax. In *MP Finance Group CC (in liquidation) v C: SARS,* the court held that deposits earned in an illegal pyramid scheme were taxable. These two cases indicate that illegality does not preclude an amount from taxation. By applying the principles of both these cases to income earned from the disposal of assets, it appears to be irrelevant whether the disposal of assets was from a legal or illegal entity.

The proceeds received from the disposal of assets in an illegal entity will be subject to capital gains tax in accordance with the Eighth Schedule of the South African Income Tax Act.

2.3 Conclusion

Chapter two provided a detailed discussion in relation to the goal of the research, which was to explore from a South African perspective whether income earned from illegal activities is, or should be taxable. This entailed a discussion of "gross income" as defined in section 1 of the South African Income Tax Act and its application to income earned from illegal activities.

The definition of "gross income" in section 1 of the South African Income Tax Act does not refer to or differentiate between income received from a legal and an illegal source. The South African Income Tax Act does not define the phrases and expressions used in the "gross income" definition and therefore case law is used to interpret the meanings. The key requirement for an amount arising from an illegal activity to be included in gross income is that the amount must have been received by the taxpayer for his own benefit. South African courts have not applied the meaning of the phrase "received by" consistently, which has caused uncertainty in relation to the taxation of illegal income.

In *ITC 1624* the court held that where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business. In direct contrast to this decision of the court is the case of *ITC 1792,* where the court referred to the law of agency and held that secret illegal profits earned by an agent were not taxable in the hands of the agent. The court held that the secret illegal profits were never received by the agent in his own right or for his own benefit, but by the principal.

In *COT v G*, it was held that stolen money did not constitute gross income in the hands of the thief, because the money never became the property of the thief, despite his own intentions. The court stated that the intention of the thief (recipient) is not conclusive. In direct contrast to *COT v G*, was the case of *MP Finance Group CC (in liquidation) v C: SARS*, where the court held that the illegal amounts were accepted by the operators of the scheme with the intention of retaining them for their own benefit.

The case of *MP Finance Group CC (in liquidation) v C: SARS* provides clarity and overturns the decisions in the cases of *ITC 1972, COT v G* and *ITC 1810* regarding the taxation of illegal income. According to SARS, the decision in this case is welcome because the principles established in this case are considered to apply equally to the theft of money through robbery, burglary or other criminal means. In relation to the case of *MP Finance Group CC (in liquidation) v C: SARS,* Muller (2007:177) reports that by following the subjective approach in *MP Finance Group CC*, all illegal income will fall into the tax net if the taxpayer intends to benefit from the proceeds.

On considering the capital gains tax consequences from the disposal of assets in an illegal entity, the definition of “taxable income” as defined in section 1 of the South African Income Tax Act together with the definitions of “disposal” and “asset” in section 1 of the Eighth Schedule of the South African Income Tax Act is taken into account. All three of these definitions do not differentiate between the disposal of assets held by a legal entity and those held by an illegal entity. On applying the principles adopted in the cases of *MP Finance Group CC* and *Delagoa Bay Cigarette Co,* it appears that the proceeds received from the disposal of assets held by an illegal entity will be subject to capital gains tax in accordance with the Eighth Schedule of the South African Income Tax Act.

The sub-goal of this thesis was to determine whether there is certainty in South African tax law regarding the taxation of income arising from illegal activities and it can be concluded that there appears to be certainty.

Chapter three provides a detailed discussion in relation to the goal of the research, which is to explore from a South African perspective whether expenses incurred when generating income from illegal activities are, or should be, allowed as a deduction for tax purposes.

Chapter Three: The deductibility of expenditure and losses incurred when deriving illegally gained income

3.1 Introduction

Chapter three provides a detailed discussion in relation to the goal of the research, which is to explore from a South African perspective whether expenses incurred when generating income from illegal activities are, or should be, allowed as a deduction for tax purposes. Chapter three entails an analysis of the deduction of expenses incurred when generating income from illegal activities, taking into account the definition of "trade" and the general deduction formula.

Income Tax in South Africa is levied in terms of the South African Income Tax Act, on "taxable income" which, by definition in section 1 of this Act, is arrived at by deducting from "gross income" receipts and accruals that are exempt from tax as well as deductions and allowances provided for in this Act. These deductions are allowed in terms of:

- the preamble to section 11 and section 11(a) read with section 23(g) of the South African Income Tax Act (referred to as the "general deduction formula"); and
- specific deductions (sections 11 to 19 of the South African Income Tax Act).

The preamble to section 11 of the South African Income Tax Act requires that:

- a trade must be carried on; and
- income must be derived from such trade.

Sections 11(a) and 23(g) read as follows:

> Section 11. General deductions allowed in determination of taxable income —
> 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 the income, provided such expenditure and losses are not of a capital nature;
>
> Section 23. Deductions not allowed in determination of taxable income —
> 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;

Both sections require the taxpayer to conduct a trade and any deduction is limited to the extent that an amount is expended for the purposes of that trade. The South African Income Tax Act provides no guidance with regard to the deduction of expenses incurred from illegal activities, except for section 23(o) which prohibits the deduction for income tax purposes of expenditure incurred in respect of –

- corruption or a corrupt activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004; or
- a fine or penalty imposed as a result of an unlawful activity.

It is clear that income from illegal activities is subject to tax, but it will be demonstrated that there is uncertainty whether expenses incurred in generating that income would be deductible.

3.2 Policies relating to the deductibility of illegal expenses

Khumalo (2016:25) relates that some authors have argued that a taxpayer conducting an illegal trade should be able to deduct the expenses that are incurred in producing income from that illegal trade. She reports that it is against this background that it is submitted that the policy that justifies the inclusion of illegal proceeds in gross income is one of revenue collection. She emphasises that the revenue laws place all taxpayers on an equal footing, as far as the taxability of their receipts goes. The South African Income Tax Act provides for the taxation of taxpayers on all their receipts, irrespective of their source. She concludes that it follows, then, that the policy underlying the deductibility of expenditure should also be one which seeks to place honest and dishonest taxpayers on an equal footing. She concludes further that if the honest taxpayer cannot be discriminated against through the taxpayer being allowed to escape the inclusion of his receipts in gross income, then the taxpayer who derives his income from illegal activities should not be discriminated against through the honest taxpayer being allowed deductions to which he (the taxpayer who derives his income from illegal activities) is not entitled.

Khumalo (2016:26) states that the principle may, however, be different when it comes to the deductibility of expenditure incurred in the production of income derived from illegal activities as, in order to determine the deductibility of expenses incurred from undertaking illegal activities, the question is whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their income from illegal activities. She elaborates that the reason behind the denial of deductions is that the government does not want to allow taxpayers to benefit from their illegal activities through the tax law. She contends that the motive for involvement in illegal activities is the profit so derived, thus if the profit is taxed, it decreases the lucrative nature of such activities. She proposes that the role of taxation in such cases would be to deprive organised crime of substantial amounts of money and therefore non-deductibility is based on public policy and supports the legislature's intention to combat crime. Thus, allowing the deduction would be inconsistent with the aim of the legislature.

Kahn and Bromberg (2016: 223) state that the justification for taxing illegal income in the USA is that those who earn income illegally should share in bearing the costs of government to the same extent as honest residents. They propose that there is no good reason to exempt criminals from paying taxes, but they are to be taxed on their profits, in the same way as everyone else. They highlight that criminals can only be taxed on their profits if their expenses are taken into account, as the deduction of business expenses is not a governmental subsidy, but it is an essential element of the measurement of the profits earned by a business, whether it is a lawful or unlawful business, and whether the expense itself is legal or not.

In contradiction to Kahn and Bromberg's opinion on the deduction of illegal expenses, is the statement of Lund (2003:10), who explains that in the USA section 280E of the Internal Revenue Code of 1954 denies credits and deductions "for any amount paid or incurred during the taxable year in carrying on any trade or business [that]… consists of trafficking in controlled substances…" He proposes that section 280E of the Internal Revenue Code of 1954 is used as a means of preventing drug dealers from having the benefit of business expense deductions. He declares that the USA and its citizens are losing billions of dollars per year to drug dealers and as a result such deductions must be disallowed on public policy grounds.

In the Australian case of *Commissioner of Taxation v La Rosa*, Hely J stated (at 55) that:

> The purpose of the Income Tax Assessment Act is to tax taxable income, not to punish wrongdoing… There should not be a higher burden of taxation imposed on those whose

> business activities are unlawful than that imposed in relation to lawful business activities. Punishment for those who engage in unlawful activities is imposed by the criminal law and not by laws in relation to income tax.

Although Hely J expressed the opinion in *Commissioner of Taxation v La Rosa* that punishment for those who engage in unlawful activities is imposed by criminal law and not by taxation laws, Lund (2003:9) explains that in Australia the primary public policy reason for disallowing the deduction of some or all losses incurred in carrying on an illegal business is to ensure that criminals do not find refuge in the Australian Income Tax Assessment Act of 1997 by obtaining tax benefits related to their illegal activities.

Williams (2009:195) submits that Lord Denning's proposition in *Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd,* that crime is not a "trade" for tax purposes is grounded in unarticulated public policy considerations, inter alia that it is abhorrent for the state to become, in a sense, complicit in crime by taking a share of the proceeds by way of tax. He proposes that there would be other distasteful corollaries to taxing the proceeds to crime. He raises the question that, if a gang of burglars is taxable on what they steal, are they then entitled to deduct the cost of the petrol used by their getaway car? Would a professional assassin be entitled to a wear and tear allowance on the murder weapon and a deduction for the cost of the bullets?

Khumalo (2016:26) states that some argue against using public policy to justify the denial of deductions from income that is generated from illegal activities as they argue that there should be no moral interpretation or consideration of public policy in interpreting the provisions of the South African Income Tax Act. She explains that the view is that if an amount falls within the ambit of the South African Income Tax Act, it must be taxed, and if on the other hand an amount meets the deductibility requirements it must be deductible because tax law is designed to collect revenue and criminal law is designed to punish wrongdoers.

There are varying arguments regarding the disallowance of deductions incurred in illegal activities on the basis of public policy considerations. There are those who are of the view that taxation laws must be fair to all taxpayers irrespective of their legally or illegally earned income. Then there are those with a contradictory view that taxation legislation must be based on morals and must uphold public policy. In first world countries like the USA and Australia, taxation legislation specifically disallows the deduction of expenses incurred in illegal activities even though the income generated is taxable. The basis for the disallowance appears to be public policy considerations.

It is submitted that it would be absurd to think that criminal law strictly prohibits illegal activities, yet taxation legislation would allow deductions in respect of those prohibited activities. It is submitted further that taxation law should not be at variance with other laws in a country because all laws in a country should be unified with the common purpose of maintaining public policy.

3.3 The "trade" requirement

The preamble to section 11 requires that before a taxpayer may claim a deduction from income in terms of section 11(a) of the South African Income Tax Act, he or she must be carrying on a trade. This is in contrast to "gross income". To be included in "gross income", an amount does not have to be derived from a trade; if an amount qualifies in terms of the definition of "gross income", it will be regarded (and be included) as taxable.

Section 1 of the South African Income Tax Act defines "trade" to include "every profession, trade, business, employment, calling, occupation or venture ...." "Trade" as defined, covers a wide spectrum of activities but there are certain activities that fall outside the scope of the definition. The most common of these are investments made in dividend and interest-bearing stock. This definition, like the "gross income" definition, does not differentiate between legal and illegal trading activities.

Williams (2009:245) reports that the largely circular statutory definition of "trade" adds little meaning to the ordinary meaning of the word and hence the question whether the transactions or activity engaged in by the taxpayer constitute a trade depends on "whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made."

In the English case of *Commissioners of Inland Revenue v Aken,* 1990 (1 WLR 1386d), the court held that:

> … if the activity is a trade, it is irrelevant for taxation purposes that it is illegal...I do not think that the word ''trade'' in itself has any connotation of unlawfulness. There may be

> lawful trade, there may be unlawful trade. But it is still trade. It is thus submitted that "legality is not an essential characteristic of a trade".

In *Natal Estates Ltd v SIR*, 1975 (4) SA 177 (A) (37 SATC 193), Holmes JA stated (at 23) that:

> In deciding whether a case is one of realizing a capital asset or of carrying on a business or embarking upon a scheme of profit making…important considerations include, inter alia, the intention of the owner, the objects of the owner, the planning, extent, duration, nature, degree, organisation and marketing operations… and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit.

Williams (2009:255) concludes that an essential element in the enquiry as to the existence of a trade is the intention of the taxpayer as evidenced by his conduct. Williams (2009:256) concludes further that trading usually but not necessarily involves an intention to make a profit.

In *CIR v Pick 'n Pay Employee Share Purchase Trust*, 1992 (4) SA 39 (A) (54 SATC 271), it was held that a distinction is drawn between the carrying on of a business and the pursuance of a profit-making scheme. The basis for such distinction is that it is more appropriate to refer to a profit-making scheme where a single transaction is involved. A series of transactions is characteristic of the carrying on of a business. Irrespective of the number of transactions, whether the receipts that flow from the carrying on of a business are revenue still depends on whether the business was conducted with a profit-making purpose, that is, as part of a profit-making venture or scheme.

In *CIR v George Forest Timber Company Ltd*, de Villiers JA stated (at 28) that "the fact to remember … is that whatever a person received in the way of his trade, business, or profession is income – *Stevens v Hudson Bay Company* (101 L.J. 96)."

In *Burgess v CIR,* 1993 (4) SA 161 (A) (55 SATC 185), Melamet J stated (at 196) that:

> In *ITC 770,* 1953 (19 SATC 216), Dowling J said (at 217), dealing with the similar definition of "trade" in Act 31 of 1941, that it was obviously intended to embrace every profitable activity and …I think should be given the widest possible interpretation. In

> the present case the appellant argued that its participation in the Fenton scheme amounted to a "venture" which is included in the definition of "trade".

The definition of "trade" includes a "venture". In *ITC 368* 1936 (9 SATC 211), the word "venture" was defined as a "transaction in which a person risks something with the object of making a profit".

In *Burgess v CIR* the court was of the opinion that an investment, in the nature of a speculation, with the hope of a future profit, would not always have to be risky to constitute a trade. According to Haupt (2016:111) if such a speculative investment did not involve risk it might still fall within the definition of "trade" by giving an extended meaning to the word "venture", or it might fall under some other part of the "trade" definition.

Haupt (2016:111) explains that trade implies an active occupation, as opposed to the passive earning of investment income. In *ITC 1476,* 1989 (52 SATC 141), the court held that the carrying on of a trade involves an "active step", that means something more than watching over existing investments that are not income producing and are not intended or expected to be so. The earning of income from an illegal activity such as the sale of counterfeit goods, as an example, involves a supply chain with a system of organisation, people, activities, information and resources involved in moving the counterfeit goods from supplier to customer. This could indicate that there are "active steps" involved in the illegal activity that could meet the definition of "trade" as defined in section 1 of the South African Income Tax Act.

The various tests that have been applied by the courts to determine if an activity constitutes a "trade" as defined in the South African Income Tax Act have been discussed above. These tests will be applied to illegal activities to determine if these activities meet the definition of "trade".

3.3.1 Illegal activities and the existence of a trade

SARS (2014:16) has based the disallowance for the deduction of expenditure incurred when conducting illegal activities on its own view that illegal activities do not meet the definition of "trade". From the decisions discussed, there is nothing that suggests that an illegal activity cannot constitute a "trade". It may only be a matter of time before a taxpayer involved in illegal activities challenges SARS on the disallowance of expenditure incurred on the basis that the activities do not constitute a "trade". The past court decisions will be of little assistance in this regard as there are a few Tax Court decisions that confirm that expenditure relating to illegal activities is not deductible, although on grounds other than illegality. As these decisions do not create precedence, the position remains uncertain.

Streicher (2015:35) states that as long as a taxpayer risks something with the objective of making a profit it will be considered to constitute a trade. He proposes that the objective of a taxpayer engaged in illegal activities is normally to realise a profit and in addition to this, there is normally a risk associated with illegal activities. He suggests that, as an example, a burglar or fraudster of money does exercise a certain level of skill and ingenuity when applying the trade. The statements above are in direct conflict with the *obiter* remarks of Lord Denning in the case of *Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd*, where he held that even though a gang of burglars acquire goods by their efforts, sell the goods and make a profit, their activities did not meet the definition of "trade" nor an adventure in the nature of a trade.

According to Williams (2009:194) there is no judicial precedent or statutory provision in South Africa which explicitly endorses (or contradicts) Lord Denning's proposition that organised crime in the form of burglary is not a "trade". The definition of "trade" has a wide interpretation, thereby further adding credibility to the argument that illegal activities do constitute a "trade" in terms of the definition.

In Natal Estates Ltd v SIR, the court held that an essential element in the enquiry as to the existence of a trade is the intention of the taxpayer as evidenced by his conduct. The perpetrator of an illegal activity may knowingly and intentionally carry out illegal acts on an ongoing basis for the purpose of earning income and making a profit. In *ITC 368* the word "venture" was defined as a "transaction in which a person risks something with the object of making a profit. The perpetrator of an illegal activity risks his or her freedom or his or her life (amongst other things) when he or she pursues his or her illegal profit motive as he or she could get caught by the relevant law enforcement authorities or be killed. He or she actively exercises skill, knowledge and ingenuity in conducting the illegal activities. The characteristics of a "trade" appear to be present, but this is in contradiction to the view of SARS that illegal activities do not constitute a trade.

3.3.1.1 Theft of money or embezzlement

According to SARS (2014:2) "embezzlement" means the misappropriation of funds entrusted to a person (for example, an employee or trustee) for care or management; "stolen money" means money obtained from embezzlement, fraud or theft. The question that arises is whether a taxpayer involved in the regular theft of money or embezzlement is conducting a trade? The definition of "trade" in the South African Income Tax Act makes no differentiation between a legal or illegal trade. It was held in *R v Sibiya* that theft is the unlawful appropriation of the property of another by intentionally arrogating to oneself the rights of the owner with the further intention of depriving the owner permanently of the whole benefit of his property.

A taxpayer involved in the theft of money or embezzlement actively uses his or her knowledge, skill and expertise to conduct the activity of theft or embezzlement. The thief who regularly engages in stealing would need to plan each theft meticulously. He or she would need to consider the costs, risks, rewards and resources involved to execute the theft or embezzlement. He or she would need to gain insider knowledge and may even recruit other parties to assist in the theft or embezzlement of the money in return for a share in the proceeds. The regular theft of money or embezzlement has the characteristics of conducting a trade.

In the event that a thief refunds all or a portion of the stolen money, the question that arises is whether having been taxed on the receipt, the thief will be entitled to a deduction for the stolen money refunded. SARS extends its opinion regarding the trade requirement to money refunded by a thief. SARS (2014:16) is of the view that section 11(a) read with section 23(g) of the South African Income Tax Act requires the taxpayer to conduct a trade and any deduction is limited to the extent an amount is expended for the purposes of that trade.

SARS emphasises that the stealing of money cannot be described as a trade and accordingly the thief will not qualify for a deduction under section 11(a) read with section 23(g) of the South African Income Tax Act. The view of SARS is contrary to the view of the court in *ITC 1545*, where the court held that until at least the owner of the stolen diamonds institutes proceedings against the thief to recover his loss from him rather than from any other party, the taxpayer's liability did not amount to "expenditure ... actually incurred" within the meaning of section 11(a) of the South African Income Tax Act. The court implied that if a taxpayer refunds the victim of his illegal activity, this amount would be deductible.

It can be questioned, on the basis of the case law discussed, whether the opinion of SARS regarding the disallowance of expenditure incurred in the theft of money or embezzlement on the basis of theft not qualifying as a trade is correct. The active "business like" steps that are carried out by a thief involved in the regular theft of money or embezzlement are very similar to the way in which a normal business would operate. The only difference is the manner in which the money is obtained. A normal business would acquire funding for the purpose of conducting its trade by legal means, such as borrowing the money from a bank, while a thief would obtain the money by illegal means such as theft. Both the thief and the legal business would have a profit-making objective.

The regular theft of money or embezzlement meets the characteristics of a trade, however SARS's opinion is that theft is not a "trade", even though the South African Income Tax Act is silent on the issue.

3.3.1.2 Theft of goods

Claassen (2017) states that the theft of goods is differentiated from the theft of money as the courts still require an actual physical dealing with the goods concerned or some conduct which is akin to physical dealing, whereas when dealing with the theft of money, even though there may be no physical handling of the stolen money, it is still considered theft. To illustrate whether the theft of goods falls within the definition of "trade" as defined in the South African Income Tax Act, as an example, the theft of vehicles will be discussed. According to Schutte (2017), the theft of vehicles in South Africa increased by 14.9 percent for the months of April to December, in 2016. He concludes that the theft of vehicles is a profession like any other and that the criminals are engaging in the activities for monetary benefit. The definition of trade includes "every profession". The organised theft of motor vehicles appears to meet the definition of "trade" as it can be considered to be a profession.

Car thieves operate as a syndicate with different role players each tasked with a specific duty. For example, the syndicate may consist of members who have skill in unlocking vehicles while others will have driving skills to enable them to get away with the stolen vehicle. The process consists of human capital in the form of thieves who acquire a stock of vehicles by illegal means and the stolen vehicles are sent to other illegal suppliers who render services such as panel beating, fitting of fake number plates and removal of tracking devices, all of which are required in preparation to have the stolen vehicles delivered to the customers across national and international borders of South Africa. The entire operation is conducted as a normal business operation with the exception that the business is illegal. The definition of "trade" includes a business. The regular theft of goods appears to meet the definition of "trade" as it is a business. Again, this is contrary to the opinion of SARS.

3.3.1.3 A once-off opportunistic illegal act

An illegal act carried out on a regular basis needs to be differentiated from a once-off opportunistic illegal act. There is uncertainty as to whether a once-off opportunistic illegal act would meet the definition of "trade".

In *Stephan v CIR*, 1919 WLD 1 (32 SATC 54), the court held that even though the company only undertook one operation, it did amount to the "carrying on" of a business because it involved numerous business transactions and the employment of capital. The conduct of the once-off opportunistic illegal act does not equate to a "business like" approach. As an example, an employee witnesses his employer leaving the company safe unlocked that has cash in it. The employee appropriates some of the cash for himself. He never repeats this illegal act again. Would the conduct of the employee constitute a trade? The employee had the intention of stealing the money when he saw the safe open. There is, however, no continuity of the illegal activity and there is no long term profit objective. The transaction lacks commercial substance. It is submitted that a once-off opportunistic illegal act will not constitute a "trade" as defined in the South African Income Tax Act.

3.4 The general deduction formula

Khumalo (2016:24) states that the South African income tax jurisprudence provides little clarity on the deductibility of any expenditure incurred in producing income from illegal activities. Like the "gross income" definition in the South African Income Tax Act, the general deduction formula is neutral with regard to the deductibility of illegal expenditures and losses. The reason why SARS (2014:16) denies the deduction of expenses incurred in carrying on an illegal enterprise is that it does not constitute a "trade". Subject to the assumption that it could meet the definition of a "trade", and thus that the uncertainty in relation to the deduction of expenditure incurred from illegal activities does not apply, the general deduction formula is discussed in this chapter to the extent that it could apply. The general deduction formula consists of section 11(a) read with section 23(g) of the South

African Income Tax Act. These sections provide certain positive requirements (which must be fulfilled in order for an amount to be deductible) and certain negative requirements, (which, if present, are a bar to deductibility).

In addition to the requirement set out in the preamble to section 11 and dealt with in section 23(g) of the South African Income Tax Act that the taxpayer should be carrying on a trade and generating income from the trade, in order to claim allowable deductions, the "general deduction formula" requires that there should be:

- expenditure and losses;
- actually incurred;
- during the year of assessment;
- in the production of the income; and
- not of a capital nature.

3.4.1 Expenditure and losses

Section 11(a) of the South African Income Tax Act refers to both expenditure and losses. According to Haupt (2016:114), whether, in truth, there is any difference between the two terms is not clear, although reference was made to a possible difference in two of the leading cases dealing with this section. In the English case, *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*, 1932 (17 TC 59), Findlay J explained (at 64) that:

> the word disbursements means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing which, so to speak, comes upon him ab extra.

The courts have not defined the word "losses", but in *Joffe and Co (Pty) Ltd v CIR*, 1946 AD 157 (13 SATC 354), the court considered that the word had several meanings, that in the context of a provision almost identical to section 11(a) of the South African Income Tax Act, its meaning was somewhat obscure, and that it was not clear whether it meant anything different from expenditure. The meaning of the word "loss" in relation to trading operations was described by Watermeyer CJ, who delivered the judgment of the Appellate Division of the Supreme Court (at 360) as "sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."

In *Ackermans Ltd v C: SARS*, 2010 (1) SA 1 (SCA) (73 SATC 1), Cloete JA stated (at 5) that according to his mind, "expenditure incurred means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability."

According to SARS (2013b:9) when applying these principles, it is apparent that in order to constitute expenditure a taxpayer must outlay or expend cash or assets in a form other than cash, or must have an unconditional legal liability to outlay or expend cash or assets in a form other than cash. SARS clarifies that whether the outlaying of such cash or other assets results in a change in a taxpayer's overall or net asset position will depend on the particular reason for the outlay and, in some situations, there will be a dilution in total assets and in other situations merely a shift of assets.

In *Port Elizabeth Electric Tramway Company Ltd v CIR*, Watermeyer AJP stated (at 15) that: "the word "losses" in this section appears to mean losses of floating capital employed in the trade which produces the income."

As a result of this, capital losses are therefore excluded and cannot be deducted in terms of the general deduction formula.

Streicher (2015:38) states that there needs to be expenditure or a loss before the general deduction formula can be applied to deduct expenditure resulting from illegal activities from the income of a taxpayer. He elaborates that the illegal expenditure or loss must be closely related to the normal business operations or as a result of an expected business risk of the taxpayer. A thief involved in the theft of money or goods may incur losses and expenditure. As examples, the thief may incur expenditure such as salaries and wages payable to other participants in the syndicate, rental expenses for office space where planning of the theft takes place, utilities, cellphones, etc. The general deduction formula is silent on expenditure and losses incurred in illegal activities. Subject to the overall question of deductibility, a taxpayer engaged in illegal activities may incur expenditure and losses when conducting that activity.

3.4.2 Actually incurred

Haupt (2016:115) states that in deciding whether or not expenditure has actually been incurred, it is not essential to decide whether it was necessarily incurred. He reports that it is not for the tax authorities to decide whether or not the expenditure was prudent or otherwise as the fact that it is actually incurred means that it passes the test. He explains that the deductibility of expenditure is not determined on a cash basis, that is, it is not necessary to have actually paid the expense before the deduction can be claimed. Streicher (2015:38) states that the difference between actually incurred and necessarily incurred widens the scope of tax deductible expenditure as what might be an unnecessarily high expense according to the Commissioner, as a result of ineffective business conduct, cannot be disallowed on this basis since the expense has actually been incurred.

In *Port Elizabeth Electric Tramway Company Ltd v CIR,* Watermeyer AJP stated (at 15) that:

> the words of the statute are "actually incurred" not "necessarily incurred." The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not "necessary" but they are actually incurred and therefore deductible. But expenses "actually incurred" cannot mean "actually paid." So long as the liability to pay them actually has been incurred they may be deductible.

In *Caltex Oil (SA) Ltd v Secretary for Inland Revenue,* 1975(1) SA 665 (A) (37 SATC 1), Botha JA stated (at 673H to 674B) that:

> The expression "expenditure actually incurred" in section 11(a) of the Income Tax Act, 58 of 1962, does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not.

According to SARS (2013a: 4) for an expense or a loss to be deductible, it must actually be incurred. SARS confirms that "actually incurred", means that the taxpayer must have a definite and absolute liability to pay an amount. SARS emphasises that a liability that is conditional or contingent in any way will not be deductible. Expenditure and losses that are uncertain or which may arise in future are not considered to be "actually incurred" and are not deductible.

In *ITC 1545*, the court held that the taxpayer's liability to the owner for the return of the stolen diamonds or their value did not constitute deductible expenditure in terms of section 11(a) of the South African Income Tax Act, as whether the taxpayer is ever made to compensate the owner or not depended in each case not only upon whether his crime was detected but also upon the non-happening of an uncertain future event. The court held further that, therefore, until at least the owner institutes proceedings against the taxpayer to recover his loss from him rather than from any other party, the taxpayer's liability did not amount to "expenditure ... actually incurred" within the meaning of section 11(a) of the South African Income Tax Act.

Scott J stated (at 467) that: "It is well established that in order for expenditure to be deductible it must have been incurred in the year of assessment concerned. In order to be deductible, the liability must be one which is definite and absolute and not one which is merely contingent."

Streicher (2015:39) reports that one of the requirements of the general deduction formula is that the expenditure and losses need to be "actually incurred" before there can be deduction. He states that the deduction can only be claimed when there is an unconditional liability to incur the expenditure at the end of the taxpayer's year of assessment. A taxpayer engaged in illegal activities may have actually incurred expenses, but the deductibility of these expenses remains uncertain. In *ITC 1545* the court implied that if the expenditure was actually incurred by the taxpayer who sold stolen diamonds, it would have been deductible. The illegal nature of the entity was irrelevant. This is contrary to the *obiter* remark of Watermeyer AJP in the case of *Port Elizabeth Electric Tramway Company Ltd v CIR,* where he stated that if the act is unlawful, the expenditure incurred from the unlawful act would probably not be deductible. Thus, the position regarding deductibility remains uncertain.

3.4.3 In the year of assessment

According to Haupt (2016:117) the courts have held that expenditure that the taxpayer claims as a deduction must be incurred during the year in which it is claimed. In *CIR v Sub-Nigel*, 1948 (4) SA 588 (A) (15 SATC 381), Centlivres JA stated (at 390) that "the whole scheme of the Income Tax Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted."

In *Concentra (Pty) Ltd v CIR*, 1942 CPD (12 SATC 95), expenditure relating to directors' expenses which had arisen in earlier years was not claimed as a deduction in those years and, by not doing so, the right to claim a deduction in terms of section 11(a) of the South African Income Tax Act was forfeited. The South African Income Tax Act deals with one tax year, as taxpayers are assessed on income they receive in one year of assessment and thus the deductions should also be claimed in that one year of assessment.

3.4.4 In the production of income

According to Haupt (2016:118) any expenditure that has not been incurred for the purpose of producing income, will not be allowed as a deduction. Goldswain (2016b:30) emphasises that the element "in the production of income" requires a link between the act giving rise to the expenditure and the earning of income. The leading case dealing with the phrase "in the production of income" is *Port Elizabeth Electric Tramway Company Ltd v CIR*, which involved the payment of compensation to a driver of a tram injured during the course of his employment and who subsequently died from his injuries. The company resisted the claim in legal proceedings but eventually was ordered to pay damages and also incurred legal costs in resisting the claim. The question was whether these expenses were incurred "in the production of income".

The meaning of the words "in the production of income" was considered in the case where Watermeyer AJP stated (at 14-17) that:

> 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…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.

Streicher (2015:40) declares that the test resulting from this case was that if the expenditure is incurred to produce income, the expenditure incurred will probably be deductible for tax purposes. He reports that it can be assumed that the expenditure should, however, not be as a result of an unlawful act otherwise it will probably not be deductible for tax purposes. This conclusion is based on the *obiter* remark of Watermeyer AJP that “[i]f the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible”. The general deduction formula does not explicitly state that expenditure incurred from illegal activities is prohibited, nor have the judgments in case law provided certainty regarding the allowance or disallowance of expenditure incurred in illegal activities.

In *Port Elizabeth Electric Tramway Company v CIR*, the court held that all expenses attached to the performance of a business operation must be so closely connected with it that they may be regarded as part of the cost of performing it. In *CIR v Sub-Nigel*, the court held that even though income may be earned only in a future year, as long as the expenditure has been laid out for the purpose of earning that income, it is deductible. Therefore, if expenses are incurred in an illegal business prior to earning income, these expenses would be deductible if they were incurred for the purpose of earning income.

There is one issue that may delay the deduction of an expense. In the case of a legitimate business, it is usually clear when the business starts to trade, and pre-trade expenses will be deductible in terms of section 11A, once trade commences and income is earned. In the case of an illegal enterprise, there may be a lengthy period in which the crime is being planned and preparatory expenses incurred. Once the crime is committed, “trading” may be said to have commenced and section 11A could apply.

3.4.5 Not of a capital nature

Section 11(a) of the South African Income Tax Act provides that expenditure and losses "of a capital nature" are not allowed as a deduction from the income of a taxpayer, even if all the other requirements of the section are met. The effect of this provision is to bring the deduction side in line with the income side, that is, as a general rule, capital expenditure is not allowed as a deduction, and capital receipts are not taxable. There are special provisions in the South African Income Tax Act that provide for the deduction of certain capital expenditure, for example, section 11(e) (wear and tear on business articles and assets), section 11(gA) (write-off of patents, trademarks, etc.), section 12 (write off of manufacturing and similar equipment) and section 13 (allowances on industrial buildings). In addition, capital gains tax legislation provides for capital losses to be off set against capital gains.

Once again, there is no definition in the South African Income Tax Act as to what constitutes capital expenditure. Therefore, one has to look to case law to provide an answer. Goldswain (2016c:2) explains that although there is a mass of judicial decisions on this subject, it is impossible to extract a universal test that will provide for all situations. One has to look at the facts of each case and the purpose of the expenditure concerned.

In *New State Areas Ltd v CIR*, 1946 AD 610 (14 SATC 155), Watermeyer CJ stated (at 163) that:

> The distinction must be remembered between floating or circulating and fixed capital. When the capital employed in a business is frequently changing its form from money to goods and vice versa and this is done for the purpose of making a profit, then the capital so employed is floating capital.

The test laid down in this case was whether the expenditure incurred was closely connected to the income-producing structure and thus capital in nature or closely connected to the income earning-operations and therefore revenue expenditure. As an example, a taxpayer conducting an illegal business as an importer of illegal cigarettes could purchase assets required for the storage or distribution of those cigarettes. This expenditure is closely related to the income-producing structure of the illegal business and thus capital in nature.

In *CIR v George Forest Timber Company Ltd*, Innes CJ stated (at 526) that:

> Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield a future profit and while the outlay does not recur, the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not...

Stiglingh, Keokemoer, Van Zyl, Wilcocks and De Swardt (2016:147) confirm that there must be a sufficiently close link between the expenditure and the taxpayer's income-earning operations in order to warrant the conclusion that it formed part of the cost of performing the taxpayer's income-earning operations, rather than the cost of expanding the income-producing structure. The authors conclude that if the expenditure is more closely related to the cost of performing the taxpayer's income-earning operations, rather than the cost of expanding his income-producing structure, it is not capital in nature.

3.4.5.1 Capital gains tax in relation to illegal expenses

It is submitted that, in line with the certainty relating to the inclusion of illegal income in "gross income", the proceeds received from the disposal of assets held by an illegal entity will be subject to capital gains tax in terms of the Eighth Schedule of the South African Income Tax Act. The question that arises is whether the illegal entity will be able to include the costs incurred in acquiring, disposing of or creating the asset in the base cost of the asset for capital gains tax purposes.

In paragraph 3 of the Eighth Schedule of the South African Income Tax Act, a person's "capital gain" is defined as follows: "for a year of assessment in respect of the disposal of an asset during that year is equal to the amount by which the proceeds received or accrued in respect of that disposal exceed the base cost of that asset." A taxpayer is therefore required to compare the amounts received or accrued during the current year of assessment from the disposal of an asset with the base cost of the asset. The capital loss on the disposal of an asset is the amount by which the base cost exceeds the proceeds. The proceeds and base cost of an asset are important for the determination of the capital gain or capital loss on its disposal. Paragraph 20 of the Eighth Schedule sets out what may and may not form part of the base cost of an asset.

In terms of section 23(b) and section 23(f) of the South African Income Tax Act, domestic or private expenses and amounts incurred in the production of exempt income are not allowable as deductions against income. SARS (2015:176) states that paragraph 20 of the Eighth Schedule overrides these sections and expenditure of this nature may qualify to be added to the base cost of an asset under appropriate circumstances. SARS confirms that an overriding measure is not required for section 23(g) as that provision is concerned only with the prohibition of a deduction from income for non-trade expenditure, something which is irrelevant for the purposes of determining a capital gain or loss.

SARS (2015:176) clarifies that the expenditure that would form part of the base cost of the asset must be directly related to the cost of acquisition, creation or disposal of the asset. Paragraph 20(1)(a) of the Eighth Schedule refers to "the expenditure actually incurred in respect of the cost of acquisition or creation of that asset". The word "expenditure" includes expenditure in cash or in kind. In *ITC 1783*, 2004 (66 SATC 373), Goldblatt J stated (at 376) that: "Expenditure in its ordinary dictionary meaning is the spending of money or its equivalent, for example, time or labour and a resultant diminution of the assets of the person incurring such expenditure."

The Eighth Schedule of the South African Income Tax Act does not specifically prohibit an amount from being included in the base cost of an asset due to the asset being utilized to conduct illegal activities. There is no provision in the Eighth Schedule that discusses the legal or illegal purpose for which the asset was acquired, created or disposed of. The costs incurred in acquiring, disposing or creating an asset could therefore be added to the base cost of the asset for capital gains purposes.

SARS (2015:186) states that expenditure actually incurred in establishing, maintaining or defending a legal title to or right in an asset is allowed as part of the base cost of the asset. In *ITC 1677*, 1999 (62 SATC 276), legal expenses incurred in resisting the competing publisher's claim for an interdict against new work on the ground of an infringement of its copyright was held to be capital and in *ITC 1648*, 1998 (61 SATC 58), legal costs incurred by a farmer in opposing an application to force him to eliminate certain boreholes on his farm were held to be capital.

SARS (2015:186) confirms that the expenditure will be allowed as part of the base cost of the asset even if the person is unsuccessful in defending his or her right or title in the asset. This provision is very similar to the equivalent rule in the Australian Income Tax Assessment Act of 1997, namely section 110-5(6). SARS does not state that the legal costs incurred in defending a legal title or right in an asset held by an illegal entity may not be included in the base cost of the asset.

3.4.6 To the extent not laid out for the purpose of trade

Section 23(g) of the South African Income Tax Act forms part of the general deduction formula. This section prohibits the deduction of expenditure to the extent to which such moneys were not laid out or expended for the purposes of trade.

Williams (2009:513) confirms that section 23(g) originally prohibited the deduction of expenditure that was not "wholly or exclusively" incurred for the purpose of trade. He explains that the sub-section has since been amended to prohibit the deduction of expenditure "to the extent to which" it was not incurred for the purposes of trade, thus explicitly allowing for apportionment where expenditure is incurred partly for trading and partly for non-trading purposes.

Where a taxpayer engaged in an illegal trade incurs expenditure partly for the purposes of that trade and partly for non-trade purposes, section 23(g) of the South African Income Tax Act could allow an apportionment of the expenses and allow the deduction of that portion incurred for the purposes of trade, provided the expenditure qualifies for deduction (which is presently uncertain). As an example, a drug manufacturer may be able to deduct the costs incurred in manufacturing drugs for his trade in drug dealing, but the expenses incurred in the manufacture of drugs that are used for his own private use will not be deductible. Although in the context of this thesis, it has been demonstrated that illegal activities comply with the definition of "trade", this is not in accordance with the view of SARS that an illegal activity is not a trade.

3.5 The general deduction formula and its application to illegal activities

In *Port Elizabeth Electric Tramway Company v CIR*, the court held that 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 they may be regarded as part of the cost of performing it. Even though the court in this case held further that if the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible, the general deduction formula does not explicitly state that expenditure incurred from illegal activities is prohibited, nor have the decisions in case law provided certainty with regard to the disallowance of expenditure incurred in carrying on illegal activities.

It has been shown that illegal activities, with the exception of a once-off opportunistic illegal act, would amount to carrying on a "trade" as defined, in terms of the tests established in case law. The characteristics of a "trade" appear to be present but this is in contradiction to the view of SARS.

In *CIR v Delagoa Bay Cigarette Company*, Bristowe J (at 49) made the following *obiter* remark in relation to the deductibility of expenses incurred in carrying out illegal activities:

"If the income itself is taxable, it follows I think that if, the prizes had been a legitimate deduction had the business been legal, they would equally be a legitimate deduction if the business is illegal."

In *Port Elizabeth Electric Tramway Company Ltd v CIR*, Watermeyer AJP stated (at 16-18):

> 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… 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.

He qualified this statement in an *obiter* remark (at 17):

> 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.

The *obiter* remark of Watermeyer AJP in the case of *Port Elizabeth Electric Tramway Company Ltd* runs contrary to the *obiter* opinion of Bristowe J in *CIR v Delagoa Bay Cigarette Company.*

In *ITC 1199,* 1973 (36 SATC 16), Margo J stated (at 19) that: "Since income from unlawful trading is assessable to tax, expenditure in the production thereof is deductible." Tax court decisions do not create precedence and therefore this decision and the two contrasting *obiter* remarks have provided no certainty regarding the deductibility of expenses incurred in carrying on an illegal activity. SARS supports the opinion of Lord Denning in the case of *Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd,* and is of the view that illegal activities do not constitute a trade. The South African Income Tax Act is silent on the deductibility of expenses incurred from illegal activities. Therefore, the position remains uncertain.

3.5.1 The deduction of illegal expenditure in a legal enterprise

Any legal enterprise is at a risk of being exposed to illegal activities. The illegal expenditure that a legal enterprise can incur may include such expenditure as the payment of fines for traffic violations, the purchase of stolen goods, the employment of illegal immigrants, the illegal use of patents, etc. Legal enterprises would also be exposed to the risk of illegal activities of employees, such as embezzlement and theft of goods belonging to the enterprise. The two aspects in terms of the general deduction formula that are relevant to this discussion are whether the illegal expenditure was incurred in the production of income and is not of a capital nature.

3.5.1.1 Examples of illegal expenses

Enterprises engaged in a legal business may be fined for an illegal action or may pay bribes to secure contracts. Section 23(o) of the South African Income Tax Act prohibits the deduction for income tax purposes of expenditure incurred in respect of –

- corruption or a corrupt activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004; or
- a fine or penalty imposed as a result of an unlawful activity.

Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004 addresses the general offence of corruption and offences in respect of corrupt activities relating to specific persons. It further provides for offences in respect of corrupt activities relating to both the receiving or the offering of an unauthorised gratification and it also provides for offences in respect of corrupt activities relating to specific matters. Specific matters identified for special consideration are corrupt activities relating to witnesses or evidential material in certain proceedings, contracts, the procuring and withdrawal of tenders, corrupt activities relating to auctions, sporting events, gambling games and games of chance.

Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 12 of 2004 also provides for miscellaneous offences relating to possible conflicts of interest and other unacceptable conduct. The chapter provides for the acquisition of a private interest in a contract, agreement or in an investment of a public body, unacceptable conduct relating to witnesses and the intentional interference with, hindering or obstruction of an investigation of an offence. Chapter 2 finally provides for the position of an accessory to or an attempt, a conspiracy or for inducing another person to commit one of the offences listed in the chapter.

An entity may pay bribes when conducting its activities. Any payment of bribes will be disallowed by section 23(o) of the South African Income Tax Act.

SARS (2010:3) reports that *ITC 1490*, 1990 (53 SATC 108), dealt with a cartage contractor who sought to claim a deduction for traffic fines under section 11(a). The court held that to allow the fines as a deduction would be contrary to public policy, frustrating the legislative intent and allow a punishment imposed to be diminished or lightened. The court added that the fines did not play any actual part in the earning of the income and were not an inevitable concomitant of the business of a cartage contractor.

It can be suggested that for a road haulage business, as an example, the payment of fines for overloading of trucks should be deductible in accordance with section 11(a) because the expenses are incurred in the production of income; however, section 23(o) specifically prohibits this deduction. It appears that the court invoked public policy considerations for the disallowance of the deduction.

A person engaged in a lawful enterprise may need to compensate a victim or victims of an unlawful act. Amounts payable as compensation may qualify for a deduction under section 11(a). The principles laid down in *Port Elizabeth Electric Tramway Company Ltd v CIR,* will apply to the payment of compensation. *Port Elizabeth Electric Tramway Company Ltd v CIR,* dealt with the issue of whether the compensation costs payable by the taxpayer to the widow of a deceased employee who was injured in a tramcar accident and later died, were deductible. The court held that expenditure and losses are deductible provided they are so closely connected with the operation that it may be regarded as part of the cost of performing the operation.

Compensation paid by a legal enterprise, where the act that entailed the expense was legal and was so closely connected with the operation that it may be regarded as part of the cost of performing the operation will be deductible. Compensation paid where the act that entailed the expense was unlawful, but was closely connected with the enterprise, would comply with this test for deductibility. The conflicting obiter remarks in the *Delagoa Bay Cigarette Company* and *Port Elizabeth Electric Tramway Company Ltd* cases create doubt regarding the deductibility of the compensation.

In certain instances, compensation may be payable by a legitimate business to the victim of an illegal act committed by an employee who was not engaged on the employer's business. This compensation is unlikely to be deductible by the business. In *Weinberg v CIR*, 1946 CPD 429 (14 SATC 210), the taxpayer owned a garage and garaged a car for one of his customers for an agreed payment. An employee took the car and drove it to his own home, but on his way back ran the vehicle into a building. The taxpayer was obliged to pay for the resultant damages and claimed these as deductible expenditure. The court held that when the employee drove the car into the building he was not engaged in the rendering of any service in the normal course of business operations of his employer. The act of damaging the vehicle was not the inevitable or practically inevitable result of the contract which the appellant had with the owner of the vehicle and the expenditure was thus not incurred in the production of income and not deductible.

Other examples of illegal expenses that a legal enterprise could incur include the purchase of stolen goods, the employment of illegal immigrants, the illegal use of patents, etc. The legal enterprise may not have been aware of the fact that the goods purchased were stolen or that the employees were illegal immigrants or that the fees for the use of the patent were illegal. Provided that these costs meet the requirements of the general deduction formula, they will be deductible. The main aspect is that the costs must be incurred in the production of income. The enterprise could face criminal or civil sanctions as a result of these transactions and would be exposed to the payment of compensation, fines and legal costs and the deduction of these expenses would be in question.

An enterprise that unknowingly engages in these illegal activities will claim the deduction, but when found guilty of having made these illegal payments, the question is whether SARS will issue a revised assessment and refuse the deductions. SARS is of the view that taxpayers that engage in illegal activities are not conducting a trade and the denial of the deductions is on this basis. Chapter 8 of the Tax Administration Act, 28 of 2011, allows SARS to issue assessments and section 92 allows SARS to issue additional assessments. SARS will be able to issue additional assessments by disallowing deductions previously allowed to a legal entity that knowingly conducted illegal activities.

3.5.1.2 Embezzlement and theft by employees

A legal enterprise may incur losses in relation to the theft of money or goods by its employees. *ITC 1221*, 1974 (36 SATC 233), dealt with misappropriation by a subordinate employee. In this case, the court confirmed that *Lockie Bros Ltd v CIR*, 1922 TPD 42 (32 SATC 150), was clear authority that theft losses by a managing director, a director or a manager in the position of a proprietor will not be deductible.

In *ITC 1242*, 1975 (37 SATC 306), the court applied the decision in *COT v Rendle*, 1965 (1) SA 59 (SRAD) (26 SATC 326), and distinguished the case of *Lockie Bros Ltd v CIR*. It was held that "as a prerequisite to deductibility the taxpayer must establish that the risk of the loss which he seeks to deduct from his income is inseparable from, or a necessary ingredient of, the carrying on of the particular business". *ITC 1242,* involved defalcations by two clerks, consisting of thefts from petty cash, appropriations of money paid by other members of staff for the account of the company, drawing of cheques on the company's bank account and destroying the returned cheques and ordering goods for their personal use in the name of the company. The court held that the costs were deductible.

Losses due to theft or embezzlement by junior employees will be deductible by the business. Based on the court's decision in *ITC 1221,* theft losses by a managing director, a director or a manager in the position of a proprietor will, however, not be deductible.

3.6 The deduction of legal expenses

An illegal enterprise has a higher probability of incurring legal costs due to the illegal nature of its trade. The perpetrators of crime would incur legal expenditure when they have to defend themselves in court after they have been caught by law enforcement authorities. The question that arises is whether the legal expenses incurred would be deductible.

The section of the South African Income Tax Act that deals with the deduction of legal expenses is:

> Section 11. General deductions allowed in determination of taxable income, —

> 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:
>
> (c) any legal expenses (being fees for the services of legal practitioners…) actually incurred by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade: Provided that the amount to be allowed under this paragraph in respect of any such expenses shall be limited to so much thereof as —
>
> (i) is not of a capital nature;

Two key elements of section 11(c) are that the legal expenses must arise in the course of or by reason of the ordinary operations undertaken by the taxpayer (or the criminal) in the carrying on of his trade and must not be of a capital nature. There is no requirement that the legal expenses must be incurred in the production of income. There is also no requirement in section 11(c) that a deduction is denied in respect of legal costs incurred in carrying on illegal operations.

3.6.1 In the course of or by reason of the ordinary operations undertaken in the carrying on of a trade

The case of *C:SARS v Thor Chemicals SA (Pty) Ltd*, 2000 (N) (62 SATC 308), is discussed as it dealt with legal expenses incurred by the taxpayer by reason of the ordinary operations undertaken by the taxpayer in carrying on its trade. The legal expenses were incurred by the taxpayer in defending itself against accusations of negligence in carrying on its operations.

The taxpayer operated a factory that manufactured mercury products. In 1992 an employee was found to be suffering from mercury vapour poisoning, while another two employees had died from the same condition. The Department of Manpower launched an investigation, followed by a magisterial enquiry. The enquiry led to the taxpayer and some of its employees facing charges of culpable homicide and numerous contraventions of the Machinery and Occupational Safety Act, 6 of 1983. In the event the taxpayer pleaded guilty to certain of the contraventions and not guilty to the rest of the charges. The Commissioner for the South African Revenue Service rejected the claim by the taxpayer that the legal costs were deductible, having been incurred in the production of its income.

The taxpayer argued that it had incurred the expenses at the enquiry in order to prevent a prosecution, and at the criminal trial to prevent a conviction. The court applied one of the principles from *Port Elizabeth Electric Tramway Co Ltd v CIR*, and enquired whether the occurrence was the realisation of a risk that was a necessary concomitant of the income-producing operations. In effect, the question was whether the risk of poisoning was an inevitable part of the business. The court found that it was clear from the evidence that the taxpayer had incurred the legal fees in order to defend its position that it had not been negligent and had not contravened regulations. The expenses were therefore deductible.

The legal expenses for *Thor Chemicals SA (Pty) Ltd* were allowed as a deduction as the taxpayer was able to satisfy the court that the expenses were incurred by reason of the ordinary operations undertaken by the taxpayer in the carrying on of its trade and the expenses were not capital in nature. The differentiating factor in *Thor Chemicals SA (Pty) Ltd* and an illegal entity is the “carrying on of a trade” requirement. Legal expenditure incurred by a taxpayer would be deductible under section 11(c) provided it is not capital in nature.

However, the first requirement of section 11(c) is that the legal expenses must arise in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his or her trade. Although it has been demonstrated that a taxpayer conducting illegal activities is conducting a “trade” as defined in section 1 of the South African Income Tax Act, SARS is of the view that a taxpayer conducting illegal activities is not conducting a trade. It appears that SARS may deny a section 11(c) deduction of legal expenses incurred by a taxpayer engaged in illegal activities on this basis.

3.6.2 Legal expenses must not be capital in nature

Legal expenses incurred will not be deductible under section 11(c) if they are capital in nature. In *SIR v Cadac Engineering Works (Pty) Ltd,* 1965 (2) SA 511 (A) (27 SATC 61), the court held that legal expenses incurred by the taxpayer were directed towards the elimination of a competitor, whereby the taxpayer’s existing market and goodwill could be protected and expanded. Thus, in this case and the case of *CIR v African Oxygen Ltd*, 1963(1) SA 681(A) (25 SATC 67), legal expenditure was incurred in order to better exploit the taxpayers’ existing capital assets and was thought to be more closely connected to the income earning structure of the taxpayers. The legal expenditure was held by the court to be capital in nature and not deductible as a result.

Even if an illegal entity incurs legal expenses that are not of a capital nature, SARS would deny a section 11(c) deduction based on its view that illegal activities do not meet the definition of "trade".

3.7 Conclusion

Chapter three has provided a detailed discussion in relation to the goal of the research to explore from a South African perspective whether expenses incurred when generating income from illegal activities are, or should be, allowed as a deduction for tax purposes. Chapter three included a discussion regarding whether the definition of "trade" in section 1 of the South African Income Tax Act applied to illegal activities and to establish, in relation to legislation and case law, if the general deduction formula (the preamble to section 11, and section 11(a) read with section 23(g) of the South African Income Tax Act) applied to expenses incurred in deriving income from illegal activities.

Most deductions are allowed by virtue of the general deduction formula (section 11(a) read with section 23(g) of the South African Income Tax Act). No deductions can be claimed in terms of the general deduction formula (and section 11 as a whole), however, if the taxpayer is not engaged in the carrying on of a trade. The opening words of section 11 are: "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…" From the analysis in the chapter it was concluded that the ongoing, intentional theft of money or goods and other illegal activities, when conducted in an active "business like" manner where the perpetrator exercises his skill and ingenuity in a profit-making scheme, will constitute a "trade" as defined in the South African Income Tax Act. The definition of "trade" includes a venture, business and profession and it is widely interpreted, further supporting the conclusion that a taxpayer earning income from an illegal activity is conducting a "trade". This conclusion is, however, in contradiction to the view of SARS that illegal activities do not meet the definition of "trade".

Subject to the overall question whether expenses linked with an illegal trade are deductible at all, in principle, a taxpayer conducting an illegal trade must satisfy the requirement that the expenses and losses have actually been incurred in the year of assessment in the production of income from that illegal trade and not be of a capital nature. In terms of section 23(g), the expenses are deductible to the extent that they are laid out for the purposes of trade. If the taxpayer has incurred the expenditure and losses with a dual purpose, for example, partly for conducting his illegal trade and partly for non-trade purposes, the taxpayer could be allowed an apportionment of the expenditure and losses incurred in the illegal trade. Subject to the overall question of deductibility, expenses incurred in conducting illegal activities could meet the requirements of the general deduction formula and be deductible.

The Eighth Schedule of the South African Income Tax Act does not prohibit an amount from being included in the base cost of an asset due to the asset being utilized to conduct illegal activities. There is no provision in the Eighth Schedule that discusses the legal or illegal purpose for which the asset was acquired, created or disposed of. The costs incurred in acquiring, disposing of or creating an asset may be added to the base cost of the asset for capital gains tax purposes.

Any legal enterprise is at a risk of being exposed to illegal activities. A legal enterprise that incurs expenses for the payment of fines or bribes, will not obtain a deduction for these expenses, irrespective of these expenses being incurred in the production of income in accordance with section 11(a), as section 23(o) specifically disallows the deduction of fines or bribes paid on the basis of unlawfulness.

Amounts payable as compensation may qualify for a deduction under section 11(a). Williams (2015:447) explains that section 11(a) imposes two tests, in relation to the deduction of compensation paid. Williams (2015:448) states that the first test is a subjective test to establish whether the purpose of the taxpayer, in performing the act which entailed the expenditure, was to produce income and the second test is an objective test to establish whether the expenditure was so closely linked to that act as to be regarded as part of the cost of performing it. His view is that if the act giving rise to the expense is unlawful or negligent, it may not be deductible. Compensation expenses incurred by a legal enterprise would be deductible, subject to the possible denial based on the fact that the act giving rise to the expense is unlawful or negligent, or that the compensation arose as a result of an action of an employee not engaged on his or her employer's business.

Expenses incurred by a legal enterprise in relation to the theft of money or goods by employees would be deductible as it is inseparable from, or a necessary ingredient of, the carrying on of the particular business, provided it is not of a capital nature. Based on the court's decision in *ITC 1221,* theft losses by a managing director, a director or a manager in the position of a proprietor will not be deductible.

Legal expenditure is deductible in accordance with section 11(c) of the South African Income Tax Act. Two key elements of section 11(c) are that the legal expenditure must arise in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his or her trade and must not be of a capital nature. Although it has been demonstrated that a taxpayer conducting illegal activities is conducting a "trade" as defined in section 1 of the South African Income Tax Act, SARS is of the view that a taxpayer conducting illegal activities is not conducting a trade. It appears that SARS may deny a section 11(c) deduction of legal expenses incurred by a taxpayer engaged in illegal activities on this basis.

It was demonstrated that in first world countries like the USA, Australia and New Zealand, public policy considerations are the reason why taxation legislation specifically disallows the deduction of expenses incurred in illegal activities even though the income generated is taxable. It would be unacceptable that criminal law strictly prohibits illegal activities, yet taxation legislation would allow deductions against those prohibited activities.

Chapter four presents an analysis and comparison of legislation and practices in the USA, Australia and New Zealand, in relation to the taxation of income and expenses arising from illegal activities, to determine whether these principles could be applied in a South African context.

Chapter Four: The taxation of income and expenses derived from illegal activities in the United States of America, Australia and New Zealand

4.1 Introduction

Chapter four addresses the goal of the research, which is to explore from the perspective of selected foreign jurisdictions whether income from illegal activities is, and expenses incurred in generating income from illegal activities are, or should be, subject to tax. The comparative discussion is based on the approach in the United States of America (the USA), Australia and New Zealand. Streicher (2015: 5) explains that in an attempt to analyse the taxation treatment of illegal activities in South Africa, it is important not to focus only on principles laid down by South African law, but also to compare these principles to the principles and interpretations laid down in legislation and by the courts of countries with taxation laws that are similar to the law in South Africa. He states that this comparison could highlight income tax principles or practices that could be useful within a South African context.

Chapter four presents an analysis and comparison of legislation and practices in the USA, Australia and New Zealand and determines whether these principles could be applied in a South African context. Chapter four focuses on whether it is an accepted practice in these jurisdictions to include illegal receipts in the taxable income of the taxpayer and, thereafter, whether expenditure incurred as a result of illegal activities is deductible for income tax purposes. The three countries form the basis of this analysis due to the similarities in taxation legislation that these countries share with South Africa.

4.2 The taxation of income from illegal activities

4.2.1 United States of America

It was concluded in chapter two, based on case law, that the broad definition of "gross income" in section 1 of the South African Income Tax Act includes income from illegal activities. Taxpayers will be taxed on all their income, irrespective of the legal or illegal nature of the income earned. It is important to establish whether the USA follows an approach similar to the South African approach of taxing income from illegal activities.

The Congress of the USA derives its power to levy and collect taxes on income in terms of the Sixteenth Amendment to the Constitution of the United States of America of 1789. Section 61 of the Internal Revenue Code of 1954 is silent on the issue of income derived from illegal activities. Khumalo (2016:29) explains that American courts have considered whether earnings derived from unlawful activities constitute taxable income in a series of cases dating as far back as the 1920s.

4.2.1.1 Claim of right doctrine

Khumalo (2016:36) refers to the fact that the USA used to have a claim of right doctrine, which held that income derived from illegal activities cannot constitute income for tax purposes because the taxpayer has no claim of right to the income and is under an obligation to return the proceeds.

The court in *Commissioner v Wilcox,* 1946 (327 US 404), held (at 408) that embezzled funds are not taxable and held further that taxable income:

> does not accrue from the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit…Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit.

The claim of right doctrine that applied previously in the USA is similar to the argument presented by the court in the case of *COT v G* where the court held that a receipt does not "cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken". The court held that stolen money would seem never to become the property of the thief, just as borrowed money does not become the property of the borrower (except in a technical sense) because of the co-equivalent obligation to repay it that arises from the moment it comes into his possession. The court held further that it matters not that the funds were acquired illegally, so much as that his possession was not such as to make the funds received by or accrued to him, for in reality he was receiving someone else's money. The court held that it is not to say that in any case will money or assets obtained with a taint of illegality would not be "gross income". It would depend on whether it has actually accrued to the taxpayer or is effectively claimable by someone else. The court held that the intention of the taker cannot of itself result in him receiving the thing in his own right as he can only receive the thing in his own right if the giver intends that result as well.

4.2.1.2 The economic benefit doctrine

In *James v United States*, 1961 (366 US 213), the claim of right doctrine was rejected, and the court held that courts in cases that involve the taxability of illegal income should apply the economic benefit approach. The court highlighted that the economic benefit doctrine asks the question whether or not the taxpayer has control over the income from illegal activities, in that it can be reasonably held that such taxpayer derives a readily realisable benefit from it. The court explained that a thief steals to derive a benefit from the stolen property either from its use or realisation. The Supreme Court held that the respondent, who was an embezzler, was required to include his ill-gotten gains in his "gross income" for income tax purposes. This decision followed the earlier decision of *United States v Sullivan*, where it was held that the mere fact that income is from an illegal source or activity does not exempt such a receipt from tax.

In *Commissioner v Tellier*, 1966 (383 US 687, 691), the Supreme Court held: "One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes…The fact that a business is unlawful (does not) exempt it from paying the taxes that if lawful it would have to pay."

In *Rutkin v United States*, 1952 (343 US 130), the court held that income is taxable as gross income when a person exercises control and derives realisable economic value from that income. The Court emphasised that when the acquirer exerts enough control over taken money such that he derives "readily realizable economic value from it," the gain is taxable.

The economic benefit doctrine is similar to the South African court's decision in the case of *MP Finance Group cc (in liquidation) v C:SARS*, where the court held that from March 1999 to 28 February 2002, the perpetrators of the pyramid scheme knew that it was insolvent and fraudulent and that it would be impossible to pay all the investors what was promised. From that date, the entities operated by the perpetrators made their money by swindling the public. This was their income, and it followed that the amounts they were paid in that period were "received", as contemplated in the definition of "gross income". The operators of the scheme accepted such amounts with the intention of retaining them for their own benefit; such amounts were therefore “received” even if the scheme was not legally entitled to retain those moneys.

Although initially the USA tax authorities applied the “claim of right” doctrine, which excluded income derived from illegal activities from taxation because the thief had no claim of right to the goods or proceeds and was under an obligation to return the good or proceeds to their rightful owners, the USA has moved away from the claim of right doctrine to implement the “economic benefit” doctrine. The economic benefit doctrine taxes the benefit derived by the thief or by the person dealing with the asset or the money in the way that an owner would. Under the economic benefit doctrine income from both legal and illegal sources is subject to tax. Section 61 of the Internal Revenue Code of 1954 defines the term "gross income" to include “all income from whatever source derived,” to encompass even illegally obtained income, except as otherwise provided. It follows from this, that as long as the Internal Revenue Code of 1954 does not specifically exclude proceeds of illegal activities from “gross income”, such proceeds will form part of gross income and will, therefore, be taxable in the USA.

4.2.2 Australia

Gupta (2008:106) explains that taxation, in theory, knows no morality as the Commissioner of Taxation will tax any income within the scope of the Australian Income Tax Assessment Act of 1997 and allow any deductions within the scope of this Act. Gupta (2008:109-110) states that the taxability of illegal profits relies upon the application of the ordinary concepts of income to the illicit activity, in short, ascertaining whether or not there is a business being undertaken. *Minister of Finance v Smith,* 1927 AC 193, involved an illegal business, namely bootlegging, where Viscount Haldane held (at 197) that: “the power of the Dominion Legislature to impose income tax would not be limited by provincial law declaring an activity illegal.”

Lund (2003:2) reports that the income tax laws in Australia have been designed to broadly ensure that taxpayers are only taxed on their “net position”. She confirms that this means that a taxpayer’s taxable income for an income year is determined by subtracting deductions from assessable income. Section 6-5 of the Australian Income Tax Assessment Act of 1997, formerly section 25(1) of the Australian Income Tax Assessment Act of 1936, states that assessable income includes gross income “derived directly or indirectly from all sources”.

The Australian Income Tax Assessment Act of 1997 does not differentiate between income that is derived from legal or from illegal activities. Therefore, the fact that a receipt is illegal does not prevent it being characterised as ordinary income.

4.2.2.1 Assessable income

In terms of section 4-15(1) of the Australian Income Tax Assessment Act of 1997, "taxable income" is calculated as "assessable income", less deductions. Van Niekerk (2016:32) explains that the definition of "taxable income" is relatively broad and no reference is made to the legality or illegality of the income.

"Assessable income", in turn, is defined in section 6-5 of the Australian Income Tax Assessment Act of 1997 as follows: "Assessable income includes income according to ordinary concepts, which is called ordinary income…"

In *Commissioner of Taxation v La Rosa*, the taxpayer earned income from drug dealing activities. In considering the assessability to taxation of the income derived from the illegal business activities, the Administrative Appeals Tribunal adopted the views of the Commissioner in Taxation Ruling (TR) 93/25. In that Ruling, the Commissioner considered that, inter alia, receipts from a systematic activity where the elements of a business are present are income, irrespective of whether the activities are legal or illegal. On this basis, the Administrative Appeals Tribunal found that the Commissioner had correctly included the $220,000 in the assessable income of the taxpayer under section 25(1) of the Australian Income Tax Assessment Act of 1936 because the taxpayer was carrying on a drug dealing business.

The Australian Taxation Office (1993:2) reports that the tests as to whether an amount is assessable income under subsection 25(1) of the Australian Income Tax Assessment Act of 1936 are the same for amounts received from legal and illegal activities. The Australian Taxation Office states that where a taxpayer systematically engages in an illegal activity and the elements of a business are present, such as repetition, regularity, view to a profit and organisation, the proceeds from the activity have an income character.

Income earned from the illegal business activities of a taxpayer in Australia will be taxable. It is clear that from an Australian perspective that it does not matter whether the receipt is legal or illegal, it would still be taxable provided the activities of the taxpayer constitute a business.

4.2.3 New Zealand

4.2.3.1 Normal tests of a business

In the New Zealand Income Tax Act of 2007, section BC 2 applies to "annual gross income" and states that: "a person's annual gross income for a tax year is the total of their assessable income that is allocated to the corresponding income year." Section BD 1(5) applies to "assessable income", where an amount of income of a person is assessable income in the calculation of their annual gross income if it is not income of any of the following kinds:

(a) their exempt income;
(b) their excluded income; or
(c) their non-residents' foreign-sourced income.

Gupta (2008:111) explains that in New Zealand, the courts have based their decision regarding the taxability of illegal income on the normal tests of whether or not there is a business activity. The relevant statutory provision in the New Zealand Income Tax Act of 2007 that deals with amounts derived from business is section CB 1(1), which provides that "an amount that a person derives from a business is income of the person." "Business" is defined in section YA 1 of the New Zealand Income Tax Act of 2007 to include "any profession, trade, or undertaking carried on for profit." The New Zealand Court of Appeal considered the definition of a "business" in *Grieve v Commissioner of Inland Revenue,* where Richardson J stated in regard to illegal businesses (at 682) that:

> the decision whether or not the taxpayer is in business involves a twofold enquiry into the nature of the activities carried on, and as to the intention of the taxpayer in engaging those activities. Statements by the taxpayer as to his intentions are of course relevant but actions will speak louder than words. Among the matters which may properly be considered in that enquiry are the nature of the activity, the period over which it is engaged in, the scale of operation and the volume of transactions, the commitment of time, money, effort, the pattern of activity and the financial results.

Richardson J stated further (at 682) that: "Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture. Nor because that business is illegal".

4.2.3.2 Colour of right

Gupta (2008:118) explains, following the Court of Appeal ruling in the case of *CIR v A Taxpayer,* 1996 (17 NZTC 12,574), that unless stolen money was made subject to income tax by express provision it was not taxable, the New Zealand Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill of 1998 was introduced. To protect the tax base, the Bill proposed amendment to the New Zealand Income Tax Act of 1994 by including within the meaning of "gross income" property obtained without "colour of right". The main purpose of the proposed amendment was to prevent people from evading income tax by re-characterising their income as stolen.

The official report on the New Zealand Taxation Bill of 1998 stated that the taxation of stolen property in no way provides a legal sanction to theft or like conduct and stated that the taxation of stolen property can be justified on the basis that by not taxing it, the tax system is in effect subsidising those who choose to steal property. Following on from this, the New Zealand Parliament enacted an amendment to make the proceeds of embezzlement, fraud, misappropriation and theft taxable, by inserting section CB 32 of the New Zealand Income Tax Act of 2007.

This provision contained in section CB 32 of the New Zealand Income Tax Act of 2007 deals specifically with how property in the hands of a criminal should be defined for tax purposes.

> Section CB 32. Property obtained by theft —
> (1) If a person obtains possession or control of property without claim of right, an amount equal to the market value of the property is income of the person…

The court demonstrated in the case of *D 57,* 1980 (4 NZTC 60), where the taxpayer was convicted on charges of possessing and selling heroin, that it is quite immaterial as to whether a business or other income was legal or illegal. The New Zealand Income Tax Act of 2007 has specific provisions that taxes income from legal and illegal activities thereby eliminating all uncertainty regarding the taxation of illegal income.

4.3 The deductibility of expenses and losses incurred when deriving illegally gained income

4.3.1 United States of America

4.3.1.1 Deduction of illegal expenditure prior to 1969

Kahn and Bromberg (2016: 209) confirm that, prior to 1969, the principle basis for denying a deduction for illegal expenses was the common law doctrine that no deduction is allowable if it would frustrate public policy in the USA. They clarify that the Court's denial of a deduction was not grounded on the construction of a Code provision, such as the requirement that expenditure must be an ordinary and necessary business expense to be deductible, but rather on the fact that even if the expense was an ordinary and necessary business expense, a deduction was disallowed if its allowance would frustrate a sharply defined public policy. They emphasise that for the doctrine to apply, the national or state policy that would be frustrated must have been supported by evidence of a governmental declaration and not merely by the mores of the community.

In *Tank Truck Rentals v Commissioner*, 1958 (356 US 30,35), the Supreme Court stated that it is not sufficient to deny a deduction where the expenditure incidentally impacts a governmental policy, as the courts must weigh the degree of severity of frustration that the allowance of a deduction would cause. The Court further stated that if the expenditure in question is illegal under a state law, "the frustration of state policy is most complete and direct."

In *Commissioner v Sullivan*, the Supreme Court allowed a deduction for rent paid by an Illinois bookmaker even though the payment of that rent for the use of a bookmaking establishment was itself illegal under Illinois statutory law. The *Sullivan* decision was overturned by legislation adopted in 1969.

4.3.1.2 Deduction of illegal expenditure after 1969

A major change took place in 1969 when Congress adopted the Tax Reform Act of 1969, in which Congress amended section 162(c) of the Internal Revenue Code of 1954. Section 162(c) is the exclusive source of denying a deduction for illegal expenditure. As amended, section 162(c) denies a deduction for the following expenditures: section 162(c)(1) denies a deduction for an illegal payment made directly or indirectly to a government official or employee if the payment is a bribe or kickback, or if the payment is made to an official or employee of a foreign government, if the payment is illegal under the Foreign Corrupt Practices Act of 1977; section 162(c)(2) denies a deduction for any payment (other than one covered by section 162(c)(l)) that "constitutes an illegal bribe, an illegal kickback, or other illegal payment under any law of the USA, or any law of a State" if that state law is generally enforced; section 162(c)(3) denies a deduction for bribes, rebates, and kickbacks made in connection with the conduct of Medicare or Medicaid programs.

The Senate Report to the Tax Reform Act of 1969 stated that the amendments replace the common law frustration of public policy doctrine and are exclusive. Kahn and Bromberg (2016: 210) emphasise the fact that, after 1969, there is no denial of a deduction for business expenses on common law public policy grounds. They report that, consistent with legislative history, regulations explicitly provide that "a deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 of the Tax Reform Act of 1969, shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."

Section 162(c)(1) and section 162(c)(3) of the Tax Reform Act of 1969 relate to bribery and other similar payments, however section 162(c)(2) of the Tax Reform Act of 1969 has been extended to disallow “other illegal payments under any law of the USA or any law of a State”. It is this section that would be applied to disallow the deduction of expenditure incurred in conducting illegal activities. In addition to adding section 162(c), the Tax Reform Act of 1969 also added section 162(f) to the Code, which denies a deduction for a fine or similar penalty paid to a government for the violation of any law. That provision essentially codifies the holding of the case of *Tank Truck Rentals v Commissioner*.

The case of *Sullenger v Commissioner*, 1948 (11 TC 1076), dealt with the question whether illegal expenditure to purchase an item could be included in the cost of the item when it was sold and thereby offset revenue received from that sale. The taxpayer purchased meat at a time when the price of goods was subject to controls established by an agency of the government. The taxpayer paid an amount for meat that was greater than the permitted price. The government contended that the amount paid in excess of the permitted figure could not be included in the cost of the meat when the taxpayer sold it. The majority of the Tax Court (only one judge dissented) held that the entire amount paid for the meat, including the portion that was in excess of the permitted figure, is included in the taxpayer's cost of goods sold. The Internal Revenue Service initially acquiesced in that decision, but subsequently withdrew that acquiescence and substituted non-acquiescence. Consistent with that non-acquiescence, the Treasury later promulgated Federal Taxation Regulation 26, 1.471-3(f), stating that illegal expenditures are not included in the cost of goods sold.

Section 280E of the Internal Revenue Code of 1954 denies credits and deductions "for any amount paid or incurred during the taxable year in carrying on any trade or business that… consists of trafficking in controlled substances…" The Senate expressly set out the following justification for adding section 280E to the Code (at 309):

> To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.

4.3.1.3 Deduction of illegal capital expenditure

Capital expenditures are not deductible as business expenses. Federal Taxation Regulation 26, 1.471-3(f), provides that the cost of goods sold does not include an item which is of a type that would be disallowed as a deduction under sections 162(c) or (f) and the regulations thereunder, in the case of a business expense. Kahn and Bromberg (2016: 211) explain that, in essence, the regulation has expanded the statutory reach of section 162(c) to capital expenditures. They confirm that, consequently, capital expenditure that is made in violation of a state or federal law is not added to an item's base cost and therefore the recovery of that expenditure on a sale of the item will be taxed.

4.3.1.4 Deduction of illegal losses

Most allowed losses (including business losses) are deductible under section 165 of the Internal Revenue Code of 1954. In *Revenue Ruling,* 77-126 1977-1 C.B. 47, the taxpayer failed to pay federal taxes that were due on gambling devices that the taxpayer owned and operated. The failure to pay those taxes made the taxpayer's use of the equipment illegal. The Federal Government seized the devices, and they were forfeited to the government. The

Commissioner ruled that the frustration of public policy doctrine prevented the taxpayer from obtaining a deduction under section 165 of the Internal Revenue Code of 1954 for the loss of the equipment.

In *Holmes Enterprises Inc v Commissioner,* 1977 (69 TC 114), the sole shareholder was caught carrying marijuana in an automobile owned by the corporation. The automobile was seized by the United States government and forfeited to it. Although the automobile was used by the corporation for business purposes, the Tax Court denied the corporation a deduction for the forfeiture under section 165 of the Internal Revenue Code of 1954 because the deduction would frustrate a sharply defined national policy against the possession and sale of marijuana.

4.3.1.5 Deduction of legal expenditure incurred when conducting illegal activities

Kahn and Bromberg (2016: 214) explain that in the absence of a statutory denial, the legal expenses of an illegal business are deductible. In *Edmondson v Commissioner*, 1981 (42 TCM 1533), the question arose whether the denial of a deduction for illegal expenses in section 162(c)(2) of the Internal Revenue Code of 1954 prevents the deduction of the legal expenses of a business that was illegal to operate. The taxpayer was in the illegal business of selling amphetamines, cocaine, and marijuana. The Tax Court held that the legal expenses incurred in conducting the illegal business are deductible under section 162(a) of the Internal Revenue Code of 1954, as the expenses were held to be ordinary and necessary. Congress was displeased with the decision of the court and responded by adding section 280E to the Internal Revenue Code of 1954.

Section 280E disallows a deduction or credit for any expenses paid or incurred in carrying on a trade or business if that business consists of trafficking in controlled substances listed in Schedule I or II of the Controlled Substances Act of 1970, if that business is prohibited by federal law or by the law of a state in which the business is conducted. Schedule I lists drugs that have a high potential for abuse, for which there is no accepted medical use of the drug in treatment in the USA and there is a lack of accepted safety for use of the drug under medical supervision. Examples of drugs listed in Schedule I are heroin, marijuana, ecstasy, etc. Schedule II lists drugs that have a high potential for abuse, where there is currently accepted medical use of the drug in treatment in the USA or a currently accepted medical use with severe restrictions and where abuse of the drug may lead to severe psychological or physical dependence. Examples of drugs listed in Schedule II are *abstral, actiq, adderall*, etc.

In the USA, therefore, taxation legislation specifically disallows the deduction of any expenditure incurred in conducting illegal business activities. There is no uncertainty regarding this disallowance, which is in direct contrast to the uncertain South African position regarding the deductibility of expenditure incurred when conducting illegal activities.

4.3.2 Australia

4.3.2.1 The general deduction provision of the Australian Income Tax Assessment Act of 1936 and 1997

South Africa and Australia have both incorporated a general deduction formula in their income tax legislation. The Australian Income Tax Assessment Act of 1997 contains a "general deduction" provision in section 8-1, previously section 51(1) of the Australian Income Tax Assessment Act of 1936. This subsection allows a deduction for losses or outgoings incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for that purpose. The Australian Income Tax Assessment Act of 1997 specifies what deductions are allowable against assessable income.

In South Africa, expenditure will be allowed as a deduction in terms of the preamble to section 11 and section 11(a) read with section 23(g) of the South African Income Tax Act, if the taxpayer is carrying on a trade and the expenditure and losses were actually incurred in the production of income, provided the expenditure or losses are not of a capital nature. In Australia, an amount of expenditure will be allowed as a deduction, in terms of section 8-1(1) of the Australian Income Tax Assessment Act of 1997, should the taxpayer conduct a business and the taxpayer can prove that outgoings or losses were incurred in the production of taxable income and that the expenditure was necessarily incurred in carrying on the business, provided the outgoings or losses are not of a capital nature.

Van Niekerk (2016:55) is of the view that the main difference between South Africa and Australia lies in the fact that South Africa's general deduction formula refers to the term "trade" as a pre-requisite for any deductions, whilst in Australia's general deduction formula the term "business" is used. She explains that the Australian Taxation Office applies a broad scope to the term "business" where, if the intention of the taxpayer is to make a profit from activities carried on, the activities will be regarded as a "business". She concludes that if a taxpayer's operations constitute a "business" in Australia, it is highly likely that it will also constitute a "trade" in South Africa, as "trade" as defined in the South African Income Tax Act includes a business.

4.3.2.2 Deduction of illegal business expenditure: definition of "business"

The South African Income Tax Act defines "trade" to include a business or venture. Richardson J in *Grieve v Commissioner of Inland Revenue,* stated in regard to illegal business (at 682) that:

> the decision whether or not the taxpayer is in business involves a twofold enquiry into the nature of the activities carried on, and as to the intention of the taxpayer in engaging those activities. Among the matters which may properly be considered in that enquiry are the nature of the activity, the period over which it is engaged in, the scale of operation and the volume of transactions, the commitment of time, money, effort, the pattern of activity and the financial results.

Chawira (2011:54) is of the view that if the above approach by the Australian (and the New Zealand) courts is adopted an illegal enterprise qualifies as a business, which is sufficient to constitute a trade under South African law because a business is a "trade" under section 1 of the South African Income Tax Act. In *Lindsay v IR Comm*, 1932 TC 43, the court held that: "Trafficking in drugs for example is of the nature of trade albeit such trafficking may in circumstances be illegal."

In *Commissioner of Taxation v La Rosa*, the Administrative Appeals Tribunal considered whether the taxpayer should be entitled to a deduction under section 51(1) of the Australian Income Tax Assessment Act of 1936 for $220,000 that was stolen from the taxpayer during an intended drug purchase. The Administrative Appeals Tribunal relied on *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation,*1956 (95 CLR 344), where deductibility was allowed in respect of a sum of money stolen at pistol point whilst being taken from the taxpayer's retail store to the nearby bank for depositing. In *La Rosa's* case, the Administrative Appeals Tribunal characterised the $220,000 loss as one incurred in the course of gaining or producing assessable income. It was lost during a robbery connected with a drug purchase operation directly connected with the taxpayer's illicit drug dealing business. The occasion of the loss was the theft of money intended to be applied in connection with the purchase of trading stock for the taxpayer's business as a dealer in drugs. It did not matter that the drug dealing business was illegal. Therefore, the $220,000 was allowed as a deduction during the year ended 30 June 1995.

The Commissioner appealed the Administrative Appeals Tribunal's decision to allow the taxpayer to deduct the stolen funds. In the first instance, Nicholson J dismissed the Commissioner's ground of appeal that deductions pursuant to section 51(1) of the Australian Income Tax Assessment Act of 1936 should only be available for legitimate business activities and stated (at 59):

> To adopt the use of legitimacy would seem to introduce a measure of subjectivism which would give rise to uncertainty in the application in the law. More fundamentally, the contentions for it do not disclose any foundation either in case law or in the wording of the Income Tax Assessment Act of 1936 upon which such a concept could be approached.

The Commissioner also submitted that the stolen funds were not deductible on public policy grounds. The Commissioner submitted that the policy of the law is not served by allowing a deduction to the taxpayer for a payment or loss of funds in acquiring or attempting to acquire a substantial supply of prohibited drugs through drug dealing activities. In particular, the Commissioner took the view that the Victorian Supreme Court's decision in *Mayne Nickless Ltd v Federal Commissioner of Taxation,* 1984 VR 863, stood for the principle that the courts will not allow a person to benefit from their own wrongdoing.

Nicholson J accepted that section 51(1) of the Australian Income Tax Assessment Act of 1936 may be limited by public policy considerations. However, he distinguished the case of *Mayne Nickless* and held that none of the authorities relied on by the Commissioner supported the more general proposition that expenditure (other than fines and penalties) that has the requisite nexus with the business operations should nonetheless not be deductible because those operations are unlawful and involve breaches of the criminal law. Nicholson J thus adopted a literal approach and held that the public policy argument for the Commissioner could not succeed.

The Commissioner appealed the decision of Nicholson J to the Full Federal Court. The Court held that the policy of the law does not disentitle the taxpayer to a deduction in relation to the $220,000. In particular, Hely J stated (at 55) that the purpose of the Income Tax Assessment Act of 1936 is:

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

Lund (2003:9) proposes that, after the decision in the *La Rosa* case, almost all losses incurred in carrying on an illegal business would be deductible as this case set a precedent for lawbreakers to receive tax deductions. In response to the *La Rosa* case, section 26.54 of the Australian Income Tax Assessment Act of 1997 was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence. The new provision applies to amounts incurred after 29 April 2005. Gupta (2008:127) explains that it seems to indicate that the punishment of those engaged in unlawful activities is not only imposed by criminal law, but also by the income tax provisions.

According to the Australian Taxation Office (2017), the income tax law allows deductions against assessable income for losses and outgoings incurred in carrying on a business. The Australian Taxation Office reports that generally deductions will be allowed if there is a sufficient link between the loss or outgoing and the business income, where the amount is not of a private or capital nature. If the business activities are illegal, however, and the taxpayer has been convicted of an indictable offence in respect of the illegal business activities, the taxpayer cannot claim a deduction for a loss or outgoing to the extent it was incurred in the furtherance of, or directly relating to those activities. The Australian Taxation Office states that similarly, such losses and outgoings do not form part of the cost base or reduced cost base of a capital gains tax asset, resulting in the taxpayer not being able to claim a capital loss or a reduced capital gain as a result of such expenditure. This applies to expenditure incurred on or after 30 April 2005.

The Australian Taxation Office (2017) confirms that indictable offences are offences that are punishable by imprisonment for at least one year and include offences such as drug trafficking, tax evasion, extortion, illegal gambling, people smuggling, forgery and piracy. The Australian Taxation Office reports that not all indictable offences will have taxation ramifications; it is only illegal activities that directly relate to the earning of taxable income that will be affected by this legislative change. This legislation only applies to offences against an Australian law, that is, any Commonwealth, State or Territory law.

The Australian Taxation Office (2017) confirms that if the taxpayer is conducting a lawful business, but is convicted of an illegal offence while carrying on the business, only the expenditure that is incurred directly, or in the furtherance of, the illegal activity will be denied, while expenditure that is incurred in undertaking the underlying lawful activity, and that would have been incurred regardless of the illegal activity, will continue to be deductible because the expenditure cannot be said to further or be directly related to the illegal activity.

4.3.3 New Zealand

Section DA 1(1) of the New Zealand Income Tax Act of 2007 is the general deductibility provision for expenses and losses. This section states that any expenditure or loss, including a depreciation loss, incurred in deriving assessable income, or in the course of carrying on a business for the purpose of deriving assessable income, is deductible. Section DA 2 of the New Zealand Income Tax Act of 2007 deals with the general limitations, for example, capital, private and exempt limitations. The taxpayer would have to prove that a sufficient relationship is established between the expenditure or loss incurred and the derivation of income, to qualify for a deduction.

Section DB 1 of the New Zealand Income Tax Act of 2007 deals with the disallowance of deductions for fines and penalties. The tax case *Z6,* 2009 (24 NZTC 14,068), dealt with the deductibility of fines imposed on a transport company for alleged overloading of its trucks. Barber DJ stated (at 109) that:

> However, it seems to me that a business should operate within the law. The disputant's business of carting logs on large trucks and trailers is able to comply with the law, but there is expense involved in weight-of-load compliance and such noncompliance can involve a relatively modest amount of annual fines. It seems to me to be illogical to seek

> to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not confirm to the law and so are not within the permitted scope of the business.

Gupta (2008:126) states that the treatment of fines is not analogous to the treatment of the income from an illegal activity. He elaborates that the courts in New Zealand have stressed that illegal incomes are taxable in the same way as legitimately derived income, regardless of moral considerations; however, when considering the deductibility of the expenditure and losses of such illegal behaviour, the courts are reluctant to consider applying the same tests of deductibility that are applicable to "legitimate" expenses.

Gupta (2008:127) states that the court and the Commissioner in New Zealand have relied upon a number of arguments to deny deductibility of expenses that would otherwise appear to meet the statutory test of deductibility. These reasons are that illegality denies deductibility on quasi-capital basis, public policy grounds, and treating expenses as private expenditure.

4.3.3.1 Legal expenses incurred by an illegal business

The decisions of the courts in relation to the general deductibility provision for illegal expenses and losses appear to run contrary to decision of the court for the deduction of legal expenses (costs relating to actions at law) incurred by an illegal entity. According to the Inland Revenue Department of New Zealand (2009:13) the New Zealand Income Tax Act of 2007 does not discriminate between legal and illegal activities in respect of legal expenses.

The Inland Revenue Department of New Zealand explains that the connection between the legal expense and the income-earning activity is relevant, not the legality of the activity. In *Nicholas Nathan Ltd* v *CIR*, 1989 (11 NZTC 6,213), the Commissioner submitted that the legal expenses the taxpayer incurred should be disallowed because they were incurred by the taxpayer illegally importing goods, rather than for carrying on its business. The court rejected this submission as it considered that as the necessity for "legal advice", after the illegal acts, was commercially prudent and an exercise of damage control; the legal costs were connected with the income earning process.

4.3.3.2 Illegal expenses incurred by legal businesses

The Inland Revenue Department of New Zealand (2009:13) reports that a taxpayer carrying on a lawful business that incurs illegal expenses may deduct the cost of the illegal expenses, but not the fines levied because of the outlay. Section DB 42 of the New Zealand Income Tax Act of 2007 deals with property misappropriated by employees or service providers. The taxpayer is allowed a deduction for the loss that they incur in the course of the business as a result of the misappropriation of the property by an employee of the business, or a person who provides services to the business. Section DB 43 of the New Zealand Income Tax Act of 2007 applies when a person carrying on a business in partnership pays an amount to make good a loss that arises from a partner misappropriating property. The taxpayer is allowed a deduction for the amount if the person is under a legal liability to make good the loss.

4.4 Conclusion

Chapter four addressed the goal of the research, which was to explore from the perspective of selected foreign jurisdictions whether income from illegal activities and expenses incurred in generating income from illegal activities are subject to tax. The countries selected for the discussion were the United States of America, Australia and New Zealand.

The analysis demonstrated that income received from illegal activities is taxable in the USA, Australia and New Zealand. In the USA, the Sixteenth Amendment to the Constitution of the United States of America of 1789 abolished the notion of taxing income from legitimate sources only and thus income from both legal and illegal sources is subject to tax. The USA used to apply a “claim of right” doctrine which held that income derived from illegal activities cannot constitute income for tax purposes because the thief has no claim of right to the income and is under an obligation to return the proceeds to the rightful owners. The tax system of the USA now bases the tax on the benefit derived by the taxpayer or by the person dealing with the asset or the money in the way that an owner would.

In Australia, the Australian Taxation Office issued Taxation Ruling 93/25 (TR 93/25) in 1993, which dealt with whether the proceeds of certain illegal activities will be treated as assessable income under subsection 25(1) of the Australian Income Tax Assessment Act of 1936. According to the Australian Taxation Office (1993:2), where a taxpayer systematically engages in an illegal activity and the elements of a business are present, such as repetition, regularity, view to a profit and organisation, the proceeds from the activity have an income character. The Australian Income Tax Assessment Act of 1997 does not differentiate as potentially assessable income between legal or illegal activities. Therefore, the fact that a receipt is illegal does not prevent it from inclusion in assessable income.

Gupta (2008:111) explains that in New Zealand, the courts have based their decision regarding the taxability of illegal income on the normal tests of whether or not there is a business activity. The New Zealand Court of Appeal considered the definition of a "business" in *Grieve v Commissioner of Inland Revenue*. The court held that businesses do not cease to be businesses due to their illegal nature. Income received from an illegal business is taxable and included in the taxpayer's annual gross income. Section CB 32 of the New Zealand Income Tax Act of 2007 applies to the taxation of the proceeds of embezzlement, fraud, misappropriation and theft. The New Zealand Income Tax Act of 2007 has specific provisions that taxes income from legal and illegal activities thereby eliminating all uncertainty regarding the taxation of illegal income.

Khumalo (2016:39) states that it is trite that once it has been determined that illegal proceeds should be included in the gross income of a taxpayer, the issue of the taxpayer's entitlement to a deduction of his expenditure or losses, arises. She explains that just like the "gross income" definition in the South African Income Tax Act, the general deduction formula is neutral with regard to the deductibility of illegal expenditures and losses. It has been demonstrated in chapter three that the South African Income Tax Act and related case law offer very little clarity on the deductibility of expenses incurred in producing income from illegal activities.

Taxation legislation in the USA, Australia and New Zealand, however, provide clarity on the non-deductibility of illegal expenditure. Tax law in the USA allows taxpayers to deduct most business expenses, but sections 162(c) and section 280E of the Internal Revenue Code of 1954 specifically prohibit deductions incurred in deriving income from illegal activities. Khumalo (2016:40) concludes that these changes have been introduced to discourage participants in illegal activities that are contrary to the laws prohibiting such activities.

In Australia, in response to the *La Rosa* case, section 26.54 of the Australian Income Tax Assessment Act of 1997 was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence. The new provision applies to amounts incurred after 29 April 2005. Section 26.54 of the Australian Income Tax Assessment Act of 1997 provides certainty regarding the disallowance of deductions incurred in illegal activities.

Section DA 1(1) of the New Zealand Income Tax Act of 2007 is the general deductibility provision. Section DB 1 of the New Zealand Income Tax Act of 2007 deals with the disallowance of deductions for fines and penalties. Gupta (2008:126) states that the treatment of fines is not analogous to the treatment of the income from an illegal activity. He elaborates that the courts in New Zealand have stressed that illegal incomes are taxable in the same way as legitimately derived income, regardless of moral considerations, however when considering the deductibility of the expenditure and losses of such illegal behaviour, the courts are reluctant to consider applying the same tests of deductibility that are applicable to "legitimate" expenses. Gupta (2008:121) states that there will be no permissible deductions whatsoever and consequently in tax being levied on the gross proceeds of criminal enterprises.

It is clear from the discussion presented above, that income earned from illegal activities is taxable in the USA, Australia and New Zealand. It is also clear that in the USA, Australia and New Zealand taxation legislation has been implemented that strictly prohibits the deduction of expenditure incurred in earning income from illegal activities. In South Africa, however, there is certainty that income earned from illegal activities is taxable, but the uncertainty remains relating to the deduction of expenses incurred in relation to illegal activities.

Chapter five discusses the research findings and recommendations are made regarding the taxation of income and expenses derived from illegal activities in South Africa.

Chapter Five: Conclusion and recommendations regarding the taxation of income and expenses derived from illegal activities

5.1 Introduction

The main goal of the research is to explore from a South African perspective and the perspective of selected foreign jurisdictions whether income from illegal activities and expenses incurred in generating income from illegal activities are, or should be, subject to tax.

The sub-goals of the research are:

- to determine whether there is certainty in South African tax law regarding the taxation of income arising from illegal activities;
- to determine whether the definition of "trade" in section 1 of the South African Income Tax Act, applies to both legal and illegal activities;
- to establish, in relation to legislation and case law, if the general deduction formula (the preamble to section 11, and section 11(a) read with section 23(g)) of the South African Income Tax Act applies to expenses incurred in deriving income from illegal activities;
- to establish the principles applied in selected foreign jurisdictions relating to the taxation of income and deductibility of expenses arising from illegal activities; and
- to recommend whether amendments should be made to the South African Income Tax Act to create certainty in relation to the taxation of illegal activities.

5.2 Conclusion

Chapter two provided a detailed discussion in relation to the goal of the research to explore from a South African perspective whether income earned from illegal activities is, or should be taxable. The conclusion reached was that in South Africa the legitimacy or legality of the source of income appears to be irrelevant. If the amount in question is "gross income" as defined in the South African Income Tax Act, it will be taxable. The South African Income Tax Act makes no differentiation between the disposal of assets in a legal and an illegal entity. The disposal of the assets in an illegal entity would trigger the application of capital gains tax. There is therefore certainty in South African tax law regarding the taxation of income arising from illegal activities.

Chapter three provided a detailed discussion in relation to the goal of the research to explore from a South African perspective whether expenses incurred when generating income from illegal activities are, or should be, allowed as a deduction for tax purposes. The conclusion arrived at from the discussion was that illegal activities, when conducted in an ongoing, "business like" manner where active steps are taken, (deployment of skills, employment of capital, etc.) with the intention of deriving income as part of a profit-making scheme, will constitute a "trade" as defined in section 1 of the South African Income Tax Act. This is contrary, however, to the view of SARS that illegal activities do not meet the definition of "trade". The conclusion that illegal activities can constitute a "trade" will not apply to a once-off opportunistic illegal act. The conduct of a once-off opportunistic illegal act lacks continuity and the intention of earning income as part of a profit-making scheme. The definition of "trade" as defined in section 1 of the South African Income Tax Act should apply therefore, to both legal and illegal activities, with the exception of a once-off opportunistic illegal act.

Chapter three demonstrated that the general deduction formula does not explicitly state that expenditure incurred in respect of illegal activities is not prohibited, nor have the decisions of case law been consistent in the disallowance of expenditure incurred in illegal activities. Based on a discussion of the "general deduction formula" (the preamble to section 11, section 11(a) and section 23(g)), and assuming that no distinction is made between legal and illegal activities, expenditure that is actually incurred when conducting illegal activities where there is a definite, absolute, unconditional obligation to pay, that is not capital in nature and the taxpayer can prove that the expenditure incurred is directly linked to the earning of income from that illegal activity, may qualify for deduction in terms of the general deduction formula, provided all the requirements of section 11(a) read with section 23(g) of the South African Income Tax Act are met. Based on conflicting opinions expressed by the judges in South African case law, it was concluded that uncertainty prevails relating to the deductibility of expenditure incurred in respect of an illegal enterprise.

Chapter four presented a discussion on how the United States of America, Australia and New Zealand have dealt with the taxation of income and expenditure from illegal activities. In the USA, the Internal Revenue Code of 1954 broadly defines the term "gross income" to include all income from whatever source derived, except as otherwise provided. The Australian Income Tax Assessment Act of 1997 does not differentiate potentially assessable income between legal or illegal activities. In New Zealand, section CB 32 of the New Zealand Income

Tax Act of 2007 applies to the taxation of the proceeds of embezzlement, fraud, misappropriation, theft, etc. The analysis demonstrated that there is certainty that income received from illegal activities in the USA, Australia and New Zealand is taxable.

Chapter four also demonstrated that in the United States of America, Congress adopted the Tax Reform Act of 1969, in which Congress amended section 162(c) of the Internal Revenue Code of 1954. Section 162(c) is the exclusive source for denying a deduction for illegal expenditure. Section 280E of the Internal Revenue Code of 1954, denies credits and deductions “for any amount paid or incurred during the taxable year in carrying on any trade or business that… consists of trafficking in controlled substances…”

It was shown that section 26.54 of the Australian Income Tax Assessment Act of 1997 denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence.

The chapter explained that section DA 1(1) of the New Zealand Income Tax Act of 2007 is the general deductibility provision. Section DB 1 of the New Zealand Income Tax Act of 2007 deals with the disallowance of deductions for fines and penalties. Gupta (2008:126) states that the courts in New Zealand have stressed that illegal incomes are taxable in the same way as legitimately derived income, regardless of moral considerations, however when considering the deductibility of the expenditure and losses of such illegal behaviour, the courts are reluctant to consider applying the same tests of deductibility that are applicable to "legitimate" expenses. Gupta (2008:121) states that there will be no permissible deductions whatsoever and consequently in tax being levied on the gross proceeds of criminal enterprises.

In the USA, Australia and New Zealand certainty is provided by the changes in legislation that govern the disallowance of expenditure incurred in illegal activities.

The conclusion reached from the discussions in the thesis is that income from an illegal source is taxable in South Africa, the USA, Australia and New Zealand. In the USA, Australia and New Zealand, but that taxation legislation strictly prohibits the deduction of expenses incurred in illegal activities. South Africa has no legislation in place that prohibits these deductions, with the exception of section 23(o) which prohibits the deduction of fines and penalties, and expenses in relation to the Corrupt Activities Act. SARS has been relying on the disallowance of this expenditure, based on its own view that illegal activities do not qualify as “trade” as defined in the South African Income Tax Act.

5.3 Recommendations

It has been concluded that the taxation of income from illegal activities is a well-established tax principle in South Africa, the USA, Australia and New Zealand, notwithstanding the fact that it is tainted with illegality. However, the position in South Africa is uncertain when it comes to the deductibility of expenditure incurred when conducting illegal activities. In the USA, Australia and New Zealand, taxation legislation specifically disallows the deduction of any expenditure incurred in conducting illegal business activities.

In the absence of relevant taxation legislation, SARS may not be able to rely on the disallowance of expenditure incurred in respect of illegal activities based on its own view that illegal activities are excluded from the definition of “trade” as defined in the South African Income Tax Act, if challenged in court. The problem of uncertainty is further exacerbated by the conflicting court decisions regarding this issue. It is for this reason that it is recommended that South Africa considers the practices and legislative provisions adopted by the USA, Australia and New Zealand in amending the legislation to create certainty relating to the non-deductibility of expenses incurred in carrying on illegal activities.

On applying the principles adopted in the cases of *MP Finance Group CC* and *Delagoa Bay Cigarette Co,* income received from illegal activities will be taxable in South Africa. South African taxation legislation has not been amended to incorporate the principles established in these cases. “Gross income”, as defined in the South African Income Tax Act can be amended as follows:

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

For the purpose of taxing the proceeds from the disposal of assets held by an illegal entity, "asset" as defined in section 1 of the Eighth Schedule of the South African Income Tax Act can be amended as follows:

> "[a]sset" includes —
>
> (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum, held by any **legal or illegal entity or person/s**; and
>
> (b) a right or interest of whatever nature to or in such property, held by any **legal or illegal entity or person/s**.

"Trade" as defined in section 1 of the South African Income Tax Act can be amended as follows: "every **legal** profession, trade, business, employment, calling, occupation or venture . . ." Alternatively, "trade" as defined can remain as it is and section 23(o) of the South African Income Tax Act can be amended as follows:

> Section 23. Deductions not allowed in determination of taxable income — 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, 12 of 2004; or
>
> (ii) which constitutes a fine charged, penalty imposed; or
>
> (iii) **any other expenditure or loss 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**;

It is submitted that it would be unacceptable that criminal law strictly prohibits illegal activities, yet taxation legislation could allow deductions in respect of those prohibited activities. It is submitted further that taxation law should not be at variance with other laws in a country because all laws in a country should be unified with the common purpose of maintaining public policy. It appears to be against public policy for the South African Income Tax Act to allow deductions against illegal income. SARS's view that illegal activities do not constitute a "trade" as defined in the South African Income Tax Act and its denial of any deductions on this basis can be contested and it may not stand up if challenged in court. The South African Income Tax Act would need to be amended to specifically disallow deductions from illegal activities. These amendments would prevent future revenue losses to the *fiscus* and would also act as a deterrent to perpetrators of illegal activities.

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