AN EVALUATION OF THE APPROACHES USED TO DETERMINE THE TAXABILITY OF INCOME EMANATING FROM ILLEGAL PYRAMID SCHEMES

by

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This research project is submitted in partial fulfilment of the regulations for the LLM Degree at the University of KwaZulu-Natal

COLLEGE OF LAW AND MANAGEMENT STUDIES

and

SCHOOL OF LAW

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July 2018
DECLARATION

I declare that ‘An evaluation of the approaches used to determine the taxability of income emanating from illegal pyramid schemes’ is an original piece of work (except where acknowledgements indicate otherwise) and that neither the whole work nor part of it has been, is being, or is to be submitted for another degree in this or any other university. It is made available for photocopying and for inter-library loan.

___________________________
SIGNED: M. MADIBA
DEDICATION

I dedicate this work in memory of my father, Mr Julius Madiba and my sister, Caroline Madiba. You were both my strength regardless of the many trials and tribulations you will never be forgotten.

I also dedicate this work to my darling son, Tsakani Lincoln Manyike, for being my inspiration. I love you so much!
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CHAPTER ONE

THE PROBLEM AND ITS SETTING

1.1 Introduction

Pyramid schemes and multi-level marketing business models have become increasingly popular in recent years in South Africa.\textsuperscript{1} Multi-level marketing businesses are legal and fully compliant with legislative requirements, whilst pyramid schemes are illegal as they do not comply with legislative requirements. The South African Reserve Bank has exposed a number of unregistered, and therefore illegal, pyramid schemes throughout the country.\textsuperscript{2} Statistics show an increasing prevalence of these illegal pyramid schemes which have lured millions of South African participants.\textsuperscript{3} The Consumer Protection Act 68 of 2008 has declared such schemes illegal, and it prohibits the promotion and participation in such schemes.\textsuperscript{4} Coupled with increased access to the internet, and the fact that the Financial Services Board has no jurisdiction to regulate these schemes,\textsuperscript{5} promoters of these schemes have enjoyed unfettered access to larger target markets.\textsuperscript{6} It is not surprising that South Africa has seen a boom in the proliferation of illegal activities in these sectors.\textsuperscript{7}

Participants in these schemes come from all walks of life, both the wealthy and the underprivileged are easily deceived into participating in these schemes.\textsuperscript{8} Their motives for

\textsuperscript{1}Examples are MMM, Dream Trips and Forever Living ‘Is Forever Living a Pyramid Scheme?’ available at https://siliconbullet.wordpress.com/2014/02/24/is-forever-living-a-pyramid-scheme/, accessed on 18 Jul 2017. The distinction between pyramid schemes and multi-level marketing businesses will be discussed in chapter two.

\textsuperscript{2}‘Don’t say bye-bye to your money. available at https://www.resbank.co.za/AboutUs/PublicAwareness/Pages/Don%E2%80%99E2%80%9999%20say%20Bye-Bye%20to%20your%20Money.aspx, accessed 13 March 2017.

\textsuperscript{3}Ibid 2.

\textsuperscript{4}M Luthuli ‘Tax implications of investing in pyramid schemes: To add insult to injury, tax awaits the majority of those left to deal with losing their capital in dodgy schemes’(2016) Moneyweb’s Tax Breaks, Income Tax 2,3.

\textsuperscript{5}Ibid 4.

\textsuperscript{6}TA Woker ‘If it sounds too good to be true it probably is: Pyramid schemes and other related fraud’ (2003) 15 MercLJ 237 247.


\textsuperscript{8}Krige (note 7 above) 72.
joining pyramid schemes range from trying to satisfy economic needs and wants, supplementing low wages, high unemployment rates and low economic growth and, more recently, the increase in value added tax, to mention a few. The one factor that seems common to all which explains why people are enticed to participate in these pyramid schemes is the notion that they can get rich quickly, and their greed feeds on the empty promises that are made. Some participants invest their life savings into these schemes, because they are looking for an easy way to achieve financial security or become wealthier than they already are. In some cases participants are aware that the scheme in which they plan to invest is illegal, but they still choose to invest in it regardless in the hope of making quick returns before the scheme collapses.

Pyramid schemes are established by investors who pay to join the scheme with the aim of recruiting others to do likewise. These monies are then directed to agents who recruited these investees and forwarded their investments on to other agents who are higher up in the pyramid structure. Some schemes lure investors with a product or service, but these are secondary to the upfront monetary investment. There is a constant need for investment by new participants in order to pay back old participants and inevitably the pool of new investors dries up and it is only a matter of time before the scheme collapses, as there are never enough new participants to sustain such schemes. Once the scheme has collapsed, ‘its promoters disappear or face liquidation and it is extremely difficult, if not impossible, for victims that take part in these schemes to recoup their initial lump sum investment.’ As a result, participants that invest last in time are left impoverished and without any legal remedy. The proliferation of these schemes and the financial consequences which result when they fail has made the need for regulating these schemes imperative.

9 Krige (note 7 above) 69.

10 J Sacks ‘Tax implication for Ponzi scheme ‘investor’: Not only are you likely to be parted from your money-there could be some unpleasant tax consequences as well’ (2010) Moneyweb’s Tax Breaks, From the Courts 1.

11 Krige (note 7 above) 78.

12 Woker (note 6 above) 248.

13 Krige (note 7 above) 70.

14 Ibid 70.

15 Luthuli (note 4 above) 72, Woker (note 6 above) 241.

16 Ibid 241.


18 Woker (note 6 above) 239.
Regardless of the legal status of a pyramid scheme, all the income received by participants is taxable and should be included in the gross income of the taxpayer, which is the starting point in determining a taxpayer’s tax liability. The reality is that a taxpayer will be taxed on any profit made from the investment in the scheme despite losing their capital investment. What is also important to note is that income emanating from the investment will first be taxed in the hands of the scheme and, in this instance, the illegality of the transaction is irrelevant. This is the basis on which the courts have interpreted the term ‘received by’ in terms of gross income as defined in the Income Tax Act.

In light of the above, this study examines whether the approach that was applied in the Supreme Court of Appeal’s decision in MP Finance Group CC (in liquidation) v Commissioner South African Revenue Service, (hereafter MP Finance), to determine the taxability of income emanating from pyramid schemes was correct. Before the MP Finance decision, different approaches had been employed by our courts to determine the taxability of illegal income. A close perusal of the line of cases suggests that South African courts have been inconsistent and have applied different interpretations in determining if illegal income should be taxed. For example, the presiding officers in MP Finance did not clarify, justify or motivate why a subjective approach as opposed to an objective approach was used to determine the taxable amount. For an amount to be taxable, it has to qualify as an amount received as per gross income definition, Therefore the question should not be whether an amount is legal or illegal in order to establish tax liability, but the focus should rather be on whether the amount ‘received by’ the taxpayer qualifies as a receipt for purposes of gross income. This can only be determined by examining the relationships amongst taxpayers and, thereafter, by examining the relationship between the taxpayer and the fiscus. Therefore, the underlying agreement plays and important role in determining the status of the taxable amount, because the relationship between taxpayers has to be analysed first.

19 Delagoa Bay Cigarette Co Ltd 1918 TPD 391.
20 Luthuli (note 4 above) 239.
21 Sacks (note 10 above) 1.
22 Ibid 1.
23 Act 58 of 1962.
24 69 SATC 141.
25 Ibid 141.
1.2 Problem Statement

The purpose of this study was to critically evaluate the applicability of the objective and subjective approaches used by South African courts in determining taxable income derived from illegal pyramid schemes in order to explain the legal adequacy of decision making in tax related illegal pyramid scheme cases.

This study examined the different approaches that had been used by the courts regarding amounts received by perpetrators who had participated in both legal and illegal pyramid schemes. More specifically, the study focused on the decision of the Supreme Court of Appeal (hereafter SCA) in the MP Finance case to explain why this decision was inadequate and incomplete.

To comprehensively examine the issue under investigation, both income tax principles and other legal principles that relate to pyramid schemes, such as the Consumer Protection Act\textsuperscript{26} and the Banks Act\textsuperscript{27} were investigated.

1.3 Rationale for the Study

This study is important because no adequate reasoning was given by the SCA in MP Finance as to why a subjective approach was applied,\textsuperscript{28} and the court failed in this case to stipulate which previous decisions the court had considered. This failure by the SCA to confirm or invalidate previous cases, adds to the confusion as to why the subjective approach was used. Moreover the court did not provide adequate reasoning for its conclusion. As a consequence, a gap exists in the law which needs to be interrogated to determine whether the approach that was employed by the SCA was correct. This study also examines other court’s decisions regarding illegal income, in order to determine whether an alternative approach should have been applied by the SCA.

This study was thus prompted by the need to address the clear dichotomy in legal interpretations regarding the subjective and objective approaches that are applied by different courts and to suggest an alternative approach that could be applied in determining if an amount emanating from an illegal pyramid scheme was ‘received’ for income tax purposes or not.

\textsuperscript{26} Act 68 of 1998.

\textsuperscript{27} Act 94 of 1996.
1.4 Research Methodology

This study focuses on a review of related legislation, case law, journal articles and information in textbooks. The focus is on examining what approach should be employed when determining criteria to define how illegal income derived from pyramid schemes should be included in the gross income of a taxpayer.

1.5 Main Research Question

What criterion should be employed to determine the taxability of income emanating from illegal pyramid schemes?

1.6 Sub-Research Questions

The purpose of this study is also to answer the following research questions:

a. How does the structure of an illegal pyramid scheme differ from a legal investment scheme?

b. Does the illegality of a pyramid scheme void entire transactions?

c. How do courts interpret the term ‘received by’ as per the gross income definition in terms of the Income Tax Act for legal and illegal income, and does the legality of the transaction or lack thereof have an impact on the amounts that the Commissioner can collect?

d. What approach should the SCA have applied in MP Finance, and should the court have considered if the illegality of a scheme voided the entire transaction?

e. What constitutes a receipt in the context of an illegal pyramid scheme, considering that in contract law one needs a right in property before it can be claimed that there is a receipt?

1.7 Scope of the Study

This study examines the taxability of income that is generated by both legal investment schemes and illegal pyramid schemes. However, the focus was to determine the taxability of income emanating from illegal pyramid schemes and it was thus limited to amounts ‘received
by the taxpayer in terms of the gross income definition.\textsuperscript{28} This study is focused on amounts received by the originators of pyramid schemes and does not investigate the taxability amounts that were accrued by investor taxpayers who participated in either legal or illegal pyramid schemes.

1.8 Overview of the Chapters

Chapter one: An introduction to the study is presented which provides the background and objectives of the study. The problem statement, the scope of the study, and the research methodology are addressed.

Chapter two: This chapter examines the structure of legal investment schemes and illegal pyramid schemes.

Chapter three: The effect of the legality or illegality of pyramid scheme transactions is examined and it is determined whether the illegality of a given pyramid scheme voids the entire transaction. The tax consequences of both void and voidable pyramid schemes are highlighted.

Chapter four: Subjective and objective approach indicators are examined. A critical evaluation of the approaches used by the SCA in \textit{MP Finance} and other cases is presented.

Chapter five: Recommendations are offered and the main conclusions are presented.

\textsuperscript{28} Income Tax Act 58 of 1962.
CHAPTER TWO

STRUCTURE OF LEGAL INVESTMENT SCHEMES AND ILLEGAL PYRAMID SCHEMES

2.1 Introduction

This chapter will focus on the structure of pyramid schemes and will elucidate issues that render such schemes illegal. A comparison is drawn between multi-level marketing (hereafter MLM) businesses and illegal pyramid schemes. Relevant sections of the Banks Act\(^{29}\) and the Consumer Protection Act (hereafter the CPA) are also discussed as the foundation from which the illegality of a pyramid scheme is determined.\(^{30}\)

As mentioned in Chapter One, a pyramid scheme can only flourish when a constant inflow of money from new investors is available to reimburse ‘old’ or earlier investors.\(^{31}\) The collapse of such schemes is often inevitable because the pool of new investors needed to sustain the money flowing out of the scheme to primary investors will inevitably run dry. The result is that many recent investors, who receive little or no return on their investment lose their entire investment when the scheme collapses and is rendered insolvent. Investors that invest when the scheme is newly established succeed in earning high returns, because as they promote the ‘lucrative’ scheme interest grows but as more participants do not get the returns they were once promised, negativity builds around the scheme. Participants stop investing and the scheme collapses. Once the scheme has collapsed, the founders of the scheme, who promised high returns in a short period of time, are nowhere to be found – or they offer fabricated excuses when the money dries up. When a pyramid scheme collapses, liquidators or the trustees of these insolvent estates try to recoup the money that was paid out of the scheme to the initial investors. They base their claims in law on provisions of the Insolvency Act and they rely on the fact that the transactions that were conducted by participants in the scheme were unlawful and therefore invalid.\(^{32}\)

In response to these legal claims, those few investors who received financial returns from these schemes may also use the defence that, because the scheme was unlawful as it emanates from

\(^{29}\) Act 94 of 1990.

\(^{30}\) Act 68 of 2008.

\(^{31}\) Krige (note 7 above) 70.

an unlawful contract, they should not be required to reimburse any amounts that they received in terms of the unlawful and unenforceable contracts they entered into. In *Janse van Rensburg v Botha* 2015 JOL. 34517 (GNP). Mr Botha, who had received high returns from the Krion pyramid scheme, relied on the fact that the contract was unlawful in order to persuade the court into deciding that he did not have to return any monies he received as an investor in the Krion pyramid scheme. The court held that although the agreement was unlawful and unenforceable the conclusion of the illegal contract was not disregarded and the defendant was ordered to reimburse amounts received from the scheme. The court went further to state that, regardless of the illegal status of the contract, other legal consequences would follow. In this case those legal consequences amounted to the application of section 29 of the Insolvency Act which resulted in the dispositions made to Mr Botha being declared void.

From the above case it is clear that an unlawful contract is not free from other legal consequences. What needs to be discussed next is what makes pyramid schemes illegal and how do they differ from legal MLM as their structure is very similar.

### 2.2 Illegal Pyramid Schemes versus Multi-Level Marketing Businesses

Section 43 of the CPA prohibits the establishment of pyramid and related schemes. In terms of section 43(2) (b), people are prohibited from taking part in pyramid schemes. Section 43 (4) defines a pyramid scheme as follows:

A pyramid scheme is “an arrangement, agreement, practice or scheme if:

(a) participants in the scheme receive compensation derived primarily from their respective recruitment of other persons as participants, rather than from the sale of any goods or services; or

(b) the emphasis in the promotion of the scheme indicates an arrangement or practice contemplated in paragraph (a)”.

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34 2014 2 All SA 670: Mabe (note 33 above) 10.


37 Ibid 43 (2) (b).

38 Ibid 43 (4).
A scheme which is dependent on deposits from investors whose funds are used to enrich founder investors, contravenes the CPA.\(^{39}\) The CPA discourages participation in and the marketing of these schemes and encourages the reporting of any such prohibited actions.\(^{40}\)

Pyramid schemes are not to be confused with MLM businesses which are typically structured like a pyramid scheme, because the recruitment and investments of others benefit investors who are higher in the ranks. The difference between an MLM and an illegal pyramid scheme is that, to participate in most MLMs, investors pay a joining fee and purchase products which they resell to the general public,\(^{41}\) whereas in illegal pyramid schemes returns are solely based on the number of people who are recruited into the scheme. MLM investors thus earn an income from the goods or services they sell or provide, and not only by recruiting investors.\(^{42}\) For example, in the case of the MLM known as ‘Forever Living’, investors pay a joining fee in order to become agents who then sell health products,\(^{43}\) and they also get remunerated for recruiting new members.\(^{44}\)

Conversely, illegal pyramid schemes do not trade in any goods or services in exchange for money. Founders of pyramid schemes may try to make the scheme look like an MLM by including an overpriced product,\(^{45}\) but upon more careful scrutiny it is evident that the scheme is prohibited by the CPA.

In both pyramid schemes and MLM businesses investors are hooked by the promise of and initial receipt of very high returns within a very short period of time. These returns are in most cases way above the expected interest rates permitted by the Reserve Bank.\(^{46}\) South Africans are not risk averse when it comes to participation in the illegal pyramid schemes. Greed and the drive for quick returns in the current economic climate motivate many to become involved in such business transactions,\(^{47}\) and the fact that these schemes are illegal is not a deterring

\(^{39}\) Section 43 of Act 68 of 2008.
\(^{40}\) Ibid.
\(^{42}\) Ibid 19.
\(^{43}\) In \textit{ITC} 1545 54 SATC 464 (C) where Adriaan Nieuwoudt sold milk cultures to for millions of rands while operating pyramid scheme.
\(^{44}\) ‘Full & part time business opportunity’ \texttt{http://www.lisasforevernatural.myforever.biz/} accessed 1 June 2018.
\(^{45}\) \textit{ITC} 1545 54 SATC 464 (C), where the taxpayer sold milk cultures to the general public and contended that the proceeds should not be included in his gross income as the proceeds emanated from a pyramid scheme.
\(^{46}\) Krige (note 7 above) 86.
\(^{47}\) Ibid 70.
factor. In some cases, fraudsters provide potential investors with false information and documentation to entice them to invest. Careful thought is given on who to recruit, because the promoters know that the scheme will eventually collapse. For instance, in the case of *MP Finance Group CC (in liquidation) v CSARS*, 2007 (5) SA 521 (SCA) 69 SATC 141, investors were informed that their investment would be used as capital for microloans for formal credit for the African consumer market. The aim was to make investors believe that they were taking part in a legitimate business. This is an example of how fraudsters exploited vulnerable consumers by presenting false hopes of entrepreneurship and self-empowerment in an economic climate where it is getting harder to simply rely on a single source of income. The result is that many investors are then lured into these schemes and the question of legality only arises after the scheme has collapsed. Investors seek reimbursement on their investments and exemption from tax based on the illegality of the contract.

Another important difference to note between MLMs and illegal pyramid schemes is that pyramid schemes are expressly prohibited in terms of section 43 of the CPA because participants in pyramid schemes are compensated with investments received from new investors who are recruited exponentially to avoid the collapse of the scheme. To reiterate, the danger of investing in such a scheme is that, the further away one is in the pyramid from the original top layers of investors, the more likely it becomes that the returns on one’s investment will never materialise. Therefore, if successful returns on an investment are based solely on the recruitment of new members with the promise of high returns based on recruitment alone, then the investment is a pyramid scheme which is unlawful. These unlawful schemes ultimately collapse and investors, who often lose their capital and/or interests, have to come to terms with the fact that the opportunity cost for the risk they took was not worth their investments.

Another piece of legislation that regulates an aspect of pyramid schemes is the Banks Act. In terms of section 11(1) of the Banks Act, only a public company which is registered as a bank can accept deposits from the general public. Section 11(2) of the Act states that if a legal subject is not registered as a public company and is not registered to operate as a bank, then it cannot collect deposits from the public and, if it does, its conduct is unlawful and this offence

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48 Ibid 71.
49 Ibid 83.
50 *ITC* 1789 67 SATC 206; Krige (note 7 above) 86.
51 Krige (note 7 above) 87.
52 Act 94 of 1990.
is punishable by law. This therefore means that founders of pyramid schemes that are not registered as public companies yet operate as banks cannot lawfully collect money from investors. Thus all agreements pertaining to investments in such schemes (ie money is ‘deposited’ into the scheme) are unlawful, as deposits are received in contravention of the Banks Act.

### 2.3 Conclusion

People from all different backgrounds, to mention a few the wealthy, the educated, the uneducated and people with low levels of financial literacy take part in these schemes. The common goal is the desire for financial security.\(^{53}\) The proliferation of these schemes that flourish in society means that participation in them has become normalised, and it has become easy for recruiters to convince the gullible public to participate in these illegal activities\(^ {54}\). The culture that has developed is one where the person who invests first benefits the most, to the detriment of participants that join the scheme at a later stage. This results in a bigger market being created for fraudsters as society has become addicted to the culture of easy returns.\(^ {55}\) Another contributing factor that fuels participation in these schemes is the fact that participants who knowingly take part in these schemes are not deterred because current legislation does not make provision for penalties for this prohibited conduct. The CPA prohibits the establishment, promoting and participations in pyramid schemes and the Banks Acts states that only a registered public company can collect deposits from the general public. More vigorous regulation of these schemes is thus required. Moreover, a higher level of policing is required because these schemes leave investors with no or limited legal remedies while the fraudsters who established gain significant financial benefits regardless of the fact that the agreement was unlawful. The question remains whether the financial benefits a taxpayer receives by luring others into an illegal investment scheme should be added to his/her gross income for tax purposes. The dichotomy is that on the one hand the contract entered into by the taxpayers is void because it is unlawful. On the other hand one needs to determine if there are any other legal consequences that follow an unlawful contract? On the other hand can the fiscus tax this unlawful transaction? This dichotomy highlighted by these questions will be unpacked in the chapters that follow.

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\(^{53}\) Krige (note 7 above) 74.

\(^{54}\) Ibid 74.

\(^{55}\) Ibid 73.
3.1 Introduction

The question that will be examined in this chapter is whether lawfulness is the ultimate factor that determines the taxability of income received from investments in illegal pyramid schemes. To unpack this question, two requirements of a valid contract, namely lawfulness and consensus, need to be examined. A discussion on the consequences of a void contract due to unlawfulness and the consequences of a voidable contract due to consensus is therefore presented.

In the case of MP Finance, the SCA only focused on the relationship between the taxpayer and the fiscus when deciding that the amounts received by the appellant from the illegal pyramid scheme had been received by the taxpayer for the purpose of gross income.\textsuperscript{56} However, for any amount to be received as income from a taxpayer, there first has to be a legal bond between the said taxpayer and another taxpayer. Therefore, for a taxpayer to have a relationship with the fiscus, an amount has to be received as per the gross income definition and this amount must firstly be received from another taxpayer. This argument is the starting point in determining a taxpayer’s liability to pay tax. This implies that there must be a legal bond between two or more persons which results in an amount being received. One of the ways in which a legal bond is created is through agreement. For pyramid schemes in particular, a legal bond is established between taxpayers by way of a contract. This agreement is instrumental in determining the tax liability of the taxpayer. Moreover, for a contract to be valid, there must be compliance with all the requirements for a valid contract. In turn, a valid contract must comply with a number of requirements where the two parties must:

1. have the intention to create and agree to enter into a legally binding agreement;
2. have full contractual capacity to enter into a contract;
3. comply with all formalities required by law or formalities required by the parties themselves; and their

\textsuperscript{56} 2007 (5) SA 521 (SCA); 69 SATC 141.
4. performance must be certain or easily ascertainable and the performance must be legally and physically possible.\textsuperscript{57}

If one of the requirements listed above is absent, then the contract is void.

In light of the above, this chapter focuses on the lawfulness and the consensus requirement of a contract. Specific reference will be made to the consequences of a void and voidable contract so that the tax consequences of an unlawful pyramid scheme can be determined. The critical issue is to determine if the illegality of a contract voids the entire transaction, and how this impacts tax liability.

\subsection*{3.2 Lawfulness as a Prerequisite for a Valid Contract}

For a contract to be valid and enforceable it must be lawful. Agreements are unlawful, unenforceable and invalid if at or after their conclusion they are contrary to common law, legislation, or if they are in conflict with community morals or go against public policy.\textsuperscript{58}

When considering public policy and community morals, the interests of the community are examined and taken into account by the courts when determining if a contract is unlawful. Public policy can dictate if an agreement is void and enforceable due to unlawfulness. This means that a balancing exercise is conducted between public and private interests.\textsuperscript{59} It is in this context that the devastating consequences of illegal pyramid schemes have resulted in a public outcry for better regulation as many people have lost large amounts of money.\textsuperscript{60} This implies that public policy can be an important factor in determining the illegality of a contract such as the one that is drawn up to participate in a pyramid scheme. However, the public’s response to the outcomes of participating in an illegal pyramid scheme can be very emotional. On the one hand people might want to protect the income they gained from the scheme, and on the other hand they might want to find recourse in the law to recoup their losses. It is therefore the courts that will have to interpret legislation and other sources of law to determine the legal status of an agreement. Legislation may forbid a particular conduct and, as a consequence, the court may declare the scheme unlawful. Legislation often allows the legislature to make provision for a

\begin{flushleft}
\textsuperscript{57} CJ Nagal \textit{Commercial Law} 4 ed (2011) 41.
\textsuperscript{58} H Dale \textit{The Law of Contract} 3 ed (2013) 176.
\textsuperscript{59} Ibid 176.
\textsuperscript{60} Woker (note 6 above) 241.
\end{flushleft}
penalty in the form of a fine or imprisonment for violating a rule or regulation. The penalty is there to deter people from contravening legal provisions. Therefore, contracts that are concluded in violation of the rules as stipulated by the legislature are unlawful and unenforceable.

The CPA as well as the Banks Act regulate the legality of pyramid schemes. The Banks Act explicitly states that if a natural or juristic person collects money while not being registered as a bank, then that person is guilty of an offence. This means that if a scheme is not established within the ambit of these Acts, then that scheme is unlawful. Unfortunately, the determination of the lawful or unlawful status of a pyramid scheme does not address the issue of the liability to pay tax after funds have been accrued from the illegal pyramid scheme. The CPA makes it clear that promotion and participation in pyramid schemes is prohibited, resulting in pyramid scheme contracts entered into being unlawful.

### 3.3 Consequences of a Void Contract

The law is clear that contracts that do not comply with the lawfulness requirement are void and unenforceable. The general rule is that if a contract is void, then restitution must take place if one or both of the contracting parties have performed. This is because the contract never existed as it lacked one or more of the requirements of a legally binding contract. Restitution is based on the law of unjustified enrichment as one party cannot be enriched at the expense of another party. However, if the contract is void because it is unlawful, the illegality of the transaction voids the contract ab initio and the consequence is that no restitution takes place. The aim here is to penalize persons, whether natural or juristic, who enter into unlawful contracts.

This rule dictates that even if a person is unaware that the contract he/she is entering into is unlawful, the contract remains void as ignorance of the law is never an excuse. Therefore, if

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63 94 of 1990.
64 68 of 2008.
66 Ibid 96.
67 Ibid 96.
68 Ibid 96.
69 Ibid 96.
one of the contracting parties has performed, he cannot demand specific performance or claim his performance back because the contract is void and unenforceable because it is illegal.\textsuperscript{70} This is based on the \textit{ex turpi causa} rule, which states that no remedy will be provided to any contracting party that enters into an unlawful contract.\textsuperscript{71} Furthermore, the court has no discretion to relax this rule as this rule serves as a deterrent for people not to enter into unlawful contracts. The fact that one or both of the parties who entered into a pyramid scheme contract was/were unaware of the illegality is therefore irrelevant. The \textit{ex turpi causa} rule also emphasises the point that a court will not grant an order for specific performance for an unlawful contract, which means that contracting parties cannot approach a court to demand performance from each other, even if the party demanding performance has already performed.\textsuperscript{72}

In view of contracts that can become void, the applicability of the principles of the lawfulness requirement in terms of pyramid schemes needs to be examined given the fact that ignorance of the law is never an excuse. It is undeniable that investors in illegal pyramid schemes are influenced by the vision of quick returns and high interest rates.\textsuperscript{73} However, it does not follow that all the investors who participate in an illegal pyramid scheme do so in the full knowledge of its illegality. Pyramid schemes therefore attract the vulnerable and innocent as well as the fraudulent and greedy. It seems unfortunate that both groups are treated the same, as the vulnerable need to be protected.

An additional rule that applies to contracts that are void due to unlawfulness is the \textit{in pari delictio} rule.\textsuperscript{74} This rule states that restitution cannot be claimed where performance has already taken place.\textsuperscript{75} This means that the rule makes provision for the fair dealing of performance claims based on contract performance and how parties would be treated when a void contract is wrapped up. The performance that a contracting party receives therefore occurs as a consequence of being in a more favourable position as opposed to the party who has received no performance in terms of the contract.\textsuperscript{76} This rule can be relaxed to do justice between

\begin{itemize}
\item \textsuperscript{70} Dale (note 58 above) 190.
\item \textsuperscript{71} Ibid 190.
\item \textsuperscript{72} Fouché (note 65 above) 96.
\item \textsuperscript{73} Mabe (note 33 above) 6.
\item \textsuperscript{74} Fouché (note 65 above) 96.
\item \textsuperscript{75} Ibid 96.
\item \textsuperscript{76} Govindjee (note 61 above) 91.
\end{itemize}
contracting parties, meaning that in cases where one party has a lesser degree of fault, or when the interest of justice permits, or where it would go against public policy not to allow restitution to take place because one party would be enriched at the expense of another, then restitution will be granted. This decision is based on the discretion exercised by the presiding officer after evaluation of all the relevant facts of a particular case.

Based on the above, it is clear that an unlawful contract is void and restitution will only take place in limited circumstances. However, this does not mean that other legal consequences do not flow from a void contract; this means that the illegality of the transaction does not free contracting parties from other legal consequences of the unlawful contract. As seen above, the courts can in some cases relax the in pari delictio rule and order restitution. Contracts that are void due to unlawfulness can have various other legal consequences in terms of the Insolvency Act and they will also have criminal and fiscal consequences. These legal consequences occur as a result of the unlawful agreement. It is noteworthy that the examination of legal consequences does not amount to the upholding of an unlawful contract and the enforceability of a contract is different from the consequences that emanate from the unlawful contract.

What is important is that there must be an underlying relationship for fiscal consequences to exist. In other words, if the contracting parties had not entered into the unlawful contract, there would not have been any fiscal consequences. Therefore, for a relationship to exist between the taxpayer and the fiscus, there must first be a relationship between taxpayers. Moreover, for an amount to be received for tax purposes, there must be a reason why that amount was received. The relationship between taxpayers is critical in determining how a taxpayer will be taxed and what amount will be taxed. This relationship between taxpayers is an essential prerequisite for determining the relationship between the taxpayer and the fiscus. For example, if an agreement is reached between a principal and an agent where the agent is collecting money on behalf of the principal, the amounts are collected by the agent but are taxed in the hands of

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77 Fouché (note 65 above) 96.
78 Jajbhay v Cassim 1939 AD 537.
79 Padayachey v Lebese 1942 TPD 10.
80 Dale (note 58 above) 191.
81 Act 24 of 1936.
84 Govindjee (note 61 above) 236.
the principal. Even in cases where the agent steals from the principal to make a secret profit, the courts have held that the amount is taxed in the hands of the principal because of the agency agreement.\(^85\) This means that there has to be an agency agreement between the agent and the principal for the principal to be taxed. Another example is when a taxpayer fraudulently overcharged his customers.\(^86\) These amounts were thus received for tax purposes in the hands of the taxpayer and the basis for this was the contractual relationship the taxpayer had with his customer.\(^87\) As a result of the contractual relationship, the amounts could be taxed in the hands of the taxpayer.

In *ITC 1545*,\(^88\) the court found that proceeds from the sale of stolen diamonds and proceeds from the appellant’s economic activities that amounted to an illegal lottery were taxable in the hands of the taxpayer, regardless of the fact that the contractual agreements were void.\(^89\) The court held that there was simply no reason not to attach tax consequences because the taxpayer had received the amounts as per the gross income definition and therefore benefited.\(^90\) The same was decided in *ITC 1789*,\(^91\) in which the court held that, as much as the proceeds had emanated from void fraudulent agreements, tax consequences did follow because the court refuted the tax principle that stated that no tax consequences follow from an illegal agreement.\(^92\)

In as much as a void contract remains void due to the fact that the lawfulness requirements is not complied with, it will be impractical not to attach tax consequences to the void transaction simply because the contract is void. The fact remains that if a taxpayer receives an amount for his own benefit, then taxation consequences must follow because in most cases innocent investors do not even get their initial capital investment back.

The other problem that arises is that once the scheme has collapsed and is insolvent, it becomes extremely difficult for investors to claim back their money and, in many cases, the liquidators or trustees of the insolvent estate claim back the amounts received by investors by asking the

\(^{85}\) *ITC 1792 2005 68 SATC 236.*

\(^{86}\) *ITC 1624 1996 59 SATC 373* Ibid 373; LG Classen ‘Legality and income tax — is SARS “entitled to” levy income tax on illegal amounts “received by” a taxpayer’? (2007) 19 SA Merc LJ 540.

\(^{87}\) Ibid 540.

\(^{88}\) 54 SATC 464 (C).


\(^{90}\) 54 SATC 467(C).

\(^{91}\) 67 SATC 205.

\(^{92}\) *ITC 1789 67 SATC 212.*
court to set aside dispositions made without value.\footnote{Insolvency Act 24 of 1936.} Sections 26, 29, 31, 33 and 34 of the Insolvency Act make provision for voidable and undue preferences, improper dispositions and dispositions made without value. In \textit{Fourie v Edeling},\footnote{2005 4 All SA 393 (SCA).} it was held that the dispositions made by the Krion pyramid investment scheme were made without value because the contracts were void due to unlawfulness.\footnote{2005 4 All SA 393 (SCA); Mabe (note 33 above) 6.} The court differentiated between capital payments and the payment of interest on investments and held that the interest on investments paid to the investors would be set aside because it emanated from an illegal transaction. Therefore, insolvency consequences applied to the unlawful contract and payments made were set aside as dispositions in terms of the Insolvency Act.\footnote{Ibid 8.} The same principle was applied in \textit{Moodly v King},\footnote{2009 ZANCHC 52.} where the court reiterated that the disposition was not made for value where the transaction was illegal.\footnote{2009 ZANCHC 52; Mabe (note 33 above) 9.}

In \textit{Janse van Rensburg v Botha},\footnote{2014 2 All SA 670.} payments were made to Mr Botha from an illegal pyramid scheme which became insolvent. The liquidators wanted to claim the amounts back. Mr Botha’s defence was that the contract was void and, as a result, the money could not be claimed from him.\footnote{Ibid 10.} The court stated that the contract was void but that it was subject to particular legal consequences.\footnote{Ibid 11.} As a result the liquidators could, in terms of section 29 of the Insolvency Act, recover amounts paid to Mr Botha. However, the fact that the illegal activities were disregarded does not mean that the contract was valid.\footnote{Ibid 12.}

In \textit{Janse van Rensburg v Griffiths},\footnote{2014 2 All SA 670.} Mr Griffiths received an amount of R224 000 from a pyramid scheme that later became insolvent.\footnote{Ibid 13.} Mr Griffiths alleged that the R200 000 was a loan that he had made to the trust and the R24 000 was interest on the loan.\footnote{Ibid 14.} The trustees wanted the court to declare these amounts as voidable preferences in terms of the Insolvency Act, while Mr Griffiths alleged that payments had been made in the normal sequence of
business. The court a quo held that given the illegal nature of the business and the fact that exorbitant returns had been paid, Mr Griffiths was liable to pay back the total amount as the activities were not seen to be in the ordinary course of business.

On appeal, Mr Griffiths asked the court only to decide if the capital contributions had been made in the normal course of business. The presiding officer placed emphasis on the importance of the nature of the commercial relationship between the trust and Mr Griffiths at the time the disposition was made. The court stated that this relationship was crucial in determining if the dispositions had been made in the ordinary course of business. The court added that, had Mr Griffiths made a claim relying on the condictio, he would have been successful in his appeal because the payments would have originated from a lawful obligation and not a void agreement. Therefore the Appeal Court dismissed the appeal. This case allows the conclusion that the courts will not enforce agreements from illegal pyramid schemes because they are unlawful and therefore void. The courts are even able to sever the illegal part of the agreement from the legal part. This does not in any way mean that the agreement is free from all other legal consequences such as insolvency, criminality or tax consequences. However, it is clear that once the relationship between taxpayers has been established, then tax consequences follow.

### 3.4 Consensus as a Requirement for a Valid Contract

The parties to a contract must agree on all the essential terms of a specific type of contract in order for that contract to be valid. One of the factors that can influence consensus is misrepresentation. A misrepresentation is a false statement that is made by one of the contracting parties which induces the other contracting party into entering into a contract. This results in a voidable contract and the innocent party has the option to rescind or abide by the contract. If the innocent party elects to rescind the contract, then restitution takes place.
and the innocent party can claim performance back with the rei vindicatio.\textsuperscript{114} The contracting parties are then put in the position that they would have been in if the contract had never been entered into.\textsuperscript{115}

### 3.5 Consequences of a Voidable Contract

Where one of the contracting parties is induced into entering into a contract by the other contracting party by making a false statement, then that contract becomes void as a result of misrepresentation. The innocent party then has a choice either to rescind or abide by the contract.\textsuperscript{116} If the innocent party elects to rescind the agreement, then performance can be claimed back based on the law of unjustified enrichment by making use of the rei vindicatio.\textsuperscript{116} If the innocent party elects to abide by the contract, then the contract continues and the innocent part can claim damages if suffered.\textsuperscript{117}

However, where the misrepresentation is made to induce a contracting party into entering into an unlawful contract, then the contract is void due to unlawfulness because a false statement cannot make an unlawful contract valid. The contract remains unenforceable because of its illegality. It can therefore be stated that in a case where one taxpayer induces another taxpayer to enter into an illegal pyramid scheme, as in the case of MP Finance where investors were lured into an illegal scheme by being provided with false information and fake documentation by the taxpayer, the contract remains void and unenforceable.\textsuperscript{118} In such a case restitution can be ordered because of the misrepresentation. This can be seen as the relaxation of the in pari delictio rule as the innocent party is less guilty. However, as much as the contract is unlawful and unenforceable, it does not follow that the contract is without other legal consequences or that the illegality voids the entire transaction.

In Rooiberg Minerals Development Co Ltd v Du Toit,\textsuperscript{119} it was held that one of the contracting parties committed a criminal offence by not completing a statutory form correctly, yet this did not mean that the entire contract was void.\textsuperscript{120} The court held that factors that made the contract

\textsuperscript{114} Ibid 72.

\textsuperscript{115} Govindjee (note 61 above) 72.

\textsuperscript{116} Ibid 72.

\textsuperscript{117} Ibid 74.

\textsuperscript{118} Ibid 73.

\textsuperscript{119} 1953 2 SA 505 (T)

\textsuperscript{120} 1953 2 SA 505 (T); SP van Zyl ‘The value added tax implications of illegal transactions’ (2011) 14(4) PER/PELJ 326.
valid and invalid should be weighed up against each other to determine which part of the contract could be severed and which could remain valid.\textsuperscript{121}

### 3.6 Conclusion

The fact that a contract has become void does not mean that there are no fiscal consequences. This view was upheld by the SCA in *MP Finance*. Thus the illegality of a transaction does not void the entire transaction because both fiscal and criminal consequences can follow from a void contract. SARS Interpretation Note No. 80 unequivocally states that it is SARS opinion that funds that were illegally received will be regarded as received as per the gross income definition,\textsuperscript{122} and it is therefore clear that tax consequences definitely flow from void contracts. What needs to be remembered is that in this instance taxation is based on an illegal contract. If the void contract did not exist, then there would be no tax consequences. The issue with amounts emanating from illegal pyramid schemes is that they have a moral taint. The question that therefore follows once illegality has been established is whether the fiscus is legitimizing the immoral transaction by attaching tax consequences to it. However, this is clearly not the case because what needs to be examined is whether the amount has been received for tax purposes, judged according to the provisions of the relevant statute. If it has, then the amount is taxable. The argument is not whether illegal income should not be taxed; rather, the focus is on the reason why the amount was paid, and this raises the point that legality should not play a major role when determining taxability. An examination of the relationship between the taxpayers involved is therefore vital, as this relationship will indicate to the fiscus whether the amount is indeed taxable. The underlying law of obligations plays an important role when the courts have to determine if an amount was received for tax purposes. Once this underlying agreement has been established, the courts then need to determine which approach to use when determining whether an amount must be included in a taxpayer’s gross income. In this context, the subjective and objective approaches will be discussed in the next chapter.

\textsuperscript{121} Van Zyl (note 120) 327.

\textsuperscript{122} Interpretation Note No. 80 (note 89) 16.
CHAPTER 4

AMOUNTS ‘RECEIVED BY’ AND THEIR IMPLICATIONS

4.1 Introduction

In order to appreciate why subjective or objective approaches are selected to examine the legality of pyramid schemes, it is important to understand how amounts ‘received by’ relate to the gross income earned. This chapter will undertake a critical appraisal of decisions by South African courts that dealt with the issue of determining when amounts ‘received by’ the taxpayer were considered legal or illegal. The focus will then shift to investigating whether the subjective or objective approach was used in previous cases and the consequences that arose as a result of the court’s decision. It is important to identify the specific trigger that will initiate the court’s selection of applying a specific objective or subjective approach in coming to their conclusion. It is important to note that the nature of the underlying agreement is often what determines how the court sees the obligations between the tax payer and the fiscus.

Finally, the principles identified in the process will be applied to the decision of the SCA in MP Finance,\textsuperscript{123} as this case indicates the current legal position on the treatment of income emanating from pyramid schemes.

4.2 The Dilemma Created by Amounts ‘Received by’ as per the Gross Income Definition

Section 1 of the Income Tax Act defines gross income as follows:

‘Gross income is the total amount in cash or otherwise received by, accrued to or in favour of a resident and in the case of a non-resident, the total amount in cash or otherwise received by, accrued to or in favour of such a person from a source in South Africa’.\textsuperscript{124}

These amounts must not be of a capital nature and must be received in a particular year of assessment.\textsuperscript{125} This definition refers to a number of elements but the focus, for the purpose of this study, will be on amounts ‘received by’ the taxpayer in a particular year of assessment. This leads to the first issue as the definition suggests that all amounts received should be included in the gross income of a taxpayer in a specific year of assessment. This study will

\begin{footnotesize}
\textsuperscript{123} 2007 (5) SA 521 (SCA); 69 SATC 141.
\textsuperscript{124} Act 58 of 1962.
\textsuperscript{125} Ibid Section 1.
\end{footnotesize}
demonstrate that not all amounts that a taxpayer received form part the gross income of the said taxpayer, and as a result not all amounts received are therefore taxable in the hands of that taxpayer. This then manifests in a dilemma created by the term ‘received by’.

An analysis of the term ‘received by’ from a legal perspective shows that a number of concepts contribute to the interpretation of the phrase and that the confusion in appreciating the scope of this phrase stems from the definition and the source of the amounts that are received in each instance.

The first confounding issue is the absence of a standard definition of the phrase ‘received by’ in section 1 of the Income Tax Act. Our courts have therefore had to interpret its meaning in light of the given the facts of any particular case to determine whether an amount has been received as gross income. Courts have stated that possession alone is insufficient to conclude that the amount was received, as per the gross income definition, and they have therefore had to decide to either employ the subjective or objective approach to determine if an amount was received and is taxable as per the gross income definition.

4.3 The Objective Approach versus Subjective Approach

When the courts employ the subjective approach, they attempt to determine the intention of the taxpayer by looking at the state of mind of the taxpayer who received the money. On the other hand, an objective approach entails the court looking at the surrounding circumstances of each case to determine whether the taxpayer received an amount as per the gross income definition. The critical question that should be asked when examining the objective approach is whether the taxpayer is or was entitled to the amounts received. This chapter will undertake a discussion of the different approaches used by the different courts and two contracts (one legal and one illegal) will be referred to as illustration of the issues under investigation.

In Commissioner for Inland Revenue v Genn & Co (Pty) Ltd, the taxpayer, a hardware and timber company, concluded valid short term loan agreements with a private company. These loan amounts were used to acquire its trading stock at a discount. As per the objective approach, and looking at the prevailing circumstances, it was held that the amounts received

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126 Act 58 of 1962.
128 20 SATC 113.
129 Ibid 113.
130 Ibid 113.
from the loan did not form part of the taxable income of the taxpayer because the lender had an obligation to repay the money that had been borrowed as per agreement.131 The court cited the example that when a truck is borrowed, the lender does not receive it for purposes of gross income because the lender’s intention is to return it.132 The court held that the same principle thus applied to the borrowed money and stated that, as much as ownership had passed to the borrower, the borrower still had an obligation to pay back the money.133 This fact, coupled with the fact that a loan amount is capital in nature, resulted in the amount not falling into the category of ‘income received’ as per the Act’s definition of gross income.134 The court emphasised this point by stating that similarly it could not be said that agents or trustees receive amounts on behalf of a trust for the purpose of determining their gross income.135

However, it is important to note that the amounts in dispute emanated from a valid contract between the taxpayer and a loan grantor. Only after this relationship had been established could the tax consequences be determined. The fact that the contract was valid did not result in the amounts necessarily being categorised as ‘received’ for the purposes of gross income. Thus one needs to examine the nature of the amounts received and this is done by first looking at the relationship between the taxpayers. In this case, the intention was that the borrower would return the loan amount to the lender, and that interest would be paid on the original amount that was borrowed as per their agreement.

As a result, the amount that was borrowed could not be regarded as income ‘received’ as per the gross income definition, and therefore no tax consequences were attached to the loan amount received by the taxpayer. The court held in this case that physical possession on its own was insufficient to constitute a receipt, and therefore it could not be said that the amount had been received for tax purposes.136 The court emphasized that the taxpayer had the obligation to pay back the borrowed amount (as well as the agreed interest) as soon as possession was acquired.137

131 20 SATC 123.
132 Ibid 122.
133 Ibid 122.
134 Ibid 122.
135 Ibid 123.
136 20 SATC 123.
137 20 SATC 123.
In *Geldenhuys v Commissioner for Inland Revenue,* the taxpayer was a farmer (a widow) who sold a flock of sheep in her capacity as *usufructuary*. The taxpayer was a widow who agreed to the terms of a joint will that she had executed with her deceased husband. The will stipulated that the surviving spouse would become the *usufructuary* of the joint estate. The taxpayer, in consultation with the heirs of the estate, decided that the flock of sheep could be sold after the taxpayer had decided to cease farming. The proceeds from the sale were then paid into her account and she invested the amount in a bond and used interest from the bond for her own benefit. The issue before the court was whether the Commissioner was entitled to tax on the proceeds from the sale of the flock in the hands of the taxpayer. The court held that the fact that the amount for the sale of the sheep had been deposited in her name, and into her account was immaterial because the heirs had consented to the sale. This fact, coupled with the fact that the original number of the flock had not increased, emphasized the fact that the proceeds from the sale belonged to the heirs.

The court had to look at the nature of the relationship between the taxpayers first to determine if amounts had been ‘received by’ the taxpayer. The fact that a valid agreement had been concluded when the taxpayer *adiated* in terms of the provisions of the joint will therefore did not result in her becoming the owner of the proceeds from the sale. The *adiation* resulted in Geldenhuys acquiring the right to use and enjoy the *corpus* of the usufruct and the children became the sole heirs of the joint estate. In this case the taxpayer (the widow) only had the right to ‘use and enjoy’, but ownership never vested in her. This case emphasises that a receipt alone is insufficient to determine whether an amount was received for gross income purposes. In this case the taxpayer did not own the flock and was therefore not entitled to the proceeds. The only reason the taxpayer had the right to enjoy the interest from the proceeds was because of her acquired right as a *usufructuary*; thus Geldenhuys never became the owner of the proceeds.

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138 14 SATC 419.
139 Ibid 419.
140 Ibid 419.
141 Ibid 421.
142 Ibid 421.
143 Ibid 428.
144 Ibid 428.
145 Ibid 434.
146 Ibid 434.
The court therefore held that the usufructuary did not receive the proceeds from the sale of the flock of sheep for her own benefit, or on her own behalf, because the proceeds belonged to the heirs, who were the ultimate owners of the flock.\textsuperscript{147} Geldenhuys received the amounts on behalf of the owners of the sheep and therefore the amounts could not be taxed in her hands.

In both \textit{Genn & Co (Pty) Ltd v Commissioner for Inland Revenue}\textsuperscript{148} and \textit{Geldenhuys v Commissioner for Inland Revenue}\textsuperscript{149} the fact that the taxpayers was not unconditionally entitled to the amounts received triggered an objective approach. The court stated that their subjective intention was insufficient and did not play a role because the taxpayer was not entitled to the proceeds.\textsuperscript{150} These cases clearly emphasize that simply being in possession of an amount does not mean that there has been a receipt for tax purposes.

The important principle that these two cases illustrate is that not all amounts received qualify for inclusion in gross income. This principle was also confirmed in \textit{ITC 1810} where the court held that it was never the intention of the legislature to tax someone on an amount that they had not received.\textsuperscript{151} The legislature’s intention cannot be to tax amounts that are received on behalf of someone else, or to tax amounts that need to be returned. The question arises whether the same principle applies when dealing with illegal transactions. The following cases will show how the courts have dealt with income emanating from illegal transactions.

The dilemma surrounding how to determine whether income received is taxable stems from the fact that the monetary source is different in every case. This issue is further complicated because the Income Tax Act\textsuperscript{152} does not differentiate between legal and illegal income. Our courts have repeatedly had to determine whether the legal status of the source of income was critical in determining whether the amount received would qualify for inclusion in a taxpayer’s gross income.\textsuperscript{153} Because amounts received emanate from different sources, different approaches have to be employed by South African courts when dealing with both legal and illegal income.\textsuperscript{154}

\begin{itemize}
\item \textsuperscript{147} Ibid 431.
\item \textsuperscript{148} 20 SATC 113.
\item \textsuperscript{149} 14 SATC 419.
\item \textsuperscript{150} Stiglingh (note 127) 18.
\item \textsuperscript{151} Classen (note 86) 539.
\item \textsuperscript{152} Act 58 of 1962.
\item \textsuperscript{153} \textit{Delagoa Bay Cigarette Co Ltd} 1918 TPD 391.
\item \textsuperscript{154} The Income Tax Act 58 of 1962.
\end{itemize}
A subjective approach relates to the state of mind of the taxpayer who is receiving the money. In *Commissioner of Taxes v G*, the taxpayer received amounts in his capacity as a government official to be used in secret government operations. In some cases he was given amounts in excess of what was needed for the operations. The taxpayer decided to use the excess amounts to purchase items for his own benefit and in other instances deposited the proceeds into his personal banking account. After the taxpayer had been convicted of theft and had been sentenced, he repaid the stolen amounts to the government. The nature of the relationship between the taxpayers in this case was based on a contract of employment and the taxpayer was in breach of this relationship as he stole from his employer. The court in this case should have first focused on the relationship between the taxpayer and his employer to determine if the illegality voids the entire transaction. This is because the relationship between the fiscus and the taxpayer emanates from the relationship between taxpayers. The court should therefore then focused on the nature of the relationship between the fiscus and the taxpayer after examining the link between the taxpayer and his employer.

However, the court had to decide if the stolen funds had been received for tax purposes. The court held that for amounts to be received for tax purposes there had to be a willing giver and a willing receiver. The fact that the government did not have the intention to give the proceeds to G in his personal capacity was an important factor to be considered as the court employed the ordinary meaning of the word 'received'. The court quoted *Geldenhuys v Commissioner for Inland Revenue* and stated that the court had to look at both the intention of the transferor of the money, and the intention of the transferee receiving the amount to determine if the taxpayer had received the amounts for his own benefit. The subjective approach used in this case entailed that both the benefactor and the patron should have simultaneously had the intention to offer and take. Therefore, the amounts were not included

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155 43 SATC 159.
156 Ibid 159.
157 Ibid 160.
158 Ibid 160.
159 Ibid 160.
160 Ibid 160.
161 Ibid 163.
162 Ibid 162.
163 Ibid 163.
164 Ibid 163.
in the taxpayer’s gross income. However, it is argued that this ruling was inadequate because there was no simultaneous intention to offer and take, and therefore it should not have been ruled that the amounts had been received for income tax purposes given the fact that court had to look at both the intention of the transferor of the money to determine if the amounts were received.

In ITC 1792, the taxpayer was a broker and worked in a stockbroking firm that was listed on the Johannesburg Stock Exchange. In his capacity as an agent, he purchased and sold shares on behalf of his principals who were his clients. This case focused on a valid agency agreement that existed between the taxpayer and his principal M, where the taxpayer was mandated to act on behalf of M. Unbeknown to M, the taxpayer formed part of a syndicate that planned to defraud him by selling stock to him at a higher price after the syndicate had purchased it, knowing that the shares would later be purchased by M. As a result the syndicate, together with the taxpayer, benefitted from the proceeds of the sale of the shares, resulting in the taxpayer making a secret profit.

The first point that needs to be examined in this case is the basis for the relationship between the taxpayer and M. This relationship was based on a valid agency agreement that had been entered into by M and the firm where the taxpayer was employed. The taxpayer breached this contract by engaging in illegal activities with the aim of acquiring a secret profit. These activities did not terminate the contract but, placed the taxpayer in breach of contract. Breach does not take away the fact that the amount was received, and the receipt of the amounts was directly linked to the valid agreement entered into by the taxpayer and M. This valid contract triggered the relationship between the taxpayer and the fiscus. I would agree that questions that should rather be posed is whether the amounts were received for normal tax purposes, and by whom. The taxpayer’s intention was to receive the amounts for his own benefit, but the question that the court needed to address was whether the taxpayer had received the amounts in his personal capacity, or as an agent of M. The Commissioner had included the secret

165 Ibid 163.
166 2005 68 SATC 236.
167 2005 67 SATC 236.
168 Ibid 236.
169 Ibid 236.
170 Ibid 236.
171 Ibid 236.
172 Ibid 238.
profit amount in the taxpayer’s gross income, for which the taxpayer then lodged an objection.\textsuperscript{173}

However, unlike \textit{Commissioner of Taxes v G},\textsuperscript{174} the court held that this did not amount to a unilateral taking.\textsuperscript{175} The court held that, contrary to the above mentioned case, the taxpayer and the ‘giver’ of the secret profit both had the subjective intention to give and receive.\textsuperscript{176} Therefore, although the agent had received the proceeds for his own benefit, the court ruled that the principal and not the agent who had received a secret profit was liable to pay normal tax on all the amounts received by the agent, because the agent had received the amounts on behalf of the principal and not in his personal capacity as per the law of agency.\textsuperscript{177} The court held in this case that the objective approach should apply because the taxpayer could not receive something that did not belong to him.\textsuperscript{178} In view of this interpretation, it would appear that fraudsters who benefit from stolen money will not be taxed on these amounts. This seems unlikely to have been the legislator’s intention.

This issue was further compounded in subsequent court rulings. In \textit{ITC} 1545,\textsuperscript{179} the court had to determine, amongst other issues, whether the proceeds of an illegal pyramid scheme should be included in the gross income of the taxpayer. The court held, unlike in \textit{Commissioner of Taxes v G}, that the scheme that was structured like a pyramid scheme did not amount to a unilateral taking and that the amounts had been ‘received by’ the taxpayer even though the proceeds from the scheme had emanated from a void transaction. The taxpayer had therefore received the amounts for his own benefit.\textsuperscript{180} Because the subjective approach was followed in this case, this interpretation by the court is logical.

In light of the conflicting decisions discussed above, the focus will now shift to the SCA decisions that dealt with amounts received by taxpayers emanating from an illegal pyramid scheme. The discourse commences with the decision of the court a quo and then moves to the SCA’s decision.

\textsuperscript{173} Ibid 236.
\textsuperscript{174} 1981 (4) SA 167 (ZA); 43 SATC 159.
\textsuperscript{175} Ibid 239.
\textsuperscript{176} Ibid 239.
\textsuperscript{177} 2005 67 SATC 240.
\textsuperscript{178} 2005 67 SATC 240.
\textsuperscript{179} 54 SATC 464 (C).
\textsuperscript{180} 54 SATC 475 (C).
In this case the taxpayer’s pyramid scheme was represented by different entities and its agents established and ran an illegal operation that defrauded the public of millions of rands.\textsuperscript{181} Investors were promised high returns on their initial investments by the taxpayer who knowingly ran an illegal and insolvent scheme\textsuperscript{182} that was operated in contravention of the Consumer Affairs Act.\textsuperscript{183} Furthermore, the taxpayer and its agents misled investors by making use of fraudulent documentation in order to deceive them. Investors were paid mostly in cash so as to avoid a trail of evidence recorded in their bank statements.\textsuperscript{184} The scheme was insolvent from the outset because there was never enough money coming in from new investors to pay back investors who had invested in the scheme at an earlier date, and this fact led to the inevitable collapse of the scheme.\textsuperscript{185} The fact that the majority of the proceeds was retained by the taxpayer and his agents catalysed the inevitable collapse.\textsuperscript{186} The final result was that participants received less than what they had initially invested, or nothing at all.\textsuperscript{187}

The court had to determine if the amounts that had been received by the taxpayer constituted taxable income as per the gross income definition. The taxpayer contended that because the money had come from an illegal source, the amounts could not have been received because the contact was void \textit{ab initio} on grounds of unlawfulness.\textsuperscript{188} The taxpayer relied on \textit{Commissioner for Inland Revenue v Genn & Co (Pty) Ltd} and stated that, because the amounts were immediately repayable to the investors, it could not be said that the taxpayer received the amounts as per the gross income definition, because the taxpayer had no right to retain the amounts.\textsuperscript{189} On the other hand, the Commissioner contended that returns from the year 2000 until 2002 were due to SARS and that the amounts had been received for tax purposes because the amounts were not subject to immediate refund.\textsuperscript{190}

\begin{footnotesize}
\begin{enumerate}
\item[181] ITC 1789 67 SATC 205.
\item[182] Ibid 206.
\item[183] Act 71 of 1988.
\item[184] ITC 1789 67 SATC 205.
\item[185] Ibid 207.
\item[186] Ibid 207-208.
\item[187] Ibid 206.
\item[188] Ibid 208.
\item[189] Ibid 208.
\item[190] Ibid 208.
\end{enumerate}
\end{footnotesize}
The court agreed with the taxpayer that there was no receipt as per the gross income definition because the proceeds had emanated from an illegal transaction and therefore had to be paid back as soon as they were received as per *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd.* 191 In the same breath, the court also held that the illegality of the scheme did not mean that the taxpayer had escaped his tax liability, 192 but held that the amounts had been received for tax purposes as long as the taxpayer had the requisite intention and took possession of the investments, regardless of the illegality of the scheme. 193 Furthermore, the court held that the principle, which stated that there were no tax consequences where a contract was unlawful, was incorrect 194 because it would be incorrect to state that the taxpayer did not benefit simply because the scheme was illegal. 195 In this context it must be considered that one cannot simply ignore the benefits of an investment because its origin is illegal, and this also means that other legal consequences cannot be ignored because a contract is void.196 If the implications are further examined, this contradiction causes further confusion because one cannot in one instance announce that the amount is not received because it is immediately repayable and then, in the same breath, indicate that the amount is received because tax consequences follow from illegal agreements. Therefore, in the case mentioned above, the fact that the amounts were immediately repayable is irrelevant because, based on the facts, the taxpayer had no intention of paying back the proceeds.

The court emphasised that the nature of the receipt had to be examined first before determining whether the amount fell within the definition of gross income. 197 Moreover, the nature of the relationship between the taxpayer and the receipt had to be examined. In this case the court employed a subjective approach and stated that getting a benefit or potential benefit was sufficient to include the amount as part of the taxpayer’s gross income, 198 and the court thus ruled in favour of the Commissioner.199 Thus the taxpayer’s intention to benefit and the fact that the taxpayer benefitted resulted in the amount being included in the gross income of the taxpayer. This reasoning is sound based on the fact that the taxpayer had no intention of paying back the proceeds.

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192 ITC 1789 67 SATC 212.
193 Ibid 212.
194 Ibid 212.
195 ITC 1789 67 SATC 207.
196 ITC 1789 67 SATC 213.
197 ITC 1789 67 SATC 211.
198 ITC 1789 67 SATC 206.
199 200 ITC 1789 67 SATC 213.
back the proceeds of an illegal scheme. Moreover, the amounts referred to were not loans as was the case in Commissioner for Inland Revenue v Genn & Co (Pty) Ltd.\textsuperscript{200} It was thus correctly stated by the court that tax consequences do follow from an illegal contract because the taxpayer had the intention to and did benefit from the void transaction. However, the court did not spend sufficient time on examining the relationship between the taxpayer and the investor. As has been argued above, this should have been the court’s starting point in determining the taxability of the amounts received by the taxpayer.

\subsection*{4.5 The Appeal by MP Finance}

On appeal, the appellant (\textit{MP Finance}) argued that the amounts had not been received for tax purposes because they had to be immediately returned to investors as the amounts were tainted with illegality.\textsuperscript{201} The appellant also based its argument on \textit{Fourie NO v Edeling NO} (hereafter \textit{Fourie}) and stated that, because the investments had been immediately refundable, the amounts could not have been received for tax purposes.\textsuperscript{202} Secondly, the appellant argued that if the amounts were taxable, it was not due by MP Finance, but by the different entities that had run the illegal scheme.\textsuperscript{203} This issue was dismissed because it was irrelevant as the appellant agreed to the consolidation of the various schemes and that the amounts could be directed to MP Finance that housed all the entities.\textsuperscript{204} On the other hand, the Commissioner contended that the returns from the year 2000 until 2002 were due to SARS as the amounts had been received for tax purposes regardless of the fact that the receipts had originated from an unlawful transaction.\textsuperscript{205}

The court focused on determining if the amounts had been received for income tax purposes and held that the illegality of the transaction did not mean that the transaction did not have any fiscal consequences.\textsuperscript{206} The SCA held that the intention of the appellant was to defraud the public, because its representatives had no intention to fulfil their obligations in terms of the contracts they had entered into with gullible investors.\textsuperscript{207} The fact that the appellant had

\begin{itemize}
\item \textsuperscript{200} 20 SATC 113.
\item \textsuperscript{201} 69 SATC 142.
\item \textsuperscript{202} Ibid 142.
\item \textsuperscript{203} Ibid 144.
\item \textsuperscript{204} Ibid 144.
\item \textsuperscript{205} Ibid 142.
\item \textsuperscript{206} Ibid 145.
\item \textsuperscript{207} Jones (note 17) 6.
\end{itemize}
retained the investments for its own benefit emphasized the fact that the appellant had no intention to return the investments from which income had been generated. As a result, the amounts received were for tax purposes as per definition of gross income.\footnote{Ibid 6.} In addition, the court held that the agreements entered into by the appellant and the investors were void as the establishment of the scheme was in contravention of the Consumer Affairs Act and the Banks Act.\footnote{69 SATC 144.} The court held that the amounts received by the taxpayer were within the definition of gross income because the taxpayer had had fraudulent intentions and had planned to retain the amounts received by investors for its own benefit.\footnote{Ibid 145.}

The court rejected the argument that this case was similar to \textit{Fourie}, as the latter case dealt with the relationship between the investor and the scheme, whilst the focus of this case was on the relationship between the amounts received by the appellant and the Commissioner.\footnote{Ibid 142.} In \textit{Fourie}, the court held that the amounts had not been received because they had to be refunded, but because refunding had not been the focus of the case in \textit{MP Finance}, this point was not taken into account.

An in-depth analysis of the \textit{MP Finance} appeal reveals that the issues relating to amounts ‘received by’ were not thoroughly addressed although the opportunity existed. Given the importance of the subjective and objective approaches with regards to the legality of pyramid schemes, the following applies:

1. The appeal court agreed with the court a quo and held that proceeds from illegal income were included in the gross income of the appellant. In this instance, the court employed a subjective approach to determine the taxable amount.\footnote{Ibid 145.} Unfortunately, the SCA in \textit{MP Finance} failed to provide clarity regarding the relevance of the source of the income when determining the taxability of illegal income. As a consequence, it is uncertain whether the appeal decision is applicable to all illegal transactions and whether it will translate to inclusion of amounts received from illegal transactions being included in the taxpayer’s gross income.

2. The SCA did not establish how the term ‘received by’ should have been interpreted and did not unequivocally stipulate that all types of illegal amounts ‘received by’ a taxpayer

\footnote{69 SATC 144.}
should be included in the gross income. Regrettably, this approach leaves a gap in judicial decision making because it is difficult in many instances to determine the subjective intention of fraudulent taxpayers because they have already been proven to be dishonest.

3. Furthermore, the SCA did not confirm or dismiss the decision in Commissioner of Taxes v G, where the approach used was that the amount received had to be for the taxpayer’s own benefit and that the amount received did not amount to a unilateral taking.213

4. The court did not confirm or dismiss Geldenhuys v Commissioner for Inland Revenue where the approach used was whether the taxpayer was entitled to the amount received.214 The objective approach that was used in Geldenhuys v Commissioner for Inland Revenue215 is important because it demonstrates how fraudulent taxpayers could escape liability by claiming that they are not entitled to the amount received and therefore the amount was not received for the purpose of gross income.216 It is therefore necessary for the SCA to differentiate between income from legal and illegal activities as the approach in determining if the amounts that are taxable will depend on the source and the underlying agreement.

5. The SCA in MP Finance correctly stated that some illegal transactions should have tax consequences.217 However, the problem is that the court should have focused on the illegality of the transaction and it should have determined if the illegality had penetrated the transaction so much so that it prevented the taxpayer from acquiring a right to the amount received. In fact, the appellant received the investments for his own benefit, unlike Geldenhuys v Commissioner for Inland Revenue. The former case demonstrates that the focus should first be on the underlying agreement with the investors. The question that should have been considered is whether the illegality of the scheme voided the entire transaction; thus the court completely missed this point by not examining this issue. Tax consequences follow unlawful contracts, because without the contract there would not have been any tax consequences. However, as such a contract existed, tax consequences should have followed.

213 43 SACT 159.
214 14 SATC 419.
215 Ibid 419.
216 Classen (note 86) 546.
217 2007 (5) SA 521 (SCA); 69 SATC 141.
The SCA should have critically evaluated what creates a receipt in the context of an illegal transaction, and it should have determined if it was necessary for a taxpayer to acquire a right in property before tax consequences followed. Here again the court also failed to analyse the relationship between the investors in pyramid schemes and the taxpayer. This relationship is crucial in determining tax liability. If the relationship between taxpayers had not existed, the court would not have had to determine if amounts had been received for tax purposes. The court in this case did not spend enough time analysing this relationship.

4.6 Conclusion

The current SCA position regarding the taxation of income emanating from pyramid schemes is that the subjective test should be employed. However, it has been demonstrated that the court tends to disregard a very important issue, which is that the fiscus can only tax an amount received from a scheme once the relationship between the taxpayers has been established. It is therefore important to determine the nature of the source of the amount received. This relationship is crucial in determining tax liability whether the source of the ‘income received’ is legal or illegal. Only once the nature of the relationship has been established should the court determine the tax consequences for the taxpayer.

The next chapter will provide recommendations as to how courts should deal with amounts emanating from illegal pyramid schemes.
CHAPTER FIVE

DISCUSSION AND CONCLUSION

5.1 Introduction

It is unfortunate that in our current economic climate, those who launch pyramid schemes will not find it difficult to lure investors. Moreover these illegal schemes will likely continue to be launched regardless of their inevitable demise. As schemes collapse and the public start to know what to look out for those devising these schemes will devise devious strategies to defraud gullible members of the public by concealing the true pyramid nature of their scheme. Therefore, it is reasonable and justifiable to urge that the legislature and the courts put measures in place to ensure that the amounts ‘received by’ the originators of such schemes are taxed yearly in the hands of the perpetrators once they receive monies from investors. Founders of schemes like these evidently have the intention to receive these amounts and retain them for their own benefit. They do so without declaring this ‘investment’ as part of their gross income to SARS. They should not be able to raise the illegality of their scheme as a justification to avoid the tax implications of their enrichment. Unequivocal legislation is urgently required so that the courts can take legal steps that will deter perpetrators from establishing these schemes. While the legislation is being formulated the courts need to in the interim establish an appropriate and watertight approach to deal with the income emanating from pyramid schemes so that taxes are not lost on the basis of claims that the amounts received were the results of an illegal contract.

It is concerning that discrepancies in court judgements continue to exist on this issue. The answer may well be that the courts employ different – and often paradoxical – approaches when making decisions regarding income that may be deemed legal or illegal. I would argue that in order to determine the illegality of a scheme, from which income is generated, the court should have regard for the scheme’s structure and its authorisation to accept investments in the form of deposits. In this context, the Banks Act218 is clear that only banks that have been licensed by the South African Reserve Bank may accept monetary deposits.219 Therefore, although pyramid schemes may function under the jurisdiction of the Consumer Protection Act,220 the Reserve Bank is mandated to investigate if these schemes are in contravention of

218 Act 94 of 1990.
219 Ibid Section 11(1).
section 81 of the Banks Act. It is thus argued that, because this legislation prohibits the establishment of any financial scheme that defrauds the public, both the Consumer Protection Act and the Banks Act should enforce severe penalties that will deter operators of illegal pyramid schemes from continuing their nefarious enterprises. In fact these penalties, and the investigative strategies to expose such schemes, should prevent their establishment in the first place. If these prohibitions are not complied with then the courts need to step in and pronounce on the approach that should be adopted when dealing with such transactions.

5.2 Consequences of the SCA Decisions for Relevant Role Players

According to decisions by the SCA, the founders of pyramid schemes will be taxed on all amounts received by the taxpayer, provided that it can be proven that the amounts have been received as per the gross income definition. Participants who suffer detrimental consequences as a result of their involvement in a pyramid scheme may rely on the outcome of *Janse van Rensburg v Botha*, where the court held that the liquidators could not recover the amount Botha had invested prior to receiving interest on his initial investment. This means that investors who take part in these schemes are entitled to recuperate only their initial capital investment and not any interest received as a result of their investment in the pyramid scheme. This will also deter members of the public from getting involved in these schemes in the first place as they will not be able to use the courts to access the interest that they lose to the scheme. This matter was unfortunately not addressed by the SCA in *MP Finance* as this was not before the court.

5.3 Examination of Underlying Agreement

The Consumer Protection Act and The Banks Act prohibit the establishment of an illegal pyramid and other schemes, as well as the collection of monies by an entity that does not comply with regulations in terms of the Banks Act. Once a scheme that is in violation of the above Acts has been established, then transactions entered into with such a taxpayer are void due to illegality. In this instance it is important to remember that the legality does not void the entire transaction and that other legal consequences may still follow.

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221 Act 94 of 1990.

222 2014 2 All SA 670.


224 Act 94 of 1990.
However, the courts have created uncertainty in this regard by applying different approaches when determining if an amount received from an illegal source. Some courts have used a subjective approach\textsuperscript{225} while others have used an objective approach,\textsuperscript{226} and this has caused confusion and ambiguity in their judgments. Another factor that contributes to the confusion is the ambiguity in the reasons for the SCA’s decision in \textit{MP Finance}:\textsuperscript{227}

It is important to note that the Commissioner taxes the result of a transaction, whether the transaction has been legal or illegal. The question that challenges this practice is therefore two-fold:

1. Could the amounts received be classified under the gross income definition, and
2. If amounts were received, should SARS collect what is due to it according to legislation?\textsuperscript{228}

To address these questions, it is important in the first instance to determine the relationship between taxpayers before one can consider the relationship between a taxpayer and the fiscus, because it is clear that in this relationship one taxpayer is dependent on the other. In other words, in order for the fiscus to tax the originator of an illegal pyramid scheme, an amount should have been ‘received by’ the originator from an investor.\textsuperscript{229} If the initial transaction had not taken place, the receiver (or fraudster) would not have collected any income. The starting point is to examine the underlying agreement and only then should the court determine whether the agreement was valid or void. Once invalidity has been established, the court should consider whether the illegality (of the scheme/contract) voids the entire transaction. Lastly the court would then have to determine if any other legal consequences follow from the void transaction, as every case has to be determined on its own merits. It must be reiterated that illegality does not void an entire transaction as tax consequences may follow irrespective of the illegality.\textsuperscript{230} Once these factors have been established, the courts must then employ an appropriate approach to determine if amounts were received as per the gross income definition for taxation purposes.

\textsuperscript{225} 67 SATC 205.
\textsuperscript{226} 14 SATC 419.
\textsuperscript{227} 69 SATC 141.
\textsuperscript{228} Jones (note 17) 7.
\textsuperscript{229} C Schembri Tax I Seminar (idea obtained during lecture, University of KwaZulu-Natal, 2016).
\textsuperscript{230} 69 SATC 144.
5.4 Determination of the Approach that Should Have Been Applied in MP Finance

To achieve the goal of legal consistency, the courts will have to employ the same unambiguous approach when dealing with illegal income, specifically in terms of income that emanates from either MLM or pyramid schemes. The approach that is employed should therefore be used uniformly and all the facts of each case should be taken into account so that like cases see the same legal principle employed in a similar manner.

Muller suggests that an intention-based subjective approach should be used in cases of ‘beneficial receipt’ to determine if amounts received should be included in a taxpayer’s gross income.\(^2\)\(^3\)\(^1\) This entails an examination of the intention of the taxpayer who receives amounts from the scheme. The question that can be asked is whether the taxpayer intended to receive the amounts for his own benefit. Olivier agrees and emphasises that ‘unilateral taking’ also amounts to receipt for income tax purposes.\(^2\)\(^3\)\(^2\) The court a quo in MP Finance made the correct decision in *ITC 1789*,\(^2\)\(^3\)\(^3\) where the focus of the court was on the subjective intention of the taxpayer. The court concluded that, because the taxpayer intended to benefit from the amount received, the amount was then ‘received by’ the taxpayer. What is important in this instance is that the court confirmed the fact that the illegal transaction was irrelevant and that the origin of the amount was immaterial.\(^2\)\(^3\)\(^4\) Therefore, if an amount has been received, it is taxable and illegality is not important in determining the taxability of the amount received.\(^2\)\(^3\)\(^5\)

This approach suggests that, as long as it can be proved that the taxpayer had the intention to receive an amount, then tax liability will follow. In practice this conclusion will result in courts having to show that the taxpayer had the intention to receive an amount. Unfortunately, this may not be possible in every instance because the courts will have to rely on the evidence of someone who has already been proven to be deceitful. As a consequence, the subjective approach alone is insufficient to determine if amounts have been received for tax purposes, and therefore this approach should be used as a secondary and not a primary test.

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\(^2\)\(^3\)\(^3\) 67 SATC 205.

\(^2\)\(^3\)\(^4\) Estate Botha and *ITC 1545* 54 SATC 464.

\(^2\)\(^3\)\(^5\) *Delagoa Bay Cigarette Co Ltd* 1918 TPD 391.
Classen suggests a different approach that should be used to determine if an amount has been received as per the gross income definition. The approach that Classen suggests is to determine who has the use of the money and then to enquire who benefits from it. In view of the answers that will be obtained as a result of this investigation, it will be possible to conclude that the taxpayer who received proceeds from the investment and who benefited from these proceeds should be liable to pay income tax on the amount received. A deceitful tax payer will then have the onus of proving he did not benefit from the transaction and that the amounts should not be taxed for gross income purposes.

5.5 Conclusion

Irrespective of whether moneys received into a pyramid scheme are tainted with illegality, what remains the fundamental factor for tax purposes is whether they are received. The question is definitely not whether the underlying agreement is lawful, but rather whether the amount was received as per the gross income definition. To determine this one begins by looking at the relationship between the investor and the founder of the scheme. Once this relationship has been established, the courts can then employ the correct approach in determining whether the amount is taxable. However, amounts received do not always depend on a valid underlying agreement as some contracts are breached. For example, a contracting party may be in breach and may have received payments regardless of malperformance, but this party keeps the amounts that were paid in until the innocent party sues. These amounts received thus form part of the gross income of the taxpayer that is in breach. The same principle should then apply to amounts received from illegal pyramid schemes and it should always be determined if the taxpayer received the amounts for tax purposes. It should therefore be asked if ownership passed from one taxpayer to the other. Therefore, a receipt is not always determined on a valid underlying arrangement. However, this does not mean that the courts should ignore the underlying arrangement as it remains relevant as was the case in Geldenhuys v Commissioner for Inland Revenue. Whether an amount is legal or illegal, the result should be the same. Sometimes it will lead to taxation and sometimes it will not, depending on whether the taxpayer has received amounts as per the gross income definition.

236 Classen (note 86) 546.
237 Ibid 546.
238 14 SATC 419.
Two vital questions thus remain: Did the taxpayer receive income from the illegal pyramid scheme? Once a scheme has been found illegal, then the question of taxability should be addressed. The court must also determine which approach should be applied by looking at differences and similarities between the current and earlier cases.

Classen’s approach, together with the subjective approach, is an appropriate yardstick that could be used by the courts when determining the taxability of income derived from illegal activities.239 The objective approach should also be used to determine whether the perpetrator objectively had the use of the money. All these factors are dependent on the facts of each case. Therefore, until the legislature and the courts have collectively resolved the issue of the approach to be used in reaching decisions about illegal pyramid scheme taxation, this issue will have to be decided by the courts and their interpretations of SCA decisions. However, for the sake of consistency and in the interest of justice, the issue should be addressed as a matter of urgency.

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